April 2021

Stewart Investors
St Andrews Partners

The Case for Latin America

With the weighting of Latin American stocks in the Global Emerging Markets benchmark slipping below 10%, down from 25% two decades ago, the region has become something of an investing backwater.[1] So why then are we optimistic about the region?

If we were to summarise our enthusiasm in one word, it would be this – inflation.

No we aren't going to argue that developed world central bankers have set us on an inexorable path to hyperinflation with their money printing. Just that after 40 years of declining inflation, the risks are rising of uncomfortable levels of inflation.

Because we are all prisoners of recent history, and even the longest investment careers rarely extend to 40 years, what defines 'uncomfortable' may not be very high at all, precisely because most portfolios are ill-prepared for an inflationary period.

This leads us to Latin America for three reasons. Firstly, if there is one subject on which Latin American executive teams are world-acclaimed in, it is protecting the real value of their shareholders' funds against inflation. Mexico discontinued inflation-accounting as recently as 2008, while Brazil last saw official inflation above 5% as recently as 2016, when they registered a nearly 9% growth in prices.[2] Chile continues to use a separate inflation adjusting currency for denominating property prices and long-term borrowing.

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For global firms which have not had to worry about rising input costs, the mantra in recent decades has been to make their operations as lean as possible, which has meant outsourcing the ownership of manufacturing assets wherever possible to maximize returns on capital. The consequences of 'just in time' and 'own nothing' models are clear today – from chronic shortages of protective equipment at the beginning of the Covid pandemic, to component shortages in the auto industry, or the impact of the Suez canal blockage on already high freight costs - all demonstrate the lack of flexibility inherent in these systems.

By contrast, one of our favourite Latin American companies, which sells cardboard, packaging materials and pulp, owns over 500,000 hectares of forested land, over three times the area of Greater London.[3] The business school textbooks would no doubt tell management to sell these assets and buy from a third party, which would probably boost returns in accounting terms. However, it is this vertical integration which insulates the company from rising prices.

Similarly, a Brazilian company, which is arguably the most successful industrial company in the region, is highly vertically integrated, manufacturing many of the constituent components that go into their extremely wide range of electric motors. Many of these are made at their enormous facility in Brazil, the largest electric motor plant in the world and twice the size of Tesla's California vehicle plant.[3] Again this helps the company keep a tight lid on costs, as well as aiding innovation.

The second reason inflation could be a boon to the region is the dependence of the region's economies on commodity exports. One of the few asset classes that has historically tended to do well in an inflationary environment is commodities, as happened in the 1970s. While our strategy has limited direct exposure to commodity exporters, this would be a very helpful tailwind for the region. The few areas where Brazil is globally competitive (other than electric motors!) include iron ore, animal rearing (chicken and cattle), soybeans and forestry. The Mexican government derived 40% of its revenues from oil & gas at the peak for oil prices in 2008, a figure that has declined to nearer 10% (partly due to lower production).[4] Peru continues to be one of the world's biggest producers of gold, silver, and copper, while Chile has a large sovereign wealth fund supported by copper sales.[5]

The final reason why Latin America is well placed for a more inflationary environment is the low level of corporate debt. In contrast, in the developed world and in China, persistently low inflation has allowed corporates to borrow historically high amounts at historically low interest rates. Assuming higher inflation is accompanied by higher interest rates, companies will have to spend a higher proportion of their cashflows servicing debt to the detriment of equity holders. The corporate sector in Latin America generally is not highly indebted, and indeed a large number of the companies we hold shares in have net cash balance sheets.

To conclude, we are not saying that inflation will rise. Our crystal ball is currently undergoing routine maintenance. We are arguing there are risks of higher-than-expected inflation and that it would be prudent to have some protection against this in a portfolio. We believe our Latin American strategy is positioned to offer this protection, holding high-quality companies with difficult-to-replicate assets, such as brands, intellectual property and lowest-cost manufacturing resources.

Dominic St George

[1] Source: Stewart Investors.

[2] Source: 'Brazil: Inflation rate from 1985 to 2025'. Statista.

[3] Source: company report.

[4] Source: OECD

[5] Source: 'Major countries in copper mine production worldwide from 2010 to 2020'. Statista.

Investment terms

View our list of investment terms to help you understand the terminology within this document

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StAP-CaseforLatam-0421