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March 2019

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Debt in Latin America: an analysis of Argentina, Brazil and Mexico

Summary

I – Argentina

Historical perspective

Argentina debt issues started with the 1976-1982 military dictatorship. During this period, in an international landscape characterized by abundant liquidity as a consequence of oil shocks, the government implemented a financial liberalization policy with a fixed exchange rate regime, causing an appreciation of the real exchange rate and a significant rise in both public and private sector external debt, where the former reached a level of about 40% of GDP.

1990-1994 and 2002-2005 were characterized by ideal international conditions, leading to robust GDP growth and an improvement in fiscal and debt policies, as well as the social environment. 1995-2001 was a period of poor fiscal performance, in which the primary result worsened (1995-1996), to then improve (reaching a surplus of about 0.22% of GDP). However, in 2001 the debt increased to $144bn (from $80bn in 1994), with the debt-to-GDP ratio increasing to 54% (from 32% in 1994). Due to the political and fiscal situation, combined with the volatility in emerging markets, interest rates increased. As markets believed that Argentina's fixed exchange rate was vulnerable, the risk premium on Argentine bonds increased as well.

In 2002-2005, fiscal results got better. The fiscal surplus averaged between 2.63% of GDP, with an unprecedented level of 3.90% in 2004. The debt-to-GDP ratio increased in 2002, thanks to the depreciation of the currency.

In 2002 and 2003, the change in debt was in great part due to off-budget government expenditure. Then, between 2003 and 2005, the debt-to-GDP ratio declined by 35%, thanks to high annual GDP growth rates of the GDP, as high as 9%. A debt restructuring programme, applied in 2005, led to an additional reduction of 26% of the same ratio.

Macroeconomic trends

Comparing the Argentinian economy to the overall economy of Latin America reveals some interesting trends. Understanding these trends in the context of Argentina's crises and the IMF bailout gives us a strong indication of where the economy is heading.

Recently, Argentina has entered a deep recession as annual real GDP growth stood at -6.20% in 2018. This is troubling considering the Latin American economy grew over the same period, albeit at a modest 0.20% (*Figure 1*). Over time it is apparent that the correlation between the Argentinian economy and the overall Latin American one has reduced, due most likely to the fact that Argentina's role in the overall Latin American economy has diminished.

