Investing in emerging markets

LatAm: repercussions of FX adjustments since the start of taper fears

Alejo Czerwonko, analyst, UBS FS
alejo.czerwonko@ubs.com

Monica De La Grange, analyst, UBS AG
monica.delagrange@ubs.com

Adolfo Acebras, analyst, UBS AG
adolfo.acebras@ubs.com

Marianna Costa, analyst, UBS Brazil
marianna.costa@ubs.com

Andrea Isoard

Donald McLauchlan, analyst, UBS FS
donald.mclauchlan@ubs.com

Luiz Pinho, analyst, UBS Brazil
luiz.pinho@ubs.com

- As developed market yields trended higher and commodity prices drifted lower, LatAm currencies suffered numerous bouts of volatility in the last 11 months, resulting in weaker exchange rates. In the past, similar combinations had unfortunate consequences, such as sovereign and corporate defaults, but we think it will not be the case this time around.
- Healthier monetary and fiscal policies have equipped the region with the ability to face receding flows, higher yields and weaker exchange rates in a more resilient way. Governments and corporates are more defensively positioned to contain the possibility of a default.
- Given LatAm's export focus, the negative effect of foreign exchange (FX) weakness on government and corporate balance sheets should be somewhat offset by higher exports, and could even benefit certain sectors.
- We therefore do not expect a 1990s-like crisis in the making, since Mexico, Chile, Colombia and Peru are well positioned for the challenge; and so is Brazil despite the recent weakening of its macro fundamentals. Argentina and Venezuela should be analyzed separately from the rest of LatAm. Populist policies focusing heavily on fiscal expenditures, subsidies, and price and foreign exchange controls have led to rampant inflation, hurting international reserves and raising social tensions, although signs of policy rationality have been emerging from both countries recently.
- Investment recommendations: We remain selective regarding LatAm assets in our intra-EM investment strategy. Mexico remains our preferred play in LatAm across asset classes.

In May 2013, the Federal Reserve signaled the end of loose monetary policy was nearing as the US economy gained traction. Tapering fears triggered a considerable sell-off across merging market (EM) assets, which have been under pressure since then (see Fig. 1 & Fig. 2). Terms of trade have also been gradually deteriorating in Latin America (LatAm), mostly as a result of commodity prices drifting lower on the back of a re-balancing of China's economic growth.

Fig. 1. Latin American currencies have depreciated, but less so than in previous crises
Depreciation vs. the USD during specified time periods

Country	Since May 22, 2013	Great recession	Asia Crisis	Tequila Crisis
Brazil	-7.6%	-16.6%	-38.0%	-87.1%
Mexico	-4.8%	-22.0%	-15.3%	-49.7%
Chile	-11.0%	-14.4%	-16.9%	13.5%
Peru	-4.1%	-3.9%	-21.9%	-3.7%
Colombia	-3.7%	-16.8%	-30.8%	-8.5%
LatAm	-6.5%	-17.5%	-27.1%	-63.7%

Source: UBS and Bloomberg as of 14 April 2014. LatAm row computed as the Gross Domestic Product (GDP) weighted average of the five countries.

Fig. 2. Latin American assets have suffered since May 2013
Performance of equity, sovereign debt, corporate debt and FX markets since 22 May, 2013

MSCI - EM vs. DM	
S&P 500	12.7%
MSCI World (DM)	10.9%
MSCI EM Asia	2.2%
MSCI EM	-1.1%
MSCI EM EMEA	-3.8%
MSCI EM LatAm	-8.7%

EMBI	
Middle East	5.8%
Africa	1.5%
Latam	-1.2%
GEM	-1.7%
Asia	-2.0%
Europe	-3.3%

ELMI	
EMEA	0.8%
Asia	-1.4%
GEM	-1.4%
Latam	-2.0%

CEMBI	
Asia	1.4%
GEM	0.1%
Latam	-0.3%
EMEA	-1.0%

Source: UBS and Bloomberg as of 14 April 2014.

Sentiment seemed to improve toward 2014 on the back of robust global growth prospects, but a confluence of events - including weak Chinese and US economic data, a deterioration of political conditions in Turkey, riots in Thailand and Venezuela, and a currency devaluation in Argentina - led to a new bout of volatility that has affected most emerging market currencies at the beginning of this year.

