



Citi Global Wealth Investments

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Latin America Strategy Bulletin

First Quarter 2022 Returns Surprise to the Upside. Maintain Core Positions. Trim Opportunistic Longs.

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Summary:

- Latin American financial markets outperformed in 1Q22. The Latam MSCI gained 26%. Major currencies were up between 3% and 17%, generating positive domestic fixed income returns in USD terms. USD denominated bonds did not fare as well, down around 5% under the pressure of rising USD interest rates.
- Why the rally? The positive momentum began well ahead of the Russia-Ukraine conflict, which accelerated an already strong commodity market. We believe this outperformance was catalyzed by the combination of extremely discounted valuations relative to fundamentals, heightened political fears and very light portfolio positioning going into year-end 2021.
- Latin America is a net exporter of commodities. But at the individual country level, less diversified exporters could also import commodity inflation. At the margin, regional fundamentals should benefit from the tail winds of higher commodity prices. We do not expect, however, a repeat of 2002-2012 when the region grew on average 4.18% p.a. After the 4.9% post-Covid GDP rebound of 2021, consensus growth for the region for 2022 and then 2023 stands at only around 2%. While we look for inflation measures to moderate in the 2H22, we expect them to remain elevated relative to recent years. This environment of low growth and higher inflation will present challenges to policy makers.
- Economic policy degrees of freedom remain constrained. Monetary policy continues to tighten, although we expect these cycles to end this year. Fiscal policy space is limited, at least not without putting further pressure on inflation and long-term growth. Political and social dynamics will continue to be key domestic drivers. With most of the region having made a clear turn towards populism, public balance sheets and monetary orthodoxy will be the key variables to monitor when trying to gauge medium-term economic prospects.
- Global Investment Committee (GIC) Asset Allocation driven portfolios are fully invested in the region. While we highlighted attractive valuations in our Outlook 2022, we failed to overweight the region as we argued that value alone was seldom a catalyst for the type of rally seen during 1Q22, especially with the level of uncertainty global financial markets were digesting. It happens we were wrong. Nevertheless, our Asset Allocation portfolios benefited from positive returns. At current levels we feel comfortable with our core index neutral exposure.
- Opportunistic, non-core, positioning -- where we have been more sanguine -- could be trimmed from their higher levels of exposure, in our view. We see signs of more crowded exposure and while we are not bearish on these markets, the sharp 1Q22 gains in equity and currency markets suggest increasingly limited potential upside.

Figure 1: Latam equities missed the global equity rally in 2021...despite participating in the global economic rebound

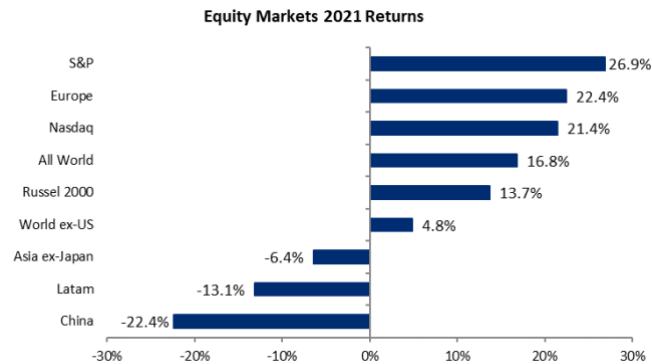
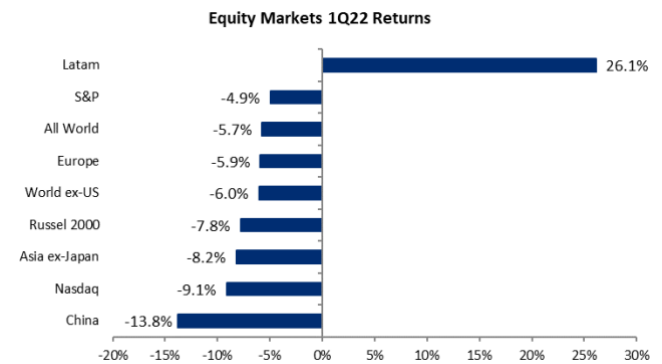


Figure 2: The valuation disparity was too large to go unnoticed in 2022...



Source: Bloomberg as March 31, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Figure 3: Latam multiples remain depressed relative to long term average, but they have re-rated sharply from the lows...

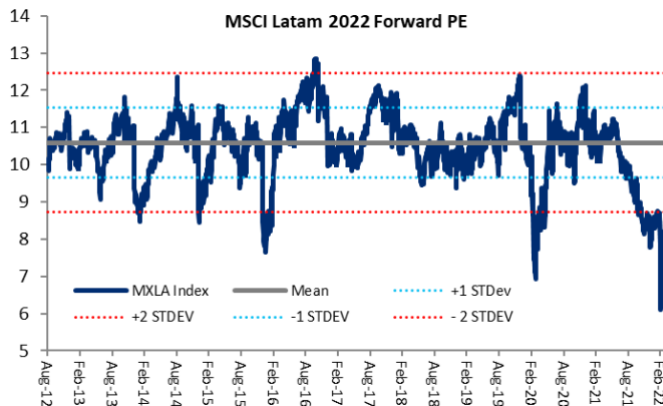


Figure 4: Earnings are expected to remain strong thanks to high commodity prices and profit margins have recovered...

