The case for Latin American equities

July 2021

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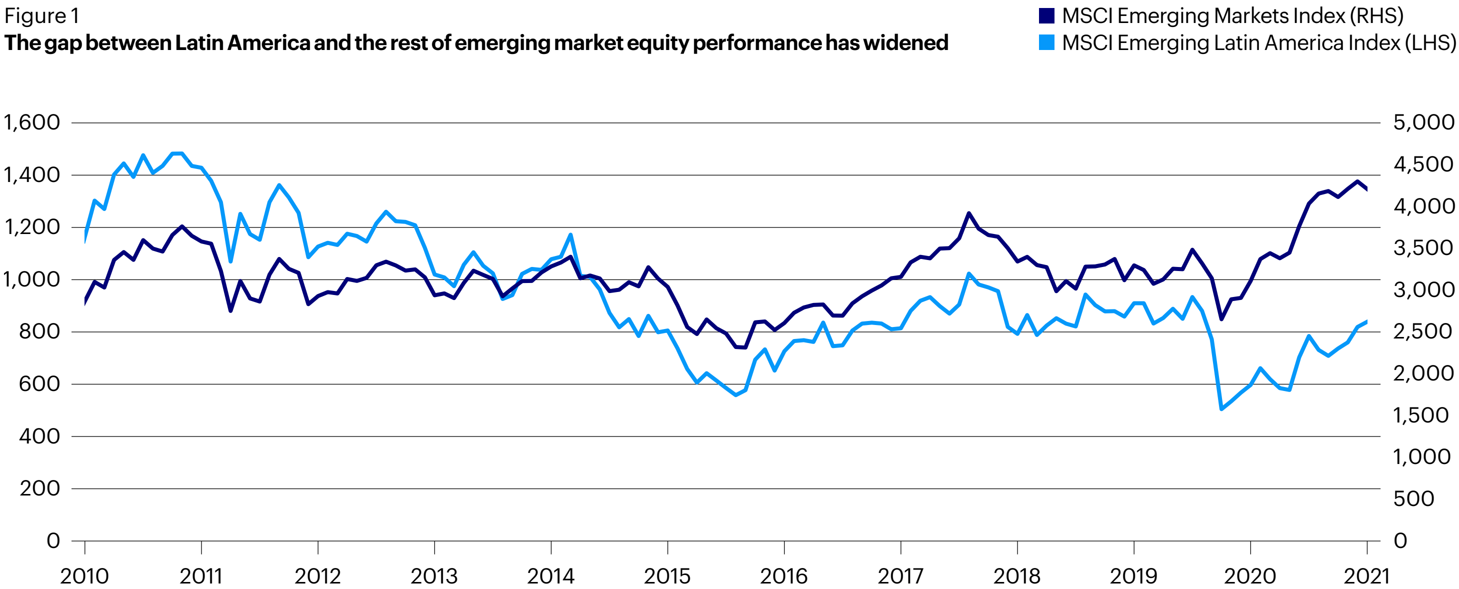
Latin American equities have had a decisively bad decade. Economic funk and socio-political drama have been broadly characteristic of much of the region over the past 10 years. However, the Invesco Developing Markets team thinks the next few years are going to be considerably better for these economies and their neglected equity markets.

Four drivers of Latin American equities

We see four drivers – three cyclical, one structural – for Latin American equities. The cyclical story is solid: strong commodities, a recovery in beaten-up currencies, and a cyclical improvement in US dollar earnings. The structural story is perhaps even more important, as the rise of disruptive technology could help underwrite a better chapter for the region and create a big opportunity for investors.

Figure 1
The gap between Latin America and the rest of emerging market equity performance has widened



Source: Bloomberg, L.P., 22 June, 2021. Past performance is not a guide to future returns. An investment cannot be made directly in an index. Data as 30 July.

