

Opportunities abound in Latin America for fundamentals-based investors. Sometimes misunderstood as only a play on China and commodities, Latin America, mired in political scandals and buffeted by capital outflows, posted the worst regional equity returns in the world last year. As of March 31st 2016, the region has lost a cumulative 54% in dollars from its 2011 peak. The market dislocation has left many securities substantially mispriced. One of the most attractive and asymmetric risk-reward investment opportunities today is to buy shares and debt of resilient companies, trading at a discount, that are focused on the domestic economy and the secular advance of the middle class. They span the Andean markets of Chile, Colombia and Peru, as well as Brazil, Mexico and Argentina. They compete in sectors as diverse as telecom, packaged foods, retail, cement, engineering services, hydroelectric generation, and banking.

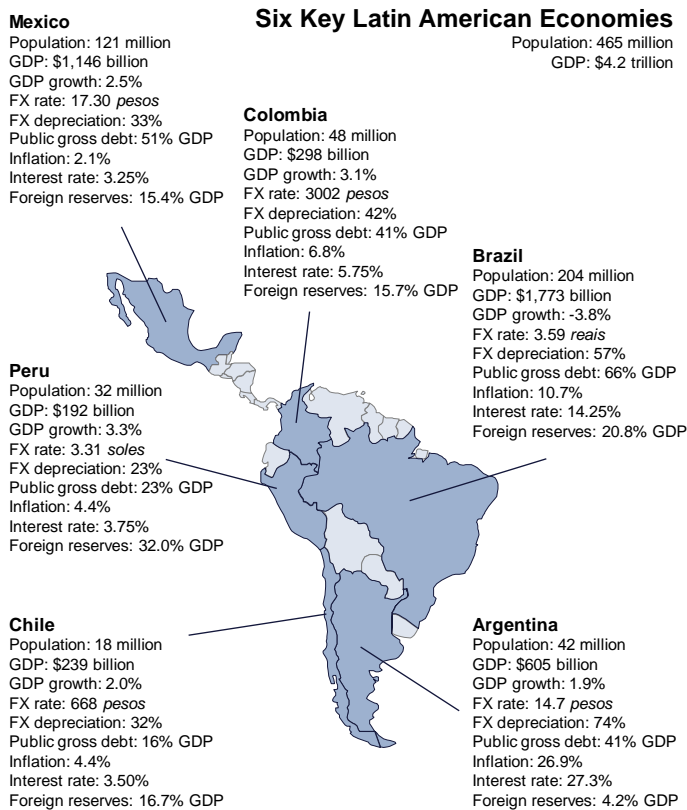
John Haskell will take the opportunity at Grant's Spring 2016 Conference to present specific investment ideas.

Market and macroeconomic context

The purpose of this memo is to provide market and macroeconomic context ahead of that discussion. Three key points:

- 1) Markets in Latin America have a history of high volatility for dollar-measured investors. The MSCI Latin America Index is down 54% from 2011 peaks. For dollar-based investors there are three components of returns: corporate earnings, valuation multiples, and currencies:
 - Corporate earnings across the region have declined 18 to 64% in local currency from 2011 to 2015.
 - The cyclically-adjusted P/E multiple for Latin America has collapsed 50% since 2011.
 - Currencies have depreciated between 13% and 51% since 2010.
- 2) Current valuations are undemanding compared to other regions. Latin America trades at a 53% discount to the cyclically-adjusted P/E multiple of developed markets and an 17% discount to global emerging markets.
- 3) Stronger economic growth trends will resume over the next 12 months, benefiting investors who position themselves today. These trends are supported by favorable demographics and, especially in the Andean region and Mexico, by low inflation, manageable fiscal deficits, free trade, and strengthening democratic institutions.

Six Key Latin American Economies



All figures 2015
FX depreciation from five year peaks through March 31, 2016

1) A history of extreme volatility (and opportunity) for dollar-denominated investors

The region's equity markets have declined 54% in dollars since 2011 peaks. If history is a guide, investors now have an opportunity similar to that of buying assets at large discounts coming out of the 2008 financial crisis, as equity markets have reached comparable levels.