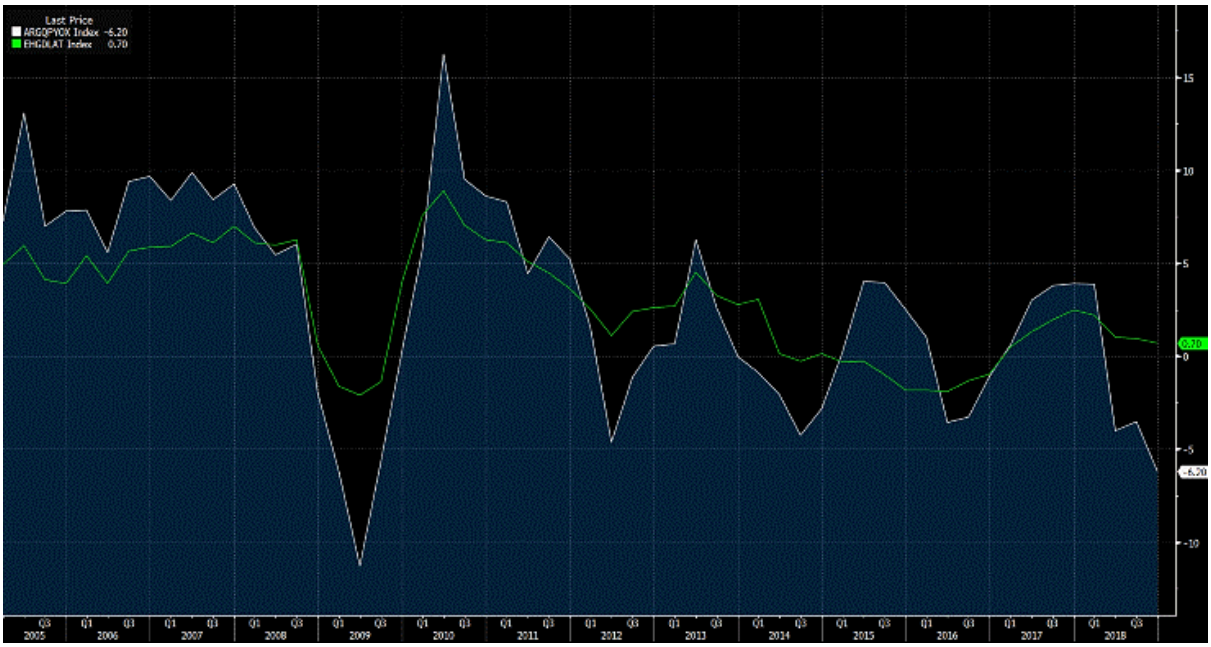

Figure 1: Comparison of year-over-year real GDP growth rate in Argentina (white) and Latin America (green) over time. *Source: Bloomberg*

Some reasons behind the recent disconnect between Argentina and its neighbours can be seen in its fiscal and monetary policy. Argentina's budget deficit, at 0.32% of its GDP, is far lower than the total budget deficit of Latin American countries, which stands at 2.01% of its GDP. This is not surprising, considering that the terms of its bailout from the IMF called for the strict management and reduction of the deficit. Argentina's contractionary fiscal policy is undoubtedly one of the major contributors to its recent recession.

Interestingly, these figures are exceptions as Argentina has consistently maintained a higher budget balance than its neighbours (*Figure 2*). This trend of relative fiscal conservatism in Argentina may even suggest that in the long run, Argentina may maintain stability relative to other Latin American economies.

Of course, Argentina's total public debt is the figure that will be closely watched by investors and IMF officials. The total debt reached a peak in 2018 (*Figure 3*). Argentina's debt-to-GDP ratio has also shown a modest decrease according to the latest data; this will undoubtedly raise confidence in Argentina's economy. The actions taken by the government, in line with IMF rules, and the recent data are promising signs that the debt will soon reach a stable level. It should be noted that the debt-to-GDP ratio is far from its historic high in the early 2000s.

Interest rates in Argentina are almost at their highest level in more than a decade (*Figure 4*). At present, the benchmark interest rate is 52%. No doubt, this is a drag on the economy in line with the contractionary fiscal policy. In addition to the contractionary effects of high interest rates, their volatility will also lead to unpredictability in the economy. As debt stabilizes and risk decreases, we should expect rates to fall to pre-crisis levels. However, it is uncertain how long it will take for rates to be reduced.

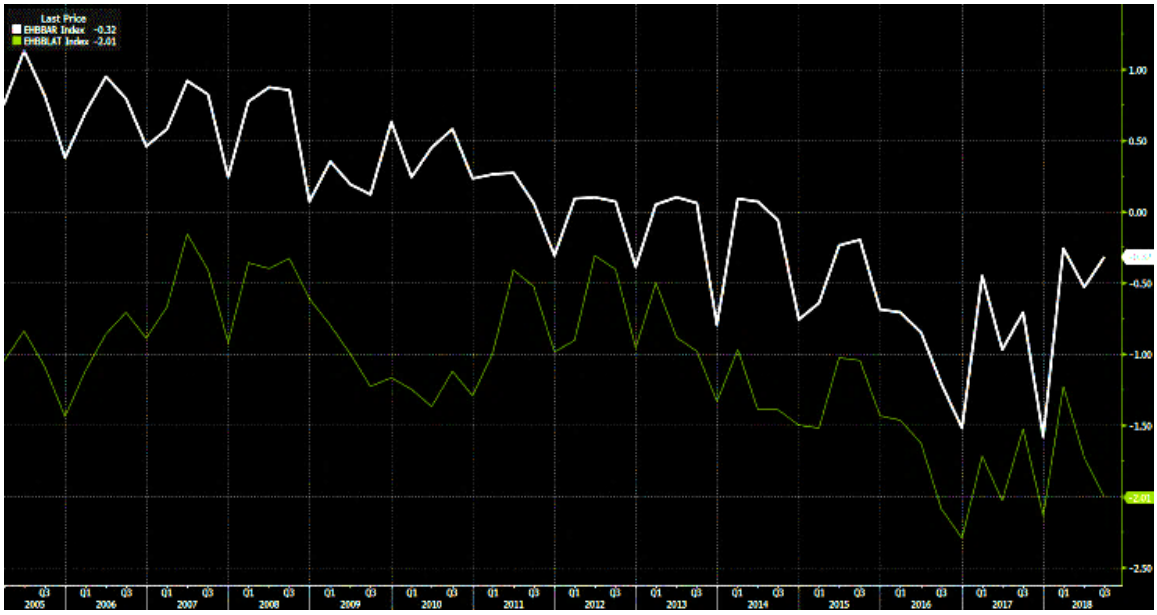

Figure 2: Comparison of budget balance as a percentage of GDP in Argentina (white) and Latin America (green) over time. *Source: Bloomberg*

