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James Yardley (JY):

Hello, I'm James Yardley and welcome to the Investing on the Go podcast. Today I'm joined by Eduardo Figuieredo, the manager for the abrdn Latin American Equity fund. Eduardo, let's start with Brazil and the recent election. Is Lula good or bad for companies in the stock market?

Eduardo Figuieredo (EF):

[00:27] Hi James. Hi everyone. Thank you very much for inviting me. Yeah, thanks for shooting a very straight and direct question on this. Well, trying to be direct, I think we take the view that the Lula administration can be positive, and I stress the 'can'. I think we see … the main thing that needs to be taken into account is that we probably have two scenarios ahead and some question marks too.

A key question is whether the new president will be pragmatic and ensure fiscal discipline in how he manages the public accounts, as well as ensuring the attractiveness for the private sector. Or, you know, if we will see, perhaps, a more ideological side of him appearing, and perhaps leading to somewhat of [a] deterioration in the fiscal accounts and the environment for investments.

We believe the fact that we have a balance at Congress; as you probably know, we had not only presidential elections happening right now, but we had Congress elections as well. And that helped because the outcome was a more balanced Congress, with centre right parties gaining more seats and that provides checks and balances to a new administration.

(JY):

So, tell us a little bit more about that, because our listeners probably don't know the details of the Brazilian constitution and things. So, where are we now in terms of the balance of power? How much can Lula do? Does his party still control the Congress? Or do they have the, you know, limited majority in terms of what they can do? What's the exact situation?

(EF):

[02:39] Sure. I guess the main difference that happened, or was even a surprise to some in the market and led to a positive reaction of Brazilian assets, was exactly that: that the outcome of Congress elections and Senate [elections] because we have a two tier system with [a] lower house and Senate - showed a stronger performance of those centre and centre right parties, which, you know, in history, they have been the opposition of the workers' party, the party of President Lula. So, which means that in order to approve material subjects, for example, changes in constitution or anything more material, even some of the projects around more spending, those will require a broader support. And those will require the Lula administration to lean more towards the centre in order to gather that support.

In isolation, the PT party [*Partido dos Trabalhadores = Workers' Party*] doesn't have support to push through any agenda on its own. So, that is a key aspect or a key positive aspect of the outcome of this election. So, you know, I guess on that, I'm going to this because I think the checks and balances that we have now, they're very important. They, in our view, reduce risks of any extremes, but there are scenarios within that, and we are still waiting to see what will be the outcome.

I think a major signal will be the announcement of the team and key seats in terms of ministers and the cabinet of the President, which is expected to come in the coming months. Now, while we wait for this, there are one area where we have a perhaps more certainty and view.

I think based on the comments from the campaign and the program of the PT party and Lula, there's a clear view on how they will treat sectors, or at least that's how we have been reading [it].

I think on the one hand you see a great support to consumption companies because of all the aim to invest more in terms of the social spend and even support some of those areas, take, for example, the education sector or the lower income housing; those companies exposed to those sectors could benefit.

In other areas as well, for example, [the] Lula administration comes with a stronger agenda in terms of environmental commitments and [is] willing to put Brazil sort of back in the global stage of the climate debate, in terms of repositioning the country as a major, not only a natural resource base, but also a powerhouse of a renewable energy and so on. And that could be positive for Brazil, that could be positive for agricultural companies in terms of securing new trade agreements and new avenues for investments within the country as well.

Now, against that, we have concerns around what would be the direction for state-run companies, and I guess the flagship on that debate or in the spotlight of that debate, there is Petrobras [*Petróleo Brasileiro S.A*], the state oil company where, you know, it is a company which has very good assets, investors like very attractive dividends and very attractive valuations for the company. But it is expected that the new government could change a little bit the strategy and use the company a bit more to invest in new areas. There are debates around them going back into refining investments and so on.

So, you know, state-owned companies like Petrobras or even Banco do Brasil [Banco do Brasil S.A.] which we don't own, are areas where we are much more wary about, as well as perhaps some of the regulated sectors that could go through a period of uncertainty as the new government settles in.