The region has experienced four market crashes since 1995, surpassed in percentage terms by their subsequent rallies. Dollar-based investors experienced losses of 54% to 68% over periods of six months to 2.6 years: in 1997-1998 during the Asian financial crises and Russian default, in 2000-2002 during the "dot-com" bust and September 11th terrorist attacks, in 2008 during the financial crisis, and now. Following each period of market capitulation (the present excluded, so far), patient and contrarian investors then realized substantial returns. Investors in Latin America in late 1998 reaped 122% in the next one and a half years. Starting in September 2002, the market delivered 30%+ annualized returns over the ensuing

five and a half years, sustained by a commodity “super-cycle.” Oil rallied 375% from \$28 a barrel to \$134. Other energy, materials and foods items rose in tandem, in an unprecedented broad-based commodity rally, fueled by demand-side industrialization and urbanization principally in China. After losses from the financial crises in 2008, Latin American markets rebounded 185% in two and a half years.

January 2016 may have marked the end of a 4.8-year decline that wiped out 67% of market value from peak to trough. Even so, as of March 2016, Brazil remains 66% from its April 2011 peaks and in line with 2008 lows. Colombia is off 60% from February 2013 peaks. Chile and Peru have declined 51% and 43% respectively from 2011 peaks. Argentina and Mexico are relative outperformers. Argentina has lost 31% in dollars. Mexico has lost 27% since peaks in April 2013.

MSCI Latin American Emerging Market Index (USD denominated)



Three drivers of returns: corporate earnings, valuation multiples, and currency impact

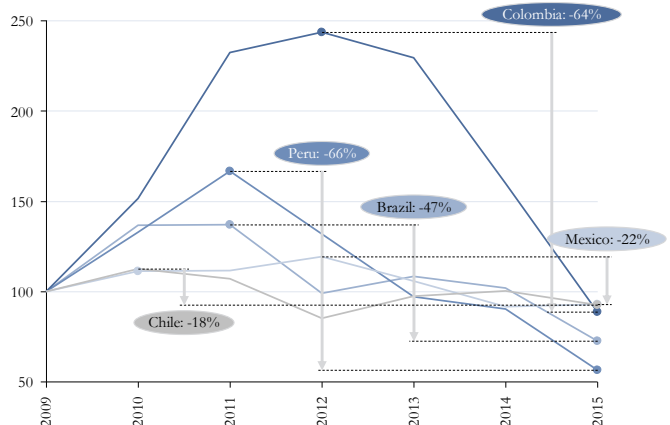
Three components drive dollar returns for investors: changes in corporate earnings and cash flow, expansion or contraction of valuation multiples paid by the market, and currency gains or losses. All three explain the current market downturn.

Corporate earnings in Peru declined 66% between 2011 and 2015 in local soles. Earnings in Colombia are down 64% from 2012 peaks in pesos. Brazilian companies earned 47% less in 2015 in reais than in 2011. Lower commodity prices impacted the energy and materials sectors in these three countries, especially.

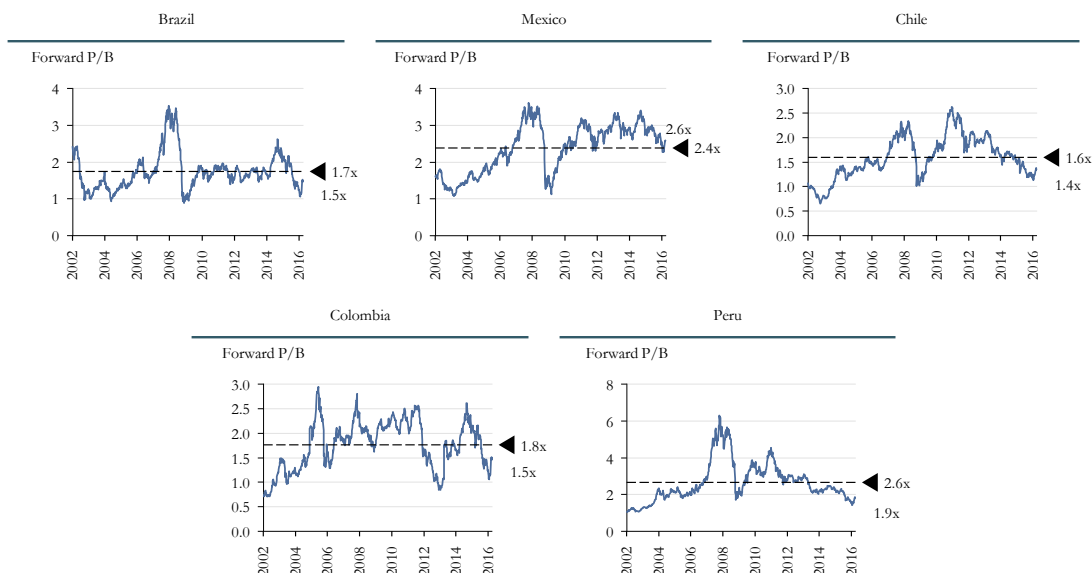
Mexican and Chilean companies have posted relatively resilient earnings, declining 22% and 18% respectively from peaks in local currencies.

