Latin America in Focus as Brazil Stumbles, Venezuela Simmers, and Mexico Rebounds

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Highlights

- On May 19, the president of Brazil, Michael Temer, was accused of participating in what has become a long-running corruption scandal that has severely weakened Brazilian political institutions.
- Following the news, the Brazilian currency depreciated by as much as 8%, and Brazilian equities declined by 16% (U.S. dollar terms), though both have subsequently rebounded off their respective lows. It should be noted that Bessemer does not have significant exposure to Brazil, and thus our clients were not materially affected.
- Venezuela, which Bessemer has no investment exposure to, remains mired in a protracted economic/political crisis that shows few signs of abating.
- Mexico has enjoyed a strong start to the year, with the peso appreciating by 15% and Mexican equities rising by almost 18%, though upcoming NAFTA negotiations and the 2018 Mexican presidential election could serve as potential complicating factors.

Brazil Swoons on Negative Political Developments

After several months of relative stability, Brazil once again found itself in the headlines after it was announced that Michael Temer, the president of Brazil, had been implicated in an ongoing corruption scandal when a media outlet reported that he had been recorded on audiotape participating in an alleged bribery scheme. Brazil's highest court subsequently stated that it would open an investigation into the claims, which Temer has officially denied, stating that "he never authorized payments to anyone to stay quiet."

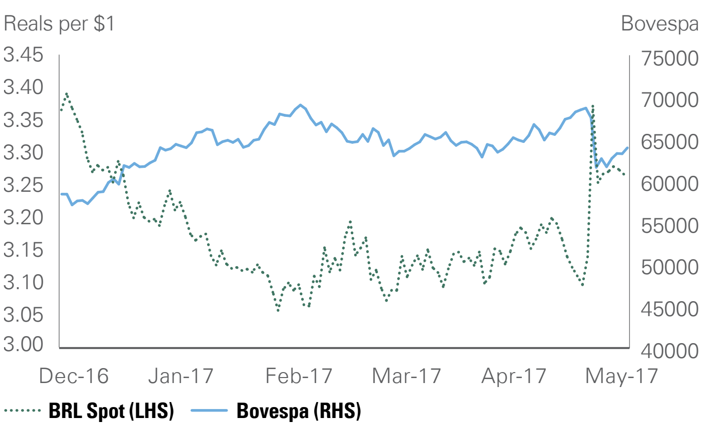
For context, Temer became president of Brazil in August 2016 following the impeachment and ensuing removal of the prior president, Dilma Rousseff. Her impeachment came after being implicated in one of Brazil's largest corruption scandals, *"Lavo Jato,"* or "Operation Car Wash." Although the case initially started out as a money laundering investigation, it quickly escalated into allegations of corruption at the state-controlled oil company, Petrobras, where Rousseff had been the chair from 2003 to 2010. The executives at the company were accused of engaging in bribery with private construction firms to award contracts at inflated prices. This led to a sustained period of financial market volatility that exacerbated an already negative economic environment, and as a result, Brazil remains mired in a protracted recession.

Following the news of President Temer's implication in the bribery scandal, the reaction in Brazilian financial markets was swift, with the currency initially depreciating by over 8% and Brazilian equities declining by as much as 16% in U.S. dollar terms, though both have subsequently rebounded off their respective lows as shown in Exhibit 1. Market participants initially assigned a high probability that Temer would resign in short order, given the fact that there was audio evidence supporting the allegations. However, since Temer has vowed to fight the charges and there have been no new developments in the interim, some investors now think that Temer may remain president for the near term, but the allegations will detract from his overall agenda and may lead to his eventual removal.

These recent events will likely be yet another setback for Brazil's fragile economic recovery as it attempts to claw back from the deepest recession the country has experienced in modern history. In the fourth quarter of 2015, real GDP growth had declined to -5.8% on a year-over-basis, and although the growth trajectory had improved to -2.5% as of the fourth quarter of 2016, unemployment in the Brazilian economy is currently 13.2%, the highest level in well over a decade.

From our view, the recent allegations of President Temer's involvement in the corruption scandal is unequivocally a deleterious turn of events, not only from a financial markets perspective, but also as it pertains to the country's reform agenda, which Temer was widely seen as pushing forward. Since assuming the presidency, he has helped to pass legislation that limits increases in government spending to zero on an inflation-adjusted basis,

Exhibit 1: Brazilian Equities and the Real Experienced a Volatility Shock on the Temer News in Mid-May



Source: Bloomberg

as well as beginning to reform the Brazilian pension system, which has long been a point of consternation in the country.