(JY):

And just finally on Brazil then, so how is the transition of power going? Because I know there was some concern initially that maybe Bolsonaro and his supporters would contest the transition. Is that all been settled down now? Have Bolsonaro supporters accepted the results, and can we just move on now?

(EF):

[07:47] Yes, we hope so. I mean, every day there's something happening like small demonstrations since the end of elections; there were smaller groups, for example, protesting [on] roads and so on. But those have been mostly cleared. And I think the President himself has been quiet, which generated some anxiety during the first few days that he would dispute, or he was preparing something to dispute the outcome. But so far nothing happened. And his close allies have even publicly sort of accepted the outcome and are collaborating with the transition team that has been announced by Lula. So, so far, so good.

And actually, the removal that was seen as the major tail risk of Brazil, that we could go into an institutional crisis that the new President, the incumbent president could dispute the outcome and so on. So, the fact that we are seeing a sort of a smooth transition so far, it's also something that ended up being a positive view. I think there was that overhang that was somewhat priced into markets. So, by removing that alone, you could perhaps move forward and focus ... investors can focus again on [the] fundamentals of companies on the market.

(JY):

Very good. And so, how much does the role of the politics in Latin America, how much does it play a role in your stock picking? And it seems like you can't really ignore it, you have to consider it a bit. Is that fair or …?

(EF):

[09:29] That's it, I guess, you know, we would describe ourselves as sort of bottom-up stock pickers, and that's where we spend most of our time; discussing companies, discussing business outlooks, outlook for earnings and so on and so forth.

However, when you are investing in emerging markets, and especially in Latin America, as you rightly said, there's no way to ignore it, because at some point, the macro could hit the micro - as you say, right? – [so] the companies themselves. I think when [you have] unclear transmission channels sometimes is just the uncertainty in general, that it can generate. And that uncertainty fits into, sort of, as a starting point, as a higher cost of capital for a given country or a given sector, depending on the level of asset that it generates.

So, these are things that we, of course, have to monitor, but I guess our focus in sort of trying to identify what we call long-term quality companies, means that we are always looking for investment pieces that are less reliant on regulatory aspects, that they are less reliant on, you know, on say the headline GDP of a country. And they're much more underpinned by sort of self-help characteristics and opportunities for growth and investments. So, when you do that, you sort of eliminate a little bit of that direct political risk, but at the macro level you know, you need to keep an eye, of course and take a view. So, we do that.

And I think actually sometimes, that can be, we talk about risk, but sometimes could be opportunities as well, if you are able to identify you know, areas of the markets where you see an excessive discount being baked into companies that, where the fundamentals are good, that they are not necessarily impacted by the political risk, as some see [the situation]. And we can find opportunity to invest in those and back those businesses with a longer-term view. So, we take it in both aspects, right, in making a view on the risks, but also on the opportunities for the companies we look at.

(JY):

Excellent. And now let's turn to Mexico. Because I believe about a quarter of the fund is invested there. So, what's the economic situation there? Why do you like Mexico and what are the sort of companies you're investing in?

(EF):

[12:30] Sure. Mexico is a … it is an interesting place where, for some time, I mean, there has been criticism to Mexico as an investment destination, I think coming back to your last point, I think we saw changes in government with AMLO [*Andres Manuel Lopez Obrador, President of Mexico*] coming into power that was three years ago. And that lead to an overhang of Mexico and actually …

(JY):

And he was quite left wing, is that right? So, that sort of scared the market.

(EF):

[13:07] That's it; for context, he was more, let's say, left wing with a lot of commitments on social [welfare]. And actually, in some of the areas, he was very specific in having strong views, for example, in reforming the energy sector, in bringing more presence of the state-owned companies in the energy sector, which is, you know, was a step back versus what the country was doing historically in terms of opening up the country for private investments and so on.

So, in some of those areas in fact, we saw investments contracting in Mexico - private investments - and that led, for some period of time, to a lot of uncertainty and a discount in valuations for Mexican stocks.

