

Latin America Strategy

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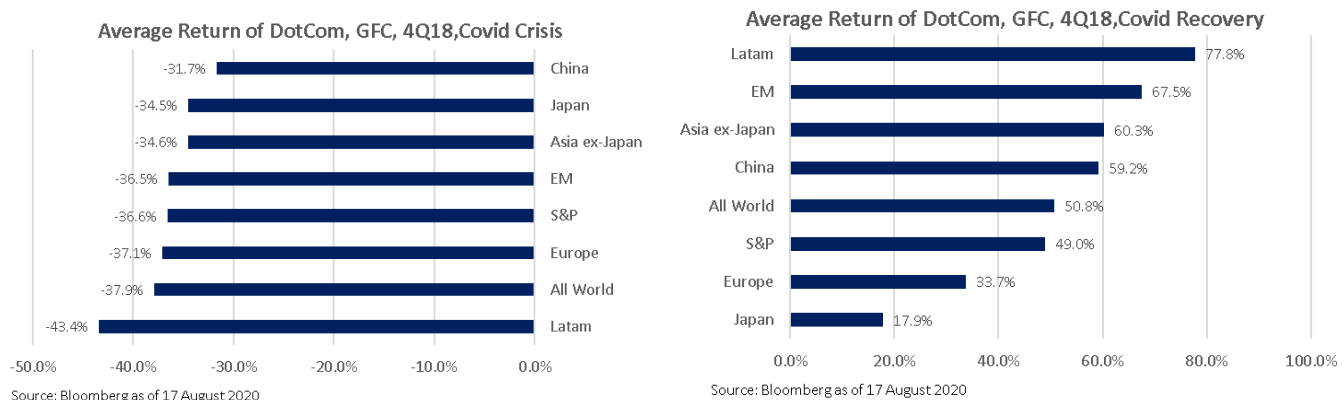
Latam Booms and Busts – We Buy the Busts

- Latam equity markets have always been a cyclical play, dominated by a confluence of domestic idiosyncratic variables, international financial conditions and commodity markets. Global shocks have historically had an outsized negative impact on the region relative to other markets.
- Averaging the returns from the peaks and troughs of four of the largest market moves of the last 20 years reveals that while Latam equities have been the “Ugly Duckling” of the crisis periods, averaging 44% return draw-downs, they also have the potential to transform into the “Beautiful Swan” when markets recovered, averaging 78% upside.
- We believe this underperformance can be explained by the region’s history and the significant cyclical tilt in its equity indices relative to other regions and to more diversified benchmarks. As our base case scenario for a global recovery materializes into 2021-2022, we expect the global cyclical sectors to recover and outperform. We expect Latam to participate in that move.
- Brazil is our preferred market to play the recovery. Brazil is the largest Latam economy, ranking as the 9th largest global economy in the world with a GDP close to \$1.8 trillion. With a population of over 212 million, it has the 6th largest population and one of the largest domestic consumption markets in the world. Finally, it is home to a number of world class companies that add up to an equity market capitalization estimated at approximately \$1trn. These characteristics combined result in a large dynamic economy and an investable equity market.
- While we fully recognize the inherent risks of Latam equity markets, we believe current levels are pricing in the widely expected economic and earnings contraction, yet very little of the recovery. The current global economic recovery is unlike any we have seen in recent decades. The path of recovery depends heavily on the development of a vaccine. Therefore, a full global economic recovery is likely to take longer than in previous recessions, generating uncertainty and anxiety in investors. Latam markets are usually never the first to bounce. Much like our other calls on global cyclicals, small and medium capitalization and value, Latam equities will only consolidate their recovery once investors have confirmation that all is clear on the pandemic front. We have a high conviction that Latam equities will rebound though it will take some time, and we advise investors to position for the potential opportunity. Current levels provide enough of a discount to suggest that global investors should continue to diversify and, rightly sized and with an opportunistic and tactical view, own Brazilian equities in their portfolios. The Global Investment Committee has an overweight allocation to Brazilian equities since May.

