Spotlight on Mexico & Chile

Brazil has historically been the power house of Latin America, but in recent weeks investors have decided to stick to the side-lines. Dilma Rousseff, the President, appears to be trying to sure up the fiscal deficit, but for every promise made another obstacle appears. At this moment in time political uncertainty and grid lock in congress remain the biggest challenges to any structural reforms capable of kick starting an economic recovery. Until then we'll likely continue to see for this year and next, inflation figures revised upwards, GDP revised downwards, rising unemployment and a deteriorating current account deficit. Despite these headwinds however, there are a small number of high quality, cash generative companies that are beginning to look very attractive at current multiples regardless of Brazil's economic health.

In light of the uncertainty in Brazil we recently travelled to Santiago De Chile and Mexico City, with a quick stop in Monterrey to further explore alternatives. We met with a range of companies from financials to utilities to retailers. In Santiago we were given mixed messages with some feeling that political uncertainty, following President Bachelet's reform agenda, has been weakening consumer confidence and as a result affecting demand. Her approval rating continues to decline, having reached its lowest ever level of 26% in July, and as a result these reforms are slowly being revised and reconsidered. Take for example the tax reform which created an overly complicated two tier system and has been heavily criticised, now finds itself under the knife once again. That brings some encouragement to the market, but it is unlikely market participants will feel fully satisfied until there is more clarity. This uncertainty coupled with the impact from the fall in commodity prices, especially copper which has fallen 20% in US dollars since May, has resulted in corporates feeling more pessimistic than we initially anticipated. The average view was that the next 6-12 months will be challenging. The retailers in particular who have considerable foreign exchange exposure on imports, and have suffered from hot weather conditions impacting winter sales, saw sluggish results in Q2.

Yet while the macro picture painted by most wasn't overly pretty, there were positives to be drawn. Amongst them are the retailers who despite the tough climate are adopting better inventory management policies to preserve margins in the face of a depreciating currency. Agriculture and generation companies could benefit from the wetter and warmer effects of a light El Niño. In addition, the banks delivered a more positive narrative. Loan growth is steady in the mid to high single digits, asset quality has shown no signs of deterioration, unemployment is not expected to rise and inflation should only increase marginally.

There are clearly going to be winners and losers in Chile and it becomes a question of whose view to trust, that of the banks or that of a large number of other companies we met. Recently published INE data for industrial production and retail sales shows a more pessimistic view coming to the fore, with industrial production declining 5.2% in August and retail sales increasing slower than anticipated at 1.9%. Unemployment however does remain stable at 6.5%. If global copper prices can find support, whether it's from a reduction in capacity abroad or a surge in demand from China, then the Chilean Peso which has seen a 15% depreciation against the US dollar should stabilise. A set of more market -friendly reforms and a pick-up in copper prices could help kick-start a

IPSA Market Weighted P/E Ratio

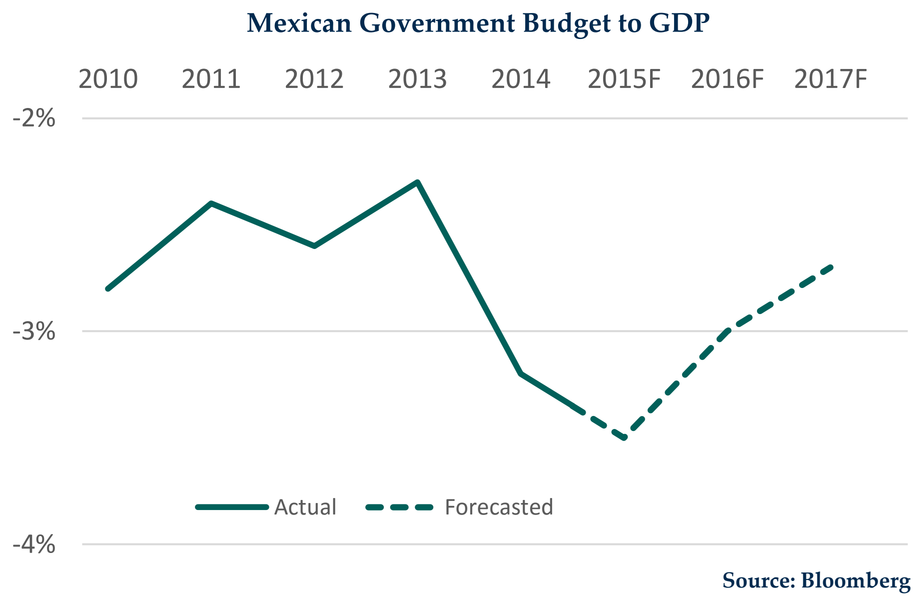
Source: Bloomberg

Market-friendly reforms could kick-start a re-rating of Chilean valuations which are currently subdued at long-term lows.

re-rating of Chilean valuations from the current earnings multiple levels, which are 1.6 standard deviations below the 3 year average.

Unlike in Chile where Bachelet's tough reforms have been weighing on consumer and investor sentiment alike, Mexico's President Peña Nieto has been pushing through reforms which aim to bolster growth above today's relatively subdued levels and encourage investment in the country. Although expectations so far have not been met, in particular with the energy reform, the progress is notable. The opening of the oligopolistic telecoms sector which will now face more competition is of particular note, as well as the tax reform that has seen a multitude of corporate tax loopholes closed. But it's no surprise the main headlines today surround the energy reform. As state owned energy monopoly Pemex prepares to welcome new players, a combination of low oil prices and uncompetitive auction terms keep private participants awaiting a sweeter deal. This was most evident for the first auction of shallow-water blocks for which a 30-50% success rate was expected, but for which only 15% of blocks received qualifying bids. The second round of auctions proved more successful, following better terms agreed by the administration and more desirable blocks on offer. Only time will tell how the third round plays out, but if the latest round was an indication of the trend going forward, then we should expect an even better turnout which will undoubtedly boost confidence in the country.

In light of the fall in oil prices and output which severely hit fiscal



Despite the impact of a collapse in oil prices on Mexico's fiscal revenues, the government is committed to showing fiscal prudence with 101 billion pesos of spending cuts announced for 2016.

revenues, the government continues to show commitment to fiscal prudence. With 101 billion pesos in spending cuts announced so far for next year, the government is taking reasonable steps to reduce the deficit and is duly appreciated by the market. The government's pragmatism is not the only positive news coming from Mexico. Inflation remains at an all-time low and consumption has remained healthy, with retail sales for August showing same store sales growing at 7.8% YoY and total sales at 11.5%. This is underpinned by a healthy labour market with rising real wages and low levels of unemployment. Our meetings with consumer companies confirmed this solid consumption trend, with expectations for robust volume and revenue growth.

The concerns with Mexico therefore are not so much with its management, but rather from external pressures. Mexico's link with the US is well understood, and with 80% of its exports heading north of the border, a potential slow-down in the US economy remains a concern. The recent delay to the Fed rate hike, and now uncertainty of when it will strike, is casting a shadow on a sector that up to now has continued to deliver. However the companies we met in Monterrey, mostly geared towards manufacturing and exports, remained comfortable with their long term prospects, as they continue to see robust demand aided by free trade agreements and a weak currency.

Similar to Brazil, companies in Chile and Mexico are facing difficult and uncertain futures. Although their respective governments are implementing reforms to varying success, economic and political failures are discouraging foreign investment, but this will not be the case indefinitely. We tend to be encouraged by these opportunities as we find very well managed companies being grossly mispriced.