Now, fast forward, what we actually saw happening is that yes, in some of the areas that were weakness, so private investments and FPI [*Foreign Portfolio Investment*] in Mexico have weakened on the back of this uncertainty, and that has dragged headline GDP. However, there are pockets of growth in Mexico, which remain very, very strong. And that's where we have, again focusing on the bottom-up, but we have mostly positioned the portfolio to benefit from those areas.

So, for example, the consumer sector in Mexico has been very resilient and strong. We like companies like WalMex [*Walmart de México y Centroamérica*], the Walmart subsidiary in Mexico; very strong operation, very profitable; companies like Arcacontal [*Arca Continental*] a coke bottler, going through a very good period of profitability enhancement, and also has some exposure to the US where the business was very strong.

And we can mention others in consumption, or [an]other area which is very attractive in Mexico is the whole near shoring, the so-called near-shoring of supply chains. That means that with the new agreement of NAFTA [North American Free Trade Agreement], we saw ties between Mexico and, of course, the United States and Canada, strengthening from a trade perspective.

But also, when you move into broader, geopolitical concerns such as we had the concerns around tensions between US and China, we had the pandemic bringing a major hit to supply chains more globally, and especially the supply chain coming from Asian markets where the lockdown measures were very strict. Suddenly, Mexico stacked up again as a place where you could build your manufacturing base, you could be in, irrespective of the sector. Historically the country was known for, of course, the car industry given the proximity to the US. But we see technology companies moving into Mexico and willing to build facilities there. And that's very …

(JY):

So, a lot of companies are moving production out of China and into Mexico, just to obviously have that closer geographic exposure to the US?

(EF):

[16:40] Correct. [JY: And greater security.] That's why we have … some have been using this term of near-shoring, right? The bringing proximity of supply chains, and rejigging supply chains a little bit, to reduce geographical risks on that supply chain. So, Mexico on this side of the world, stacks up very well because it's a cheap labour force, but also a highly qualified labour force that you can find in Mexico. And again, in terms of logistics very close to the US with favourable trade agreements as well.

So, within that, we have found companies that benefit from that, such as an industrial real estate company called Vesta [*Corporacion Inmobiliaria Vesta SAB de CV*], which is exposed directly to the regions where some of those companies are going and building up industrial warehouses and so on, or even the banks in Mexico where they have an exposure to the northern part of the country, and they benefit from the whole supply chain and manufacturing industries within those regions.

So overall, those pockets of growth are probably the ones that, you know, even [if] we're having some concerns around the headline figures in terms of GDP for Mexico, are the ones that have been very resilient, and that we continue to believe that they can perform well going forward.

(JY):

And Latin American equities have had a good year relative to other stock markets. Why have they held up so well? Because I guess traditionally, they're probably thought of as more of a 'risk on' market and potentially sensitive to high US [interest] rates in the past, and yet they have held up pretty well. So, what's going on?

(EF):

[18:35] Yes, I think we need to separate a little bit what is the economy, sometimes, from what is the index composition. And I think that that is important because, every now and then, you can see, if you discuss the outlook for the economy itself, you may lead or exit this conversation with the loophole view. There are always uncertainty around where, again, headlines; GDP for Latin America where [it] will go, and the fundamentals behind that.

But one thing that it's … that impacts both the economies and the index composition, is that Latin American economies, and again the equity markets, are heavily exposed to commodities – [the] Latin American index is probably one of the heaviest in terms of having exposure, if you add materials, energy and the more cyclical sectors in the EM [Emerging Markets] context, and those were sectors which benefited from higher energy prices.

If you take the price of oil going up, or even the whole inflationary pressures on the commodity companies that, as a result of - you could name quite a few factors - but, as a result of supply issues during the pandemic, but also more broadly from years of under investment into new capacity across the commodity space, when the global economy emerged from the pandemic, we suddenly saw shortfalls across - it was a common theme - across almost every commodity. So, the Latin American companies, or if you take the benchmark as the main reference, it benefited a lot from that.

