Economic Viewpoint

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South America: Soon to see some light at the end of the tunnel?

Opportunities for bold investors

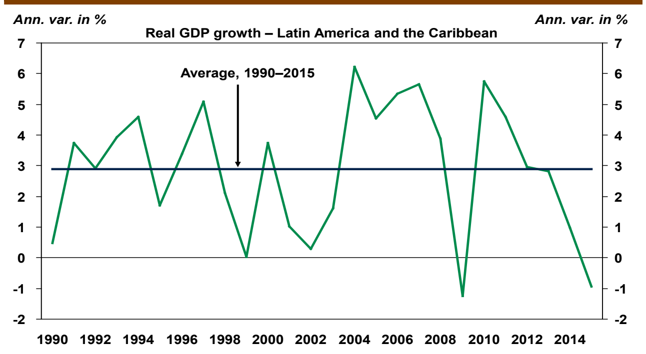
Several factors have undermined economic growth in South America in recent years. The slump in commodity prices, the slowdown in global trade and the Chinese economy, and numerous political problems have given the region a rough ride. We note that Brazil and Argentina have been particularly hard hit. However, the situation now appears to be improving, with the help of encouraging political reforms. Things are looking brighter for the years ahead, for South America and for investors who take an interest in this region.

Since 1990, the average annual real GDP growth of Latin America as a whole has been close to 3.0%. However, after years of fast economic growth fuelled by a commodity boom, South America[1] has recently been languishing in the doldrums (graph 1). The slump in commodity prices, soft Chinese demand, high inflation largely caused by depreciation in South American currencies against the U.S. dollar, and numerous political problems have even driven a few countries (Brazil first and foremost) into recession. For the first time in 30 years, South America seems to be on the verge of having two straight years of contraction in real GDP, in 2015 and 2016. This economic reversal is being observed in a few countries of the region (graph 2), but particularly in Brazil which, with around 3% of global GDP based on purchasing power parity (PPP) in 2014, carries a good deal of weight.

GROWTH THAT IS DEPENDENT ON GLOBAL CONDITIONS AND THE COMMODITIES MARKET

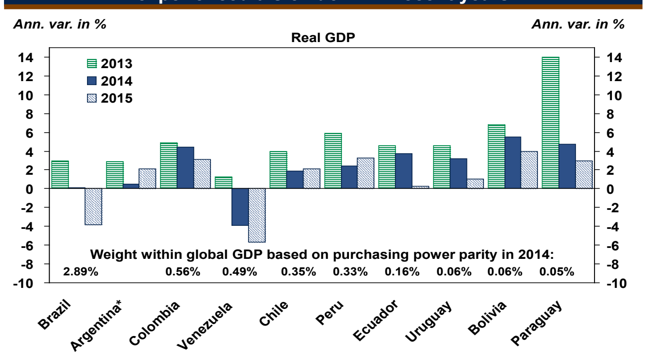
The weakness of the Brazilian economy in particular and of the South American economies in general is partly due to the slowdown of the global economy. The slower growth in imports in most of the advanced nations, and in emerging countries like China, has done considerable damage (graph 3 on page 2).

Graph 1 – In the past two years, growth has lagged well below the historical average



Sources: World Bank and Desjardins, Economic Studies

Graph 2 – Most of the countries of South America have experienced a slowdown in recent years



* The World Bank does not calculate GDP based on purchasing power parity for Argentina.
Sources: World Bank and Desjardins, Economic Studies

In fact, the rise of the Chinese economy since the beginning of the 2000s has had major negative consequences on the

[1] This report mainly discusses the major countries of South America. However, some data released by international institutions such as the World Bank and the International Monetary Fund cover Latin America (which also includes the countries of Central America, including Mexico) and the Caribbean. We published an analysis on Mexico in May 2016, www.desjardins.com/ressources/pdf/pv160505-e.pdf?resVer=1462452919000.

