Global Insights

The Emerging Question: Investing in Latin America

In our Nov. 2 Global Insights, we considered the limitations of making investment decisions on emerging markets as a whole and explored conditions in the category that could drive outperformance over the medium term.

Although we think that the emerging markets category could benefit from the US dollar’s decline, we believe that Latin America is uniquely positioned among emerging market economies to also take advantage of 1) gains in the war on inflation, 2) more mature rate-hiking campaigns and 3) trends in supply chain risk management.

This issue of Global Insights is dedicated to exploring opportunities in emerging markets. In this note, we focus on Latin America.
The MSCI Emerging Markets Index is in a bear market. Although bear markets are part of a normal economic cycle, they happen more frequently in emerging markets than in the US. In fact, according to Morgan Stanley & Co.’s Latin America equity strategy team, the emerging markets have experienced 10 bear markets since the late 1990s—excluding the present and longest episode (see Exhibit 1). This compares to five in the US.

Exhibit 1: Bear Markets Are Common, but They Happen More Frequently in the Emerging Markets

![Chart showing bear market activity in MSCI Latin America Index vs. MSCI Emerging Markets Index, with key dates and values from 1997 to 2022.]

In our Nov. 2 Global Insights, “The Emerging Question: A Three-Part Series on Investing in Emerging Markets,” we explored the return dispersion for the regions that make up the emerging markets and found a wide range. Naturally, we also expect variability in the magnitude of bear market declines. On the surface, this makes sense; after all, the MSCI Latin America Index’s beta relative to emerging markets is 1.1, which means that Latin America is more volatile than the broader category.

On closer review, we found that Latin America tends to underperform emerging markets by 3.5%, on average, during bear market periods. Admittedly, a key problem with averages is that they often obscure important details. For example, in half the bear market periods for emerging markets that we observed, Latin America outperformed emerging markets broadly. Still, we find the region’s unprecedented resilience during the latest downturn astounding (see Exhibit 2).

Exhibit 2: The MSCI Latin America Index Has Been More Resilient During This Downturn Than in Prior Bear Periods for Emerging Markets

<table>
<thead>
<tr>
<th>Bear Market Peak Date</th>
<th>Bear Market Trough Date</th>
<th>MSCI Latin America Index Drawdown</th>
<th>MSCI Emerging Markets Index Drawdown</th>
<th>Latin America Minus Emerging Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 9, 1997</td>
<td>Sept. 10, 1998</td>
<td>-0.1%</td>
<td>-0.6%</td>
<td>-0.5%</td>
</tr>
<tr>
<td>Feb. 10, 2000</td>
<td>Sept. 23, 2001</td>
<td>-2.5%</td>
<td>-2.7%</td>
<td>-0.2%</td>
</tr>
<tr>
<td>April 18, 2002</td>
<td>Oct. 10, 2002</td>
<td>-3.2%</td>
<td>-2.4%</td>
<td>-0.8%</td>
</tr>
<tr>
<td>April 12, 2004</td>
<td>May 17, 2004</td>
<td>-18.6%</td>
<td>-20.4%</td>
<td>1.8%</td>
</tr>
<tr>
<td>May 8, 2006</td>
<td>June 13, 2005</td>
<td>-24.7%</td>
<td>-25.4%</td>
<td>-0.7%</td>
</tr>
<tr>
<td>Oct. 29, 2007</td>
<td>Oct. 27, 2008</td>
<td>-63.7%</td>
<td>-56.6%</td>
<td>7.1%</td>
</tr>
<tr>
<td>May 21, 2011</td>
<td>Oct. 4, 2011</td>
<td>-63.2%</td>
<td>-31.6%</td>
<td>31.6%</td>
</tr>
<tr>
<td>Sept. 3, 2014</td>
<td>Jan. 21, 2016</td>
<td>-57.3%</td>
<td>-37.5%</td>
<td>-19.8%</td>
</tr>
<tr>
<td>Jan. 26, 2018</td>
<td>Oct. 29, 2018</td>
<td>-26.4%</td>
<td>-26.5%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Jan. 20, 2020</td>
<td>March 23, 2020</td>
<td>-52.8%</td>
<td>-33.8%</td>
<td>-19.0%</td>
</tr>
</tbody>
</table>


From an asset allocation perspective, Latin America is likely underowned in global portfolios relative to its contribution to global equity market capitalization. In fact, according to the BlackRock Advisors Insights Guide, incorporating data based on an analysis of nearly 10,000 portfolios, the average US-based advisor’s equity allocation to emerging markets is 8.2%. For reference, the emerging markets make up 13.1% of the MSCI All Country World Index. Looking deeper into the MSCI Emerging Markets Index—a regional component of the MSCI ACWI Index—Latin America’s 9.4% allocation is quite small compared to Asia’s 76.4% (including China).

Just a little misunderstanding. As such, it’s understandable that investors would assume that Asia drives emerging markets, and to a large extent, it does. However, the popular saying “Don’t throw the baby out with the bathwater,” seems appropriate here, especially in regard to investor perceptions of the risk-reward tradeoff in Latin America.

