Bond Blog

PGIM FIXED INCOME

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Latin America: Churning Waters Highlight an Imperfect Gem

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The Russia-Ukraine conflict rattled an investing environment already grappling with the withdrawal of fiscal and monetary stimuli amidst unsettling inflation dynamics and a softening global economic recovery. The scale of the geopolitical shock has markedly increased the potential for global stagflation.

Against this vexing backdrop and after a stretch of relative underperformance, assets from Latin America have generally outperformed year-to-date in 2022 (Figure 1). While the region is not fully insulated from the global financial gyrations and faces its own idiosyncratic challenges, its largest economies appear well positioned to weather the turmoil provided that the war doesn't catalyze into stronger stagflationary headwinds or metastasize into a wider conflict.

FIGURE 1: Latin America's window for relative outperformance

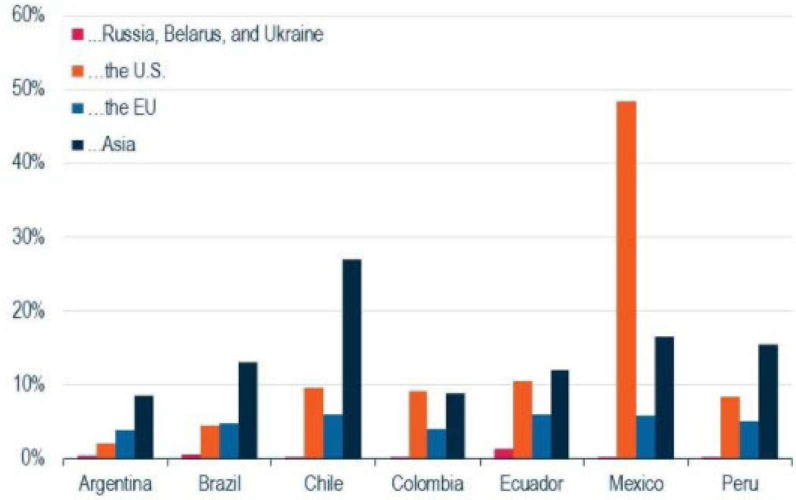
	Value	YTD Change
EMBIG Div	**451.8**	**83.3**
By Rating		
High Grade	214.8	66.0
High Yield	732.8	93.8
By Region		
Africa	658.0	46.0
Asia	274.0	39.0
Europe	915.0	591.0
Latin America	388.0	7.0
Middle East	323.0	-3.0

Source: Bloomberg. As of March 25, 2022.

A first consideration underpinning the relative insulation of the largest Latin American economies - which combined make up around 80% of the region's GDP - to the geopolitical upheaval stems from the minuscule trade links between Latin America and the countries at war, as shown in Figure 2.[1] For reference, we see euro area growth slowing from 2.7% in 2022 to 1.3% in 2023, while we see LatAm growth accelerating from 1.1% in 2022 to 1.7% in 2023.

However, the indirect trade links could be more material insofar as the conflict hinders economic activity - via additional supply-chain disruptions or by forcing tighter monetary policies, for instance - in regions that hold closer trade relationships with Latin America. The region's insulation is further bolstered by the highly remote probability that these countries are drawn into the conflict given their limited military capacity and penchant for pacifism.

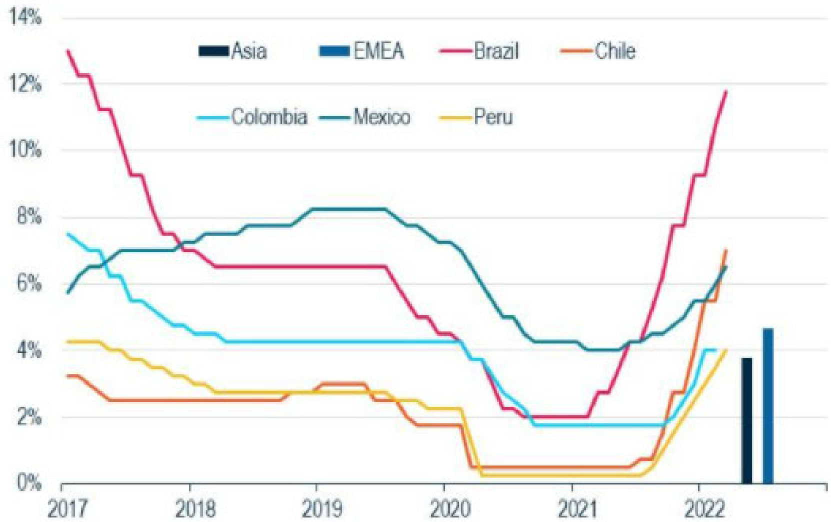
FIGURE 2: Latin America's 2021 trade with... (Estimated; % of GDP)



Source: National Statistical Offices, IMF, Haver Analytics and PGIM Fixed Income.