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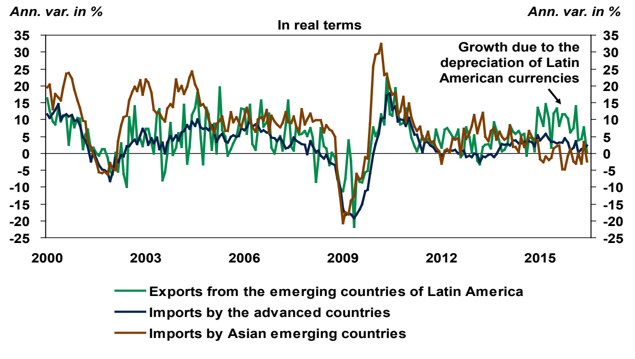
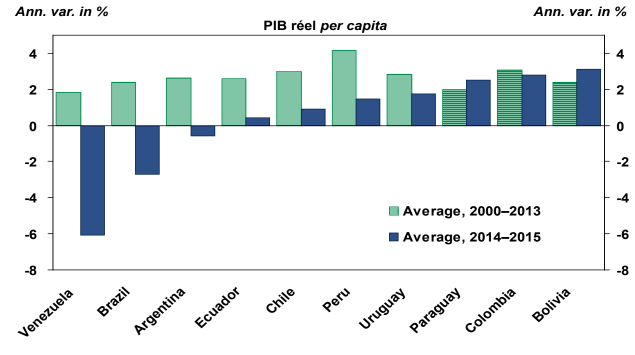
Graph 3 – Growth in exports from the emerging countries of Latin America is keeping pace with the global cycle



Sources: CPB Netherlands Bureau for Economic Policy Analysis and Desjardins, Economic Studies

Graph 4 – GDP per capita has also deteriorated in some countries of the region



Sources: World Bank and Desjardins, Economic Studies

South American manufacturing sector. According to the World Bank, Chinese competition caused a shortfall of over 6% in Brazilian exports of manufactured products between 2001 and 2011. For the rest of the region, that shortfall is between 3% and 7%. On the other hand, China's fast development has boosted exports of agricultural products by over 10%, and mining products by 20%. Not only do global economic conditions, primarily those of China, clearly influence the volume of exports from South America, but they also dictate the type of its exports.

The commodities market has become increasingly important to the South American economies during the latest upward cycle. Oil prices in particular are key to the exports and investments of Columbia, Ecuador and Venezuela. Brazil, Chile and Peru are also highly dependent on commodities, especially in the mining and agricultural sectors.

But we must not overlook the influence of currency movements on trade, especially when they are intense, as has been the case in recent years. Consequently, despite global growth that was still slow in 2015, Brazil's real exports climbed by 6.1% last year, thanks to depreciation by its own currency, the real.

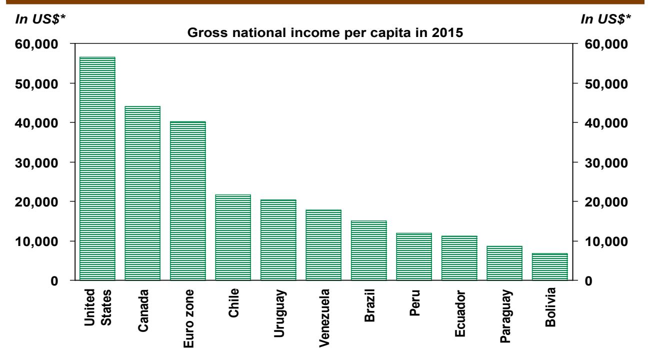
POVERTY IS STILL VERY PREVALENT

Despite the progress of recent decades, poverty is still rampant in South America, and the situation has deteriorated in recent years with downturns in real GDP per capita in Venezuela, Brazil and Argentina (graph 4). We also note that national income per capita is still extremely low in South America compared with the advanced countries (graph 5). But most of the major countries of the region find themselves better off than China or India.

CLOSE-UP ON BRAZIL

Boasting the seventh largest GDP in the world based on PPP, Brazil is by far the largest economy of South America.

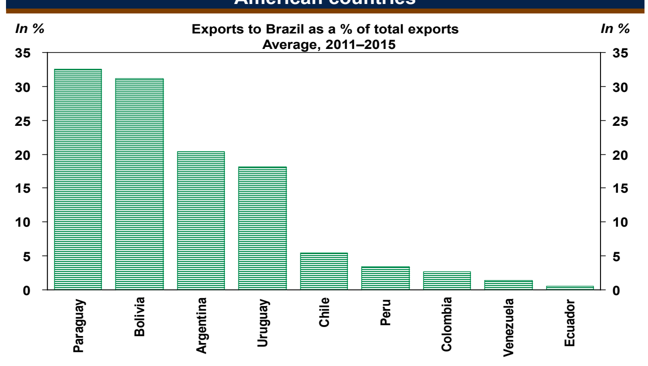
Graph 5 – The South American countries lag far behind in terms of income per capita



