

LATIN AMERICA

BONDS RISE ABOVE POLITICAL RISK

The coming year will see plenty of political uncertainty in Latin America as eight countries in the region go to the polls. But as **Josh Goodman** reports, even this is not damaging demand for Latin American corporate bonds, which are trading tighter than ever

Among veteran Latin American investors, it's a time-tested maxim that everything boils down to politics. A cursory look at the region today would give ample reason for concern. Near daily threats of presidential impeachment in Brazil; the likely election of a leftist leader in Mexico; a resurgence of anti-American sentiment from Venezuela to Argentina – it's hard to imagine a more perfect storm.

But despite the political turbulence, Latin America has never appeared more attractive. For the first time, investors brimming with cash are looking beyond the scary headlines and focusing on the underlying economic fundamentals. On October 3, the average spread on JPMorgan's benchmark Emerging Market Bond Index Plus (Embi+), 60% of which is weighted in Latin American debt, narrowed to an all-time low of 241 basis points over US Treasuries. Since then, spreads have widened to about 275 basis points on expectations of continued tightening of US interest rates. By comparison, as recently as 2002, spreads were trading over 1,000.

Behind the surge in prices, and consequent drop in yields, has been the global liquidity glut. Foreign investors, fed up with tepid returns from US and European securities, have been flocking to the asset class.

According to fund research website EmergingPortfolio.com, Latin American-dedicated fixed-income funds received a net inflow of \$4.5 billion this year, equal to nearly 25% of their total assets at the start of the year.

The lion's share of the new money went to Ashmore Investment Management and Pimco, collectively managers of more than \$12 billion in emerging market debt. Also contributing to a spike in prices is renewed interest in the region by investment banks and the growth of hedge funds and exchange-traded funds that track the Embi+ or other indices. "Emerging markets are becoming part of the investment mainstream," says Siobhan Manning Morden, desk analyst at Wachovia Securities in New

York. "The proof is that when General Motors and the US auto sector were downgraded to junk status in August there was not a single sign of contagion in Latin America."

More amazingly, given Latin America's chequered credit history, investors are shrugging off increasingly loud political noise. Elections in eight Latin American countries are taking place next year, including economic heavyweights Brazil and Mexico. Although the outcome of most races is difficult to predict, leftist parties are expected to extend gains made across the region since 2001.

"It's astounding the complete divorce of investment activity from politics, given some of the very serious problems facing the region's governments," says Enrique Alvarez, strategist at research firm Ideaglobal in New York.



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Ricardo Amorim, WestLB

That's especially true in the case of Brazil, with more than \$460 billion in public sector debt – 16% of all emerging market debt – the very lynchpin of the emerging markets. Mired in a vote-buying scandal, and facing an uphill re-election battle, Brazil's market-friendly president Luiz Inacio 'Lula' da Silva has all but lost the necessary momentum to push through congress tax reform and a controversial plan to eliminate budget deficits. Although a recession is unlikely for Latin America's biggest economy, thanks to a record export of commodities to China, growth is expected to slow to 3% this year compared with 4.9% in 2004.

Despite the slowdown, Moody's upgraded Brazil's credit rating to Ba3 on October 12 from B1, citing the scandal's scant

impact on bond prices as proof of Brazil's improved debt structure and "newly acquired resilience" to political shocks. Since taking office in 2002, Lula's economic team has undertaken an almost Herculean effort to reduce debt levels, from 63% of GDP in 2002 to a current 51%. The upgrade was the second by the rating agency since September 2004.

For some analysts, the market has totally undervalued the scandal's impact. A day after the Moody's upgrade, Brazil's congress – perhaps anticipating the bitterness that awaits next year's presidential race – defeated what should have been popular tax

incentive legislation for targeted export industries. "This episode calls into serious question the newly acquired resilience theory that Moody's and other Brazil boosters have been trumpeting for the last few months," says Christian Stracke, head of emerging market research for CreditSights. "Governability is a serious issue."

Insulating Brazil from the political turbulence are some stellar fundamentals which are the envy of the region. Tax receipts from a \$35 billion trade surplus this year are helping to boost the public sector's primary surplus to over 6% of GDP. On the



brink of default after its 1998 devaluation, the country, by some analysts' measures, could be poised to achieve investment-grade status within another one or two years. Despite the socialist roots of his Workers Party, Lula has proven a staunch supporter of free-market reforms. Even if he is replaced, "the next government is likely to be even more market friendly, not less," says Ricardo Amorim, head of emerging market research for WestLB in New York.

If Brazil is Wall Street's star pupil, then Mexico, the other Latin heavyweight, is the class underachiever. Although Mexico boasts an even stronger fiscal situation than Brazil's, its investment-grade bonds, with yields of 6-7%, offer none of the return and significantly more political risk. First in the polls to replace outgoing president Vicente Fox next year is the leftist former mayor of Mexico City, Andrés Manuel Lopez Obrador. Despite

agree that, for now, that possibility remains remote, pointing out that rates in the US and Japan remain at historically low levels, making high-yield emerging market debt more attractive.