The promise of Latin American equities begins with benign neglects

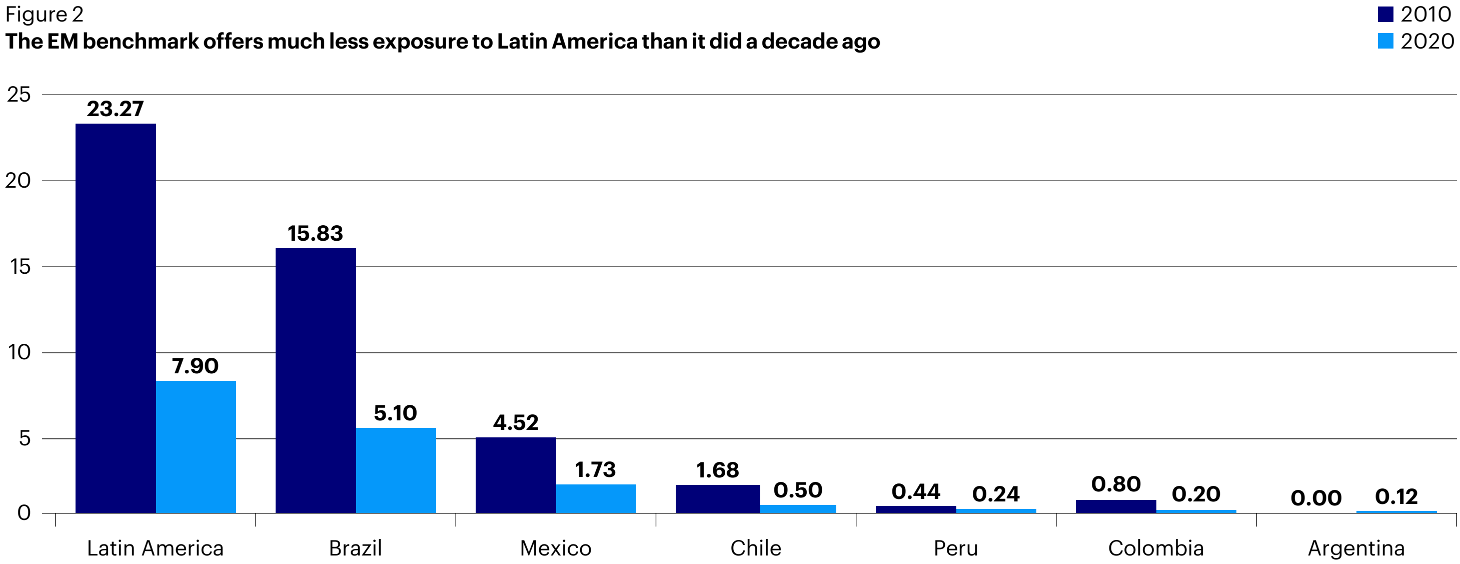
Global investors have profoundly lost interest in the regional bourses, which are 25% smaller (a decrease of US$200 billion) than they were in 2011.[1]

The marginalisation of Latin American equities is also visible in the decline in relative importance in the EM benchmark. As shown in Figure 2, the region has fallen to less than 8% of the weight of the MSCI Emerging Markets Index, from 23% in 2010.[2]

In comparison, Taiwan Semiconductor Manufacturing alone represents 6.19% of the index's weight, followed by Tencent at 5.33% and Alibaba at 4.78%.[3]

In other words, these three Asian tech giants are twice as important to the index's performance as all of Latin America.

Figure 2
The EM benchmark offers much less exposure to Latin America than it did a decade ago



Sources: Bloomberg, L.P., MSCI, as of 31 December, 2020. As represented by the MSCI Emerging Markets Index. Past performance is not a guide to future returns. An investment cannot be made directly in an index.

Understanding today's opportunity in Latin America

In our view, this neglect creates conditions – though not certainties – for opportunity. To understand the opportunity in Latin America, one must look at what has ailed the region and its markets over the course of the past 10 years:

> ... what ultimately drives Latin American economies – and the bourses – are commodities and foreign capital. And the news here has become much more encouraging over the last few months.

Economic funk

During the past decade, the entire region has fallen into a disturbing pattern of low real growth. Nominal GDP ($4.2 trillion in 2020) is nearly 18% lower in US dollar terms than it was in 2010.[4]

To put this in perspective, Latin America's population is about twice the size of the US population, but its economy is just 20% of the size of the US economy.[5] Poverty, inequality, development, and economic insecurity among the fragile lower middle classes have all gotten far worse, with per capita GDP figures stunted or in dramatic decline in all countries, bar Peru.

The historic challenges of Latin America persist – low levels of domestic savings, weak fiscal capacity (or in the case of Brazil, high fiscal capacity but poor delivery of public services), low investment in human capital, enormous inequality, large informality of the economy, and monopolistic competition.

But these have been challenges for Latin America for many, many decades. What changed in the past decade to arrest development progress so spectacularly? Well, what ultimately drives Latin American economies – and the bourses – are commodities and foreign capital. And the news here has become much more encouraging over the last few months.