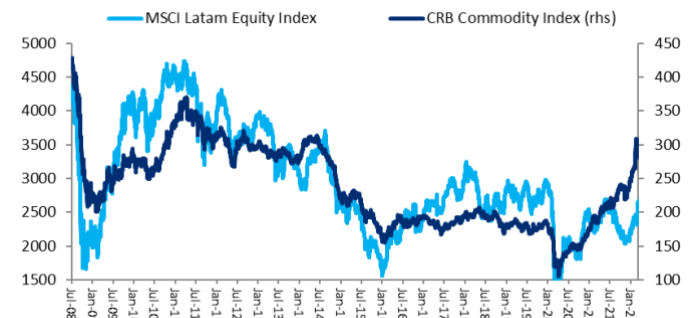


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Figure 5: Latam earnings could struggle to match the growth rate of 2021...Citi Research forecasts significant average commodity corrections by 2023

	Unit	Spot	2022	2023	2022 vs Spot	2023 vs Spot
Corn	USD/bu	735	706	550	-3.9%	-25.2%
Soybean	USD/bu	1,583	1,575	1,375	-0.5%	-13.1%
Wheat	USD/bu	985	995	856	1.1%	-33.4%
Sugar	USD/lb	19.37	17.50	16.50	-9.7%	-14.8%
Coffee	USD/lb	228.40	210	160	-8.1%	-29.9%
Iron Ore	USD/MT	159.80	135	80	-15.5%	-49.9%
Copper	USD/MT	10,343	10,500	9,500	1.5%	-8.2%
Zinc	USD/MT	4,339	3,650	3,025	-15.9%	-30.3%
Lead	USD/MT	2,452	2,140	2,050	-12.7%	-16.4%
Gold	USD/T.oz	1,919	1,805	1,675	-5.9%	-12.7%
Coal	USD/MT	374	215	150	-42.5%	-59.9%
Brent crude	USD/bbl	104.39	91.00	59.00	-12.8%	-43.5%

Figure 6: A gap in the tight relationship to commodities remains, but current Latam MSCI levels are no higher than the average price of the index of the last 5 years...



Source: Citi Research (citivelocity.com) and Bloomberg as March 31, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Figure 7: Brazil's currency positioning shows high levels of investor interest, suggesting a lot of positive bets have been placed...While neither Lula nor Bolsonaro represent ideological uncertainty, the elections could bring volatility and profit taking...

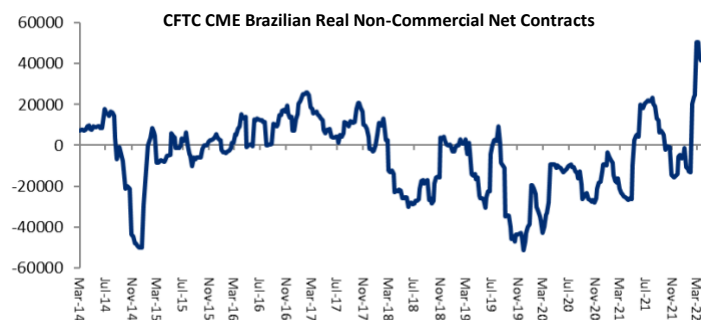


Figure 8: We expect the Brazil MSCI to test the 2021 highs, roughly 6% higher from current levels...but we would look to have very light opportunistic exposure by the time it gets there...

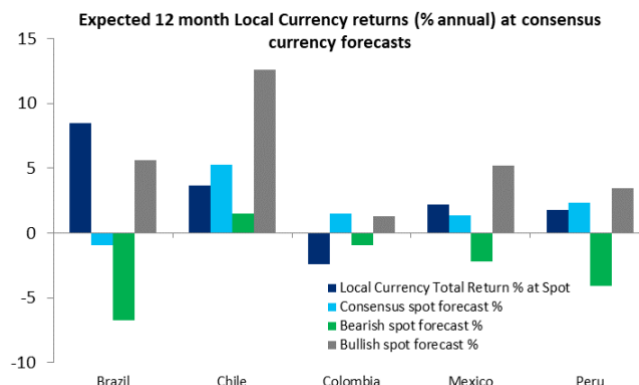


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Figure 9: Late last year we highlighted that the Citi Economic Surprise index was showing a deep negative reading, suggesting investors were too pessimistic and had already discounted negative data. This measure is now back into positive territory, opening up downside of data versus expectations...



Figure 10: Given the strong 1Q22 rally in local currencies, most of the local fixed income upside is likely to come from high nominal rates going forward. Only under the most bullish of scenarios would FX appreciation be the main driver of total returns for foreign investors in local bonds -and these would be limited to Brazil, Chile and Mexico.



