Private Bank

Latin America Strategy Bulletin

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Latam elections: a 3 round fight

- **Presidential elections in Colombia, Mexico and Brazil are likely to generate high levels of investor anxiety. We expect currency markets to play shock absorbers, as they have done in the past.**
- **We remain positive on the economic recoveries in these countries and we look for market friendly candidates to win. Hence we maintain our positive outlook and overweight recommendations for the region.**
- **However, non-core positioning could benefit from opportunistic strategies to potentially help enhance returns or hedge exposure against any unexpected political outcomes.**

The GIC remains constructive on the Latam region for 2018. Growth and economic activity should continue to accelerate as domestic aggregate demand finally begins to reap the benefits of more stable nominal exchange rates, competitive real effective exchange rates, a moderately positive commodity outlook, lower inflation and available credit.

A positive outlook for the macro and attractive valuations will, however, clash against higher volatility derived from major elections in Colombia, Mexico and Brazil. While we continue to recommend overweight core exposure to the region's equity and fixed income markets we believe there are opportunities to capture volatility and/or hedge against the immediate risk of an unwanted electoral result via the currencies.

History suggests we are likely to see higher volatility

Our base case expectations for the results of these elections include center-right candidates so our recommendations for global portfolios maintain overweights in the several markets in the region, including those with elections. The better the macro environment is ahead of the elections, the higher the probability of a market friendly candidate will win.

However, if history repeats itself, and we think it will, investors could find opportunities in the rise of market volatility, particularly in the currency markets.

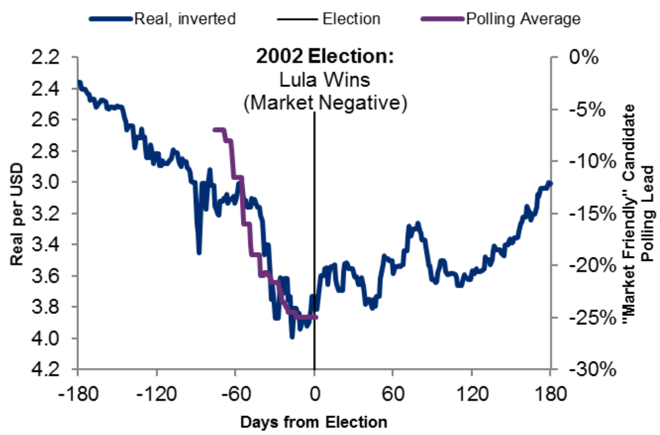
Given an election with 2 candidates in opposite sides of the political spectrum, as it tends to be the case, we expect currency markets to react to the spread in polling intentions between the market friendly (center-right) and the populist (leftist) candidate.

In the charts below we can see that in past presidential elections, as the populist candidate closes the gap with the market friendly candidate the currencies reacted by depreciating. Once the uncertainty is over it recovers. The highest correlation in this relationship between polls and currency moves happens typically no earlier than 90 days before the election date.

Brazil's 2002 election was atypical in the post-election period –the FX rallied even after Lula (the left leaning candidate) won- because the new president did not end up delivering on this pre-election rhetoric so the currency begun appreciating 4 months after the results.

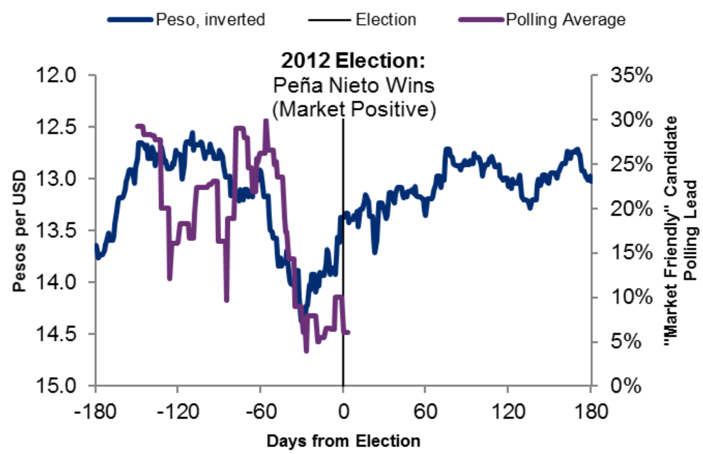
We suspect the populist cycle in the region had its moment in the early 2000s (Lula, Chavez, Kirchner, Correa). Since then, popular discontent with the model has given room to different alternatives and we believe the pendulum has swung towards the center of the political spectrum. Given this base case for center right candidates to have a reasonably high chance of winning we look to trade currency volatility with a contrarian bias.

Figure 1: Brazil's 2002 elections



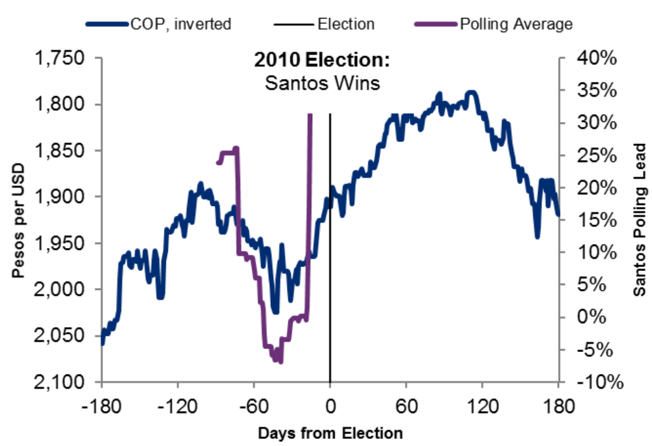
Source: Bloomberg, Citi Private Bank as of January 2018

Figure 2: Mexico's 2012 elections



Source: Bloomberg, Citi Private Bank as of January 2018

Figure 3: Colombia's 2010 Elections



Source: Bloomberg, Citi Private Bank as of January 2018

We recommend that clients consider implementing opportunistic strategies in their non-core portfolios to take advantage of volatility and/or hedge our overweight core exposure in equity and fixed income markets.