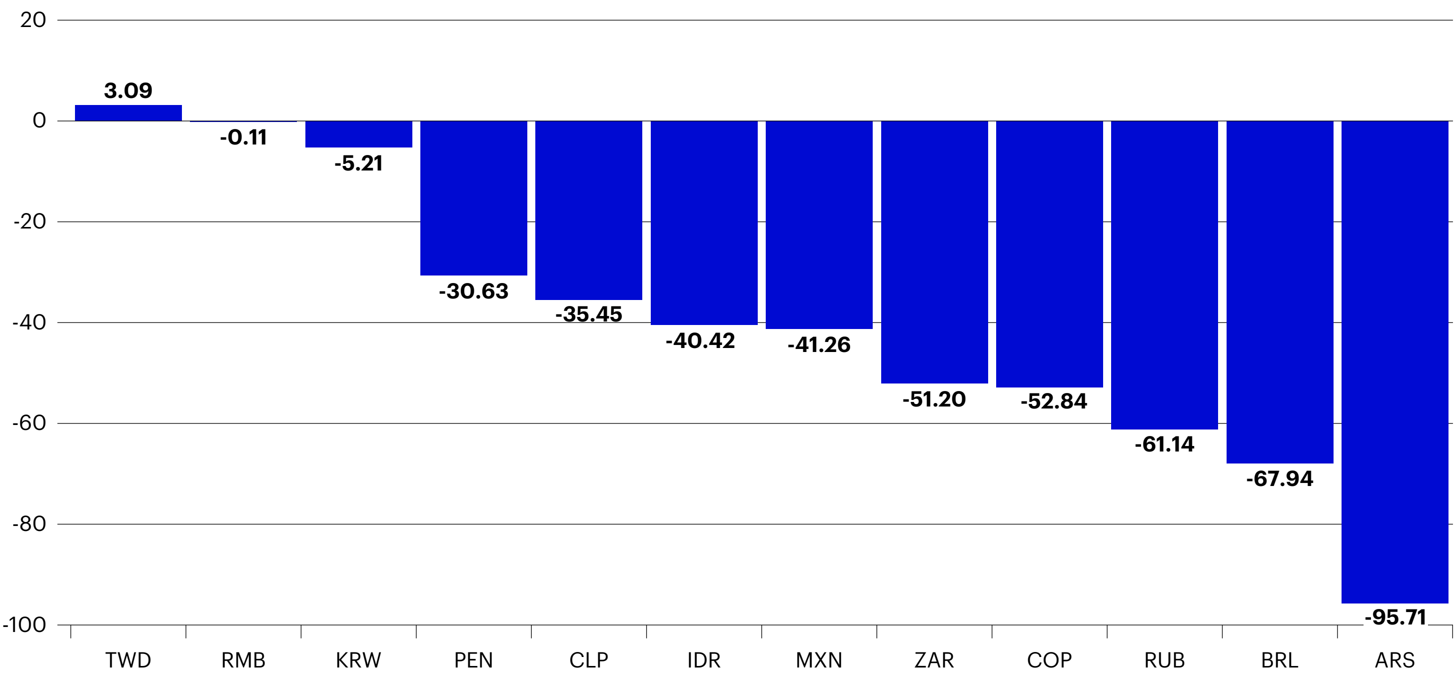
Commodities and currencies

With the exception of Mexico, these are commodity-exporting economies. Commodities represent 60% to 70% of total exports in the large economies of Brazil and its Andean neighbours (Chile, Colombia and Argentina).[6] And it is commodity prices that therefore underpin both balance of payments and the region's currencies, which have been in sharp reversal for the better part of 10 years, as shown in Figure 3.

Figure 3

Latin American currencies have underperformed the US dollar over the past decade

(10-year performance of various currencies versus the dollar, %)



Source: HSBC, as of 23 June, 2021. Past performance is not a guide to future returns.

> Additionally, ESG pressures have compounded socio-political challenges (permits, taxation, water and environmental concerns) in large swathes of resource-endowed regions like Chile, Peru and sub-Saharan Africa.

Commodities and growth
Commodities are also the historic USD economic growth engine of Latin American economies – through channels of net exports, private investment and, of course, the currencies. These economies' domestic savings are generally insufficient to beat back entropy of the capital stock (i.e., depreciation of physical assets) without foreign direct investment and foreign portfolio flows. These sources are generally pro-cyclical and available in environments of hot commodity prices and low global rates, such as we are experiencing today.

In our view, the outlook for commodity prices remains strong
We contend that the backdrop for a strong resource price environment remains encouraging. While global reflation clearly helps, the real story is on supply constraints.

Our view is that the behaviour of the global mining industry has changed structurally. Greenfield projects, debt and acquisitions are off the table for most boards. And suspicious investors are demanding limited growth capex and rich dividend payouts after the disastrous decade that was.

Additionally, ESG pressures have compounded socio-political challenges (permits, taxation, water and environmental concerns) in large swathes of resource-endowed regions like Chile, Peru and sub-Saharan Africa.

Meanwhile the developed world is determined to mitigate against climate change with aspirational investments in renewables and electric cars, which are going to require significant increases in consumption of "green metals" (copper, nickel and cobalt).

It will be difficult to reconcile the need for more mines – which themselves are depleting assets – with ever growing investor pressures around ESG. The result is likely sustained high prices – and free cash flows – in the resource industry.

And then there is weakness in the dollar – but that is another, longer story. The bottom line is that we do not envisage an environment where iron ore prices consistently remain at $200/ton or copper prices above $4/lb over the next few years. We do, however, expect them to remain comfortably strong for the foreseeable future.

