



Weekly Market Musings

It's All Relative

Investors could benefit from the relative valuation discount between Latin American equities and their U.S. peers.

It's All Relative

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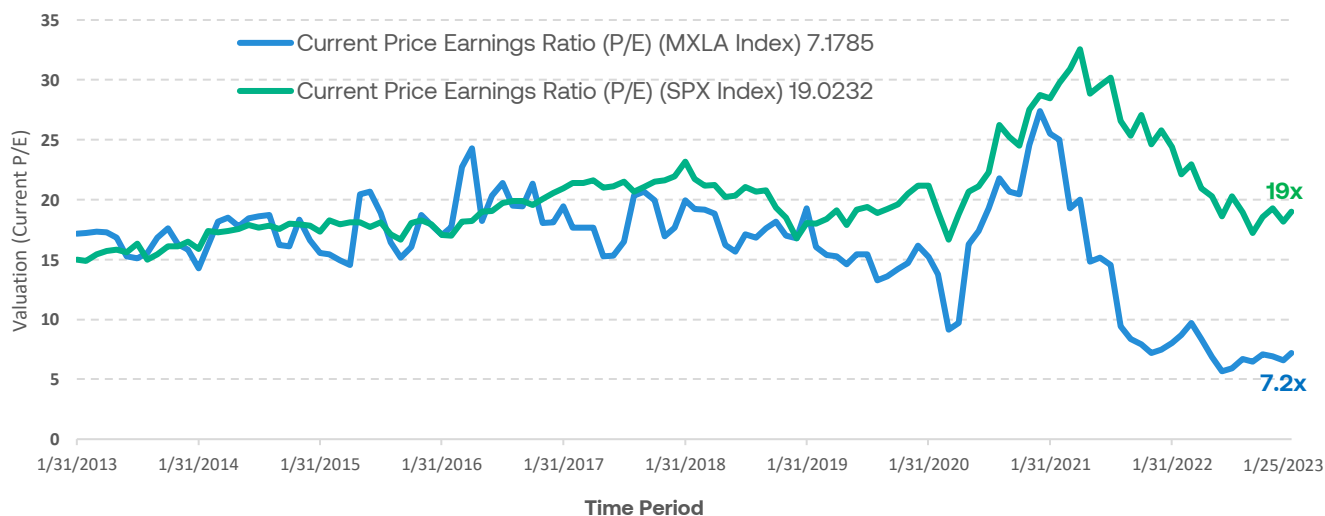
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We hear this expression often. Truthfully, it is applicable to many aspects of our lives. We tend to view things based on how they compare relative to something else. We do it every day, whether we are at work, shopping, or simply deciding what to have for dinner. Investing is one of those areas where this also rings true. We often evaluate our portfolios in terms of how they performed against a certain benchmark. We compare assets against each other when evaluating which one to buy or

sell. We seek relative value between two potential investments. When it comes to investing, sometimes relativity creates opportunity.

An example of what we think is an attractive relative value opportunity is the current valuation discrepancy between Developed and Emerging Markets equities, particularly between the U.S. and Latin America. On a current Price/Earnings basis, the MSCI All Cap World Index is trading at 17x earnings, compared to the MSCI Emerging Markets Index at 13x. **In a starker comparison, the S&P 500 Index is trading at 19x earnings, while the MSCI Emerging Markets Latin America Index (MXLA) stands at 7.2x.** This valuation gap is evident on the chart below.

Relative Valuation of MXLA Index VS S&P 500 Index



Source: Bloomberg (as of January 25th, 2023)

It is important that we do not consider this relative valuation gap in a vacuum; we need to dig deeper into what types of companies make up these indices. As of the end of last year, the MSCI Emerging Markets Latin America Index held 90 stocks. Out of these, Vale and Petrobras are the biggest constituents, together accounting for nearly 20% of the benchmark. From a country exposure standpoint, Brazil and Mexico combined make up 89% of the index. These two data points provide a clue into the relatively low valuation of the MXLA index. The Brazilian and Mexican bourses have large exposures to the Energy, Materials, and Financials sectors, which tend to be value oriented. As a result, these three sectors, making up 58% of the benchmark, tilt MXLA to the Value style camp.

On the other hand, the S&P 500 Index sees companies in the Information Technology, Communication Services, and Consumer Discretionary sectors making up 44% of its constituency. In fact, Apple, Microsoft, Amazon, and Google combined make up 17% of the index. These sectors, and these companies in particular, tend to be growth-oriented, tilting the index to the Growth style camp.

After studying the individual index compositions above, the argument could be made that the relative valuation gap between both indices is due to their style biases. After all, Growth tends to be more expensive than Value, so it would make sense that the MSCI EM Latin America index is trading at a relative discount to the S&P 500. This seems logical, but once again, it pays to look below the surface. Looking again at the chart on the previous page, we can appreciate the magnitude of the

current relative valuation gap between both indices. We can see that over the past 10 years, this gap has been much narrower, even reversing at times, where MXLA was the more expensive asset.

To get a different perspective of this relative value opportunity, it is worth looking at the indices' valuations against their own historical values. The 10-year average P/E ratio for the S&P 500 has stood near 20x, while the MXLA has averaged 16x over the same time period. We are not arguing that the S&P 500 is overvalued, as it is still trading at an approximately 5% relative discount to its 10-year average. However, when we consider that the Latin American index is trading at less than half its 10-year average of 16X, we can further appreciate the potential relative value opportunity. **In fact, Latin American equities are currently trading at over 2 standard deviations below their 10-year average valuation.**

A logical question comes to mind, why is there currently such a wide valuation gap? We believe the answer is two-fold. First, given the historically low level of interest rates in the U.S. over the past few years, companies in the country flourished, driving up stock prices and valuations. This was particularly true for growth-oriented stocks that benefited from low-cost access to capital. Second, companies in Latin America tend to be more export-oriented than their U.S. peers. As such, they were disproportionately affected by the effects of the Covid pandemic on global demand as well as a high U.S. dollar. Local political uncertainty did not help either. Although political uncertainty will likely remain, we believe that the continued reopening of the global economy, and a decrease in the value of

the U.S. dollar should boost Latin American stock markets. At the same time, higher interest rates in the United States will likely continue to keep pressure on valuations of growth-oriented companies. To be clear, we are not suggesting exiting the U.S. stock market altogether. **What we are suggesting is that investors could benefit over the long-term, by taking advantage of the relatively low valuations in Latin American equities and investing a portion of a diversified portfolio in this asset class.** Again, it's all relative.



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