Unlike past years, when high-net-worth insiders and investment banks dominated Latin bond markets, the archetypal Latin investor today is the same investment fund to which millions of Americans and Europeans entrust their retirement savings. "The move of pension funds and other strategic investors into the asset class can be expected to continue for many years," says Jerome Booth, head of research at Ashmore Investment Management in London.

But in the hunt for high yield, Latin American borrowers now find themselves in the awkward position of not being considered sufficiently risky – and therefore insufficiently rewarding. With the influx of so much foreign money, prices have inflated to the point that Latin American credits of all ratings trade nearly flat to their US counterparts, even though Latin America still poses the threat of sovereign default.

Chile may be the best example of this paradox. Despite a high dependence on the price of copper, its main export, and uncertainty surrounding its December presidential elections – low by emerging market standards, but still a factor – Chile's Baa1/A-bonds now trade flat to double-A rated Wal-Mart. "Valuations are the biggest hurdle next year," says Carl Ross, head of emerging market research at Bear Stearns in New York.

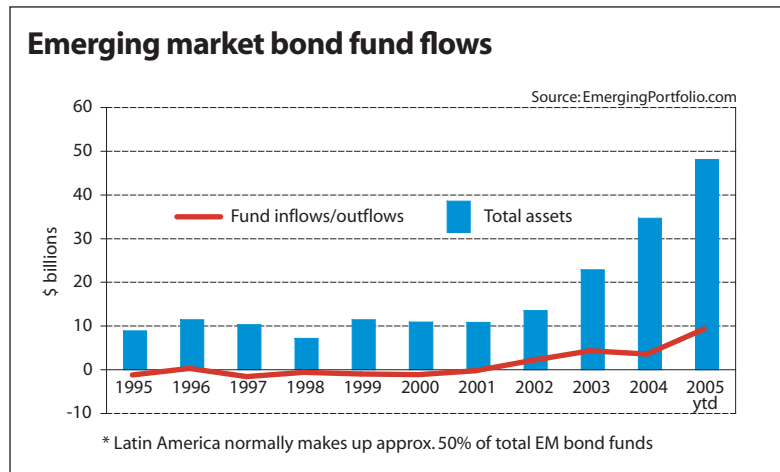
Some analysts are beginning to sound the alarm. The last time Latin America was awash with liquidity was the 1970s, when the region was a popular destination for recycling petrodollars. Eventually

the buying spree ended, giving way to the 1982 Mexican debt crisis and the so-called 'lost decade' of economic stagnation across the region.

This time around, the cash is being pumped in from high commodity prices and the US real-estate market. "Elections are coming up, policy across the region is moving towards [Venezuelan president Hugo] Chavez and everyone is on commodity steroids," says CreditSights' Stracke. "Am I missing something or have people totally lost perspective?"

The bulls, however, do have some solid evidence to back up their claims that the rally in Latin American debt is justified. Most importantly, Latin sovereigns are decreasing – not increasing – their dependence on foreign capital to meet their refinancing needs. Thanks to a healthy flow of trade with Asia and the development of pension funds and other local investors, net external liabilities across the region have fallen by 29% since 2003 to \$462 billion, according to research by US investment bank BCP Securities.

Shrinking debt-to-GDP ratios, expected to reach 52% at the end of the year versus a high of 61.5% in 2002, are another sign of the region's relative health. "It's true that the global pattern paints a dark cloud for the US, but Latin America could be better



recent approaches to Wall Street, Lopez Obrador remains at best an untested convert to economic orthodoxy.

More worrisome, whoever wins Mexico's election will inherit a divided congress that has fallen way off the reform bandwagon the past few years. At the same time, intense competition from Chinese manufacturers threatens to chip away at the trade privileges with the US afforded by Nafta (North American Free Trade Agreement). "Of the nine biggest economies in Latin America, Mexico has been among the three most sluggish, in terms of growth, over the past three years, averaging around 2.3%," says Amorim.

By contrast, Latin America's other investment-grade borrower, Chile, has posted GDP growth of over 6% in the past two years, thanks to strong export growth. The region as a whole is expected to grow 4.5% in 2005 and nearly the same amount next year.

Interest rate fears

Being so dependent on global liquidity, the concern for the region is whether rising US interest rates will reverse the flow of capital back into higher-yielding US Treasuries. In the absence of any abrupt rate hike of 50 basis points or more, most analysts

positioned to withstand a squall in the global financial marketplace,” says Walter Molano, BCP’s chief economist at Greenwich in Connecticut.