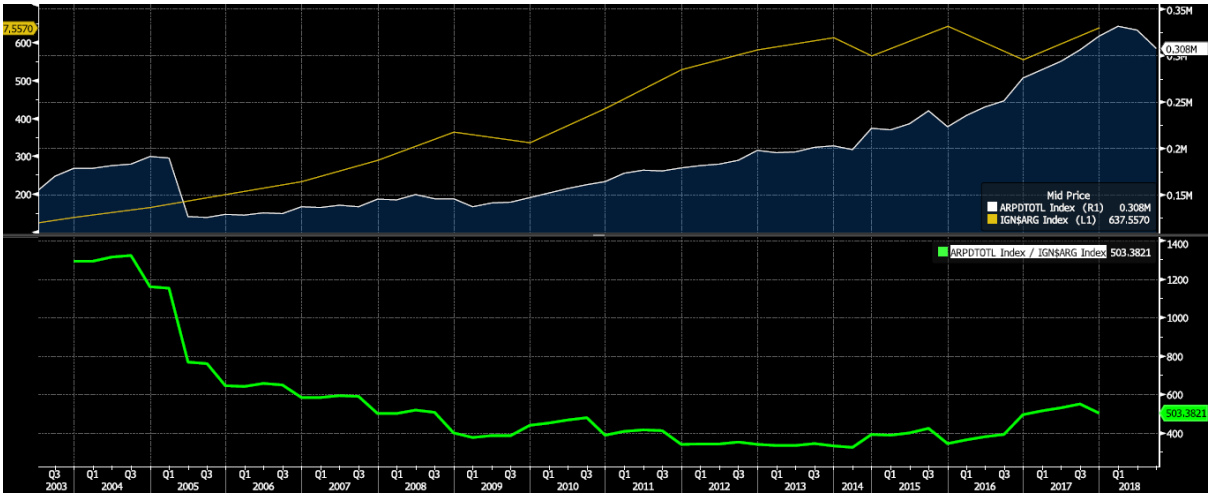

Figure 3: Above: Comparison of public debt in Argentina (white) to nominal GDP in Argentina (yellow) over time; Below: Debt-to-GDP ratio in Argentina (green) over time. *Source: Bloomberg*