Russian involvement in Ukraine's political turmoil transformed an economic crisis in a peripheral economy into a potential armed conflict with global consequences, further deteriorating the appetite toward EM assets.

EM assets have rebounded since mid-February, mostly on the back of technical factors, as EM dedicated equity and bond funds saw inflows in March and April of this year, after almost a year of outflows. Whether this rally is sustainable is still an open question.

Global funding conditions have remained favorable in recent months, with US 10-year yields dropping year to date. However, we expect a renewed focus on the effects of less accommodative US monetary policy on emerging market economies - after the Fed tapered its bond purchases by another USD 10 billion (bn) in March and shifted away from a fully quantitative forward guidance framework - as investors' attention slowly shifts to the timing of the first US rate hike.

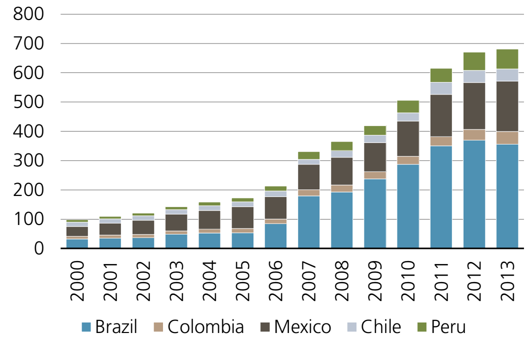
On the commodities front, the strength of broadly diversified commodity indices this year (DJUBS up by over 7% on a total return basis) cannot hide the structural challenges the asset class faces. The rise in some commodity prices is largely weather-related, whereas the weakest performers this year are all linked to China. Iron ore, copper, and coal prices have declined by double digits and are predominantly driven by China's demand for natural resources. Our commodity experts believe that, beyond a potential short-term stimulus impulse from China to prevent economic growth from decelerating too quickly in 2Q14, a structural slowdown in Chinese investment activity as a result of the re-balancing of Chinese growth toward a more consumer oriented economy should keep the prices of these commodities in check and under pressure in some cases. Further pressure on the most commodity exposed LatAm currencies cannot therefore be ruled out.

Against this backdrop, the purpose of this note is to assess the possible consequences of weaker currencies on LatAm economies and asset classes. LatAm currencies have depreciated 6.5% since 22 May 2013 (see Fig. 1), although the Brazilian real, the Mexican peso and the Colombian peso[1] have regained some ground in the last few weeks.

LatAm countries, with the exception of Argentina and Venezuela, are better equipped to weather FX storms than they were in the past. Several structural changes implemented in the past 15 years are pivotal.

1. The introduction of foreign reserve accumulation as one of the principles of new monetary policy regimes. LatAm currently has close to 700bn US dollars in international reserves (see Fig. 3). Some countries have built stronger war chests than others (see Fig. 4); Brazil, Mexico, Chile, Peru and Colombia have adequate stocks of FX reserves by most measures, which allow their economies to smoothen movements in their exchange rates during periods of reduced or increased capital flows.

Fig. 3. Foreign exchange reserves have risen steadily over the past decade
Cumulative foreign exchange reserves



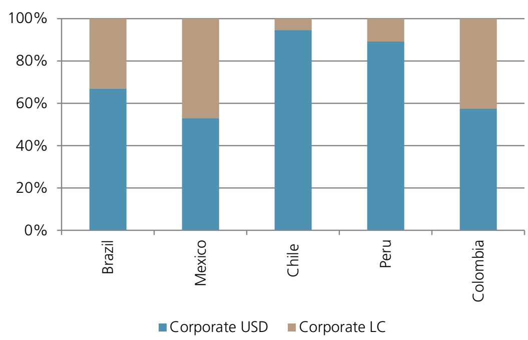
Source: UBS and IIF, as of December 2013

Fig. 4. International reserves relative to monthly imports by country at year-end 2013
FX reserve coverage of imports

Country	Months of imports covered by Int. Reserves
Mexico	5.8
Brazil	20.3
Chile	7.8
Colombia	8.8
Peru	18.8
LatAm	11.4

Source: UBS, Bloomberg and IIF, as of April 2014

Fig. 5. The share of USD-denominated sovereign debt has decreased considerably across the region
Sovereign debt breakdown in local and foreign currency (as a % of total)