Beyond the fiscal control and pension reform, Temer was also planning to pass additional reforms that would impact education, labor laws, and tax regulations. Investors were very supportive of this reform agenda because it is widely acknowledged that these reforms are necessary in order to support the long-term viability of the Brazilian economy. These expectations were cited as helping to underpin the notable rally in Brazilian equities, which saw Brazilian stocks rise 20% since the start of the year through May 16 (just prior to the allegations), and roughly 100% since the beginning of 2016, both in U.S. dollar terms. With Temer now politically compromised, these reforms are clearly in jeopardy, hence the dramatic rise in volatility following the corruption allegations.

Although there was some concern that Brazil's troubles could spill over into the broader emerging market complex, there was relatively little, and the small amount that did occur was short lived. There will undoubtedly be more twists and turns in the Brazilian political arena over the months and years to come, but ultimately economic fundamentals and the outlook for growth drive our investment decision-making process. From a portfolio-positioning perspective, we do not hold a material amount of exposure to Brazil, and thus the impact of the most recent events on our clients' portfolios was relatively minimal. In a Balanced Growth 70/30 portfolio, our emerging market equity exposure is only 6.6%, and of that, only 0.8% is derived from Latin American emerging markets.

Venezuela Simmers as Political and Social Unrest Rock the Country

Although Bessemer does not hold any direct exposure to Venezuela, we follow the country closely due to the potential for regional spillover should the conditions there continue to deteriorate. The current situation in Venezuela is dire, with the economy rapidly contracting, inflation rising, and many citizens unable to buy food or medicine. Although Venezuela has some of the largest proven deposits of crude oil in the world, a number of failed policies has resulted in the country going from one of the wealthiest in South America to one of the poorest. Because oil accounts for roughly 95% of the country's export revenues, the decline in the price of oil since 2014 has served to further constrain growth and limit the policymaker options.

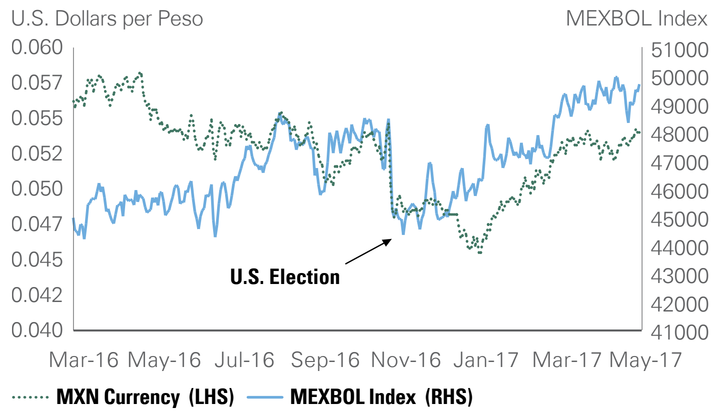
Since early April, there has been a rise in violence as backers of the current president, Nicolas Maduro, face off with the opposition, which has controlled the National Assembly. A Supreme Court decision at the end of March that stripped the National Assembly of its powers led to the spate of violence before being overturned three days later in the face of significant protest. Most recently, President Maduro has tried to create a "citizens assembly" to help create a new constitution, but this proposal has been met by limited support. A decision by Goldman Sachs to buy Venezuelan debt at a discount — thus providing the incumbent administration with a financial lifeline — was also met with fierce criticism from the opposition.

While the situation is tenuous, it is our view that the risk of significant regional spillover remains contained. If the economic situation were to markedly deteriorate, we expect that other South American countries and/or the United States would likely intervene, but it would take a worst-case scenario before that occurs. From a portfolio positioning standpoint, we do not anticipate any changes to our Latin American exposure over the near-term, though it should be noted that this situation remains highly fluid.

Mexican Financial Assets Rebound Following 2016 U.S. Election Outcome

Mexico has enjoyed a strong start to the year, with the peso appreciating by 15%, and Mexican equities rising by almost 18% in U.S. dollar terms, which some market participants have attributed to a "softer" U.S. President Trump as it relates to U.S./Mexico relations in the aftermath of the 2016 U.S. election. Recall that the peso sold off sharply after Trump won the U.S. election, as many investors feared that Trump's policies would have a large negative impact on the Mexican economy. As we have discussed in prior pieces, Trump has largely failed to follow through with the majority of his most aggressive international trade promises, which has generally been met with a collective sigh of relief from market participants. Consistent with this narrative the peso has rallied, appreciating by 15% against the U.S. dollar since the start of the year as shown in Exhibit 2.