Booms and Busts – We Buy the Busts

Latam equity markets have always been a cyclical play, dominated by a confluence of domestic idiosyncratic variables and international financial and commodity markets. Global shocks have historically had an outsized negative impact on the region relative to other markets. The high volatility was related to the region's heterodox monetary and FX policies (fixed exchange rates, capital controls), high dependency on foreign currency credit markets and inconsistent fiscal policy management. Since the early 2000s, however, macroeconomic policies in most of the largest economies in the region have shifted towards monetary orthodoxy (inflation targeting), flexible exchange rates, local versus external credit, and fiscal discipline to greater commitment. Despite this improved macroeconomic framework, nevertheless, significant equity market underperformance continues to be the norm when facing a global financial shock. Luckily, with the improved macro framework, the recoveries from the troughs of the crisis have been equally strong, providing investors with attractive potential opportunities.

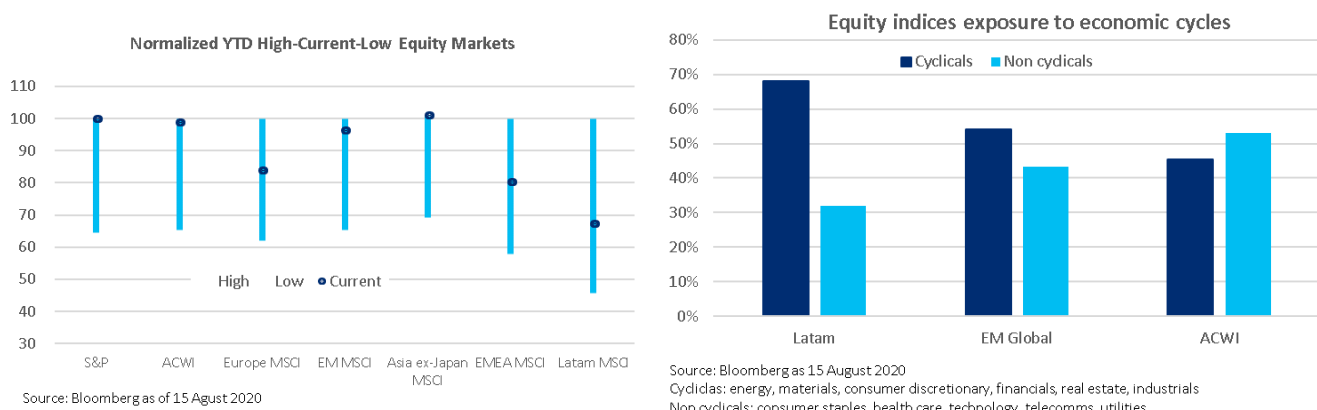
Averaging the returns from the peaks and troughs of four of the largest market moves of the last 20 years reveals that while Latam equities have been the "Ugly Duckling" of the crisis periods, averaging 44% return draw-downs, they also have the potential to transform into the "Beautiful Swan" when markets recovered, averaging 78% upside. Unfortunately, these transformations have never become permanent.



Data Range Periods:				
	Dot Com	GFC	4Q'18 Scare	Covid Pandemic
Crisis	3/31/00 - 9/30/02	5/30/08 - 3/6/09	10/8/18 - 12/26/18	2/19/20 - 3/23/20
Recovery	9/30/02 - 12/31/03	3/6/09 - 4/8/11	12/26/18 - 3/20/19	3/23/20 - 8/14/20

Note: All MSCI Indices except S&P500. Returns do not include dividends.
GFC: Global Financial Crisis

Looking at the current COVID crisis specifically, we see Latam equities experienced a 50% drawdown from the February high to the April low, making Latam the worst performing regional equity market in the world. Despite having bounced 55% from the lows, as of 18 August, the Latam MSCI remains down 32% YTD, lagging behind other markets. The underperformance could be attributed to the region's history and the significant cyclical tilt in its equity indices relative to other regions that have more diversified equity benchmark indices. As our base case scenario for a global recovery materializes into 2021-2022 we expect the global cyclical sector to recover and outperform. We expect Latam to participate in that move.