Consider USD positioning against "election currencies"

As a hedge to an unexpected political outcome, or as a means to trade pre-election volatility, investors can short "election currencies" like the Colombian and Mexican peso and the Brazilian Real. In addition to electoral risk, Colombia's peso could likely have to deal oil prices retracing from current near 70dpb (Brent) levels. Meanwhile NAFTA is likely to remain a source of additional volatility for the Mexican peso.

At the same time an investor could go long currencies that exhibit stability or upside potential. In the case of Chile and Peru we have inflation, interest rate and political stability coupled with a positive outlook on base metals. This domestic and external backdrop is likely to generate growth and a stable or appreciating currency. In the case of Argentina, while we believe the real effective exchange rate is overvalued, it is likely to remain so during 2018 given the country's external debt position and issuance strategy and the upcoming period of export flows which also result in USD selling. The recent significant weakening of the Argentine Peso could also provide a good entry point.

Carry and directionality bias will depend on how the strategy will be implemented, and are meant to be actively managed (with a contrarian bias) in response to the individual currency moves. Technical levels and flows are likely to play an important role in optimizing returns. Please discuss this strategy with your banker or investment counselor.

The investor must ascertain if they are suitable for each investment strategy based on their unique investment objectives and risk tolerances.

Currency Risk: *One currency may decline in value versus another. The value of a multi-currency portfolio will fluctuate with exchange rates.*

Asset Allocation Definitions

Asset classes	Benchmarked against
Global equities	MSCI All Country World Index, which represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.
Global bonds	Barclays Capital Multiverse (Hedged) Index, which contains the government -related portion of the Multiverse Index, and accounts for approximately 14% of the larger index.
Hedge funds	HFRX Global Hedge Fund Index, which is designed to be representative of the overall composition of the hedge fund universe. It comprises all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.
Commodities	Dow Jones-UBS Commodity Index, which is composed of futures contracts on physical commodities traded on US exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The major commodity sectors are represented including energy, petroleum, precious metals, industrial metals, grains, livestock, softs, agriculture and ex-energy. The Thomson Reuters / Core Commodity Index is designed to provide timely and accurate representation of a long-only, broadly diversified investment in commodities through a transparent and disciplined calculation methodology.
Cash	Three-month LIBOR, which is the interest rates that banks charge each other in the international inter-bank market for three-month loans (usually denominated in Eurodollars).

Equities	
Developed market large cap	MSCI World Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in 23 developed markets. Large cap is defined as stocks representing roughly 70% of each market's capitalization.
US	Standard & Poor's 500 Index, which is a capitalization-weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.
Europe ex UK	MSCI Europe ex UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in each of Europe's developed markets, except for the UK
UK	MSCI UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in the UK
Japan	MSCI Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in Japan.
Asia Pacific ex Japan	MSCI Asia Pacific ex Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the performance of large cap stocks in Australia, Hong Kong, New Zealand and Singapore.
Developed market small and mid-cap (SMID)	MSCI World Small Cap Index, which is a capitalization-weighted index that measures small cap stock performance in 23 developed equity markets.
Emerging market	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure equity market performance of 22 emerging markets.

Bonds	
Developed sovereign	Citi World Government Bond Index (WGBI), which consists of the major global investment grade government bond markets and is composed of sovereign debt, denominated in the domestic currency. To join the WGBI, the market must satisfy size, credit and barriers-to-entry requirements. In order to ensure that the WGBI remains an investment grade benchmark, a minimum credit quality of BBB–/Baa3 by either S&P or Moody's is imposed. The index is rebalanced monthly.
Emerging sovereign	Citi Emerging Market Sovereign Bond Index (ESBI), which includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.
Supranationals	Citi World Broad Investment Grade Index (WBIG)—Government Related, which is a subsector of the WBIG. The index includes fixed rate investment grade agency, supranational and regional government debt, denominated in the domestic currency. The index is rebalanced monthly.
Corporate investment grade	Citi World Broad Investment Grade Index (WBIG)—Corporate, which is a subsector of the WBIG. The index includes fixed rate global investment grade corporate debt within the finance, industrial and utility sectors, denominated in the domestic currency. The index is rebalanced monthly.
Corporate high yield	Bloomberg Barclays Global High Yield Corporate Index. Provides a broad-based measure of the global high yield fixed income markets. It is also a component of the Multiverse Index and the Global Aggregate Index.
Securitized	Citi World Broad Investment Grade Index (WBIG)—Securitized, which is a subsector of the WBIG. The index includes global investment grade collateralized debt denominated in the domestic currency, including mortgage - backed securities, covered bonds (Pfandbriefe) and asset-backed securities. The index is rebalanced monthly.

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