Exhibit 2: Mexican Peso and Mexican Equities Have Appreciated Since U.S. Election



Source: Bloomberg

Although Mexican financial assets have gotten off to a relatively good start this year, we are less sanguine with respect to the intermediate-term outlook due to the upcoming North American Free Trade Agreement (NAFTA) negotiations, the potential for 2018 political uncertainty, and other idiosyncratic factors.

With respect to the NAFTA negotiations, the Trump administration formally notified Congress on May 18 of its intention to renegotiate the agreement. This did not come as a surprise to most market participants. The Trump administration feels that the current NAFTA agreement is outdated due to the fact that the U.S. economy is markedly different than it was three decades ago, and the agreement should be renegotiated to reflect this new economic reality. For historical context, some of the key milestones of the current NAFTA agreement are shown in Exhibit 3.

Exhibit 3: NAFTA Milestones

1989
Canada-U.S. Free Trade Agreement takes effect

December 1992
NAFTA signed by U.S. President George H.W. Bush, Mexican President Carlos Salinas de Gortiari, and Canadian Prime Minister Brian Mulroney

August 1993
U.S. President Bill Clinton negotiates labor and environmental side agreements to NAFTA

December 1993
NAFTA legislation signed into law by President Clinton

January 1994: NAFTA enters into force
- U.S. eliminates tariffs on Mexican beef, corn, pork, poultry, and many other agricultural products
- Mexican automotive products gain unfettered access to Canada and the U.S.
- Mexican tariffs on U.S. and Canadian autos drop from 20 to 10%

January 1998
- Mexico eliminates tariffs on many U.S. fruits
- U.S. eliminates tariffs on Mexican cotton and wheat
- Most remaining U.S.-Canada agriculture tariffs phased out

January 2002
Canada eliminates tariffs on Mexican flour, meat, and sugar

January 2003
- Mexico eliminates tariffs on U.S. dairy, pork, rice, and wheat
- U.S. eliminates tariffs on Mexican dairy, rice, and other vegetables
- Mexico eliminates remaining tariffs on U.S. and Canadian cars and auto parts

October 2007
Elimination of remaining U.S.-Mexico sugar tariffs

January 2008
Elimination of remaining Mexican tariffs on U.S. and Canadian corn and Canadian tariffs on Mexican corn

1989 1993 1996 1999 2002 2005 2008

Sources: Council on Foreign Relations, "Nafta Revisited" (Hufbauer/Schorr), NAFTA treaty text, US Trade Representative, The Wilson Center

The two-page NAFTA letter released by the Trump administration, much like the recently released tax plan, contained few specifics and was generally considered to be more of a placeholder than anything else. That said, the letter does trigger the 90-day period required before negotiations can actually begin, and it's expected that the Trump administration will confer with Congress between now and then to draft a more robust plan for conducting the NAFTA discussions. The earliest talks can actually begin is August 16, and the U.S. Trade Representative, Robert Lighthizer, has stated that he plans to conclude the negotiations before the end of this year. Given the recent difficulties the administration has faced moving their various agenda items forward, they may be shooting for the stars in the hope that they land on the moon, though if the administration's recent legislative track record is any bellwether, it's likely that these negotiations will drag on into 2018.

Although we think the administration's timeline may be aggressive, we do not think the recent issues in terms of investigations and poor political optics will be as much of a drag on the NAFTA negotiations as they have been on the health care and tax-reform initiatives. Much of these negotiations will be handled by policy professionals away from the spotlight, and Canada is also supportive of the renegotiation process, so this topic is likely to be less of a political lightning rod than the others.

Mexico has largely resisted calls to renegotiate the NAFTA agreement, particularly after the divisive rhetoric that was used during the 2016 presidential campaign. The country has threatened to withdraw from NAFTA completely if it feels undue pressure, but our base case is that negotiations will take place, and that some changes, particularly around such hot-button issues as intellectual property rights, but it's still too early to have a high degree of conviction with respect to the final outcome.