On the other hand, the sharp rise in the price of energy and food commodities is poised to add inflationary pressures at an unfavorable juncture consisting of elevated inflation and unmoored inflation expectations. Against this backdrop, the region's main central banks may need to respond to the shock by tightening monetary conditions even further than previously envisaged, notwithstanding the actions that governments may undertake to mitigate the impact on inflation or the conventional prescription that supply shocks don't warrant a policy reaction. That said, relatively high policy rates (Figure 3) could be a differentiating factor favoring Latin America in the global allocation of portfolio flows as the interest rates present the potential for attractive carry opportunities.

FIGURE 3: Comparison of monetary policy rates



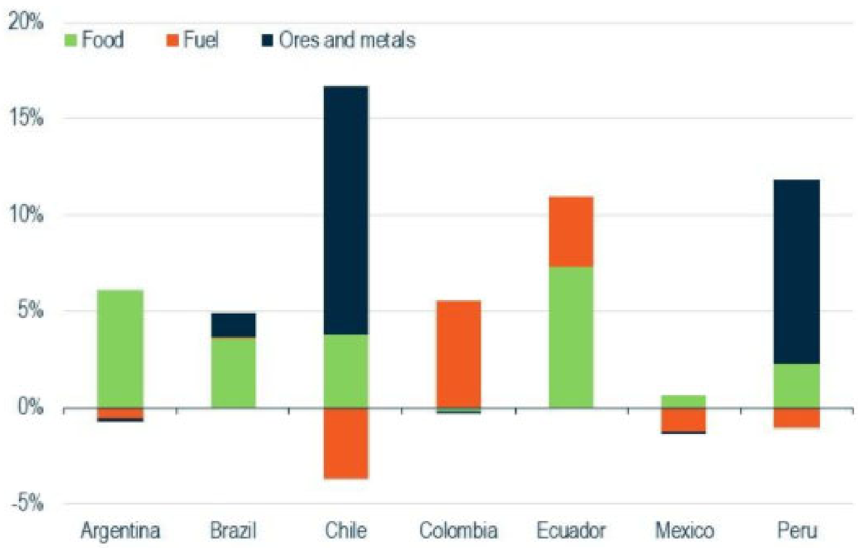
Source: Central Banks, IMF, Haver Analytics, and PGIM Fixed Income.

Given the reliance of the region's tradeable sector on commodities (Figure 4), the key tailwind behind the major Latin American economies pertains to the terms-of-trade windfall they might enjoy following the surge in commodity prices. A positive terms-of-trade shock would improve the region's growth outlook, contribute to the post-COVID correction in fiscal accounts, and bolster external positions. While Colombia and Ecuador stand to significantly benefit from the sharp increase in oil prices, the extent of the tailwind will vary by country.

Indeed, high oil prices blunt the windfall from the high prices of metals and food commodities, potentially even overcoming it, which could become the case in Chile. Although Mexico's export matrix chiefly relies on manufactured goods and holds a small surplus in food commodities, its position as a net importer of fuels raises the prospect that the surge of commodity prices ends up producing a negative terms-of-trade shock for this economy. However, Mexico's deeper integration to global supply chains compared to the rest of the region places the economy in a better position to benefit from the recent near-shoring drive that has mounted on the back of trade spats among major economies, COVID-related supply disruptions, and the deepening geopolitical chasm amidst the conflict in Eastern Europe.

As Latin America's largest economy, Brazil stands to benefit from its net exports of food commodities coupled with smaller net exports of ores and metals. Importantly, these exports are not offset by the need for fuel imports.

FIGURE 4: Net exports of commodities (2017-2019 average; % of GDP)



Source: World Bank, Haver Analytics, and PGIM Fixed Income.

When recalibrating their holdings of Latin American assets, investors should also consider the region's latent political risk. Candidates with unorthodox policy platforms are poised to be highly competitive in this year's elections in Brazil and Colombia, which take center stage after last year's election of left-leaning presidents in Chile and Peru. Argentina and Mexico are also being governed by leftist administrations that have challenged market confidence. Ecuador has bucked the trend by electing a market-friendly president, who nevertheless faces a left-leaning legislature in which his party lacks a majority.

Conclusion

The churning market uncertainty combined with Latin America's relative insulation from the war highlight the differentiation and relative value that exists across the region on multiple levels.

Indeed, the surge in commodities prices stand to benefit net exporting countries without sizable fuel imports, while others may see their windfall offset by commodity imports. Furthermore, the region's elevated monetary policy rates present some of the most attractive carry opportunities globally.

In this context, the sovereign and quasi-sovereign dollar bonds of some LatAm countries - including the short-duration debt of Colombia, Brazil, and Mexico's quasi-sovereign oil giant Pemex - present compelling value. We prefer the five- to seven-year portion of the curve, which trades with yields in the 5.0-6.5% range, as investors can benefit from the roll down and carry opportunities. Relative to longer-term debt, these tenors also present less exposure to interest-rate risk as well as the region's secular growth and political challenges. While these risks require continual monitoring, they currently pale in comparison to those unfolding in Europe.

[1] The largest economies consist of Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, and Peru.

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