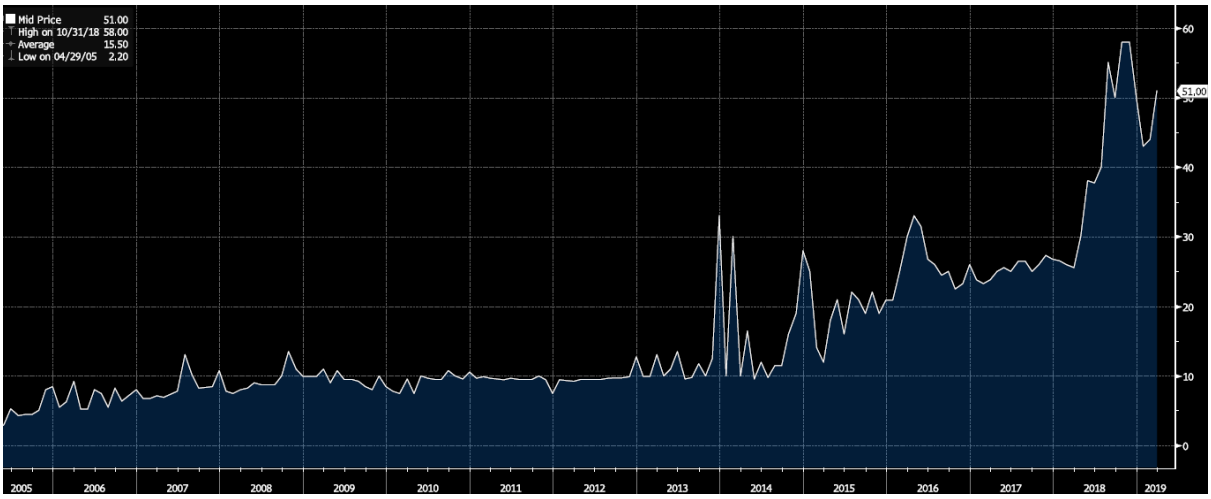

Figure 4: Argentina benchmark interest rate over time. *Source: Bloomberg*

Forecasts

In the short to medium run, we should expect a continued recession due to the strong contractionary fiscal and monetary policy in place. In the long run, however, Argentina should continue to enforce its commitments in order to build confidence. Argentina stands out from its neighbours and it is likely that the economy will begin to grow within a few years.

Figure 5 depicts analysts' forecasts for real GDP growth in Argentina. These forecasts seem overly optimistic; however, we agree with the general trend in which the economy is expected to move.

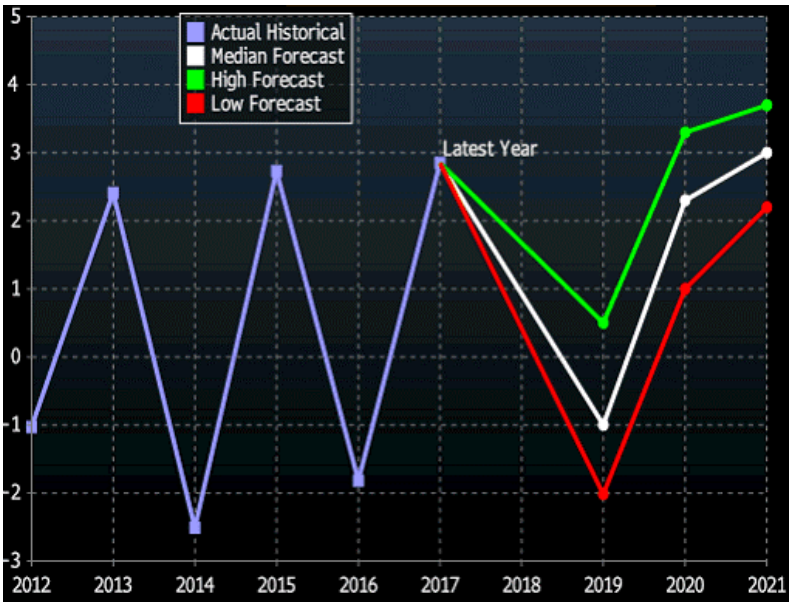

Figure 5: Analysts' forecasts for annual real GDP growth in Argentina. *Source: Bloomberg*

II – Brazil

Historical and macroeconomic perspectives

Brazil is the largest economy and most populous country in South America. Brazil's economy has had a growth rate of approximately 2% in the 2007-2017 period, according to data compiled by the World Bank. The latest GDP breakdown indicates that consumption occupies around 63%, government expenditure 20%, gross fixed capital formation around 16%, with net exports being 1% (exports 13% and imports 12%). Brazil's main exports are Soybeans, Iron Ore and Crude Petroleum. The largest trade partners are China, the United States, Argentina and Germany. In the same time period, the most representative stock index, IBOVESPA recorded a gain of around 80% (*Figure 6*).

Figure 6: IBOVESPA performance between 2014 and 2019. *Source: Yahoo Finance*

As many of its Latin American neighbours, Brazil too has defaulted on its debt - 9 times. In the 1980s it has tried to combat hyperinflation by introducing 5 new currencies until it settled on the real in 1994. Today, Moody's latest credit rating for Brazil is Baa2, while both S&P and Fitch boast a BB-. All the agencies have expressed stable outlooks. Brazil's 5-year CDSs are trading at 157, a one year minimum, implying a 2.6% probability of default on a 40% recovery rate.

In the past few years, Brazil has had a fair share of its issues. The main problem was the world-known Petrobras scandal. It all started in 2014 with the so-called Carwash Operation that unveiled a huge scheme of bribery and corruption between the state-owned Brazilian oil company and lots of high levels figure in the country. The prosecutors found that top official of the company overcharged Petrobras for construction and service work

receiving back bribery. The amount of money in the scandal is more than 3$ billion, including Rolexes, luxury bottles of wine, helicopters and much more. The earthquake scandal led to the impeachment of Dilma Rouseff, the imprisonment of the former president Lula and more recently the arrest of Michel Temer that made the stock index tumble by more than 5%. All these cases have reshaped the political scenario and put an end to more than 20 year of power of the left-wing Partidos dos Trabalhadores.

