Market Commentary
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English Version

Weathering A Latin American Political Storm

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Weathering A Latin American Political Storm

Mexico and Brazil, the two biggest economies of Latam, were also the darlings of EM investors for the most part of 2023. Both countries saw their currencies and assets appreciate even as some political rumblings were starting to emerge. In contrast, 2024 has been a year of underperformance for both countries, amid rising concerns surrounding their respective fiscal outlooks, as well as the impact of their government's role in their economies. Therefore, we deemed it fit to assess the situation in depth, analyze what the consequences are for both markets and how Brazilian and Mexican assets may fare once the fiscal storm has passed.

Brazil

When Brazil's president, Luiz Inácio Lula da Silva, took office in 2023, markets initially believed they were walking onto familiar ground, being that this was the third time Lula was going to be at the country's helm. However, Lula's most recent administration has not been a smooth ride, and the latest fiscal developments, together with the challenging macroeconomic back-drop, prove that point.

Lula's third presidential period has maintained an elevated level of spending with a focus on different subsidies amid an increased intervention in state-owned entities like Petrobras, to the point of changing the company's leadership over the extraordinary dividend policy that initially was not aligned with Lula's wishes.

Here, it is worth stressing that the deterioration of the country's public finances has led Fernando Hadad, Brazil's FinMin, to outline fiscal measures aimed at preventing an increase in the country's public debt. This comes amid a sustained widening of the fiscal deficit to 9.57% of GDP in May, the largest deficit since mid-2016. Furthermore, Brazil's primary balance has exhibited a deterioration from the surplus observed at the end of last year to a deficit of 2.53% of GDP that same month. This setback has been influenced by some one-off factors – such as the observed increase in spending to cover for the precatórios and the emergency spending due to the floods in the state of Rio Grande do Sul –, with falling inflation also playing a part. In all, the latest figures published by the central bank exhibited a wider deficit than what the market was expecting (BRL 21.3bn), together with an increase in the stock of gross general government debt to 78.5% of GDP. These figures underpin a loose, procyclical fiscal policy, together with a government that has exhibited few intentions of reigning in spending, which in turn undermines the fiscal credibility of Brazil.

— "Current market expectations are **factoring in the possibility of rate hikes in the upcoming months** as per the current levels of the Brazilian real-denominated interest-rate swaps curve."

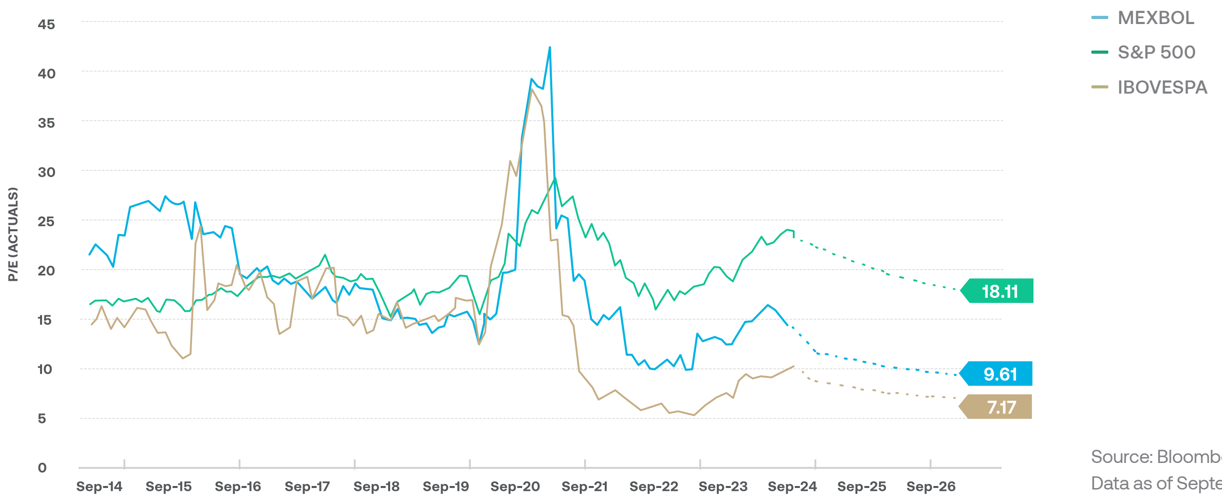
According to the 2025 budget proposal presented on August 30th, Brazil's mandatory spending is set to rise by BRL 132.2bn, largely driven by social security benefits and public sector spending while practically consuming all available space for new spending next year. On the revenue front, the government expects to raise BRL 168.2bn via taxes and administrative measures; however, these measures require congressional approval, which at this point seems challenging.