* According to purchasing power parity.
Sources: World Bank and Desjardins, Economic Studies

It represents 42% of Latin America excluding Mexico. As a result, the swings of its economy greatly affect the other countries of the region. Brazil receives the lion's share of the exports of Argentina, Bolivia, Paraguay and Uruguay (graph 6). At the same time, we note that despite its size, Brazilian demand is far less important to the countries on the continent's Pacific coast. For Venezuela, Colombia and Ecuador, the primary export destination is the United States. For Chile and Peru (as well as for Brazil), it is China.

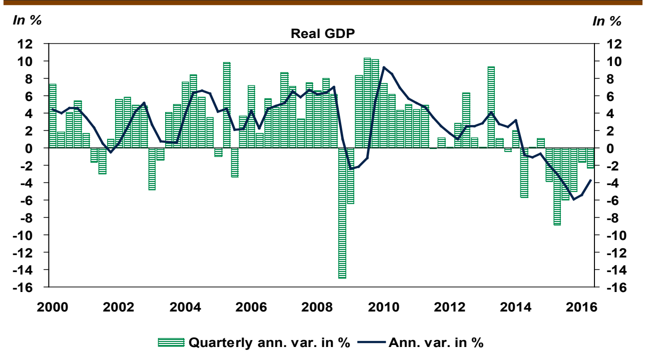
Graph 6 – Brazil is an important destination for many South American countries



Sources: International Monetary Fund and Desjardins, Economic Studies

The Brazilian economy has done well in the 2000s, apart from 2008–2009 when the global economy collapsed (graph 7). Between 2000 and mid-2013, it recorded average real growth of 3.6%. Its exports particularly benefited from rising prices for commodities (iron, oil, etc.) and agricultural goods (soybeans, sugar, coffee, etc.). It has also benefited from the general development of the emerging countries, in particular by being a member of the BRIC block (Brazil, Russia, India and China), that new pole of global growth. In fact, foreign investment has expanded fairly quickly, reaching an average annual change of 19.6% between 2000 and 2013. A relatively expansionist budgetary policy throughout the period has also supported growth.

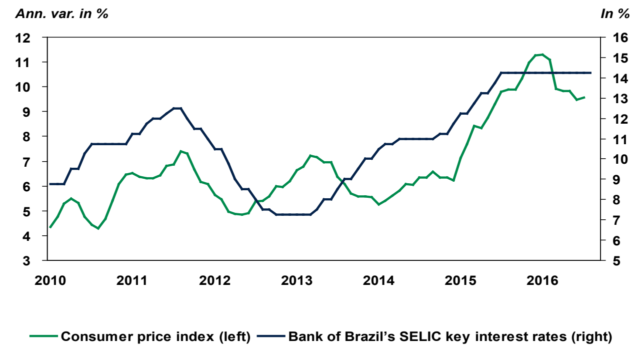
Graph 7 – Up until the recent period of weakness, the Brazilian economy had shown fairly strong growth



Sources: Central Statistical Organisation and Desjardins, Economic Studies

But this virtuous circle has been replaced with a far more difficult situation. The slump in commodity prices, political and financial scandals (affecting Petrobras in particular, Brazil's largest company), the slowdown in Chinese demand and a new wariness on the part of international markets towards the emerging economies, have all conspired to rock the Brazilian economy. It now finds itself in a recession from which it has yet to completely emerge. Real GDP has pulled back by 7.9% between the cyclical peak of the first quarter of 2014 and the beginning of 2016, recording seven quarters of contraction during the period, including six in a row. The World Cup of soccer in 2014 and the Rio Olympics this summer do not seem to have managed to give a boost to the Brazilian economy. As mentioned earlier, the currency's depreciation, losing nearly half of its value against the U.S. dollar since 2013, has provided some support for exports. However, the internal cost of that depreciation has manifested itself in rising inflation and falling foreign investment. Moreover, the Bank of Brazil has been forced to react by tightening its monetary policy several times, raising the main key interest rate by 700 basis points (from 7.25% to 14.25%) since 2013 (graph 8).