First, based on our calculations, the implied probabilities of sovereign default by Brazil and Colombia—assuming a 40% recovery rate—are 3.6% and 4.5%, respectively (see Exhibit 3). On an absolute basis, this does not seem severe. However, Brazil and Colombia’s 1.2 and 2.3 Z-scores of implied probability of default suggest high relative risk versus long-term averages. (Z-score is the number of standard deviations a given data point lies above or below the mean.)
Exhibit 3: Elevated Five-Year Probability of Default in Several Latin American Nations May Overstate Risks

Note: Implied probabilities of default are based on five-year credit default swaps and assume recovery rates of 40%. They are calculated by dividing the five-year credit default swap by one minus the recovery rate.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 7, 2022

Second, as with emerging markets broadly, investors in Latin America are rewarded for taking equity risk. In Exhibit 4 below, we plot equity risk premium (ERP)—the compensation above the risk-free rate that an equity investor requires to own stocks—for the major equity indexes of several countries as well as for the equities of a blended mix of countries (the Blended Emerging Markets). Although investors in Latin American countries are receiving more compensation than those in the blended mix, the variability is not uniform.

Chile stands out as an interesting case. Although its probability of default is lower than Brazil’s (see Exhibit 3), its ERP is essentially the same (see Exhibit 4). Said another way, investors require the same compensation to own Chile’s stocks despite the country having a lower probability of default—highlighting potential market inefficiencies.

Exhibit 4: Some Countries Saw Big Increases in Equity Risk Premiums

Note: Blended Emerging Markets is an equal-weight mix of MSCI India Index, MSCI China Index, MSCI Brazil Index and MSCI Korea Index. Other MSCI emerging market countries represented are Argentina, Brazil, Chile, Colombia, Peru and Mexico.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 30, 2022

Getting a handle on inflation. As global central banks tighten monetary policy to combat higher prices, the Latin American region has seen some success (see Exhibit 5). For example, although prices peaked in the region at 9.3% on a year-over-year basis in June, price gains in developed markets have shown few signs of abating. In fact, inflation in developed economies remains elevated, while price increases in Latin America have moderated to 2021 levels.

Exhibit 5: Latin America Is Making Gains in the War on Inflation

Note: Latin America data excludes Argentina and Venezuela.

Latin America’s central bankers have moved aggressively to tame inflation. In fact, by the time Federal Reserve Board Chairman Jerome Powell indicated it was time to stop using the term “transitory” to describe inflation, central banks in Latin America were already on the monetary tightening path (see Exhibit 6). Furthermore, by the time the Fed raised its policy rate in March 2022, Brazil, Chile, Colombia, Peru and Mexico had already tightened by the equivalent of 90 25-basis point hikes in aggregate.

Exhibit 6: Several Latin America Central Banks Tightened Aggressively in Response to Rising Inflation

Note: Hike defined as every 25-basis-points worth of policy rate increase.
Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 8, 2022
Latin American equities look cheap versus history. The region’s 6.8x trailing 12-month price/earnings (TTM P/E) ratio looks attractive versus its own history (see Exhibit 7) and the 10.5x and 18.9x TTM P/E for emerging markets on average, and the S&P 500 Index, respectively. By this metric, Latin America is its cheapest to emerging markets for the bear market periods that we observed. We find this notable because when Latin America has traded more cheaply than emerging markets at the bear market trough, it has outperformed emerging markets by a median 20% to the next cycle peak.

Exhibit 7: Latin America Valuations Have Become More Appealing

<table>
<thead>
<tr>
<th>MSCI Latin America TTM P/E at Trough of Bear Markets</th>
<th>MSCI Emerging Markets TTM P/E at Trough of Bear Markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>30x</td>
<td>20</td>
</tr>
<tr>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>10</td>
<td>0</td>
</tr>
</tbody>
</table>


Investment Implications

The MSCI Emerging Markets Latin America Index is highly concentrated. In fact, Brazil and Mexico account for 60% and 27%, respectively, of its market capitalization. Below, we share our insights on those economies.

Mexico. First, we believe that Mexico’s economy could face headwinds as spending on tourism slows. In 2019, according to Oxford Economics, the Mexican travel and tourism industry represented 15% of total gross domestic product (GDP). Moreover, the industry’s economic activity supported 7.2 million jobs—roughly 13% of all jobs in Mexico. This compares to roughly 3% of all jobs in the US, according to industry information publisher IBISWorld. An additional factor contributing to our concerns is the high concentration of US visitors. According to Mexico’s secretary of tourism, the US represents more than 70% of international passengers arriving at or passing through Mexican airports. Already, there is evidence that travel may slow in the coming months. According to Morgan Stanley & Co.’s AlphaWise US Consumer Pulse Survey, US household plans to travel in the next six months declined from 64% in August 2021 to 51% in October 2022.