Multiples on earnings paid by the market have contracted 50% on a cyclically-adjusted forward price-to-earnings basis. The market pays just 9.3 times the average of the past 10 years’ earnings compared to 18.4 times just five years ago.

Aggregate corporate earnings in local currency, Index 2009 = 100



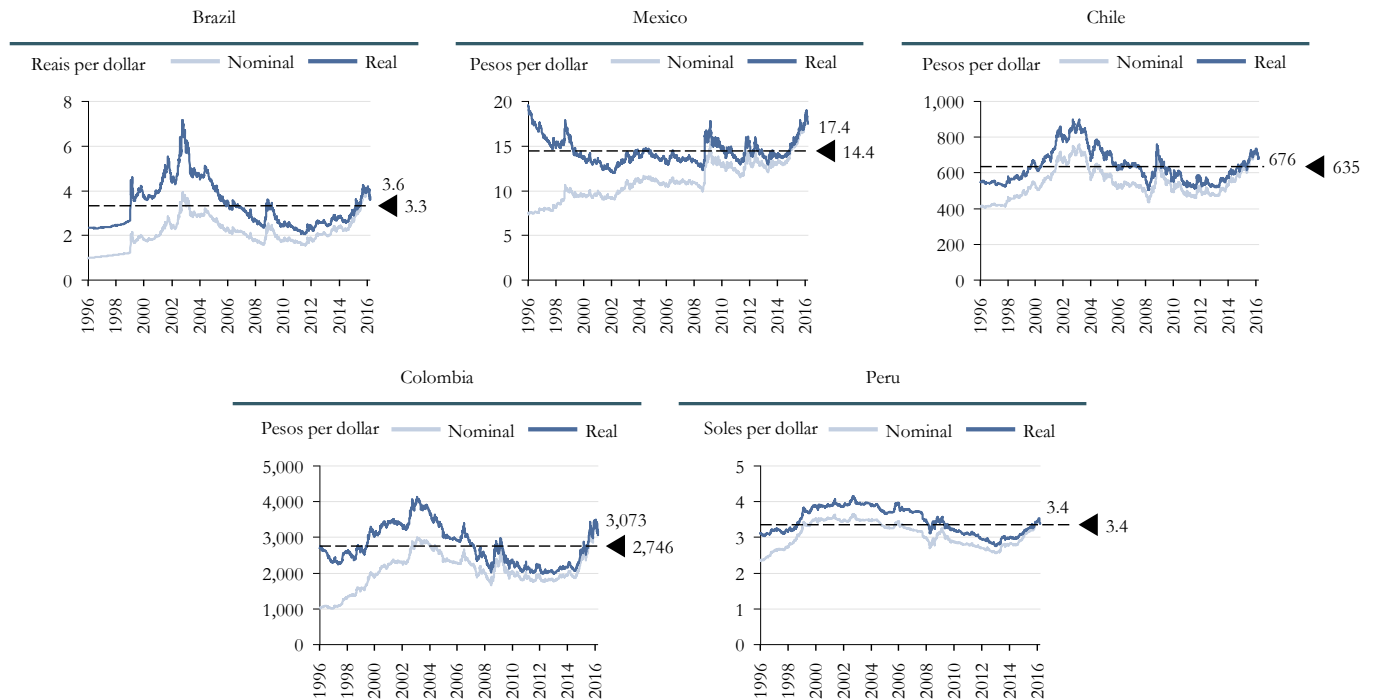
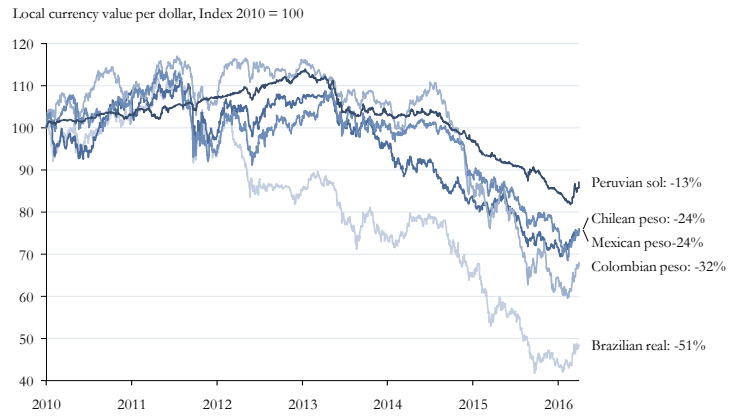
Snapshot multiples (not cyclically adjusted) are selectively below average, though less so due to presently depressed corporate earnings. Forward price-to-book multiples between 1.4x and 1.9x are below long-term averages in Brazil and the Andean countries. Mexico currently trades at 2.6x price-to-book, a premium to its 2.4x fourteen-year average.