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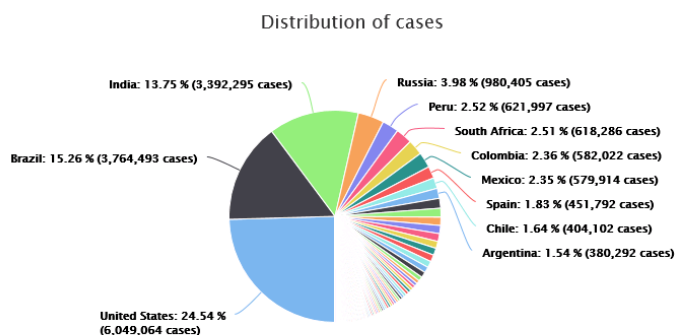
Make no mistake, we are not suggesting that Latam economies, or its markets, will fully recover from this crisis without challenges. As a matter of fact, we expect further damages in the medium term from increasing fiscal pressures, debt burdens and higher political uncertainty. The new equilibrium level of regional GDP in a post-COVID world could be inferior to that of 2019 –which is not encouraging considering that the 2016-2019 period had already been anemic in terms of growth. Having said that, we expect most economies to recognize the fiscal difficulties and maintain reasonable levels of fiscal discipline.

As investors, the challenge is to identify the opportunities that might arise when large shocks create dislocations between prices (dictated by the market and influenced by human psychology, technicals, positioning, and investor segmentation) and value (determined by the underlying long-term fundamentals). While we could see lasting value destruction as a result of the COVID pandemic, we will argue that current prices conflict with the new equilibrium. Consistent with the extreme under/outperformance we have seen in the past, we believe the risk/reward in Latam equities is attractive as current prices are likely over-discounting the loss in value.

Brazil is our preferred market to play the recovery. Brazil is the largest Latam economy, ranking as the 9th largest global economy in the world with a GDP close to \$1.8 trillion. With a population of over 212 million, it has the 6th largest population and one of the largest domestic consumption markets in the world. Finally, it is home to a number of world class companies that add up to an equity market capitalization estimated at approximately \$1trn. These characteristics combined result in a large dynamic economy and an investable equity market.

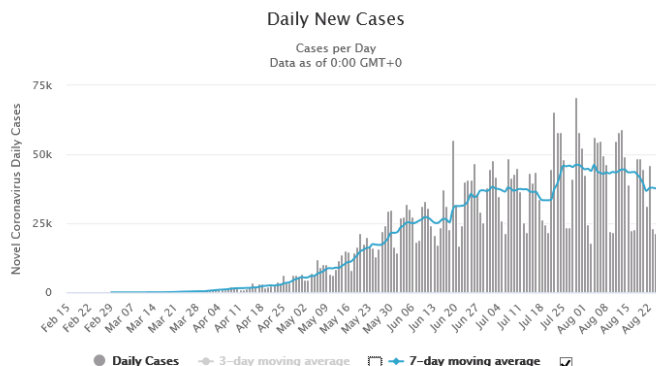
With nearly 3.8mm confirmed cases and over 118k deaths, Brazil is the 2nd worst hit country by the Covid-19 pandemic. The 7-day average for new cases has fallen and stabilized around 37k, compared to close to 46k in late July. While it is too early to tell if the curves have peaked we are seeing the economy begin to open and activity picking up.

