COVID-19 and Latin America: another lost decade?

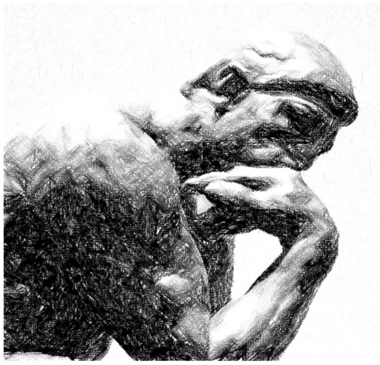
In this issue of the Thinking Man, we continue to examine the coronavirus and its effects, but we now shift our focus to Latin America ("LatAm"). Despite still being in the midst of the pandemic, we believe that some countries and regions will emerge strong, while others will experience a painful recovery from the virus-induced recession. We are bearish on the outlook for LatAm, given several negative trends, and believe the region's countries will unfortunately be ranked in the second tier compared to developed nations.

Executive summary

During the lockdown period, developed nations have deployed aggressive fiscal and monetary stimulus to protect the economy. The stimulus should help people survive, and should sustain businesses so they do not disappear, until restrictions can start to be gradually lifted. This should minimize the destruction of production capacity, increasing the chances of a speedy recovery. Hence, recovery prospects will ultimately be conditioned by the size of the fiscal and monetary stimulus enacted by policy makers in their respective countries.

LatAm countries have tried to replicate the measures taken by developed nations, by implementing fiscal and monetary policies to support the economy. However, the programs are much more limited in size and scope. Ultimately, these policies will not be enough to prevent a severe contraction in our view. Stimulus programs will also lead to a severe deterioration of public finances that will force LatAm countries to implement painful adjustments, such as tax hikes and cuts in government spending, over the next few years. Even if the governments of the region tried to use unlimited fiscal stimulus to minimize the damage to the economy today, the informality that characterizes the region's workforce will likely prevent the aid from reaching the people most in need. These individuals will sooner or later break the lockdown, also hindering the virus containment efforts, in our view. The infrastructure of health systems in LatAm is particularly fragile, making the potential for loss of human life elevated if containment efforts are not successful. In addition, coming into

The Thinking Man's Approach



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- COVID-19 is an external shock for which no country around the world was fully prepared.
- To contain the spread of the virus most countries have implemented isolation measures that have effectively pushed the global economy into a recession.
- Developed nations have responded aggressively with fiscal and monetary stimulus to protect the economy during the lockdown period.
- LatAm governments have also tried to protect their economies, but they do not have much flexibility. They have fewer tools at their disposal, which will significantly produce less results.
- We believe that LatAm economies will take longer to recover from the virus induced recession. As a result, the region's financial markets will underperform.
- Investors with a high exposure to LatAm issuers should continue to consider the benefits of a global diversification to mitigate the region's idiosyncratic risk.
    - For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

2020, the region was particularly vulnerable after years of swings between extreme left and extreme right governments that has led to an important decline of production capacity. The continent is also in the midst of a humanitarian crisis, where exiles from Venezuela and several Central American countries, roam the streets of neighboring countries. Last but not least, the finances of LatAm countries are deeply hurt by the sharp decrease in the price of oil and other commodities.

The outlook for LatAm economies and markets does not look bright. We believe a wave of LatAm defaults and debt restructurings could hit the market over the next 12 to 24 months. . This will include corporate issuers, as well as a few sovereign ones like Ecuador. With this in mind, we remind our LatAm investors of the importance of continuing to diversify their portfolios, in order to mitigate their natural exposure to the region's idiosyncratic risk.

Covid-19 repercussions for Latin America

As the virus continues to spread, countries around the world have been forced to issue lockdown orders and to temporarily shut down economies. With an almost certain global recession looming, governments and central banks are now stimulating the economies. The U.S. and other developed nations have issued aggressive fiscal and monetary policy measures to protect businesses and workers during this period, hopefully increasing the chances of a sharp recovery once the situation starts to normalize and the economy is able to reopen. In the U.S. the $2.2 trillion Coronavirus Aid, Relief, and Economic Security (CARES) Act, which represents approximately 10% of the country's Gross Domestic Product (GDP), should provide enough cushion, at least for the next couple of months. Similar measures have also started to be adopted throughout Europe and Asia.

In LatAm, governments have also responded by issuing sizable fiscal policy measures. However, we believe that despite the stimulus, the outlook of the region does not look promising. We believe the pandemic will have dire consequences for LatAm, and some countries and sectors will struggle to recover. This issue is particularly important to us, since most of our clients are from LatAm, and either have a big exposure to local issuers in their investment portfolio, or the family businesses are still based there. Below, we address the main issues that makes us question the economic prospects for the region.