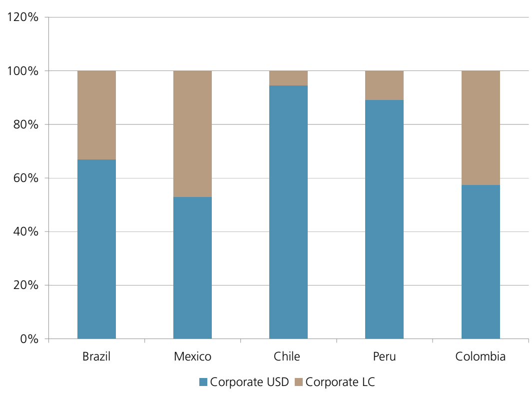
Source: UBS, Bloomberg and JPMorgan

2. Exchange rates are no longer fixed. This means the adjustment process, when needed, can take place gradually, rather than suddenly. Fixed exchange rates were largely to blame for the sudden stops of the 1990s as they exacerbated macroeconomic imbalances and promoted FX speculation.
3. The development of local currency bond markets has helped both sovereigns and corporates in the region to circumvent the "original sin" (currency mismatch) and limit their FX exposure. As a result, the proportion of total debts of LatAm sovereigns and corporates that is denominated in local currency is tangible nowadays (see Fig. 5 and Fig. 6). Corporations have also learned to hedge their FX exposure either by matching flows or through capital markets. These developments translate into limited consequences from FX depreciation on sovereign and corporate balance sheet and income statements, limiting the possibility of a default. It could be argued, however, that the "original sin" is still present in a different form if countries face large foreign ownerships of local debt as foreign investors can still inflict significant pressure on local asset prices in times of stress. LatAm faces manageable levels of foreign ownership of government debt, according to data compiled by Arslanalp and Tsuda (2014). On average, 37.9% of LatAm's government debt was held by foreign creditors as of 2Q13, compared to 46.9% in CEEMEA and 25.7% in Asia. Exceptions are Peru (62.7%) and Mexico (49.3%)[2]. Also, recent evidence suggests foreign ownership of domestic EM government bonds is more sticky than previously thought, holding up relatively well since US tapering fears began on 22 May[3].
4. Current account (CA) deficits in LatAm stand at manageable levels (see Fig. 7). In addition, the largest CA deficits are covered by foreign direct investment (FDI) flows (see Fig. 8 & Fig. 9). The recent adjustment in exchange rates will help reduce CA imbalances by boosting exports and restricting imports.

LatAm countries have faced the dramatic consequences of receding flows and depreciating exchange rates several times in the past. Corporate and sovereign defaults were commonplace in past decades. However, monetary and fiscal policies in recent years have moved in the right direction by strengthening the macroeconomic foundations that have been crushed before. Figure 10 summarizes what we consider to be some of the key differentiators that should help the region face depreciating exchange rates without major consequences.

[1]The strengthening of the COP in recent weeks has been influenced by the announcement of a rebalancing of two JP Morgan benchmark portfolios - GBI-EM Global Diversified and GBI-EM Global. These will give increased weights to Colombian asset, which is expected to lead to capital flows into the country.
[2]Arslanap and Tsuda, 2014, "Tracking Global Demand for Emerging Markets Sovereign Debt", IMF Working Paper No. 14/39.
[3]"Capital Flows to Emerging Market Economies", IIF Research Note, January 2014.

Fig. 6. Brazilian, Mexican and Colombian corporates have also opted for local-currency-denominated bonds
Corporate debt breakdown in local and foreign currency (as a % of total)



Source: UBS, Bloomberg and JPMorgan

Fig. 7. Current account deficits as a % of GDP have also decreased
Current account (as a % of GDP)

Source: UBS and IIF

No more tequila for Mexico despite a weaker MXN
Monica De La Grange, Economist UBS AG

Weak growth dynamics have added unwanted pressure on the MXN since mid-2013. The government has approved an ambitious reform agenda that expands Mexico's long-term growth capabilities, which has led to a recent upgrade of the sovereign credit rating to A-.

