Tuesday, September 20, 2011

HALLGARTEN & COMPANY

Latin American Risk Analysis

Armen Kouyoumdjian
akouyoumdjian@hallgartenco.com

How Thick is LatAm's Armour?

Complaisance in a time of cholera?

LatAm's Economic Armour

Ready to be tested...again

- \+ Latin America appears not to be attracting any negative vibes (for once) as the world's leading economies sail towards another crisis
- \+ Most economies are in relatively robust shape, many with trade surpluses, quite a few with fiscal surpluses, many with sizable foreign exchange reserves, some with high credit ratings and most with low dependency on sovereign bond issuance
- ✘ Economies are still vulnerable to commodity shocks at the global level due to the make-up of exports from the region
- ✘ Banks in the region have a strong nexus, particularly, with Spanish banks. This is very much so in Chile and Mexico and also the case in Brazil and Argentina
- ✘ Economies are still vulnerable to commodity shocks at the global level
- ✘ Brazil's offer to help rescue Europe with some of its own financial resources looks more like "whistling past the graveyard"
- ✘ Despite a superfluity of funds and reserves, many governments are tight-fisted in dealing with domestic problems, as evidenced by Chile's feeble efforts to relieve the plight of earthquake victims from several years back.

An Oasis of Stability?

As Chile is in the midst of its 201st independence celebrations this weekend, with record attendance at the festivities, the rest of Latin America also appears to be vastly immune, or rather indifferent to what happens in the world. It is a fact that several countries of the region face immediate internal security issues, which are understandably a priority for their rulers.

The outside world, which for two decades looked at these countries as crisis-prone, is now setting them up as examples. Portfolio and direct investment is pouring in, and the Davos World Forum has declared this period as "the decade of Latin America". Never missing an opportunity for "*folie des grandeurs*", Brazil even offers help to beleaguered Europe. Analysts and journalists are yet to realise (not that the figures are any secret) that the country's public debt is around 60% of GDP, and that it has to borrow a third of the cost of its interest bill (which runs at nearly U$ 400 million per day), because it cannot cover it with other income.

Contrary to other times when the world has been hit by global problems, the authorities of the region have been somewhat more candid this time. Even if the new government of Peru boldly claims that it has "weapons against the crisis", others have warned of a deterioration. Unfortunately, their warnings relate to a few decimals in lower GDP, rather than a tsunami which can hit them very deeply. You cannot pretend to be globalised <u>AND</u> immune at the same time.

What kind of crisis?

In order to know if you are sufficiently protected, it is essential to know what the risk is. This is no simple matter in this case. We are in uncharted territory, with mutant phenomena not seen previously. You can imagine almost any scenario ranging from a deep recession if European governments take the bull by the horns and effect deep cuts, damning the consequences, to a collapse of the European, and through it the world banking system, with an almost complete paralysis of trade, investment and construction, all of which are financed through credit markets. No government has yet had the courage to tell the truth: either you accept lower wages, pensions and benefits, however unpleasant they are, or the alternative is that within a short few years, you will get none at all. I personally do not think that the death of the Euro is on the cards. It is not practical, considering the long preparation and structural change its introduction required. Unraveling and rolling back all that, in a crisis environment, appears nearly impossible. One cannot however rule out that some unworthy members such as Greece could be thrown out. There has been a trend by international organisations (*je ne nomme personne, mais suivez mon regard*), to admit anyone wearing a suit who passes by the door, and they should introduce tougher terms.

How to measure the fiscal situation, which is what really matters? Debt as a percentage of GDP is, to put it mildly, a most imperfect measurement. Debt, give or take some voluntary or accidental calculation mistakes, is a more or less measurable figure. Dividing that by the vague nebulosity which is GDP, is meaningless. Even with the same percentage of GDP, if your debt costs 2%, it is not the same as if you are paying 10%. The correct measure is how much of the interest bill you can finance from other revenue, and how readily can you roll over principal maturities. This has been my constant position for over four decades as a country risk analyst.

On this basis, the real worries about the biggest sinner of them all, the USA, were surprisingly short-lived, and the newly appointed head of the IMF had to remind the world of that hard fact this past week.

Latin America's Strengths

The region (and I use the word geographically, not nationalistically) is currently in a better economic and financial shape than it has been for a long period. It has no balance of payment problems, its fiscal situation, with a couple of exceptions (such as Brazil and Venezuela), is much improved, with some countries (such as Chile and Peru) even running budget surpluses, and economies are growing at rates which, though slowing down, would make many a European government green with envy.