Currencies in Latin America were among the worst-performing globally against the U.S. dollar during 2015. The value of the Brazilian real declined by 33% in 2015. Other currencies in Latin America's key markets declined by 13 to 25% during the year. Cumulatively since 2010, regional currencies have depreciated between 13% and 51%. Exchange rates throughout the region are near or below the weakest levels of the 2008 global financial crisis.

The drop in the value of these currencies largely reflects a concurrent decline in the price of hard and soft commodities, which comprise the largest component of exports from Latin America. The decline in local currencies has been further exacerbated by weak policy responses on the fiscal front in certain markets (e.g., Brazil), which are difficult to implement in any democracy. Brazil's weak progress on fiscal reform (i.e., spending cuts) has been further worsened by political gridlock, most notably due to the Petrobras corruption scandal.

At current levels, exchange rates reflect an opportunity, both as an important adjustment mechanism for the real economies in the region, as well as for dollar-measured investors deploying fresh capital today. Currency fundamentals are now attractive. Purchasing power of the dollar is substantially higher in countries like Brazil and Colombia than just three years ago. Exports are sufficiently competitive at present exchange rates to resolve current account deficits. Brazil's current account deficit, for example, declined from 4.7% of GDP in February 2015 to just 2.7% in February 2016. More orthodox policy by central banks has led to rising interest rates to anchor inflation expectations, which further supports a positive currency outlook at present levels. Regional currencies trade at historically cheap levels, even when adjusting for inflation differentials. This suggests appreciation in the future, as real exchange rates tend to revert to the mean over time.



2) Undemanding market valuations in an asset-price inflated world: 60% discount to cyclically adjusted P/E multiples of the S&P

Since 2010 the MSCI World Index has risen 41%. During the same period, MSCI Emerging Markets declined 15% and Latin America 47%. Latin America is one of the only regions today where fundamentals-based investors can find an abundance of value.

Lower equity prices in Latin America are justified -- to an extent. Declines in commodity prices have contributed to slowing economic growth, which has reduced corporate earnings across the region. The declines caused major exchange rate devaluations, challenges on the fiscal front, and some inflationary pressures. All of this has resulted in slower economic growth and weaker consumption. Equity markets therefore reflect reduced

earnings today and tempered growth expectations. The impairment is largest for companies highly exposed to commodities or dollar-based inputs, for companies with thin operating margins, or for companies with too much leverage, often denominated in dollars.