These structural changes do not seem to compensate for weaker sentiment toward EM or for a sluggish start to 2014; hence, the peso traded as much as 10% weaker in February, and is now only 5% weaker since May 2013. We think the MXN is considerably undervalued and expect it to follow a sharp appreciation path once concerns on global growth dynamics recede. Nonetheless, a weaker exchange rate does not represent a risk for the Mexican economy; at the margin, it is slightly positive given the country's exporting nature.

Twenty years after the worst financial crisis in its recent history, Mexico is in a much more comfortable position to face a weaker currency. The Mexican peso's depreciation meant higher inflation and liquidity constraints for government and corporate balance sheets two decades ago. Much has changed in 20 years as foreign government debt is now only 9.5% of GDP. Local price dynamics have also developed in such a way that inflation pass-through is now merely 0.05 basis points (bps) for every 10% depreciation. In terms of flows, we have seen a slight deterioration of the current account on the back of lower oil exports and higher imports.

However, we think the current monetary policies are appropriate mechanisms to gradually adjust the monetary conditions in the Mexican economy. The peso remains one of the few fully floating currencies in EM and the most liquid of the EM block. The central bank is determined to keep increasing foreign reserves which have reached a decent level; plus, it also has access to a flexible credit line from the IMF. The only risk we would highlight is the ~50% foreign ownership of the MXN-denominated sovereign debt. While it has remained impressively stable, and even increased in recent months, if investors were to reduce exposure simultaneously, yields would increase and the MXN would be under additional pressure. This is not our base case, but should be considered as a possible stressful situation for the government.

The reader may refer to our recent publication "Investing in Mexico: Monthly strategy update" for more information.

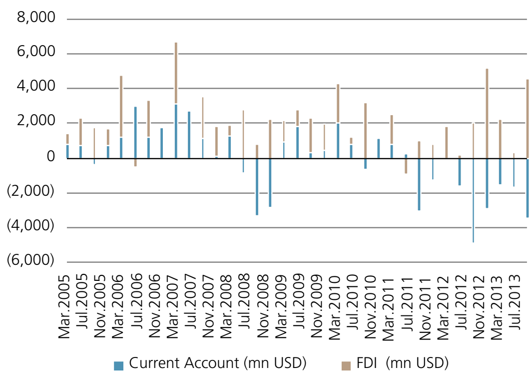
We remain cautious on Brazil, but not because of a weaker real
Marianna Costa, Economist UBS Brazil

The BRL has appreciated against the USD in recent weeks, against our expectations. Several factors explain the BRL's strengthening; including the Brazilian central bank's hawkish inflation report in March and a significant fall in the government's approval rating. At current USDBRL levels, however, we think the BRL's valuation is already in slightly expensive territory.

Uncertainty surrounding the presidential election in October 2014 and possible electricity rationing should also weigh on the currency in the months ahead. The currency depreciation, however, does not necessarily represent bad news for Brazil.

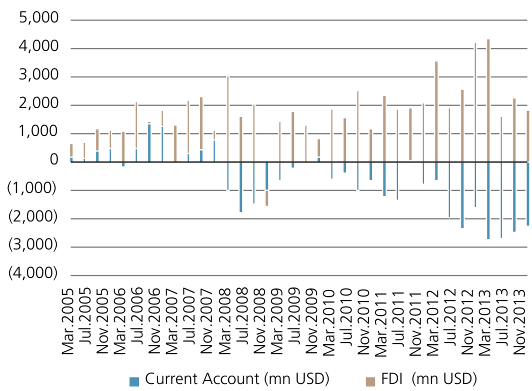
Brazil's current account deficit over the last 12 months totaled 3.7% of GDP in February 2014. The devaluation of the BRL in the last 11 months will induce improvements in the balance of payments in the coming quarters

Fig. 8. Chile's current account deficit is well covered by Foreign Direct Investment ...
Current account and Foreign Direct Investment (FDI) (in USD)



Source: UBS and BCC

Fig. 9. ...Peru's situation is quite similar
Current account and Foreign Direct Investment (FDI) (in USD)



Source: UBS and BCRP

Fig. 10. Prudent fiscal and monetary policies should help the region face the depreciation in an organized manner, with the exception of Argentina and Venezuela
Selected indicators as a % of GDP (unless otherwise stated)

	Current Account	Budget Balance	Government Debt	Debt Service (% of FX reserves)
Brazil	-3.0	-3.9	34.8	18.4
Chile	-3.5	-0.7	11.0	23.1
Colombia	-2.5	-2.3	30.1	21.5
Mexico	-2.2	-4.0	38.7	38.0
Peru	-5.0	-0.5	18.7	8.3
Argentina	-0.8	-2.4	43.7	68.7
Venezuela	2.4	-1.9	23.7	52.6

Source: CIO, Bloomberg and IIF

by boosting net exports, helped by robust flows of FDI. A weaker currency and improving global conditions would lead to a reduction of the current account deficit to 3.0% of GDP in 2014, from 3.6% in 2013, in our view.