External reserves are at record levels in most countries (Venezuela being again a notable exception), commodity prices, both agricultural and mineral, have managed to keep strong despite the recession elsewhere (and thanks to the continuing high growth in China). One exception is oil, which seems to be more quickly reactive to the world situation.

However, all the above is useful fat, but it is not Kevlar KM2.

Deep Vulnerabilities

Despite the increasing intra-regional trade and investment, Latin America still depends overwhelmingly on the global economy. Much of its exports go there, many of the high-rolling tourists come from there, and a good deal of foreign investment too.

Oil, which is already well down from its heights, could easily be joined by other non-food commodities, with lower prices and therefore a drop in exports and fiscal revenue. Though basic foods such as grains may hold up due to tight supplies, "luxury" exports of food such as salmon and wine will obviously be hit, including exotic fruits and flowers. Gold, if it continues to be a refuge (and a tradition of over 2,000 years is unlikely to change), will continue to do well. **However, Gold is not as yet an overwhelming export earner in any country.**

If the silly policy of keeping high exchange rates continues, local output will increasingly suffer from exports, and Europe and the USA will join Asia in dumping even more cheap imports on the region's markets, with the consequences on local industry and employment.

Mexico probably is most at risk from a combination of lower oil prices, and a recession in the USA affecting other exports, including the all-important in-bond industry oriented to exports, overwhelmingly to the USA. Despite long efforts at diversification, in the first half of 2011, exports to the USA still made up over 82% of the total. The equivalent figure for Canada is around 73%. It is difficult to combat the inertia of geography.

In the worst case scenario of an international banking collapse, Latin America is very vulnerable. Not only will the financing of trade and investment would become a nightmare, but the greater part of the reserves are in foreign banks, and pension funds also have substantial assets (over 44 % in Chile's case) abroad.

Even if the region's banking systems are now healthy, after a series of crises over the past three decades, many of them are closely linked to foreign banks which may be in big trouble. Spanish banks account for over 28% of the Chilean banking system, and the proportion for Mexico is 37%. European and US banks are present throughout the region. Can their subsidiaries decouple from their parents? How much interbank and derivative exposure to them do they have? Is it legally and practically feasible? Many questions with pregnant answers. Let us not even talk of all the Latin American bigwigs and corporate entities who have monies stashed abroad, legally or otherwise.

The China Antidote

"China can save itself, not the world", said a recent commentator. However, in order to save itself, it might well have to save the world first.

With over U$ 3,000 bn of external reserves, China could probably buy the whole of Greece and Portugal, though why it would want to add to its delicate cuisine a bunch of people who cook bad Turkish food, and a collection of sardine in olive oil fans, remains a point of conjecture. The fact is that a major collapse, or even a deep recession in Europe and the USA, would also hurt China. Not only would it lose financially, as the biggest holder (nearly 10 %) of America's National Debt, but it will find it more difficult to sell all the things we buy from it. Considering the country is on a delicate political balance, with both labour and social demands, not to mention ethnic tensions, a sharp increase in unemployment that would result from a collapse of export markets is unwelcome news. Yes, its domestic market still has much potential for development, but only to the extent that its workers have jobs in order to buy the local goods. Around a third of workers in industry are employed by exporters. Moreover, Chinese based companies sell goods locally at much higher than in export markets, even though buyers have lower salaries at home.

So far, the country has bought some low quality European debt and has made the right noises, but it may have to intervene in a bigger way. It has also invested in strategic sectors and industries, mostly commodity-oriented, in many countries. If it turns out to be the "lender of last resort", it would also have tremendous leverage on a good chunk of world economic management, without firing a single bullet. Quite an achievement, which the Soviet system tried and failed to do during more than 70 years.

The Chilean Attitude

Closer to us, how is Chile taking all this? As was said before, politically correct warning messages have been coming out of Hacienda, but they revolve about decimal adjustments to GDP. Presumably, the government, which has the lowest approval rating in Latin America, and many a domestic problem on its plate, does not need to also scare people about a foreign storm.

What is it planning to do about it? The 2012 budget should be presented to Congress by October 1st, and there are two versions on its contents. The authorities have hinted that, in view of the deteriorating international environment, the budget will be "conservative" (a euphemism for "austere"). On the other hand, a recent Bloomberg article sustained that "Chile would abandon austerity". I tend to believe the first version, based on recent history.