Distribution of Global Covid-19 Cases



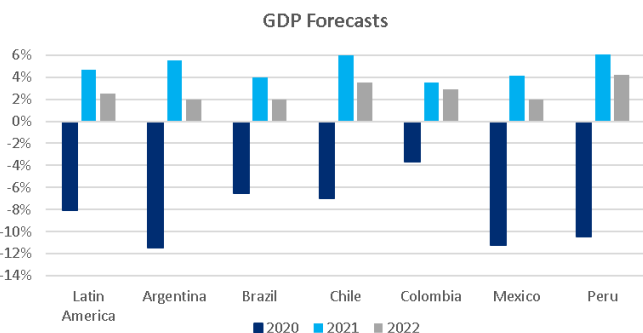
Source: Worldmeter. www.worldmeter.info. As of 27 August 2020

Brazil New Cases – Daily & 7 day moving average

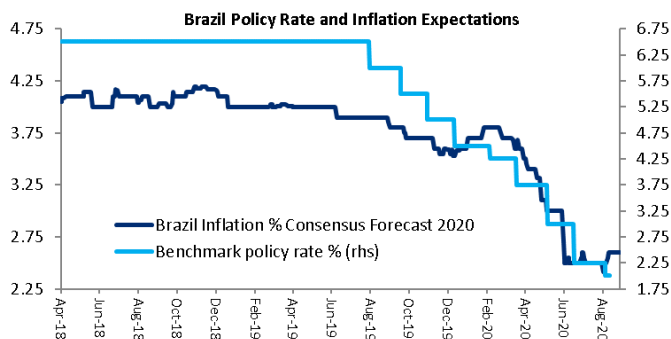


Source: Worldmeter. www.worldmeter.info. As of 27 August 2020

The economy is expected to contract close to 6.5% in 2020 and rebound 3.5% in 2021 in real GDP terms. The administration's early response to the pandemic related slowdown included a large fiscal support program worth roughly 8% of GDP and aggressive rate cuts. The fiscal support program is currently being reviewed and discussed between the economic team and Congress. The Central Bank has cut rates by 250bp to a record low 2% since the beginning of the year, providing liquidity and a boost to credit.



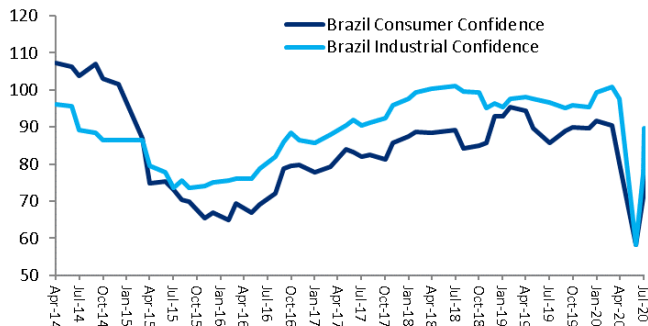
Source: Citi Research as of 5 August 2020



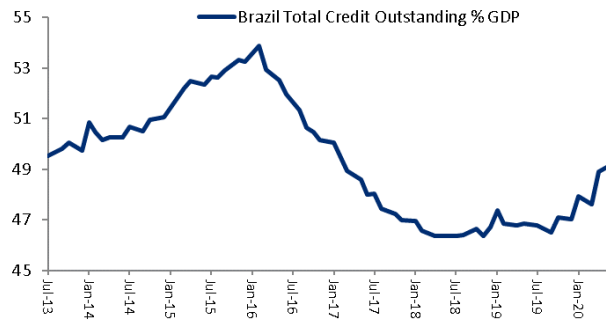
Source: Bloomberg, as of 13 August 2020

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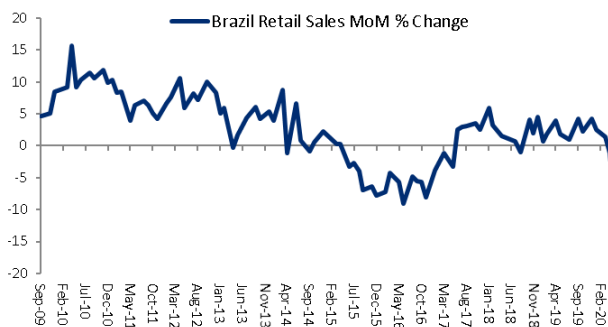
These measures combined with a slow and partial reopening have helped the economy bounce and confidence recover. While we are likely to see a deceleration of the recovery in the coming months, we believe that economic activity could have hit the bottom in May.