Furthermore, the fiscal situation has gained so much importance that Brazil's Monetary Policy Committee, the COPOM, has expressed on past occasions that a credible fiscal policy that is committed to debt sustainability, contributes to the anchoring of inflation expectations, and directly affects the behavior of risk premia from the different financial assets, impacts monetary policy. Current market expectations are factoring in the possibility of rate hikes in the upcoming months as per the current levels of the Brazilian real-denominated interest-rate swaps curve.

The fluid fiscal situation has also taken a toll on Brazil's currency. The Brazilian Real has been on a steady decline for the better part of 2024, having lost approximately 12% of its value for the year. In fact, the currency continues to remain one of the weakest in Latin America, surpassed only by the Argentinian and Mexican Pesos. Most of this weakness can be explained by two factors: uncertain fiscal and monetary policy. We already addressed the country's fiscal policy above. However, monetary policy remains another important piece of the puzzle. Inflation remains a moving target for Brazil's central bank, as evidenced by the downward trend of this metric earlier in the year, only to be followed by increased inflation expectations for the balance of 2024 and 2025. At the same time, the country's economy appears to be gaining strength. Recent GDP figures showed that Brazil's economy grew by 1.4% in the second quarter of the year, on a quarter-on-quarter basis, implying that the economy could expand by as much as 3% in 2024. This could be considered good news, as much of the growth appears to be driven by increased consumer demand. However, this dynamic also makes the job harder for the Central Bank, as it might have to reverse its policy of monetary easing, to one of monetary tightening, to rein in inflation. In fact, the markets are pricing in a 0.25% hike in the Selic Rate during the Central Bank's next meeting. In theory, an increase in the Selic would be good for the Real. However, a shift in monetary policy could lead to increased uncertainty, increasing volatility for the currency itself.

Relative Valuation for the Mexican, US, and Brazilian Equity Markets

P/E multiples over a 10-year period and including forward estimates.



Source: Bloomberg, Insigneo.
Data as of September 6, 2024

On the fixed income front, and according to the fixed income index created by Bloomberg, Brazilian USD-denominated debt has exhibited a positive return on a year-to-date basis, albeit lower than what the comparable EM index has displayed. Still, all tenors across Brazil's USD-denominated sovereign curve have displayed a yield tightening move, with the mid and long-end of the curve having the most prominent move. Meanwhile, Brazil's local currency bonds have exhibited a widening in their yields in the last month together with a bear flattening of the sovereign curve, in what could be interpreted as the market's take of a potential change of course by the COPOM.

With regards to Brazilian debt issuers, we continue to favor those whose fundamental stories are solid and that are part of crucial sectors for the Brazilian economy, such as CSN, Gerdau, and Banco do Brasil. Regarding Petrobras, we continue to monitor the government's intervention in the company's dividend policies that could potentially undermine Petrobras' cash position, as well as the company's capex policy, amid a more challenging backdrop for oil prices.

Brazilian equity markets, in our opinion, could prove to be an attractive long-term investment for investors with a high tolerance for risk. Initial market expectations were for the country's central bank to continue a trajectory of monetary easing. However, the bank's more prudent stance on rates is currently being digested by the markets, which has pushed equity prices lower. As we can see in the chart above, Brazil's IBOVESPA Index is currently trading at a forward P/E ratio of 7.2x, a discount relative to its global and regional peers. From a historical perspective, Brazilian stocks continue to trade close to 10-year lows. Political and fiscal uncertainty have created a headwind for Brazil, as the market has been uncertain as to what changes the Lula administration could impose and what shape fiscal policy could take.