The debt issue

Since 2014, Brazil has had a decreasing current account deficit. Despite having a positive trade balance in 2017, the current account deficit stood at 0.48% of GDP. Brazil had a record debt to GDP ratio of around 74%. According to the Center for Economic and Policy Research, headquartered in Washington DC, Brazil paid 7.6% of its GDP as interest payment on its public debt in 2016. This was the fourth highest rate in the world at the time, usually reserved for countries plagued by war and significant probability of default. Additionally, a large share of public debt is tied to the short-term overnight lending Selic rate set by the central bank. When adjusted for inflation this rate has averaged a very high 6.14% in the 2003-2015 period. Despite the foreseeable drop in credit growth, widening spreads between lending and borrowing had made banking sector particularly attractive with profits rising 460% in the corresponding time period. According to Brazil's ex-president, Michel Temer, Brazil's budget deficit for 2018 is less than $33.3 billion or around 7.9% of its GDP. Balancing of the budget deficit is likely to be a time-consuming and politically challenging task.

Brazil sports a yield curve with normal term premiums for bonds with residual maturities great than one year. Interestingly, the yield curve is inverted in the 3-month to 1-year period, with respective yields of 6.509% and 6.446% (*Figure 7*). Average annual inflation in 2018 was 3.66%.

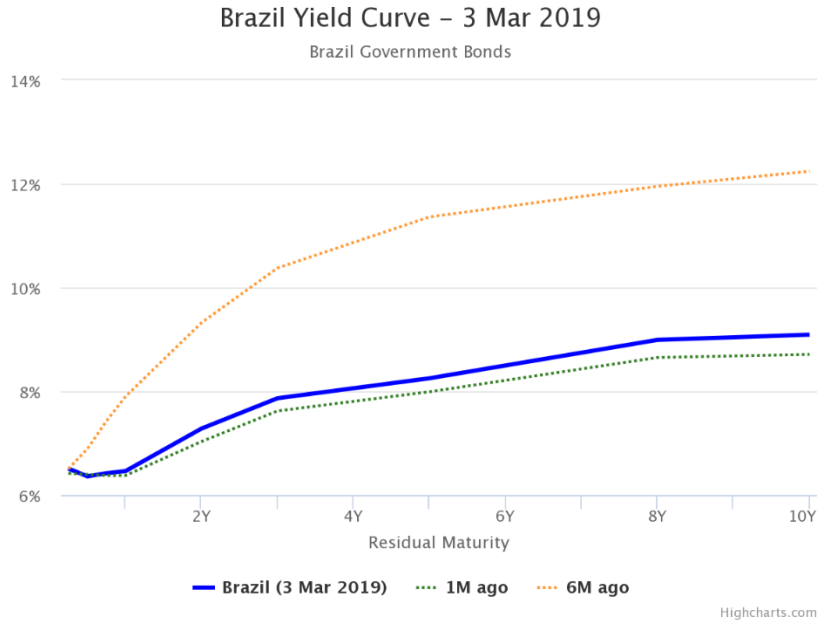

Figure 7: IBOVESPA performance between 2014 and 2019. *Source: worldgovernmentbonds.com*

Forecasts

The newly elected president, Mr. Bolsonaro, is a free market supporter and, together with the finance's ministry (Mr. Guedes), is planning to ease the business conditions in the country. The government wants to transform Brazil's economy from a failed dirigiste economy to one that is truly market driven. Their main focuses are to revise the tax code, cut useless spending, overhaul the pension system and start making private lots of public assets. By doing this, the aim is to make the country pro-business and reach a transformation from emerging to developed market.

There are lots of expectations in financial markets from this new administration. The main institutions are confident that a virtuous cycle in the country's economy, that is the result of low inflation and history-low interest rates, can propel the companies' profit, reduce their leverages, and attract more foreign investment. The main issue for the coming months for Mr. Bolsonaro will be passing the pension bill in parliament, finally putting to an end the previous system that make up the main part in the budget's deficit (with target savings in the next decade of more than one trillion of reais, or $259 billion. Since the beginning of the new administration, Brazil's market index IBOVESPA has risen to an all-time high and, if the government will be able to implement the electoral promises, the forecasts for 2019 are of a great 20% rally.