Following the sell-off, Latin American equities trade at 9.3 times the average of the past ten years' earnings. Developed markets trade at 19.9x times and global emerging markets 11.2 times. Latin America therefore trades at a 53% and 17% discount, respectively.¹ The S&P 500, which has rallied from 1,272 five years ago to 2,060 today, is even more richly valued at 23.5 times. Latin America's discount to the S&P on a cyclically adjusted P/E ratio basis is 60%.

The most compelling investment opportunities are in individual securities, not the aggregate market

Market declines have overshoot the mark for a subset of companies with substantial and measurable value, despite a slower-growth environment. This reduction in valuations is due to investor behavior and to an uneven dispersion of market liquidity. Global investors without on-the-ground knowledge to discern the resilient from the distressed will indiscriminately (and perhaps rationally for them) sell. Trading liquidity, meanwhile, has decreased unevenly, disproportionately affecting small and mid-cap companies



3) Medium-term economic growth trends are intact in the Andean region and Mexico

It can be difficult to examine and act on the medium-term macro-economic outlook during such times of market volatility. Fiscal and currency adjustments have hurt the region in the short-term, precipitated by the crash in commodity prices. Nevertheless, the growth outlook for the Andean region and Mexico remains constructive. Each country expanded in the 2% to 3% range in 2015, with 2% to 4% growth expected in 2016 and 2017. The Peruvian economy expanded by 3.3% in 2015, and will likely accelerate to 4.0% in 2016 and 2017. The Brazilian economy contracted by 3.8% in 2015 and will decline in the 4.2% range in 2016. Growth in Brazil should rebound slightly in 2017 (in the 0.5% range) and accelerate further in 2018 and beyond, as inflationary pressures ease and rates decline as we expect. A positive resolution to the current political crisis would provide further needed stimulus to the Brazilian economy. Argentina is a unique case. Within its first 100 days, the Macri administration has taken meaningful steps toward normalization. They have reached an agreement with bond holders, unified the official and parallel FX rates, reduced capital controls, cut export taxes and taken steps toward opening up to trade and investment.

Demographics: an increasingly affluent population of considerable scale comes of age

Underpinning Latin America's economic growth prospects is the region's large, increasingly affluent, and young population. The region has nearly 600 million people, roughly divided into one-third Brazil, one-third Andean countries and Mexico, and one-third the remainder. 200 million are now part of the middle class, double that of 2003. The World Bank estimates that an additional 100 million will enter Latin America's middle class by 2030. Latin America today resembles the United States in the 1960s and 1970s, as "baby boomers" entered the workforce and formed households, fueling decades of economic growth and wealth creation. Half of the population is under age 30, which compares favorably to half under age 40 in the US.

Low inflation

Stable prices permit companies and households to execute on longer term planning and investment decisions. Inflation is expected to be below 5.5% in the Andean region and Mexico this year and next. In Brazil, inflation peaked at 10.7% in 2015. Economists expect inflation to drop to the 7.6% range in 2016 and 6.0% by 2017 due to tight monetary policy and a recessionary environment. Runaway hyper-inflation is not a high-probability outcome, because of aggressive central bank actions (and ultimately the political will of electorate). Brazil's central bank raised interest rates to 14.25% in July 2015. The country has now reached the end of its two-year rate hike cycle to battle inflation. Inflation-adjusted interest rates are now about 5% in real terms, some of the highest in the world, and should be sufficient to begin to reduce inflation. As inflationary pressures ease, we expect to see a gradual decrease in interest rates in Brazil, which will be a catalyst for fixed investment and stronger growth in 2017 and beyond.

Fiscal balance, low debt, high reserves, and free floating exchange rates

The relatively manageable fiscal balances in Latin America's key economies are an added source of resilience. Most emerging market crises occur due to a sovereign credit event, which is essentially the accumulation of fiscal deficits. Across Latin America, the decline in global commodity prices directly and suddenly reduced tax receipts. Most governments are adjusting spending, however slowly. Any pickup in economic growth would increase government receipts.