Overtaking Eurobonds

The best evidence of the global liquidity glut is spectacular growth in local bond markets. For the first time ever, local market turnover in Latin America surpassed Eurobond trading levels. According to the EMTA (formerly the Emerging Markets Traders Association), local instrument trades in the second quarter totalled \$653 billion – a 53% increase versus 2004 – versus \$638 billion for Eurobond trading. The trend is likely to continue so long as spreads on global bonds remain tight and the macroeconomic outlook remains upbeat.

Brazilian and Mexican debt have been the most frequently traded local instruments. The underlying logic to this is easy to grasp. Whereas the yield on Brazil’s 2040 global bond – the most widely traded instrument in emerging markets – has hovered all year around 7–8%, a similarly long-term bond issued locally can fetch 17–18%.

Global issues in local currencies are also gaining steam. Colombia kicked off the trend in 2004 by raising \$375 million in local pesos. More recently, in September, America Movil, a telecommunications firm, became the first Mexican corporate to issue a peso bond outside its borders when it placed a 10-year 5 billion peso note in Europe and the US. For investors, local issues are attractive as a hedge against a weakening dollar. Meanwhile, for Latin sovereigns and corporates, issuing in the same currency in which they collect tax and revenue lowers their exposure to global volatility.

By far the biggest borrower has been Brazil. In September, the government went to market with its first ever global bond issued in local currency, the real. The 3.4 billion real (\$1.5 billion) paper, which matures in 2016, drew heavy demand with yields of 12.75%. Paving the way for the ground-breaking sale – another is rumoured to be in the pipeline – were smaller sales by corporate issuers Banco Bradesco, Eletropaulo Metropolitana and Banco Votorantim. “For investors who are upbeat on the region it’s a home run,” says Jim Barrineau, senior vice-president in emerging market research at Alliance Capital Management. “Not only do you get higher yield, but there’s the extra kick provided by a strengthening currency.”

To be sure, Latin America has courted foreign money in the past, often with unfortunate consequences. But rarely with such vigour. In November, Brazil unveiled plans for a one-stop internet site where foreign investors will be able to register to buy locally traded securities in 24 hours compared with the current 10 days. “Traditionally big funds wouldn’t even be allowed to invest in local markets,” says Roger Scher, head of sovereign ratings for Fitch Ratings in New York. “The barriers to entry are high: you need a partner, there are capital controls and tax issues to resolve. But investors are so yield-starved they’re willing to play ball.”

Even deadbeat Argentina is seeing a piece of the action. Less than a year after restructuring some \$62 billion in defaulted

bonds, the country came to market in October with \$632 million in dollar-denominated 10-year bonds. Most of the paper, which carried a fixed 8.75% yield, was bought locally by state-run banks. But foreign investors picked up enough of the instruments to lend credence to the argument that the sign of genius is a short memory in a bull market.

Indeed, thanks to heavy intervention by Argentina’s central bank, which aims to keep the peso artificially low to spur exports, Argentine bonds have been among the top-performing LatAm securities this year. Since the start of the year, its weighting among dedicated emerging market funds has almost doubled to over 6%.

Corporates sitting pretty

Ahead of next year’s election cycle, big borrowers have taken advantage of the market’s sweet spot to pre-finance the bulk of their 2006 debt obligations. As a result, if sentiment remains upbeat, it’s likely to be corporates – especially export-driven companies and their banks – which see the bulk of the windfall.

Companies that successfully weathered the financing crunch in the wake of Brazil’s devaluation and Argentina’s default are now reaping the rewards. “A few years ago things were so bad, Brazilian companies couldn’t even secure trade financing for two or three weeks,” says Dan Kastholm, managing director for Latin American corporate finance at Fitch Ratings. “Now they’re able to issue long and large at the lowest historical rates ever seen.”

A sign of confidence in the corporate market is the emergence of perpetual bonds. Driven by strong demand from Asian retail

“Latin America could be better positioned [than the US] to withstand a squall in the global financial marketplace”

Walter Molano, BCP

investors, a handful of top-shelf companies, starting with Mexican oil giant Pemex in 2004, have started issuing papers with no fixed maturity date. “This would never have been possible even a few years ago,” says IdeaGlobal’s Alvarez. Among the companies to have successfully placed deals are Mexico’s largest tortilla maker Gruma (\$300m, 7.75% coupon), Brazilian steelmaker Companhia Siderurgica Nacional (\$500m, 9.50%) and Brazilian construction firm Odebrecht (\$200m, 9.625%). Others, such as Chile’s Codelco, the world’s largest copper exporter, have achieved advantageous financing terms by issuing 30-year bonds.

Even more than sovereigns, corporate bonds are vulnerable to a sudden collapse in commodity prices because much of their growth derives from overseas trade. But for now, such concerns couldn’t be farther from the forefront. With the region’s debt market on fire, who’s arguing? ◉