With this in mind, we favor stocks in the Financials and Industrials sectors. Financial companies like Banco Itaú, Banco Bradesco, and NU holdings, operating as NU Bank, could benefit from increased domestic consumption, leading to an increased need for banking services. At the same time, an industrial company like

Embraer is likely to continue to benefit from increased global defense spending, bolstered by Brazil's technological competitiveness in the Latin American region. We believe that the Brazilian equity market should move higher over time from its near record low valuation level. However, it is important to note that the individual stocks referenced here may exhibit high degrees of volatility and are best suited for investors with a long investment term and a high tolerance for risk.

Mexico

Mexico has been faced with several challenges in 2024 amid a deteriorating macroeconomic backdrop and the presidential transition that should finalize on October 1 when president-elect Claudia Sheinbaum will receive the presidential baton from Andrés Manuel López Obrador - AMLO.

Unusually, AMLO has not been the classic "lame duck" – a leader who is still in office but has little power because their term is almost over – but rather has taken the task of making the most of his last month in office. That was visible during the first week of September, when the newly appointed Lower House approved the full text of AMLO's judicial reform that, among other things, seeks to elect all federal judges by popular vote.

The Senate also approved said reform with the support of an opposition senator, and market analysts are already penciling in that the 18 remaining reforms that AMLO had originally presented to Congress in February will be approved thanks to the overlapping between his last month in office and the newly appointed Congress, where his party holds a majority in both chambers. It is worth stressing that the approval of the judicial reform has heightened the volatility of an already fluid investment environment, to the extent that US Ambassador to Mexico, Ken Salazar, stated that the proposal would weaken the country's rule of law while turning away investors who need certainty. Furthermore, newly elected President Sheinbaum is inheriting an economy with a widening fiscal deficit, weak activity, and an observed rebound in inflation that pose risks to its monetary policy easing process.

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Zooming in on the fiscal perspective, investors have their attention turned to the 2025 budget presentation that will take place in November. Aside from monitoring whether Pemex will maintain a line in its 2025 budget, market participants will focus on what the Sheinbaum administration will present as proposals to achieve fiscal consolidation, considering that AMLO tasked Sheinbaum with "continuing the transformation" and finishing the pending projects of his administration, and that an important part of the current fiscal deficit stems from excessive spending performed in the period preceding the presidential elections. Furthermore, the fact that Banxico added its voice to those market participants that had already cut their GDP forecasts for the Mexican economy in 2025 complicates the much-needed fiscal policy adjustment in 2025.

The Mexican Peso has not been immune to the ever-changing political situation. The "Super Peso" had proven to be one of the strongest major currencies in the world over the past few years. Sadly, the Super Peso appears to have lost its superpowers over the past few months. Two variables were responsible for most of the Peso's strength in 2023 and 2024: The economic outlook of the United States and the direction of interest rates in Mexico. However, things have meaningfully changed since the Summer. First, and most importantly, the elections in June sent the Peso on a new trajectory plagued by volatility. The stability afforded by increased Foreign Direct Investment because of nearshoring was quickly depleted, giving way to a choppy path downward, culminating in a nearly 20% loss of value since the beginning of June. Investors expected volatility to subside as more clarity was gained surrounding the new government. Unfortunately, volatility has only increased, as the ruling party attempts to enact sweeping reforms that continue to erode investor confidence. At the same time, the benefits of Mexico's close commercial ties to the U.S. could be starting to become a headwind as the latter country's economy is appearing to cool down. The Peso has the potential to stabilize over time; however, as long as political and fiscal uncertainty continues, volatility will continue to plague the currency.