Second, we believe that Mexico’s economy could face headwinds as auto sales languish. According to the International Trade Administration, the automotive sector represents 20% of manufacturing GDP. Moreover, independent researchers at Autodata Solutions found that during US recessions, retail lightweight vehicle sales have fallen by 21% on a forward three-month basis. Ultimately, we don’t believe that the MSCI Mexico Index has fully priced economic headwinds. In fact, its ERP is the lowest among the economies that we measured and is lower than that of the Blended Emerging Markets (see Exhibit 4).

Longer term, Mexico could benefit from “nearshoring”—a supply chain risk management strategy whereby a business moves its operations to a nearby country from one at a greater distance. According to analysis from Morgan Stanley & Co.’s Mexico equity strategy and economics team, exports could rise by a potential total addressable market of US $155 billion (or more than 10% of Mexico’s GDP) over a five-year period. Moreover, according to the Inter-American Development Bank (IDB), more than 80% of export-related “quick wins” will come from the US (see Exhibit 8). The IDB defines a “quick win” as a nation capturing 15% of US imports of the top 50 products already exported to the US from the top 10 US markets of origin of those same products outside the Western Hemisphere.

Exhibit 8: Nearshoring Offers Mexico an Opportunity

<table>
<thead>
<tr>
<th>Potential Opportunities for Increased Goods Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quick Wins: US Medium-Term Opportunities</td>
</tr>
<tr>
<td>Quick Wins: Intra-Latin America and Caribbean</td>
</tr>
</tbody>
</table>

Note: Based on data for 2019. Intra-Latin America and Caribbean quick wins are defined as capturing 15% of Latin American and Caribbean imports of the top 50 products exported by each Latin American and Caribbean country from the region’s top 10 markets of origin of those same products outside the Western Hemisphere. Medium-term opportunities are defined as capturing 15% of US imports of the top 50 products exported to Europe by each Latin American and Caribbean country from the top 10 US markets of origin of those same products outside the Western Hemisphere.

Source: Inter-American Development Bank, Morgan Stanley Wealth Management Global Investment Office as of June 7, 2022
According to IHS Markit, the average manufacturing industry wage is $5.58 per hour in mainland China versus $3.90 in Mexico. Given attractive wages, rising demand for labor and political pressures to distance from China, we think Mexico will be a major economic beneficiary of US investment.

Additional work conducted by our colleagues at Morgan Stanley & Co. Research suggests that the electronics, metals, automotive and machinery sectors will be the greatest beneficiaries of onshoring.

**Brazil.** The setup for Brazil is compelling. First, we think that its economy will benefit from stronger growth and declining inflationary pressures—the country’s headline Consumer Price Index fell to 6.4% from 12.1% in April. Second, we anticipate momentum in labor market gains that could be further supported by the Bolsa Familia antipoverty program. Third, we think that Brazilian equities are attractively priced. In fact, Brazil is trading at a deep discount to the MSCI Emerging Markets Index (see Exhibit 4), and Brazilian equities have decoupled from forward earnings per share (EPS) estimates—providing an opportunity for a potential catch-up trade given developing tailwinds (see Exhibit 9).

Finally, Brazil could benefit from China’s reopening from COVID-19 lockdowns. In fact, according to the International Monetary Fund, approximately 28% of Brazil’s global exports are to China, and only 12% are to the US. Moreover, of the $88 billion of exports to China, approximately 34% are iron ore slag and ash—a base metal concentration used for the production of iron and steel.

Should China ease its zero-COVID policy stance, Brazil’s trade with China could improve. In fact, China’s policymakers have been encouraging lending, as we see in the chart below, which captures the China Credit Impulse Indicator—a leading gauge of industrial metals demand.

**Exhibit 10: China’s Credit Impulse Often Leads Industrial Metals Demand**

![Chart](source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 30, 2022)

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Please refer to important information, disclosures and qualifications at the end of this material.
GLOBAL INSIGHTS

Charts You Can't Miss

Exhibit 11: Mexico’s Reliance on US Is an Outlier Among Latin American Countries

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021

Exhibit 12: Brazil Has Outperformed Many Other Emerging Markets

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 7, 2022

Exhibit 13: The Recent Decline in Food Prices Is a Reprieve for Several Latin American Countries


Exhibit 14: Latin America’s Exports of Goods and Services Are Already Ahead of Pre-COVID Levels

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021

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Current Readings From Our Quantitative Framework

<table>
<thead>
<tr>
<th>Top 5</th>
<th>Value</th>
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<th>Momentum</th>
<th>Capital Use</th>
<th>Overall</th>
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<table>
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<th>Overall</th>
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<td>●</td>
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<td>Europe</td>
<td>Real Estate</td>
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<td>●</td>
<td>●</td>
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</tbody>
</table>

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Ongoing Development Spotlight

Ongoing Development Spotlight will return on Nov. 30.
Disclosure Section

Index Definitions

STRINGENCY INDEX is a composite measure based on nine response indicators including school closures, workplace closures and travel bans.

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

Glossary

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