Low sovereign debt balances, substantial central bank reserves, and free floating exchange rates give these countries the tools and resources needed make their fiscal adjustment. Public sector net debt to GDP is 40% or below in the countries where we invest. Chile's figure stands at just 3%. By

¹Cyclically adjusted P/E ratio espoused by Benjamin Graham in *Security Analysis*, comparing current market prices to the average earnings over a sufficiently long time period to adjust for peaks and troughs of market cycles

comparison, the United States stands at 80% and Japan 130%. Foreign reserves range from 15.4% of GDP in Mexico to as high as 32.0% of GDP in Peru. Free floating exchange rates act as a shock absorber, by stimulating exports and inbound fixed investment.

Free trade

Mexico and the Andean region formed the Pacific Alliance to promote trade among its members and with the rest of the world. Collectively, the economies of Mexico, Chile, Colombia and Peru represent the sixth largest economy in the world as measured on a purchasing power parity (PPP) basis, with a combined GDP of \$3 trillion. Each member of the Pacific Alliance has a free trade agreement with the United States. In addition to trade, the Pacific Alliance has created an integrated stock exchange and has promoted visa-free movement of its citizens among member countries. Dollar volume of trade has dropped in line with the recent decline in commodity prices, but as competitive low cost producers, these countries continue to export all the physical volumes they produce, which helps support employment levels.

Argentina is emerging from economic isolation. We expect the country to sign free trade agreements with Europe by 2017 and the United States by 2020.

Brazil's macroeconomic and political distress may mark a sharp turn toward free markets. Recent headlines report that Brazilian legislators are considering breaking with Mercosur red-tape to negotiate bi-lateral trade agreements with Europe and the Pacific Alliance.

Democratic law and strengthening institutions

Rule of law in Latin America is reasonable compared to many other emerging markets and is improving with the maturation of democracy and the decentralizing effects of technology. For those with a short-term view, headline scandals across the region feed negative sentiment. But these scandals also demonstrate the progress towards stronger institutions on a longer-term time horizon. These scandals gain traction in the free press and social media and catalyze civil society to protest. Governments are responding.

Political corruption manifests in Latin America because the power held by bureaucrats and politicians is high compared to income levels and because rule-of-law enforcement mechanisms are weaker than many developed economies. Corruption scandals have impacted many Latin American markets recently.

- In Brazil, the acute nature of the current recession and currency devaluation are partially tied to a political crisis that is rooted in scandal at the state-controlled and heavily indebted oil producer, Petrobras. Brazilian President Dilma Rousseff was the chairwoman of Petrobras from 2003 to 2010. After Dilma's presidential re-election in 2014, planned fiscal reforms (e.g., to adjust to lower tax receipts due to lower commodity prices) became more difficult because politicians and Worker's Party leaders were accused of participating in a multi-billion dollar contract rigging scheme that resulted in some politicians, as well as senior executives from a dozen leading construction firms, being arrested. The scandal has reached the highest levels of government, including former President Lula being charged for money laundering. The likelihood of Dilma's impeachment has increased, and consensus points toward this being the most likely outcome. While the events in Brazil inspire negative headlines, the high profile "Lava Jato" investigation is showing the strength of country's federal police and judiciary.
- In Mexico, a conflict of interest scandal has emerged, involving homes bought by the President, his wife and the Finance Minister from prominent contractors who won very lucrative public work contracts. Mexico's congress passed an anti-corruption law in April 2015, strengthening oversight of public officials and appointing a special prosecutor to tackle corruption.
- In Peru, the Prime Minister was embroiled earlier this year in an alleged spying scheme against lawmakers, reporters and businessmen. Peru's President Humala subsequently sacked the Prime Minister.
- In Chile, President Bachelet's son is accused of influence peddling to secure favorable loans in 2013. A large local mining company is accused of a fraud scheme with links to campaign finance violations across several political parties. In May 2015, President Bachelet reshuffled her cabinet and put forth a series of measures aimed at improving transparency and curbing corruption.

Sources: Bloomberg, Itau, Morgan Stanley, World Bank, Explorador analysis

Data current as of 3/31/2016