LatAm countries do not have as much "ammunition" to combat the recession as developed nations

The first, and probably most important reason, is that LatAm countries do not have the ability to issue the same type of fiscal and monetary stimulus packages ("bazookas") that are currently being used in developed nations. Central banks in the region have responded by aggressively cutting interest rates. Governments have also tried to support the economy with fiscal stimulus mainly in the form of temporary tax relief and transfers to low-income households. Nonetheless, these plans look weak when compared with the ones enacted by developed nations, as on average, these measures account for a few percentage points of the country's GDP. A recent study by the OECD, tried to quantify the impact of the lockdown measures that have been put in place to contain the coronavirus, and found that it was reasonable to expect a 2% drop in a country's GDP for every month that the economy remains in lockdown. The plans proposed and currently being implemented by LatAm countries will only have a short-term effect and are not sufficient to protect the economy in the long run.[1]

LatAm countries start from weaker fiscal and monetary positions; the stimulus required to combat the recession may not be possible or may be difficult to recover from

Even as LatAm's fiscal plans look weak when compared to the developed world, they are still sizable from a local perspective. The stimulus packages, combined with the recessionary backdrop, will lead to a significant deterioration of fiscal metrics, mainly large increases in budget deficits, leading to an increase in public debt. Once the threat of the pandemic is behind us, LatAm governments will be forced to enact painful fiscal adjustments or risk facing a funding crisis, both of which are negative for the economic outlook. On the monetary front, some LatAm countries still have space to stimulate the economy, however, not with additional rate cuts, but with liquidity and credit easing. Goldman Sachs' Head of LatAm Economics, Alberto Ramos, put together a scorecard with the stimulus room and inflation outlook for the main countries of the region, which is shown below. From the countries listed on the table, Peru seems the best positioned, while Argentina is the worst positioned.

Exhibit 1: Policy Room Scorecard

	Fiscal Policy Space	Monetary Policy Space	FX Intervention Space	Inflation Outlook
Argentina	Low	Low	Low	Poor
Brazil	Low	Medium / Low	High	Comfortable
Chile	High	Low	Medium / Low	Comfortable
Colombia	Medium	Medium / Low	Medium / High	Moderate
Ecuador	Low	N/A	Low	Comfortable
Mexico	Medium	High	Medium / High	Moderate
Peru	High	Medium / Low	High	Comfortable

Source: Goldman Sachs Global Investment Research

Informality of LatAm economies makes quarantines difficult to sustain

Even if the governments of the region tried to use the same "whatever it takes" approach as developed countries, the informality of the workforce that characterizes LatAm economies, would make it almost impossible to reach the people who are most in need. On average, estimates suggests that approximately 50% of the workforce do not have a formal occupation, with the vast majority of individuals living on what they are able to earn on a daily basis by working odd jobs. The majority of these individuals probably do

[1] OECD is an intergovernmental economic organization with 37 member countries, founded in 1961 to stimulate economic progress and world trade.

not file taxes and in most cases are not users of the financial system. Sending checks or wire transfers with financial aid to these individuals are practically impossible. Despite the strict quarantine measures enacted in LatAm, after a few weeks most of these individuals will have no option but to break the isolation measures and go out to the street to try to "make a living". With this in mind, we think that a long-lasting quarantine where people respect isolation measures to successfully contain the spread of the virus does not seem feasible.

Healthcare systems in LatAm countries may get overwhelmed more easily as they are less robust

Moving our focus to the treatment of the disease, the healthcare infrastructure of LatAm is also far less robust than in developed nations. Most of the countries have weak and fragmented healthcare systems that do not guarantee the universal access needed to confront the pandemic. The number of Intensive Care Unit (ICU) beds and ventilators per capita, is far lower in LatAm than in the U.S. and Europe. If the health care system collapses as it did in Italy and Spain, the system could get quickly overwhelmed in any of the countries of the region. This will lead to unnecessary deaths not only because of untreated COVID-19 patients, but also from unrelated conditions that will not receive timely treatment. As studies from the 1918 Spanish flu have shown, countries and regions that are slow to contain the virus will also be the slowest to recover.

Production capacity in bad shape in some countries; virus containment measures absent in others

Furthermore, the fundamentals of the region were not solid coming into the crisis. After several decades of swings between extreme left and right governments, the production capacity of many countries has been completely decimated. Other countries, such as Mexico and Brazil, have relatively new extremist governments that have taken some questionable measures on how to address the pandemic. Until recently, they had not issued any lockdown measures to contain the outbreak, and had been encouraging the countries' citizens to continue with their normal lives. Experts believe that if strict measures are not taken soon, the human tally will be immense, leading to a greater economic cost as was explained before.