III – Mexico

Historical perspective

Mexico's economy was relatively stable and healthy between 1950 and 1970, with annual GDP growth around 7%. In 1970 things changed. The newly elected president, Mr. Echeverria, ran a programme of fiscal expansion, with the budget deficit booming at 10%, public debt-to-GDP increasing to 30% and inflation reaching levels above 20% in just a few years. As 75% of interest payments were tied to the LIBOR and other US benchmark rates, the economy was under severe pressure. In 1976, the new president, Mr. Portillo, agreed with the IMF to embark the country, in a recession, on a stabilisation programme, with fiscal policies becoming healthier.

The IMF programme was dropped three years later, with the discovery of new oil reserves. The initial impressive surge in oil prices benefited Mexico, but the consequent global recession was especially damaging to Mexico's economy, as LIBOR skyrocketed in the early 1980s (to more than 16%). In the same period, the real exchange rate started appreciating considerably (due to double-digit inflation), making real interest rates negative and incentivising new debt issues. Capital flights were, indeed, significant.

All things considered, fiscal deficit boomed, and so did the debt-to-GDP ratio (49% in 1982), with debt service accounting for 24% of GDP. In 1982, during the Latin American debt crisis in the 1980s, Mexico was therefore the first country to default (1982). In the space of a year, the Mexican government ran out of reserves (despite a sharp devaluation of the Peso) and, by nationalising the private banking sector, all debt repayments (public and private) stopped to be done. The situation improved thanks to IMF loans, structural reforms and a debt relief programme issued by the US.

Mexico was at the protagonist of another crisis in 1994, following a significant depreciation of the Peso (13-15%) and increasing interest rates (to 32%). As many businesses had debt denominated in US dollars, this led to significant problems in paying them back. Again, as few years earlier, Mexico was bailed out by the US, in exchange for structural reforms to rein in fiscal and monetary mis-policies, leading to a recession and hyperinflation (the so called "Tequila crisis").

As the debt-to-GDP ratio is now near to all-time highs (*Figure 8*), is the country heading towards a new debt crisis? To answer this question, we shall analyse the main macroeconomic trends shaping the bond market.

Figure 8: Mexico's debt-to-GDP ratio. *Source: Trading Economics*

Macroeconomic trends and forecasts

The GDP outlook is not set for a brilliant performance. Over the last years GDP growth has been decelerating, considering a 2.5% YoY average growth rate between 2016 and 2018 and a 2.1% YoY growth rate in 2017, 2% in 2018. In addition, Bloomberg Intelligence forecasts expect Mexican GDP to slow further to a 1.8% growth in 2019. Similar forecasts for Q2 YoY growth are to be found among other sources, but it can also be argued that the recent slowdown can be attributed to a the local central bank's hawkish stance over the last few years, which, as the rate hikes have been stopped for now, may leave space to a gradual return to a 2.5% growth more consistent with the country's long-term average growth rate. Nevertheless, with a horizon of a few years, the market consensus is that economic growth with continue to cool down. Trading Economics econometrics models call for a 1.5% growth in one year's time and 1.1% in 2020 (*Figure 9*).