Commodities can drive economic growth and currencies in the region, thereby driving USD earnings and equity returns. Currencies are cheap, commodities may potentially remain elevated, and growth may rebound from COVID-despair. But is this just a cyclical story? Well, yes. And, maybe, no.

The region has a long checklist of very long-term challenges, including grave inequality
As we are witnessing in the United States, inequality and democracy are incompatible bedmates and can create difficult political conditions.

These conditions are evidenced in the tremors in Santiago (post-2019 protests have evolved into new constitutional efforts and an uncertain forthcoming presidential election), Lima (four presidents in two years plus the election of Pedro Castillo), and Mexico City (midway through the Lopez Obrador (AMLO) "fourth wave" administration).

However, relatively, we are more sanguine about the prospects for democracy and capitalism in Latin America. We see little evidence that the electorate is tolerant of a drift toward abandoning either capitalism or relatively young and lively democracies, for instance the Chavez Revolution. And institutions seem to be holding up – independent central banks, fiscal prudence (everywhere but Brazil) – while divided government is constraining the worst policies in Mexico, Colombia and likely now in Peru.

As AMLO has demonstrated, few countries in the region have appetite – even under the left – to explore no-go zones of macroeconomic stability. This drift toward the left, in our opinion, comes from frustrations with the lack of social mobility, efficient delivery of public goods, and economic vulnerability. Historically, inequality, monopoly and weak fiscal capacity have not been equal to the task.

Successfully tackling these issues through efforts to facilitate competition and build human capital through regulatory and fiscal reform create the opportunity to turn a cyclical recovery into more sustainable growth.

And there is one more thing – technology

The rise of the disrupters is beginning to have a marked (and positive) impact in the large economies of Latin America, most notably Brazil. And we suspect it will ultimately hit the rest of the region.

Growth in middle income economies is challenging because of informality. Small, minority hubs of relatively high-productivity companies (and middle-class employees) are surrounded by large numbers of informal, low-productivity small enterprises, which employ a significant majority of the 650 million lives in Latin America. This low productivity growth is the direct source of economic stagnation and inequality.

In the developing world – as we have witnessed in Asia, particularly China – technology is a profound enabler of inclusive growth. The dynamic rise of fintech (where just 55% of the entire regional population has access to bank accounts)[7], O2O services, and e-commerce and logistics, has the potential to facilitate significantly greater inclusivity and innovation. This ultimately drives productivity and growth.

Of course, the rise of these industries will create significant investment opportunities for tech winners and, for investors in Latin America, a richer menu of choice. It is perhaps unsurprising that five of the new entrants in Latin America's top market capitalisation giants in the past decade have come from e-commerce and fintech.[8] There are likely more to come as cosy oligopolies in banking and retail get shaken up around the region.

Another knock-on effect of the rise of the tech economy in the region is the growth of talent and new jobs. While millions of gig-economy jobs have already been created through the growth of food delivery, e-commerce logistics, and fintech, we also note the steady tailwind to high-paying IT jobs. About 277,000 such jobs had been created in Brazil by mid-2020, as per a study by the Progressive Policy Institute. Industry association Brasscom predicts an additional 400,000 jobs in the ICT space cumulatively between now and 2025.[9]

As annual demand for engineers in Brazil reaches the 100,000 mark (expected in a few years), we expect structural dysfunctions of the education system to be challenged. As per Brasscom, Brazil recruits about 120,000 students annually for a capacity of 380,000 seats, which we find oddly inefficient. Worse, about two-thirds of said students drop out before completing their course, driving a low engineering output of about 40,000 annually. As was seen in India over the last two decades, demand for quality talent can help fix supply bottlenecks, bringing positive, far reaching loops across the economy and society.[9]

Seeking extraordinary companies with structural growth drivers

What does this mean for us? In short, while Latin American equity markets have been marginalised for several years, we believe they are poised for a better decade. As bottom-up, benchmark-agnostic, global emerging market investors, we continue to seek extraordinary companies with structural growth drivers, durable advantages and a host of options across our asset class.

1 Source: Bloomberg, L.P., MSCI as of 31 Dec, 2020.

2 Source: Bloomberg, L.P., MSCI, as of 31 Dec, 2020.

3 Source: MSCI as of 31 May, 2021.

4 Source: IMFWEO, World Bank, Haver, as of 31 Dec, 2020.

5 Source: World Bank, as of 31 Dec, 2020.

6 Source: CEIC, EMED, Emerging Advisors, as of March 2021.

7 Source: World Bank Financial Inclusion Index 2017.

8 Market capitalisation data sourced from Bloomberg. All data accurate as at the time of writing, 6 July 2021.

9 Source: Progressive Policy Institute, "The Brazilian App Economy 2020", April 2020.

Risk warnings

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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EMEA1757423/2021