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PORTFOLIO INVESTMENT STRATEGY

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The Latin American Risk Review

- Argentina: Growth confounds the skeptics
- Brazil: Local elections lack ringing endorsement of Lula.
- Mexico: Wolves pounce on AMLO
- Venezuela: Oil surge reins cash on Chavez regime
- Peru: Key Toledo ranks continue to thin out

ARGENTINA

Not so long ago, we came near to having yet another new president in Argentina. The presidential plane, Tango I, suffered a fire in one of its engines soon after take-off (a dangerous moment for engine trouble). The pilot managed to land safely, and some soiled underwear was the only consequence. Rolls Royce engineers who examined the faulty engine declared that it was "unserviceable" from the outset, and the plane should never have flown in that condition. Charitable comments may mention budgetary restrictions, but the truth is that we are faced with just one more regional manifestation of the attitude to following safety precautions, which range from the use of seat belts in cars to the proper >care and maintenance of delicate equipment as per the manuals. If they cannot bother to do it for the presidential plane, what chance does anyone else have?

Contrary to other analysts, I still fail to see the signs of "slowdown" in the local economy. Activity was up 8.8 % in August, above the 8-month cumulative total of 8.6 %. Construction in September rose by 17%, accumulating an 23.8 % advance over 9 months, and industrial production in the same month was 10.54 % higher (car output jumped by 56.9 %, accumulating 53.3 % in the year). Capacity utilisation in industry stood at 72 % in September, compared to 67.4 % a year earlier. Tax collection rose by 30.4 % in September and 27.2 % in October. Trade also continues to be buoyant, with imports up 78 % in August (71 % in the first 8 months), whereas exports rose 24 % for the month, accumulating a 13 % advance in 8 months, though the volume increase was just 1 %, with the rest due to higher commodity prices.

There was also slow but steady progress on the debt front, with better offers made to help out local pension funds and small holders. One cannot fail to be surprised at the expectations arising from this matter, whose eventual solution is being dubbed as "coming out of default". How can a scalping of 75 % (still the main offer, whether this is expressed by a reduction of principal or being locked-in for 30 years at an interest rate of below 2 %) be described, as "coming out of default" is an interesting point in semantics? The more significant event was the Supreme Court decision to back the earlier conversion of dollar deposits into pesos at a rate challenged in the courts by many bank clients. In theory, those who won decisions in the other direction in lower courts and were compensated accordingly, might have to pay the money back.

Lest all the above should give the impression that all is well, remember the millions of poor still struggling for a living and the employed whose average wage is only $ 226 per month, in what is not exactly a cheap country, even post-devaluation.

BRAZIL

You cannot fool all the people all the time (Part One). The political acrobatics which Lula undertook since taking office finally took their toll at the two rounds of municipal elections which took place during October. Though the ruling PT did not do too badly overall, it lost several emblematic towns, the most symbolic of which was Sao Paulo. The PT candidate there was soundly defeated former center-right PSDB presidential candidate José Serra, whereas in Porto Alegre, the PT was overtaken on its left by the PPS, whose leadership is now mumbling about leaving the governing coalition by year-end. As these reports have insisted from the beginning, Lula drifted away from his original electoral platform at his own peril, and is now paying the price for it. Land invasions have also increased again, and an impression that some imperial "folie des grandeurs", never absent from Brazilian diplomacy, is pushing the government towards such initiatives as throwing its weight in regional conflicts, and eyeing a permanent Security Council seat (about which the US has turned around and now given its full support, some say against a promise of winning the contract for combat aircraft).

All this is happening at a time when the economic figures continue to look good. Capacity utilization is at its best since 1977, September unemployment (at 10.9 %) was 0.5 points lower than a year ago, and at its best for 2004. With motor vehicle output up 21.7 % in the first 9 months, export sales rose by 49.5 % and domestic sales by 13.8 %. Overall, industrial production is at its best level for 10 years. The economy grew by 4.2 % in the first semester. On the external front, the current account surplus to September rose by 153 % to U$ 9.65 bn.

What about the workers? The average wage as of September rose by 3.2 %, but however welcome that trend might be, it has to reverse a 7-year cumulative decline of 18.8 %, at its current level equivalent to U$ 242 per month. Lending rates continue prohibitive, particularly for consumers who have to pay from 50 % p.a. for car loans to nearly 300 % when they borrow from finance companies.