Since the end of the tenure of Eduardo Aninat as Finance Minister during the presidency of Eduardo Frei *The Younger*, all his successors have had only one fiscal instrument: the scissors or the scalpel. They have reduced, cut, and withheld even expenditure voted by Congress, with the zeal of a convention of Mohels. To propose an austerity budget rather than a counter-cyclical one, at a time of pending world recession, when you have a substantial budgetary surplus, is ridiculous.

For the current year of 2011, Congress voted a budget which expected a 6.1% increase in income and 5.5% in expenditure (both variations in real terms). However, during the first semester, even though revenue grew by 14.2% (over twice what was expected), expenditure actually went down by 0.8 %. Unbelievable.

The other night, at an official reception, I had the chance, well, the opportunity, to talk to the Housing minister. "What do you do?" he asked me. "I comment on the Chilean reality" I said. Not to lose the opportunity, I asked him why most of the 600,000 affected by the earthquake were facing a third winter in makeshift accommodation. He was wringing his hands "do you know that rebuilding housing for 600,000 people is like building the third largest town in Chile? Do you know how many formalities and bureaucracy is needed?". "Well, you've got plenty of money, use it" (I fell short of informing him that the Chinese had rebuilt a town of one million in six months, and that if he felt Chilean construction workers were slow and useless, he could always contract a Korean company, with workers et al). As for the bureaucracy, reduce it or go around it.

I dared say that I they were short of money (which they are not), they could always borrow, as the country's sovereign debt was minimal. "I totally disagree with you" he said, "it is condemning future generations to a burden". "Well, Mr Minister, you have 600,000 condemned now, not in the future, to a life of hardship". I forgot to ask him why his Hacienda colleague had borrowed U$ 1bn abroad the previous week when he did not even need it. What future generation will be "burdened" by that? The minister studied at the Universidad de Navarra in Spain and given classes in Chile at the Universidad de los Andes (*á bon entendeur, salut*).

Not a single person has focused on another major scandal in the handling of Chile's public finances (and even after this paper, nobody will mention it, I'm sure). In the past few years, the authorities have literally thrown away US$1.7bn of assets they could have spent on improving the country's infrastructure. How come? As the copper price and therefore tax revenues started climbing in 2006, the first year of the Bachelet government, Hacienda started to put money away "for a rainy day" (obviously their definition of rain did not include earthquakes or riots). On average, between 2006 and 2010, this fund held U$ 19 bn in assets. *Lamentablemente*, as Chileans will tell you when they do not want to do what they should do, these assets were invested abroad, mainly in US dollars. With the dollar falling by an average of 13 % over that period, if they were to spend it now, they would have US$1.7 bn fewer pesos for their "savings". The "rainy day" did actually happen. It rained on their economic models. (Where is Luis Felipe Cespedes these days, the former chief adviser to the previous Finance minister, who once tried to explain to me that an 8% of GDP budget surplus, "depending how you looked at it", could actually be seen as a deficit? Well, he is head of research at the Central Bank). As I also told the Housing minister, "Chile is not Norway, where I'm sure all schools have all the equipment they need, so they can afford to sit on their sovereign fund until the reindeer come home". Curiously, US$1.7 bn is about the same amount that the UBS trader lost recently...... but in his case he is facing the courts.

Important disclosures

I, Christopher Ecclestone, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. Hallgarten & Company may have received compensation from any, or all, of the companies mentioned in this report for services rendered, including corporate advice, marketing strategy or other financing endeavors.

Hallgarten's Equity Research rating system consists of LONG, SHORT and NEUTRAL recommendations. LONG suggests capital appreciation to our target price during the next twelve months, while SHORT suggests capital depreciation to our target price during the next twelve months. NEUTRAL denotes a stock that is not likely to provide outstanding performance in either direction during the next twelve months, or it is a stock that we do not wish to place a rating on at the present time. Information contained herein is based on sources that we believe to be reliable, but we do not guarantee their accuracy. Prices and opinions concerning the composition of market sectors included in this report reflect the judgments of this date and are subject to change without notice. This report is for information purposes only and is not intended as an offer to sell or as a solicitation to buy securities.

Hallgarten & Company or persons associated do not own securities of the companies described herein and may not make purchases or sales within one month of the publication (before or after) of this report. Hallgarten policy does not permit any analyst to own shares in any company that he/she covers. Additional information is available upon request.

Web access at:

Research: www.hallgartenco.com

60 Madison Ave, 6th Floor, New York, NY, 10010