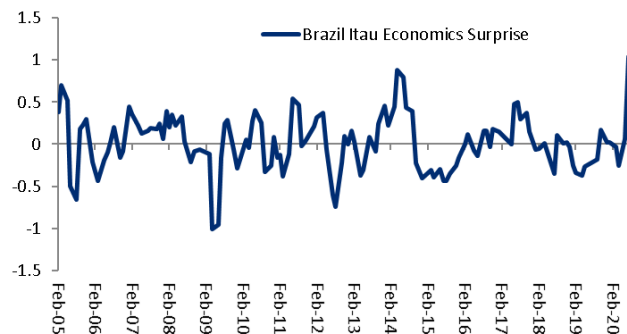
Source: Bloomberg, as of 3 August 2020



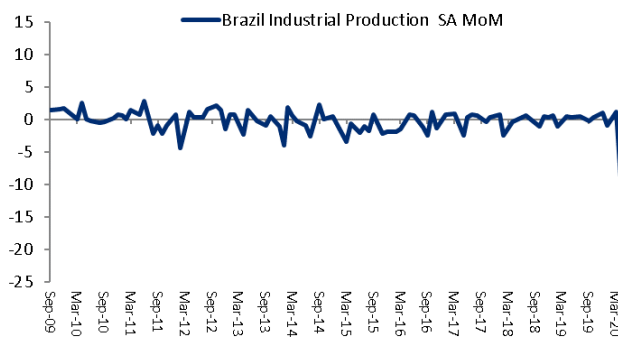
Source: Bloomberg, as of 1 July 2020



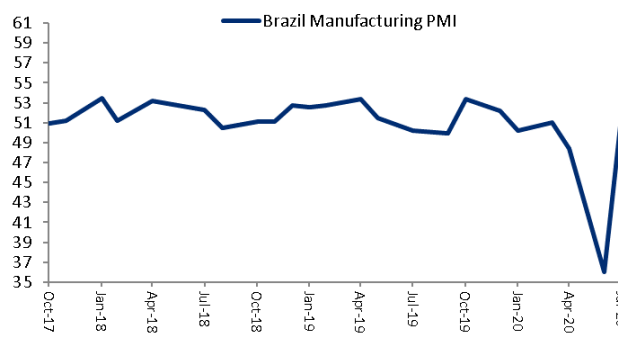
Source: Bloomberg, as of 1 July 2020



Source: Bloomberg, as of August 2020



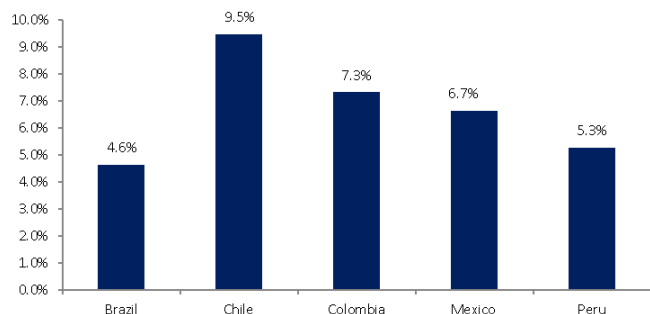
Source: Bloomberg, as of 1 August 2020



Source: Bloomberg, as of 2 August 2020

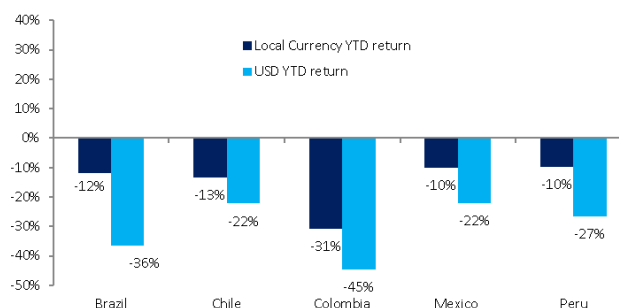
The biggest impact of the Covid crisis on Brazil (and most other Latam regions) has been the depreciation of the currency. Free floating currencies act as escape valves for external shocks. In the case of Brazil the currency depreciated from close to BRLUSD4 to close to BRLUSD6, before bouncing to current level of around BRLUSD5.50. Unlike previous crisis, however, the nominal exchange rate depreciation did not “pass through” to inflation. This is because intrinsic, domestic, BRL demand did not collapse. If we measure the performance of Brazil’s equity markets in domestic currency, we can see that the performance, while negative, was nowhere as poor as suggested by the returns measured in USD terms. While this is of little consolation to foreign investors, it is a strong signal that the “internals” of its monetary system remains sound and this is very supportive of a strong recovery.