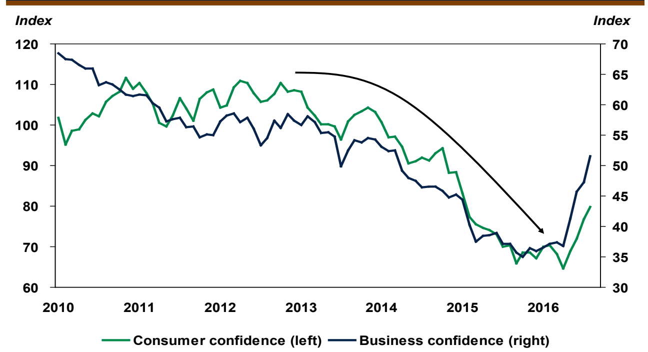
Graph 8 – A falling currency and rising inflation have led the Bank of Brazil to tighten its monetary policy



Sources: Banco Central do Brasil, Datastream and Desjardins, Economic Studies

This state of affairs has greatly affected the mood of economic agents. Both business and consumer confidence indexes in Brazil have dwindled (graph 9).

Graph 9 – Confidence has eroded considerably in Brazil



Sources: Fundacao Getulio Vargas, Brazilian National Confederation of Industry and Desjardins, Economic Studies

FAIR WEATHER ON THE HORIZON

On the bright side, we note that the Brazilian economy appears to be nearing a turning point. Many indicators, such as confidence indexes, have begun heading up since the start of the spring. The annual changes in retail sales and industrial production are still broadly negative, but the downturns are already less severe. The monthly economic activity index compiled by the National Bank of Brazil has risen in two of the past three months.

Since the beginning of the year, many commodity prices have been stabilizing or increasing, giving support to this improvement in the Brazilian economy. For example, international prices for iron ore, the country's main export, have soared by 39.8% since the start of the year. Coffee prices are up by 28.2%, oil prices by 25.2%. Soybean prices have risen more slowly over the summer, but this comes on the heels of a spike of 31.7% in the first half of 2016. Since the start of the year, we nevertheless note a gain of 10.6%.

This fairly generalized upward movement in the prices of Brazilian exports is also one of the factors that have enabled the currency to appreciate by 29.5% since the January low. Furthermore, Brazil's main stock market index has boomed by 60.3% since last January's low, whereas it had contracted by 39.4% since its peak of 2014.

POLITICAL SUPPORT FOR GROWTH

In Brazil: One of the factors that are helping Brazil glimpse some light at the end of the tunnel is the change in the country's leadership. To make way for the parliamentary impeachment process, President Dilma Rousseff—in office since January 2011, and re-elected in 2014—was temporarily removed from power in May 2016. She was then permanently impeached by the Senate on August 31. The numerous political scandals linked to the Rousseff administration and to the Brazilian ruling class in general (especially those associated with the Petrobras oil company) were factors underlying the deteriorating confidence and decline in investment of recent years. The government led by Vice-President Michel Temer has been welcomed very favourably by the markets, notably thanks to high-calibre appointments to important economic positions. It remains to be seen whether the progress achieved by Mr. Temer's administration will continue.

<u>In Argentina</u>: Argentina has also experienced serious economic, financial and political problems in recent years. However, the replacement of the populist regimes of Christina Fernandez and, before that, her husband Nestor Kirchner by the reformist government led by Mauricio Macri is generating a good deal of optimism. In the very short term, the reforms could be harmful to economic growth, because the government is trying to regain financial credibility by reforming a system that is largely based on subsidies and state-sponsored waste. However, we are already seeing reductions to import trade barriers and export taxes. In the longer term, if these efforts are not curtailed through legislative action by supporters of the former regime, they should bear fruit and accelerate Argentina's economic growth. We already note that the government has managed to return to the international financial markets with its first bond issues after 15 years of "exile". One of the challenges that remain to be tackled is the necessity of easing the Argentinian inflation rate, which still stands at around 35%. Investments in infrastructure, especially in the energy sector, will also be needed to generate more stable and lively economic growth.

<u>In Peru</u>: Although it is not terribly dependent on the Brazilian economy, the Peruvian economy nevertheless has slowed due to the weakness of Chinese demand and the slump in commodity prices, especially that of copper. Yet, the growth rate in 2015 still reached an enviable 3.2%. One of the positive factors for the Peruvian economy is the soundness of its institutions, especially where the management of the economy is concerned. The recent election of Pedro Pablo Kuczynski as President, over the right-wing populist candidate Keiko Fujimori, should mean that this sound and prudent management of the Peruvian economy will continue to promote growth.