September fiscal results show a public debt equivalent to U$ 317 bn, of which nearly half is at a maturity of less than one year. Results for that month alone appear to be more in line with traditional trends than the earlier miraculous recovery. The interest bill of U$ 3.87 bn was covered by the primary surplus only to the extent of 52.7 %. The primary surplus actually declined by 22.1 %, though it was up by 22.2 % to U$ 23.5 bn in the first 9 months, covering 75 % of the u$ 32.05 bn interest bill. The overall fiscal deficit stood at U$ 8.58 bn or just over 2 % of GDP, compared to 5.2 % in 2003. It would be futile to deny that this is an impressive achievement, if it can be kept up. The benchmark SELIC rate went up by 0.5 points to 16.75 % on October 20.

Will the election results finally cause a U-turn by Lula, which many have been expecting? If the better statistics did not produce enough of a "feel-good" effect at election time, then maybe something else is needed. At a time of more world uncertainties and rising interest rates, it will not be an easy choice.

CHILE

You cannot fool all the people all the time (Part II). Chile also had local elections on October 31, and the ruling coalition was bracing itself for big advances from the Rightist opposition, whose forecasters claimed that they would equal if not overtake government candidates. However, it seems that finally rising from the emasculation that kept them away from politicking for 17 years of military government, the Chilean electorate has become perceptive. Seeing through the opposition's lack of anything more than vague and gimmicky proposals for change, they shunned away from the child molesters, cashiered Pinochet hit men and greedy savage capitalists, to back candidates from a government coalition which, after more than 14 years in power, could understandably have been on the defensive. The opposition lost 63 mayoral slots, whereas the government coalition gained 31.

In effect, in the polls for mayor (being voted for separately for the first time), the ruling coalition had a lead of over 6 points, with nearly 45 % of votes, whereas in the wider poll for municipal councilors, the gap was more than 10 points, with the coalition scoring 48 %. The alliance of Communists, Humanists and other Leftist group also did well, with 6 % of the mayoral votes and over 9 % of the councilor votes. The flagging Christian Democrat party recovered its position as the country's largest, which it had lost to the very conservative UDI. These results cast a major doubt about the opposition's chances in the December 2005 presidential and legislative polls, but also put the heat on the ruling coalition to agree on its own candidate among no less than half a dozen hopefuls.

The economy continued to be artificially fuelled by high commodity prices and offer-induced consumption. Most economists now agree, at least in private, that of the 5 % or so growth rate, at least 2 points is due to the statistical effect of commodity prices. This would explain why September unemployment, at 9.7 %, was still 0.5 points above the year-ago level, and the September index of economic perception was at the year's low of 45.3, compared to its February peak of 54.

For portfolio investors interested in corporate governance, it might be good to meditate the tactics adopted by the D&S retail group, whose chairman expelled journalists from an annual meeting, thus preventing also those shareholders who could not attend from being informed as to what went on. Amazingly, the company is also listed in ADR form on Wall St. but presumably the US regulators are too busy chasing their own miscreants to worry about the Latino immigrant stocks. In fact, nobody should be surprised. The same chairman, previously accused of beating his wife by the victim herself in an article printed in a nationwide newspaper, sent hundreds of members of his staff out early in the morning to buy up all the copies. If you beat your wife, what chance do journalists have?

COLOMBIA

Sue for peace but prepare for war appears to be the policy of president Uribe. The 2005 defense and internal security budget will jump from 3.5 to 5.3 % of GDP, for a total of some U$ 4.6 bn. A further 16,000 personnel will be recruited into the military and police forces, making a total increase of 95,000 since the president was elected in mid- 2002. With the latest increase, the country's military and security forces will total 374,125. The latest proposals for peace, in fact towards an exchange of hostages and prisoners, were made to the FARC, which has yet to react formally.

Though earnings from the leading 106 listed corporations rose by 15 % in the first 9 months of the year, the fall in unemployment fell into reverse during August, when the percentage rose from 12.9 to 13.1 %. Though this is still 1.7 points lower than the year-ago level, the more worrying figure is that of underemployment, which totalled 30.8 % (though it again was substantially lower than the 38.9 % recorded in August 2003). Until such time as the security situation improves exponentially, any lasting improvement in macro-economic performance remains problematic.

MEXICO

Though there are short-term signs of improvement in such statistics as consumption, maquiladora activity, etc.. and the high oil price awards some degree of comfort, the truth is that one should be worried about the middle and long-term outlook for Mexico.