Latam Local Rates FX Hedged YTD Returns



Source: Bloomberg, as of 17 August 2020

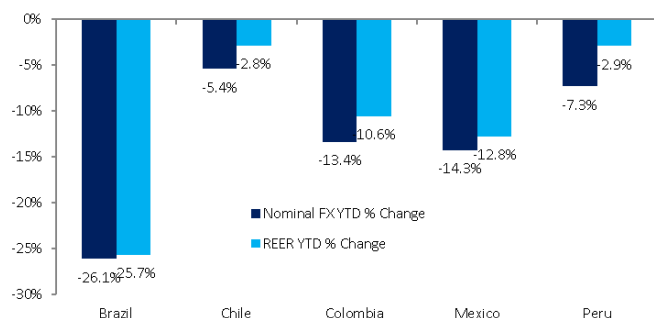
Latam Local vs USD Equity Returns



Source: Bloomberg, as of 17 August 2020

Moreover, because inflationary pressures have remained very low, the brunt of the nominal depreciation has been absorbed by the real effective exchange, providing a large competitive cushion to the economy.

Latam Nominal and REER % Changes



Source: Bloomberg, as of 17 August 2020

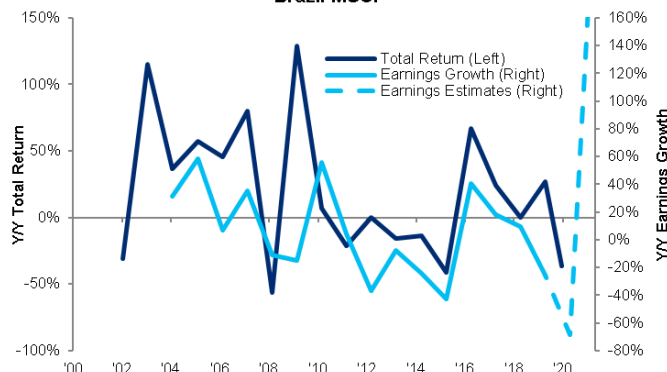
Brazil Real Effective Exchange Rate



Source: Bloomberg, as of 15 August 2020

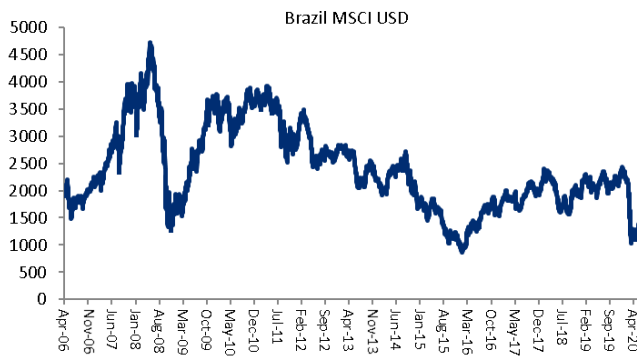
The deeply discounted exchange rate should help the economy recover. In addition to the tail winds generated by a cheap exchange rate, Brazil's relatively well diversified export sector should also benefit from higher commodity prices, which are part of our global base case scenario. The equity market is trading near 2008 (Global Financial Crisis) and 2016 (crash of the commodity super cycle) lows. These levels are consistent with the expected 65% contraction in 2020 EPS but not with the +200% EPS recovery consensus expectations have for 2021.