Brazil has also plenty of resources to weather an FX storm. International reserves stood at USD 380bn by the end of 2013. The country is also a net external creditor with total foreign currency assets outweighing public and private liabilities. On the activity side, GDP growth lost steam in the end of 2013; however a combination of a cyclical rebound in private consumption and a pickup in the contribution of net exports should support a GDP expansion of between 1.5% and 2.0% this year. For industrial production a weaker BRL also implies that investments should remain weak, on rising costs. The sharp rise in interest rates since mid-2013 - by 375bps - will also weigh on investments.

The reader is referred to our recent publication "Investing in Brazil: Monthly strategy update" for more information.

Mexico equities
Adolfo Acebras, Analyst UBS AG

The Mexican market is biased toward foreign exposure, typically from acquisitions of foreign assets. Many of the largest and most successful Mexican companies today have significant broad exposure. This makes the market somewhat defensive in the case of peso depreciation.

We estimate that around 35% of revenues come from abroad and about a third of Mexico's EBITDA is generated from abroad. The sectors with more exposure to foreign revenues are materials and industrials; these two sectors also have the highest exposure to costs in foreign currencies (mostly dollars but covered by their foreign revenues). Historically, these two sectors benefit the most from MXN depreciation.

In the past, the biggest negative impact of the peso's depreciation on Mexican companies has been on their foreign currency-denominated debt. Companies with dollar-denominated debt saw their interest expenses in pesos increase, and their peso debts increase. Over the last few years, however, more companies have started to hedge their FX exposure, especially their debt exposure in foreign currency. Still, the peso depreciation will be slightly negative for some companies.

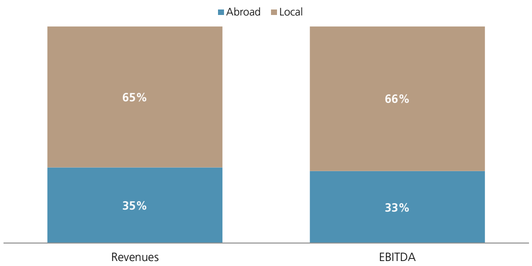
Brazil equities
Luiz Pinho, Analyst UBS AG

We believe that a 'moderate' or at least a gradual currency depreciation (which has been the case for the Brazilian real in the last couple of years) only has a limited impact on Brazilian equities.

In fact, when we look at the EPS growth forecasts, a sizable contribution for this year comes from materials (19% of MSCI Brazil), which is likely to benefit from stronger commodity prices in BRL. Industrials (5% of MSCI Brazil) is also poised to benefit from currency devaluation.

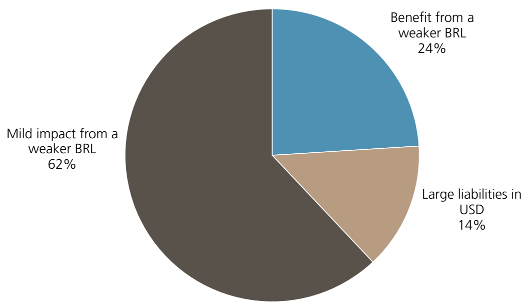
This should more than compensate for any potential negative impact on the energy sector (14% of index) which typically has a large portion of liabilities denominated in dollars while its top-line does not necessarily follow the currency devaluation in the short term. Nonetheless, we note that part of this negative impact was mitigated by the adoption of the so-called 'hedge accounting' policy in which currency translation impact stopped flowing through the income statement, with adjustments being made directly on the book value of equity.