The country is just not creating sufficient jobs to absorb the one million annual newcomers into the labour market (a fifth of that at best in formal employment), and with the decline in oil output and Chinese competition in traditional strongholds of activity does not augur well. On January 1st, textile import quotas end after 40 years. With Chinese wages a third of the Mexican level, it is expected that Mexico's share of US textile imports will plunge from 10 to 3%, all of which will be taken up by China, whose share will jump from 11 to 18 %. The industry is a major employer.

The political drift does not help either, with the only satisfaction being the slap on the face to all those who thought than an end to PRI government was the answer to all the country's problems. Not only have the existing problems not been solved, but new ones have arisen, such as a lack of governability and flagging from the top. PEMEX, that den of corruption, is no better under Fox, with the latest scandal being the U$ 800 million of money transferred to its unions for "housing and medical needs", some of it possibly finding its way into the coffers of the PRI, which would be poetic justice.

With Federal District mayor AMLO apparently unsinkable as presidential front-runner, another attempt is being made to squeeze him, this time through an educational reform under the guise of "decentralisation" but in fact putting a heavy additional financial burden on local authorities. The experience of most countries which have transferred educational funding from central to local government has been disastrous, but the name of the game here is to force AMLO to increase local taxes or reduce services. At national level, though it is not in the 2005 budget, the authorities are having another go at introducing a reduced rate of VAT on food and other basic goods and services, which is unlikely to get anywhere. There has also been a complicated arrangement to distribute oil revenue above the base level of U$ 23 per barrel. Anything between U$ 23 and 27 will go on infrastructure spending. Above that, 50 % would go back to PEMEX, and the rest will be split between infrastructure projects and the states. Despite the high oil price, trade is still in deficit, but non-oil exports have performed well, with a 13 % increase, similar to that of imports.

With another two years of drifting expected until the next administration takes over, observers should plead for a return of the PRI. An AMLO government is unlikely to have a sufficient congressional base to be much more effective than a Fox one, even with the more decisive personality of the DF mayor.

PERU

President Toledo has been losing people from his administration (such as the head of the Central Bank, and the Energy Minister) and both he and his family are under various investigations for corruption, but he is hanging-on in there.

Relations with neighboring Chile have deteriorated steadily, and the government's handling of the aviation crisis, whereby they refused to comply with a judicial order to close Lan Chile's local subsidiary but let the local Nuevo Continente go over the edge, have been strongly criticised. It is highly possible, even probable, that the measure against Lan Peru was motivated by political reasons, whereas Nuevo Continente was unviable, but the impression given was one of "sleeping with the enemy".

Economic statistics continue to be good. Helped by fishing and manufacturing activity, GDP jumped by 6 % in August, accumulating an 8-month advance of 4.4 %, whereas exports to September rose by 33.4 %. The Central Government's deficit to September was down by 27%, with the overall gap for the year estimated at 1.4 % of GDP, further falling to 1 % in the 2005 forecasts. The first ever bond issue in EUROs was made during October, collecting 800 million for a 10-year maturity and a coupon of 7.55%.

There is obviously a pent-up feeling of extreme frustration. In late October, in a small indigenous town of the Puno region, the expelling of one person from a nightclub, following which he was accidentally killed, caused the population to riot and burn ten such establishments.

VENEZUELA

Regional and local elections were held on October 31st, though the results are slow to get out. What is certain is that abstentions (55 % of the electorate) prevailed, among a population obviously weary of years of campaigns and contests. Though the opposition had been in disarray nationally, it might have made some useful gains at local level.

The administration meanwhile continues to enjoy the high oil price, and has felt comfortable enough in the circumstances to raise from 1 to 16 % the royalty on heavy crude. Originally set at a low level to attract investment in a product, which at the time was selling at no more than U$ 13 a barrel, it is now profitable enough to dispense with favors. Venezuela now produces 0.5 million barrels a day of that variety. The 2005 budget is based on an average oil price for the Venezuelan "mix" of U$ 23 a barrel, compared to the U$ 40 it is currently getting.

The economy is officially expected to grow at 11.3 % this year, of which 9.1 % will be the outcome for the non-oil sector, and 15.3 % for the oil sector.

SMALLER COUNTRIES

Discussions are still going on in Bolivia about the shape of the new energy legislation, whilst the hydrocarbon rich provinces are getting restless with central bureaucracy and pushing for federalism. Ecuador's government did very badly in recent municipal polls, giving a new boost to those wishing to impeach the president. In Paraguay land invasions and violent crime continue apace. In Uruguay the first ever Leftist president won comfortably in the first round, though in a basically set-in-its-ways country, not great upheavals should be feared.