Mexican Elections on the Horizon

With the 2018 Mexican presidential election quickly approaching, all eyes were on the June 4 election in the State of Mexico, the largest of Mexico's 31 states, as it is often viewed as a potential bellwether of voter sentiment. While the final result is still being tallied, the initial ballot counts show that the candidate of President Enrique Pena Nieto's ruling faction, the Institutional Revolutionary Party (PRI), has a slim lead. For context, the PRI has governed the State of Mexico for 88 years without interruption, and thus losing the election would have been a significant blow to the party in terms of momentum heading into the 2018 presidential election.

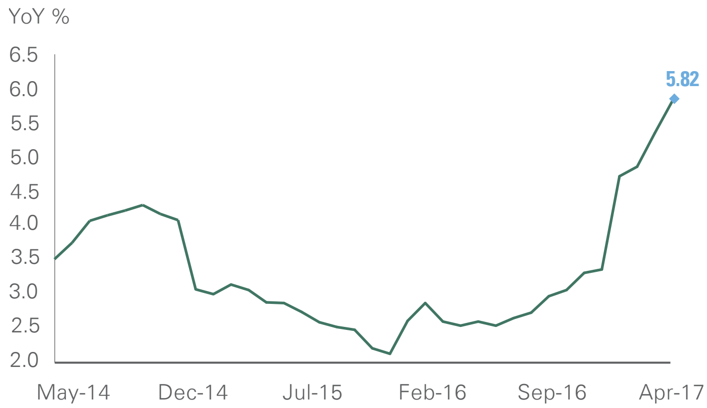
The party of leftist presidential candidate Andres Manuel Lopez, leader of the Movement for National Regeneration (MORENA), is likely to place second in the Mexican State election. Polls conducted prior to the Mexican State election showed that the MORENA party had a slim lead (33%) in the 2018 presidential race. It should be noted that much of Lopez's surge in the polls over the past year has been attributed to an increase in nationalist sentiment following the Trump presidential campaign and subsequent victory. Former First Lady Margarita Zavala (wife of Felipe Calderón), who is also running for president, is currently polling at 27%. Additionally, some news organizations have reported that Mexico's two main opposition parties, the center-right National Action party and the center-left Democratic Revolution party, may join forces to try and defeat the incumbent PRI party, as President Enrique Pena Nieto is ineligible to run in the 2018 election.

With respect to Mexico's economic situation, first-quarter 2017 GDP was reported at 2.8%, as shown in Exhibit 4, modestly above the preliminary 2.7% estimate and higher than the 2.3% annualized growth rate measured in the fourth quarter of 2016. Following the data release, the Mexican Finance Ministry increased its growth forecast for the year to between 1.5% and 2.5%. The increase in GDP growth was led by farming output and services, though industrial activity was somewhat sluggish, increasing by only 0.5%.

Exhibit 4: Mexico's GDP Trended Up Slightly in First Quarter 2017

Source: Bloomberg

Exhibit 5: Mexico's Inflation Rate (Headline CPI) Has Been Rising Rapidly



Source: Bloomberg

Mexico's inflation rate has been a point of concern, as the 2016 currency weakness and a rise in fuel prices by 20% during the first quarter of 2017 have led to rapidly rising headline and core inflation. Headline CPI was recently reported at 5.8%, as shown in Exhibit 5, while core CPI in Mexico is currently at 4.7% and has been rising steadily since early 2016.

This continued increase in inflation led the Mexican central bank to deliver a surprise interest-rate hike in May, which bumped its policy rate up by 25 basis points to 6.75%. The combination of rising inflation and tighter credit conditions could cause consumers to tighten their purse strings, which would prove challenging for Mexico in the quarters ahead due to the fact that consumer spending has been helping to support Mexican economic growth over the past several years.

Wall Street foreign exchange strategists' median second-quarter 2017 forecast for the Mexican peso is 19.22, and the fourth-quarter forecast is 19.74, which reflects a modest amount of depreciation from the current level of 18.7. We agree that a moderate amount of depreciation over the next several quarters is likely due to a combination of relatively range-bound oil prices, rapidly rising inflation, upcoming NAFTA negotiations, and political uncertainty as the presidential election approaches.

The Bottom Line

While certain countries in Latin America continue to struggle with economic and political uncertainty, our limited exposure to the region and our overweight position to the United States has left us relatively unaffected. We do not expect that the issues plaguing Venezuela and Brazil will be resolved quickly, and hence it is unlikely that we will increase our exposure to those countries in the foreseeable future.

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