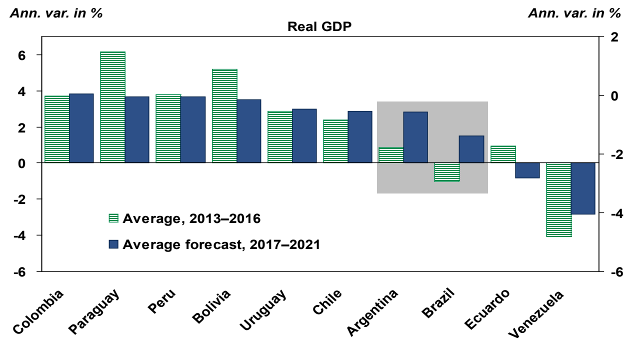
<u>In Colombia</u>: In this country it is not so much a change of government that could support economic growth, but rather the recent peace accord between the government and the revolutionary army that have been waging war for 52 years. If it is endorsed by the population through a referendum to be held on October 2, this permanent cease-fire should promote investment and tourism.

<u>But not yet in Venezuela</u>: Venezuela is still in the throes of a serious recession, in fact a real economic crisis. Real GDP reportedly contracted by 3.9% in 2014 and by 5.7% in 2015. In April, the International Monetary Fund (IMF) was forecasting a slump of nearly 8.0% in 2016 and another, of 4.5%, in 2017. Obviously, it is falling oil prices that are to blame for these economic woes. That market represents nearly 95% of Venezuela's exports, with the United States, India and China as the main destinations. Public finances are a complete mess, inflation is hovering around 800%, the currency has totally collapsed and power outages and problems in the distribution of essential goods are commonplace. For the time being, the government is receiving financing from China, but great political and economic uncertainty prevails.

INVESTMENT OUTLOOK

Times have generally been tough for the South American economy in recent years, in particular for Brazil and the countries that have close trade ties with it. However, the stabilization of the commodities market and the moderate continuation of price increases should give a lift to the economy of the entire region. Some indicators are already showing this, and it is reasonable to assume that this new trend will continue. In fact, the IMF's forecasts are calling for such improvement (graph 10 on page 5). Despite a downward revision of nearly all the growth scenarios due to concerns relating to the Brexit vote (which actually should not affect this region much), that organization has revised its forecasts for Latin America upwards slightly (+0.1% in 2016 and in 2017). The IMF is now predicting a 0.4% contraction of real GDP in this region this year, and a 1.6% gain next year. The upward revision mainly affected Brazil. This economic spurt should promote the renewal of faster growth in the domestic market, and in investment, in Brazil and Argentina. The IMF's forecasts for the

Graph 10 – The years to come are looking brighter for Argentina and Brazil



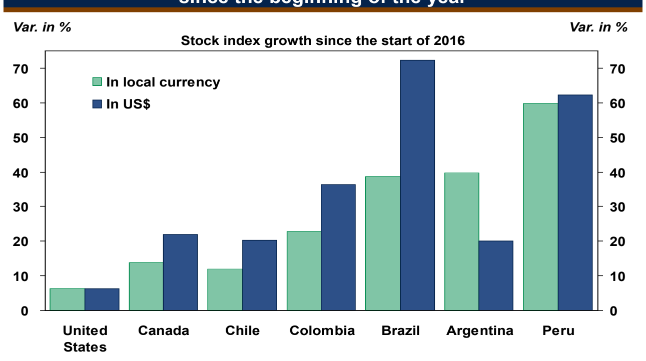
Sources: International Monetary Fund and Desjardins, Economic Studies

other countries do not really change things, but they were prepared last April based on rather pessimistic forecasts about commodity prices.