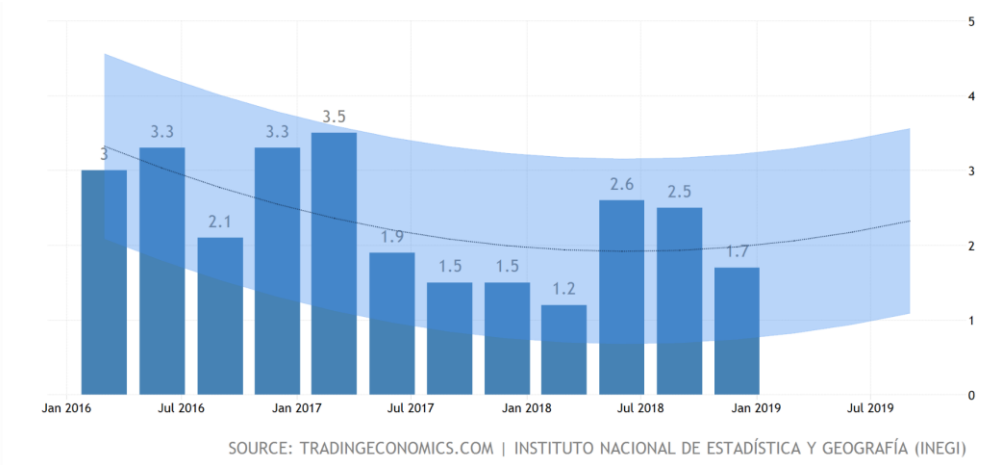

Figure 9: Mexico's GDP growth rate forecasts. *Source: Trading Economics*

After spiking to near 7% levels in recent years inflation has been steadily cooling off thanks to the intervention by the Mexican Central Bank. Indeed, the nominal policy rate has risen from as low as 3.5% in 2015 to the current 8.25%, which is well above neutral (estimated to be around 2.5%). These tight monetary conditions helped anchoring inflation expectations to 4.1% for 2019, down from 4.9% in 2018. Some expectations are for an additional decrease even down to 3.5% in the coming months, which would be well within the central bank's target of 3% +/- 1% and could sustain the case for an ease of monetary conditions (*Figure 10*). Currently no indications have been given by the authorities in this direction, but the bank has signalled that it will stop for now with tightening its stance. Furthermore, the appointment of major bankers in the central bank's board by AMLO due in the coming months in his office spikes speculation about a more dovish stance.

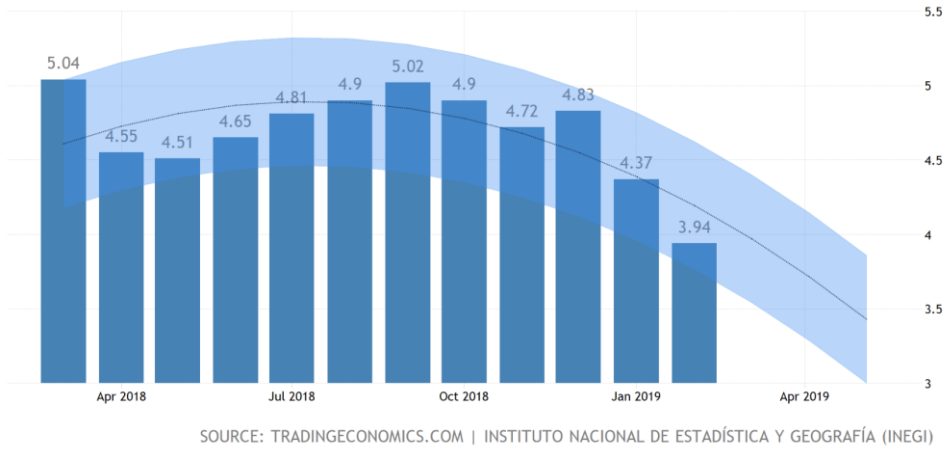

Figure 10: Mexico's inflation forecasts. *Source: Trading Economics*

The IPC Mexican stock market index has performed remarkably bad over 2018, amid the EM turmoil and strong investor's concerns about AMLO's proposed left-lining policies. After a bottom in November 2018, after AMLO's election, the market has been recovering but it is still trading in a sensibly lower range than a year ago (*Figure 11*). This is a sign that equity investors' confidence has not come back yet and, while there may be much upside for stocks in case the president will gain investor's trust, as of now the market doesn't appear to be ready for a move in either direction.

Figure 11: Mexico's stock market performance between 2017 and 2019. *Source: Yahoo Finance*

Shortly after taking office AMLO's government presented a conservative budget for the year, with a non-financial public sector deficit set at 2.5% of GDP and a 1% primary budget surplus. In addition, total public spending is set to decline to 23.2% of GDP in 2019 from 23.7% in 2018. Analysts and rating agencies have praised these objectives

outlining how they were consistent with a good fiscal discipline and based on realistic projections for growth and crucially for oil prices. This outlines that investors' worries about excessive social spending plans are not contemplated as of now by the president and that on balance such fears appear unjustified.

Currently, Mexico is rated at BBB+ from S&P and stands on the brink of losing its investment grade status mainly in relation to the financial troubles of Pemex, the state-owned oil giant. The company has more than $100 bn of debt outstanding and only cash to repay these year's payments, with instead half of the debt load coming due in a few years. The major rating agencies have made it clear that Mexico's rating is tied to that of Pemex and they currently have a negative Outlook for the country's creditworthiness. Recently, talk by AMLO about increasing spending at Pemex for a new project has been dismissed and the project put on hold. Nevertheless, Pemex's situation and its link to the sovereign credit standing of the country are possibly the greatest concern to investors interested in holding Mexican debt.