The Mexican fixed income market has also experienced the volatility of 2024: on a year-to-date basis USD-denominated Mexican debt, according to the fixed income index created by Bloomberg, exhibits a negative return, with the most prominent drops occurring right around the time of the presidential elections. If we focus on the USD-denominated sovereign curve, it is worth highlighting the yield tightening move observed across all tenors in the last month, with the curve exhibiting a more pronounced bull steepening. On the corporate debt front, and even if we are aware of the risks that the nearshoring thesis is currently facing, we also maintain a constructive view on the companies that could benefit from said phenomenon in the long term, and thus favor entities like Banorte, Fibra Uno, and Cemex.

The Mexican equity markets have not been spared either by the changing political situation. Mexican equities saw a strong year in 2023, with the iShares MSCI Mexico ETF (EWW) rising 39% for the year. This was followed by a natural pullback earlier in 2024, leaving the ETF 4% lower for the year, as of the end of May. However, the results of the June elections engendered a precipitous drop, close to 20%, over the subsequent three months. A large portion of last year's gains could be attributed to the near-shoring phenomenon and increasing stability in the Mexican economy. Although the near-shoring phenomenon is likely to continue over the long term, a cooling U.S. economy could slow activity down in the near term. The bigger question mark is the stability of the Mexican economy. Although a slowing economy in its northern neighbor would clearly impact Mexico, the country's fundamentals remain strong. However, the uncertainty brought about by a shifting political landscape is eroding investor confidence in the country's institutions, bringing an added level of volatility and risk.

— "Unfortunately, **political uncertainty will make volatility the predominant force** in the country's equity market in the foreseeable future."

In a piece published after the June election results, we stated: "Volatility will likely remain high, and the market could trend lower in the short term. However, all things being equal, the underlying strength of the Mexican equity market should remain present, as long as the new administration continues the policies of the previous mandate...However, this is contingent on the new administration not rocking the boat, which at this point, remains to be seen." Although we believe that the underlying fundamentals of the Mexican equity market remain strong, the country's politics are certainly rocking the boat and could unfortunately erode this strength. Companies like Cemex, Grupo Financiero Banorte, Walmart de Mexico, and Fomento Economico Mexicano are good companies with strong fundamentals and attractive valuations. Unfortunately, political uncertainty will make volatility the predominant force in the country's equity market in the foreseeable future.

As is evident in the case of both Brazil and Mexico, unpredictable fiscal policies add a high degree of uncertainty to a country's currencies and asset markets alike. That said, fiscal predictability is a luxury not always present in many emerging economies, so some volatility in these markets would naturally be expected. However, add the specter of political uncertainty to the picture, and volatility runs rampant. Investor confidence in a country's fiscal and monetary policies is very important for its markets, and the cases of Brazil and Mexico highlight the importance of these two elements within an asset allocation perspective. ■

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House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
Global Asset Allocation		
Equities	UNDERWEIGHT	NEUTRAL
Fixed Income	OVERWEIGHT	OVERWEIGHT
Cash	OVERWEIGHT	UNDERWEIGHT
Regional Breakdown		
US Equities[1]	OVERWEIGHT	NEUTRAL
European Equities	OVERWEIGHT	NEUTRAL
Japanese Equities	OVERWEIGHT	NEUTRAL
Emerging Market Equities	UNDERWEIGHT	NEUTRAL
Chinese Equities	NEUTRAL	NEUTRAL
US Treasuries[2]	OVERWEIGHT	OVERWEIGHT
Investment Grade Fixed Income	NEUTRAL	UNDERWEIGHT
High Yield Fixed Income	NEUTRAL	UNDERWEIGHT
Emerging Market Sovereign	NEUTRAL	NEUTRAL
US Dollar	NEUTRAL	OVERWEIGHT
Energy[3]	UNDERWEIGHT	UNDERWEIGHT
Precious Metals	NEUTRAL	OVERWEIGHT

[1] *Relative to global equities in USD*
[2] *Relative to aggregate fixed income markets in USD*
[3] *Relative to an overall commodity allocation*

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