Fig. 11. Mexican companies have diversified their currency exposure away from the MXN
Revenue and EBITDA currency exposure for Mexican companies (as a % of total)



Source: UBS

Fig. 12. A weaker BRL is not a threat to the MSCI Brazil
Estimates impact of a weaker BRL by sectors (as a % of the MSCI Brazil Index)



Source: UBS

Certainly, strong FX sell-offs could have a negative impact on the funding costs of financials (29% of MSCI) and on certain operational costs of consumer discretionary (5%) and consumer staples (13%) companies. Besides, most of the capex made by IT and telecom companies (6% of MSCI) is dollarized. As a mitigating factor, we note that many of those listed companies have strong pricing power and in theory they would be able to pass-through to clients.

Finally, it is also worth mentioning that currency devaluations have been a recurring theme in past decades; therefore one could argue that companies have a relatively conservative approach to it, thus being either naturally hedged (liabilities in USD hedged against exports, for example) or already protected through derivatives.

Latin American corporate credit
Donald McLauchlan, Analyst UBS FS

Abrupt foreign exchange movements are often unwelcome events that raise investors' concerns about currency mismatch risk. If revenues are denominated in local currencies and balance sheets carry liabilities expressed in foreign currencies, a major devaluation cannot bode well for fundamentals and creditworthiness. However, a top-down overview of the major constituents of J.P. Morgan's CEMBI Broad LatAm sub-index suggests that the situation may not be as dire as initially thought.

Brazilian corporates account for over 56% of CEMBI Broad LatAm, Mexican credits come in as a distant number two with a 19.3% slice, followed by Colombian, Chilean, and Peruvian issuers with 7.8%, 6.7%, and 5.6%, respectively. Since Brazil and Mexico comprise about three quarters of CEMBI Broad LatAm, our analysis will focus on these two sub-indices.

Fig. 13. Brazil and Mexico comprise more than 50% of the index
CEMBI LatAm and CEMBI country breakdown (as a % of total)

Segment	CEMBI Share	CEMBI LatAm Share
LatAm	34.2%	100.0%
Brazil	19.2%	56.1%
Chile	2.3%	6.7%
Colombia	2.7%	7.8%
Mexico	6.6%	19.3%
Peru	1.9%	5.6%
Other	1.6%	4.5%

Source: JP Morgan as of February 2014

Banks represent about 27.6% of CEMBI Broad Brazil, and include triple-B rated entities with either close links to the sovereign or high systemic importance. In addition, Brazilian banks partly hedge their foreign exchange exposure. Oil and gas, with a 26.5% sub-index weight, is mostly quasi-sovereign risk and revenues are USD-linked, although retail pricing mechanisms may not be as transparent as we would wish. Metals & mining and industrials jointly account for 18.6% of CEMBI Broad Brazil, and include large corporations, some of which are major exporters (i.e. hard currency earners), rated triple-B or higher. The consumer sector represents about 9% of CEMBI Broad Brazil. At first glance, this is a sector that should come under significant pressure in times of currency weakness. However, meat packers or protein producers account for over 75% of this group. There are many reasons - including high disease risk, high leverage, and low margins - why we do not favor or recommend this group, but a weaker BRL actually helps them as over two thirds of their revenues are either derived from exports or are generated in subsidiaries that operate in developed markets.

Over 30% of CEMBI Broad Mexico is comprised of single-A and triple-B rated large telecommunications and multimedia conglomerates with sound fundamentals and strong capabilities to generate hard currency revenues. Mexican consumer credits, which represent about 17% of CEMBI Broad Mexico, include triple-B rated credits that are regional leaders in their respective lines of business. Mexican industrials account for about 30% of CEMBI Broad Mexico, and include a couple of triple-B rated petrochemical companies that are expected to benefit from the recently approved energy reform, and a single-B rated cement producer that is on recovery mode and has strong presence in the US.

Argentina and Venezuela – signs of policy rationality at the margin
Alejo Czerwonko, Economist UBS FS

Populist governments have ruled Argentina and Venezuela for over a decade now. These have pursued policies focusing heavily on fiscal expenditures, subsidies, price and foreign exchange (FX) controls, nationalizations and non-independent central banks. The political dividend of staying power that these policies initially paid their rulers is collapsing economically: the peso and the bolivar are under pressure, FX reserves are shrinking, inflation is soaring, and economic activity is contracting. As a result, social tensions have been increasing in both countries. Necessity is the mother of invention, and since social unrest has spiked in both Argentina and Venezuela in early 2014, authorities have taken steps in the direction of more pragmatic policy making.