IV – An investment idea

Considering the macroeconomic trends, we believe there are interesting investment opportunities in Mexico. We will therefore now consider what are the consequences of the recent backdrop for bond investors and what are the investment opportunities available.

All in all, the prospect for the sovereign bond market in Mexico is positive. It is certainly true that GDP growth is reducing, but in the short term this effect may be attributed to the central bank's action to rein in inflation, while the economic potential of the country remains unscathed. Long term investors can therefore expect a return to an average larger growth of the order of more than 2%. This will help keep the country's finances in order, which, nevertheless, are as of now in not a bad condition, with a debt/GDP ratio of around 46%, decreasing from a peak of 47.5% in 2016 and set to remain stable and sustainable in accordance with the latest government's budget. No problems are therefore in sight as for what concerns the country's ability to face its obligations.

In addition, the signals from sharply lowering inflation and the consequent stop to rate hikes provide a more positive environment to sustain bond prices. Indeed, as the stock market continues to underperform (even though there may be a lot of upside left there), sovereign debt is still on track to provide a good investment opportunity in the short term, after the good returns offered in 2018.

Considering more specifically the available investment opportunities, the main opportunities are in the short-medium end of the yield curve.

The 1-year yield has been declining from 8.671% in December 2018 to a current 8.09%. According to recent forecast the trend is set to continue to 7.4% by the end of 2019, signalling that room to price gains is large (*Figure 12*).

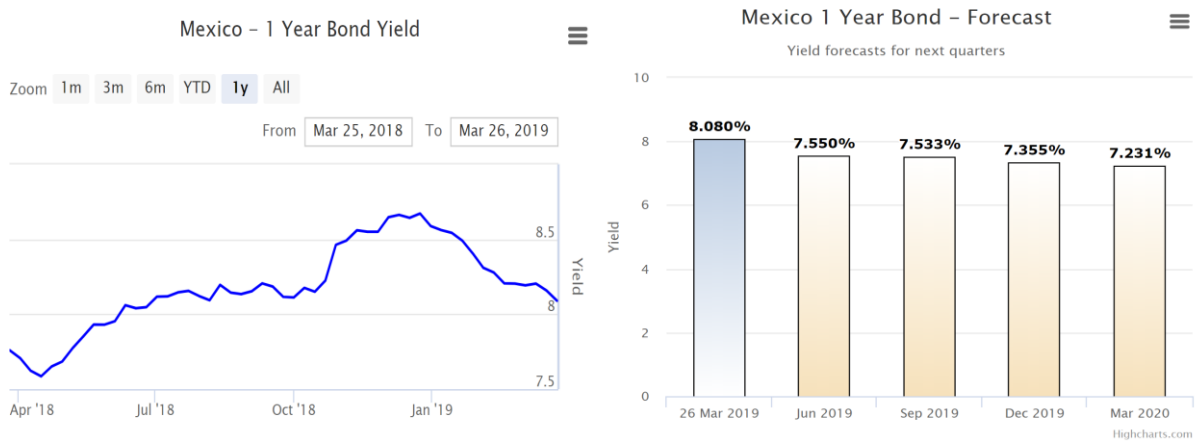

Figure 12: Mexico's 1-year bond yield performance and forecasts. *Source: worldgovernmentbonds.com*

The trend is exactly the same as that followed by the 3-year, 5-year and 7-year notes, for all of which a further downward move of the curve is expected.

Moving to longer term securities, the same situation is true for the 10-year note, while in the range of 15 to 30 years the expectation is for a reduction of 40 to 35 bps in the yields from now and September.

In conclusion, the yield curve appears set to move downward and steepen.

Investors might consider therefore a long position of 1-3-year bonds as a way to reap this expected price surge while at the same time keep a close exit from the investment in case of a downgrade in the nation's rating in the next reviews by rating agencies. If this risk doesn't materialise, a longer horizon position could be an interesting consideration, if noticing that the 5y probability of default implied in 5y CDS is of now 2.5% and that the cost of such protection has been declining steadily since AMLO's election, in a sign that after all investors' confidence might be creeping back after all (*Figure 13*).

Figure 13: Mexico's 5-year CDSs. *Source: worldgovernmentbonds.com*

V – Sources

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