The recent displacement of millions of Latin Americans adds to the challenges

To make matters worse, there are millions of Latin Americans who recently have been forced to flee their country of origin. The ongoing human rights crisis in Venezuela has led to more than 4.9 million people leaving the country. Most Venezuelans are hosted in neighboring countries, often without international protection, working in low-paid informal jobs and living in insecure or temporary housing. Meanwhile, Hondurans, Guatemalans and Salvadorans continue to flee the violence of their countries, making their way through Mexico towards the U.S. Finally, at least 100,000 Nicaraguans have fled the ongoing human rights crisis in their country, many of whom live in Costa Rica, where access to asylum processes and basic services remain a challenge. [2]

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[2] https://www.amnesty.org/en/latest/research/2020/03/americas-at-a-crossroads-in-response-to-covid19/

Fall in commodity prices hurt LatAm economies disproportionately

Finally, as if the outlook was not bad enough, the recent collapse in oil and other commodity prices, dealt the final blow to the finances of the region. Some countries such as Mexico, Brazil and Colombia rely heavily on the royalties received from the state-owned companies. Credit rating agencies have already taken note of the situation and have been swift to issue outlook downgrades noting that if finances continue to deteriorate, credit downgrades are likely to follow. This becomes a vicious cycle where, as the finances of a country deteriorates, its credit rating is revised downward, making it more difficult for the country to receive the necessary funding to enhance its economic prospects.

LatAm is expected to suffer the biggest contraction since World War II

In fact, a recent study by the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), found that the region is on a weaker position to confront the pandemic, than the rest of the world.[3] They believe that the indirect effects of the crisis unleashed by the pandemic are being felt in the region through six external transmission channels which are the following: 1) The decline in economic activity among its main trading partners; 2) The fall in commodities prices; 3) The interruption of global value chains; 4) The lower demand for tourism services; 5) The decline in remittances; and 6) The intensification of risk aversion. As a result, the ECLAC revised its economic growth forecast for the region for 2020, from a 1.3% growth to a contraction of between 3% to 4%. Goldman Sachs, is also predicting that the overall region will contract by 3.8%, which would be the biggest decline in the post-war period. The International Monetary Fund also revised its forecast to a contraction of 5.2%.

To the last point, it is worth noting that some countries in Latin America seem better positioned than others. Specifically, countries such as Chile, Colombia and Peru, have been fiscally disciplined over the last few decades, and have created sovereign wealth funds or stabilization funds, precisely to be used in times of need. Even as the amount of these funds seem tiny when compared to the massive fiscal and monetary packages announced in the U.S. and Europe, they will definitely help to soften the blow. Other countries such as Mexico, Brazil and Argentina, among others, appear to be more vulnerable.

Conclusion

The outlook is not bright for LatAm. Before the coronavirus outbreak, global foreign direct investment in the region had already started to decline as a result of structural and political problems. Investors will not

[3] The United Nations Economic Commission for Latin America and the Caribbean, known as ECLAC, is a United Nations regional commission to encourage economic cooperation. ECLAC includes 46 member States (20 in Latin America, 13 in the Caribbean and 13 from outside the region), and 13 associate members which are various non-independent territories, associated island countries and a commonwealth in the Caribbean. ECLAC publishes statistics covering the countries of the region and makes cooperative agreements with nonprofit institutions. ECLAC's headquarters is in Santiago, Chile.

be returning any time soon, as LatAm central banks are aggressively cutting interest rates, and local currency sovereign and corporate bonds yields are not providing compelling returns as a result.

A recent study by the Institute of International Finance (IFF), found the COVID-19 shock resulted in a pronounced sudden stop of flows to emerging markets. Non-resident portfolio flows witnessed the largest outflow ever during the first quarter of 2020, exceeding the heights of the Great Financial Crisis back in 2008. The IFF forecasts that despite a recovery in flows during the second half of 2020, the pickup will not be strong enough to return to the 2019 levels. However, LatAm's recovery could take even longer, as most of the recovery is expected to come from Asian emerging markets.

In our view the main risk in hard currency debt is the expected credit rating downgrades, as well as an expected increase in default rates, mainly in corporates but also in sovereigns. For example, Argentina already needed to restructure its sovereign debt before the pandemic. The Ecuadorean Congress, has announced that it wants to suspend debt payments to free up cash to deal with the coronavirus. We think that this is just the beginning of trend that will gain momentum over the next 12 to 24 months, where a wave of LatAm defaults and debt restructurings could hit the market. We have seen this story play out in LatAm several times before over the last decades.

Despite the historical losses from investing in the region, stemming from a series of defaults, currency devaluations, and asset market crashes, the average high net worth LatAm investor still maintain a regional bias. As LatAm's outlook does not look bright, we believe it is more important than ever for our clients to continue diversifying their "Total Balance Sheet" exposure, outside of LatAm. Unlike a pension fund that is regulated by the government, private investors are not bound by any constraint and can increase their international exposure without limit. We believe LatAm high net worth individuals should use this opportunity to diversify into more of the "global markets portfolio", while decreasing the regional idiosyncratic risk.

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