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Valuation, macro and political considerations:

As Figure 6 shows, commodity prices and Latin American equities have been, historically, strongly correlated. Consensus earnings expectations have been revised to the upside to close to \$300 per share for the Latam MSCI for the 2021-2023 period, a level of EPS not seen since the highs of the 2002-2012 commodity super cycle. Equity prices have lagged these EPS expectations, resulting in low price-earnings multiples. This dynamic could provide some downside protection to equities -- i.e., valuations are attractive- and potentially more near-term upside. However, commodity prices are forecast to stabilize in 2022 and fall in 2023, as per Figure 5. This suggests that equities need to continue re-rating their multiples if prices are to move significantly higher. This will have to happen in a rising interest rate environment, both globally and domestically. While inflation could moderate in the coming months as regional economies continue to reopen and global supply disruptions reaccommodate, the impact of higher basic goods prices could place additional pressure on monetary and fiscal policy.

Policy rates in the region should peak in 2022, as Central Banks have been raising rates since early last year. Real rates could be positive by 2H22 providing further stability to local currency demand. Significant nominal appreciation, however, is likely increasingly challenging to achieve.

Economic growth is likely to be constrained by tighter monetary conditions both domestic and abroad, as well as slower activity in China, the region's largest trading partner. Fiscal policy could have limited room to expand given the social and economic spending pressures sustained before, during and after the pandemic. On this front we expect to see governments resorting to the use of price caps, direct and indirect subsidies and limits on exports among potential measures. Growth in the region could be an anemic 2% in 2022 and 2023, compared with consensus forecasts of around 3% for the world and around 5% for emerging Asian economies. These low levels of growth follow a nearly flat average growth over the last 5 years, likely explaining the social pressures brewing in the region before the pandemic, and which are likely to linger in the near future.

Can you say “Bingo!”? By year-end the largest Latin American economies will all likely have populist governments, some more ideological or extreme than others. But we don’t believe these political shifts will likely result in immediate crisis. As we’ve argued before (see [“On EM Monetary and Fiscal Policy...and the Importance of Central Bank Independence”](#)) the countries that run free floating exchange rates in combination with orthodox monetary policy, have managed to provide strong nominal anchors for the expectations of value of their currencies. This, in turn, has allowed for the creation of larger pools of domestic savings and less reliance on foreign currency financing. Having said that, these systems are not 100% detached from external financing or the gyrations of global investors’ appetite and can, and do, suffer from capital flight. But broadly speaking, having a domestic currency allows for more policy flexibility, creating more degrees of freedom against shocks. This is the reason, in our view, the sustainability or continuation of current currency and monetary policies by incoming administrations is key.

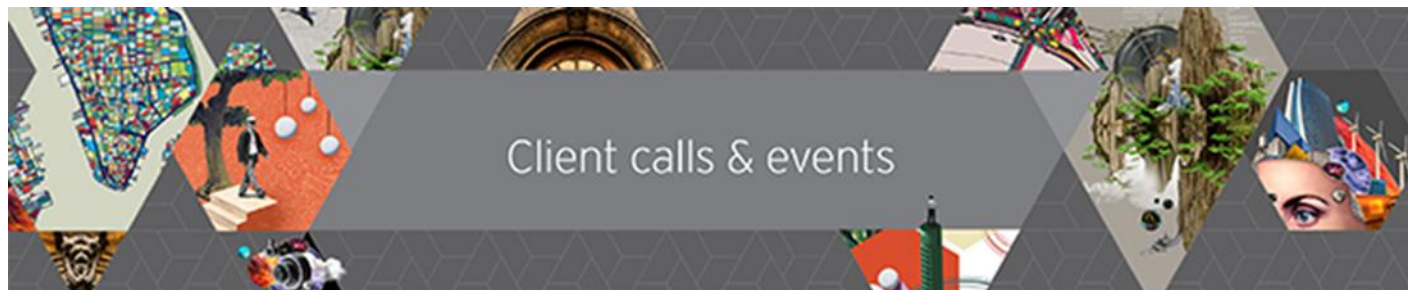
Critical to this monetary sustainability will be the stability of public accounts and fiscal policy along with of basic frameworks of free markets: rule of law and private property. Of outmost importance then will be the composition and balance of the legislative powers which can determine policy fate. From this perspective, there is some hope, given that even in countries where more extremist candidates have won, the elections in their legislatures have shown much more balanced results, suggesting that the executive’s power to control policy or deviate significantly from current policy paths is likely to be limited -- at least in the near term.

Nevertheless, we would note that we do see the shift towards populism in the region as a net negative, with potential implications for medium and long-term deterioration of institutions and policy. New incoming administrations and their actions should be watched closely.

Investment strategy conclusions:

GIC core Asset Allocation portfolios remain fully invested in their Latin American benchmark exposure. To date, these positions have added diversification and positive return to overall portfolios, partially cushioning the pain of negative returns seen in the rest of the markets. Having missed the opportunity to overweight these core portfolios in late 4Q21, we see current levels as presenting a relatively balanced risk-reward, suggesting that for the time being we maintain our neutral to benchmark even as we see more near-term potential for upside.

Opportunistic, non-benchmarked, exposure across the region’s asset classes could be trimmed, in our view. While we would not rush to the exits and hold no specific bearish view, the extent of the returns, positioning, price action in spot and options markets and levels suggest taking some chips off the table as an active risk management strategy.



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