In Venezuela, President Maduro's recent implementation of a system that partially liberalizes the FX market has led to a significant rally of Venezuelan bonds, despite ongoing social unrest in several large cities. The liberalization of the FX market is positive for the fiscal balance sheet. Numerous risks remain however, which could lead to renewed widening in bond spreads. First of all, the FX reform may be significantly watered down by regulations and restrictions. The domestic situation can also therefore deteriorate further. Moreover, recent policies have led to a swift depletion of FX reserves and a further decline in oil production. Together with plentiful economic challenges, further reform measures are required to put the economy back on a sustainable path. Our investment advice to existing holders of Venezuelan bonds is to use the current rally to reduce exposure.

Please refer to our recent publication "Emerging market bonds: Venezuela: New FX law eclipses riot concerns near term" for more information.

In Argentina, after the accelerated decline in international reserves and increasing exchange rate pressures in early 2014 led to a 17% depreciation of the peso in January, authorities took some steps in the right direction. By increasing interest rates sharply and capping the exchange rate exposure of financial institutions, the central bank managed to stabilize the demand for local currency. The inflation problem was partially acknowledged through the launch of a new price index in February. On the external front, the government agreed to compensate Repsol with USD 5bn for the 2012 expropriation of a majority stake in Argentina's largest energy company (YPF), and re-launched negotiations with the Paris Club of creditors.

Further positive developments involving the Argentine sovereign took place in recent weeks. First, by announcing a cut in gas and water subsidies, authorities made the initial, politically costly step of acknowledging the current subsidies scheme is putting unsustainable pressure on fiscal accounts. Second, the Treasury's return to local markets to finance part of the fiscal deficit takes some pressure off of the central bank to do so via money printing. Lastly, regarding the pari passu case in the US courts, the probability the US Supreme Court will decide to either take the case, ask for the opinion of the Solicitor General or deny the hearing petition in the fall rather than before the summer has increased, therefore buying Argentina time.

However, policy measures in Argentina have a long history of inconsistencies and lack of rationality. Also, fundamentals in the country remain weak; economic activity has been deteriorating sharply and inflation, already hovering around 30% a year in 2013 according to private polls, is poised to increase further. The possibility the country falls into a technical default as a result of litigation with holdout creditors in US courts cannot be ruled out yet. Uncertainty remains high, and from a risk-reward standpoint, we advise investors not to increase their exposure to Argentina's credit for now.

Please refer to our recent publication "Emerging market bonds: Argentine bonds: Small steps in the right direction" for more information.

Investment recommendations in the region
As global liquidity becomes less abundant, country differentiation will prevail. We therefore remain selective regarding LatAm assets in our intra-EM investment strategy.

Mexico remains our preferred play in LatAm and we like the country across asset classes. In our emerging market equity strategy, Mexico is among our preferred markets despite expensive valuations. The market offers exposure to the US recovery while we estimate earnings will expand by more than 10%, maintaining above-average ROEs. In the fixed income universe, we also have an overweight on Mexican sovereign bonds on expected further rating upgrades. We finance this overweight with an underweight in Peru, which exhibits one of the longest durations in the EM sovereign credit universe and will therefore remain vulnerable to rises in US Treasury yields. We remain cautious on Argentina sovereign debt given deteriorating fundamentals, and a technical default outcome cannot be ruled out yet. We would use short periods of strength to marginally reduce exposure to Venezuelan sovereign bonds given the low economic and political visibility. Regarding FX, we keep the Mexican peso as our most preferred currency in the region.

The reader may refer to our monthly publication series "Emerging markets equities", "Emerging markets bonds" and "Emerging markets currencies" for more information.

We expect EM currencies to remain volatile in the months ahead but do not foresee a 1990s-like currency depreciation. Most LatAm countries should be able to face rising global yields in an organized manner and benefit from prudent fiscal and monetary policies implemented in recent years. A sudden stop of international flows into the region should stretch the situation and could result in sharp currency depreciations, but this is not our base case. Even when considering this possibility, we think the probability of a default in the corporate sector is quite limited, and more so for sovereigns.

Appendix