Brazil MSCI



Source: Factset, as of 27 August 2020

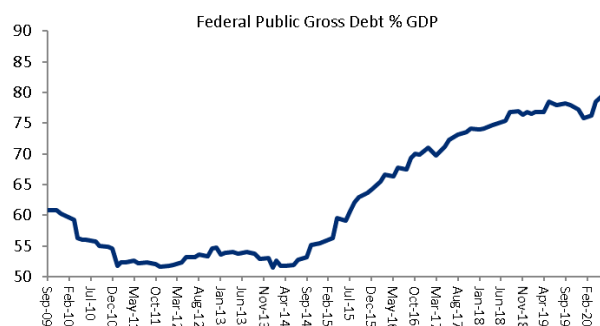
Brazil MSCI USD



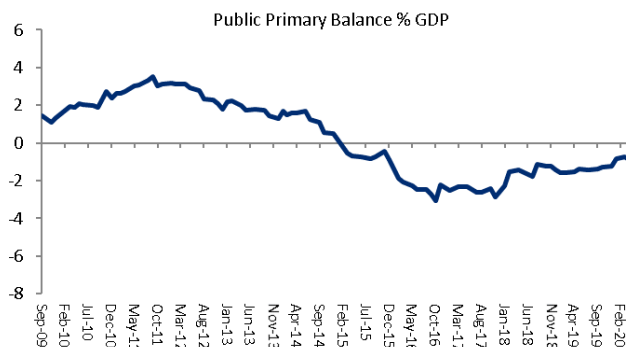
Source: Bloomberg, as of 17 August 2020

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The risks as usual are that in periods of economic stress, policy makers cave and abandon monetary and fiscal discipline. The pressures that Covid fiscal support will place on public accounts will be significant. The economic bottoming and recovery came with a high cost and potentially long-term risks. The primary fiscal deficit could balloon to nearly 10% of GDP and the gross public debt could reach 100% of GDP. It will be critical that the administration and the political establishment provide enough signals to the markets that orthodox monetary policy and fiscal discipline will not be abandoned.



Source: Bloomberg, as of July 2020



Source: Bloomberg, as of 2 July 2020

In summary. While we fully recognize the inherent risks of Latam equity markets, we believe current levels are fully pricing in the widely expected economic and earnings contraction, yet very little of the recovery. The current global economic recovery is unlike any we have seen in recent decades. The path of recovery depends heavily on the development of a vaccine. Therefore, a full global economic recovery is likely to take longer than in previous recessions, generating uncertainty and anxiety in investors. Latam markets are usually never the first to bounce. Much like our other calls on global cyclicals, SMIDs and value, Latam equities will only consolidate their recovery once investors have confirmation that all is clear on the pandemic front. We have a high conviction that Latam equities may rebound though it will take some time, and we advise investors to position for the potential opportunity. Current levels provide enough of a discount to suggest that global investors should continue to diversify and, rightly sized and with an opportunistic and tactical view, own Brazilian equities in their portfolios. The Global Investment Committee has an overweight allocation to Brazilian equities since May.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
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Additionally, the underlying collateral supporting non-Agency MBS may default on principal and interest payments. In certain cases, this could cause the income stream of the security to decline and result in loss of principal. Further, an insufficient level of credit support may result in a downgrade of a

mortgage bond's credit rating and lead to a higher probability of principal loss and increased price volatility. Investments in subordinated MBS involve greater credit risk of default than the senior classes of the same issue. Default risk may be pronounced in cases where the MBS security is secured by, or evidencing an interest in, a relatively small or less diverse pool of underlying mortgage loans.

MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

The indexes 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. Index returns do not include any expenses, fees or sales charges, which would lower performance.

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