STOCK MARKETS

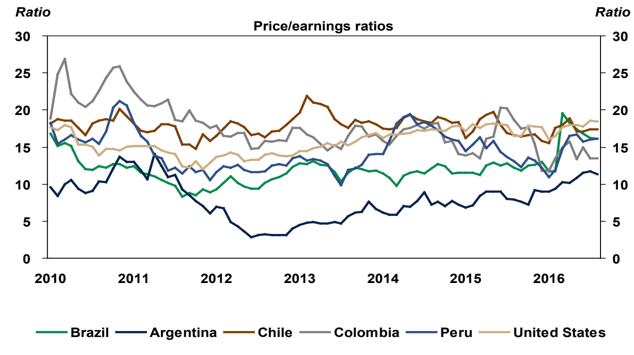
South American stock markets, which have been depressed throughout the slowdown and contraction phase, have started picking up in recent months. Since the beginning of the year, the main stock indexes have seen very strong growth that looks even better when expressed in U.S. dollars (with the exception of Argentina). Peru comes out on top in this department: its stock market has boomed by almost 60% so far in 2016 (graph 11). However, these gains come on the heels of some fairly large contractions in 2015. Actually, the price/earnings ratios do not appear to be exaggerated, and they generally stand below what is observed in the United States (graph 12). If the economy keeps improving and confidence recovers, higher profits should materialize as the stock indexes keep rising. Indeed, the outlook on profits is relatively good, similar to that of the United States or Canada (except for the spike in Peru) (graph 13). It has generally been improving in recent months.

Graph 11 – Stock markets have been booming in South America since the beginning of the year



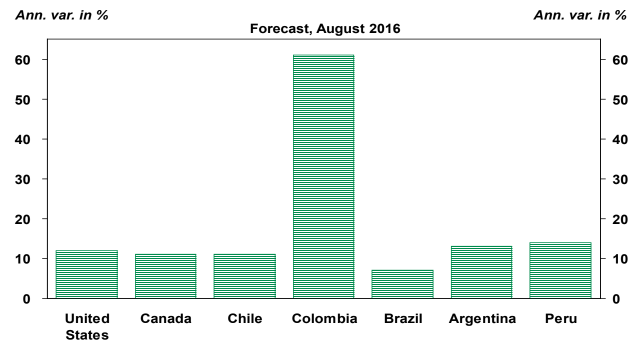
Sources: Bloomberg and Desjardins, Economic Studies

Graph 12 – Price/earnings ratios are not showing any major overvaluations



Sources: Institutional Broker's Estimate System, Datastream and Desjardins, Economic Studies

Graph 13 – Forecasts of long-term, average, annual growth of earnings per share



Sources: Institutional Broker's Estimate System, Datastream and Desjardins, Economic Studies

For Canadian or U.S. investors, the upswing in the South American stock markets has been inflated by currency exchange trends. The sharp appreciation of the currencies of many emerging countries since the beginning of the year is not likely to continue, however. The relatively strong inflation rates in some countries of the region, especially Brazil and Argentina, should prevent the currencies of those countries from advancing further. The prospect of another key interest rate hike by the Federal Reserve represents another constraint on the appreciation of emerging currencies, one that could even lead to an outflow of capital. We cannot rule out the possibility of more optimistic confidence supporting both the economy and the currencies but, in the short or medium term, those factors should not inflate the stock market value when calculated in Canadian or U.S. dollars to the same degree as they have been doing.

CONCLUSION

After some difficult years, it is undeniable that a gentle breeze of optimism is starting to blow over South America. Many of the global and national impediments that had been undermining economic growth in recent years have started to fade away. It is too early to talk about a new momentum, but things are not as gloomy as they were. First and foremost, the political landscape seems more conducive, especially in Brazil and Argentina, to a sustainable renewal of confidence that could attract more domestic and foreign investments.

However, the problems have not all disappeared, and the South American economy remains fragile and vulnerable to the ups and downs of the international commodities market and of demand from China and the advanced countries. That fragility also stems from long-term weaknesses such as endemic poverty, persistent income inequality and major corruption problems. To all those we must add more recent phenomena like the zika virus crisis, which is likely to hinder tourism.

But attractive opportunities do exist for these economies in the medium term. To take advantage of them, it will be necessary to undertake or continue reforms, especially those pertaining to the transparency of public institutions. Improved productivity, through education and more developed infrastructures, is key to enable the countries of South America to reap greater benefit from global growth, especially since such growth is likely to stay relatively slow, compared with previous cycles. Improved intracontinental trade via the Mercosur zone (the common market of the south) will have to continue, and agreements will need to be reached with other parts of the world. On this point, the Trans-Pacific Partnership (TPP) represented a good opportunity for Peru and Chile (along with Mexico), which were planning to participate, but political pressures, particularly in the United States, are such that it probably will not see the light of day.

If global economic growth manages to maintain a satisfactory pace and the political reforms keep moving forward, the opportunities for investors who are interested in South America should proliferate and become more attractive, although they will remain relatively risky.

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