Now, another sector where Latin America has the big exposure to, is the banking sector. The banking sector is a beneficiary of high rates in general, if I can make a… it varies according to country, but if you think around high inflation and higher rates, those are typically positive for EM banks, and Latin American banks for sure. So, we saw a very good performance of banks as well, and as they emerged from the pandemic with strong balance sheets, and suddenly we saw a relatively fast recovery in profitability, and even faster than what we witnessed in some other markets.

So, when I describe the weight of the benchmark, I think it helps you understand why we saw such a good performance and, again, irrespective of what was happening with … in terms of the headline GDP of the economies. But the important aspect is that we see the earnings outlook for companies in Latin America as positive as well, because those things, you still have a high - if you take the energy sector -you still have a high oil price supporting results for those companies.

[The] materials sector, while we saw some correction in commodities, it's still a higher level than it was not long ago. And on the consumption side as well, we see companies that have focused on cost cutting, that have focused on efficiency [are] very well positioned to deliver good earnings, especially as the region sort of exits or enters in a phase of stability in interest rate heights, as it has moved a bit faster in controlling the inflation pressures when compared to some of the EM and different EM countries.

So, that's a scenario where [it] underpins a constructive view for the market, from both the operating environments for companies, but also when you go more granular to the balance sheet than the P&L [Profit & Loss] of Latin American companies today.

(JY):

Yes, I mean, that sort of feeds into my final question, which is, why should investors consider investing in Latin America? And I think you've answered it, but why should investors bother now when other stock markets are down pretty materially? Obviously interest rates have risen, you can get pretty good yields in terms of bonds. Why should UK investors, I guess, bother with Latin America today?

(EF):

[23:48] Yes, that's … it's a fair question, and I guess there are two elements of it. I think Latin America has historically been seen as a bit of a tactical trade rather than a structural location even, and I think that's the nature of Latin America, given sort of the high beta to the external environment as we discussed. The exposure to commodities, at times, was seen even as a risk for some, for many of the countries. But depending … it depends a lot on, of course, the view for what is going to happen abroad.

But what we see right now, is that when [you] look at the fundamentals again of the economies and bringing that to the operating environment of companies, the external backdrop, if you draw … if you think around, it's still sort of an inflationary environment; of course, there is the issue of rising rates in developed markets, and the US and the stronger dollar potentially impacting the economies. But Latin America is a place which is relatively insulated or hedged even on that, because, again, the exposure to commodities is a good source of dollars for the economies: the companies benefit, the exporters ultimately benefit from a stronger dollar, in terms of bringing that cash flow back to the economies.

And if we think around the importance of Latin America as a natural resource base, and we could discuss here Latin America being one of the leading producers of copper, for example, which is a commodity which will be needed in terms of the energy transition and electrification trends.

Brazil is [also] one of the major agricultural producers, and therefore a major supplier to China. But even more importantly now, it's positioning itself to be an alternative to the supplies that you had maybe from places like Russia or Ukraine, and you could name all the sectors as well, such as the energy sector, which again the region is very well positioned in terms of having low-cost reserves and still high-quality assets to explore on that.

So, when you combine those things, we believe those provide a good backdrop for an environment where inflation is high globally, there are challenges around the supply of natural resources and then Latin America stack[s] up very well from that from that top-down positioning.

Now, finally, just to finalise the point, I guess when you go into the specifics of the region, yes, it had an outperformance, but in the context of history, that outperformance [of] the region had been lagging [behind] the broader equity markets, even the EM, in a longer history. So, the recovery, although we have seen a recovery, we're still seeing the region as trading below historical levels in terms of its relative valuations.

And therefore, we believe both the combination of the operating environment being supportive, and the valuations being attractive, hopefully provides you [with] a good tailwind for investors to invest in the region.

(JY):

Thank you very much, Eduardo. Really interesting insights and thank you for speaking to us today.

(EF):

It was a pleasure. Thank you very much for having me.

(JY):

And if you'd like to learn more about the abrdn Latin American Equity fund, please visit FundCalibre.com and please remember to subscribe to the ‘Investing on the Go’ podcast. Thank you very much for listening.

[Outro]

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