Come and join the carnival

ARE YOU HEAVILY WEIGHTED IN EUROPE? WHERE ARE THE OPPORTUNITIES FOR DIVERSIFICATION? LOOK NO FURTHER THAN LATIN AMERICA, ADVISE **KAREN BOXALL** AND **SONSOLES CASTILLO DELAGDO.**

The consumer market is almost 'saturated' in Europe but there is still plenty of opportunity in Latin America. For example, 11% of the population have personal computers compared with 55% in Europe and only 27% are internet users while in Europe 59% of us log-on regularly. If you travel on the train at all you will probably have an idea that in Europe there are 117 mobile phones for every 100 people compared to 67 in LatAm. The difference is perhaps most clearly emphasised by the the fact that all of Europe's roads are paved but in Latin America this figure is a paltry 22%.

However, the recoveries in the economies of Latin America countries compare favourably to developed Europe. The sustainability of the recovery beyond 2010 is in doubt for Europe and concern about the longer term consequences of rising public debt levels on the continent has increased risk premiums, which are likely to continue for an extended period. Meanwhile, emerging economies are benefiting from the strength of their own domestic demand; and are seeing more sustained recoveries.

Brazilian GDP is expected to grow 5.9% this year with the strength of domestic demand the main driver. Brazil will also benefit from the recovery in the US, relatively robust growth in China and high commodity prices. With dynamic activity and the consequent surge in inflation, we expect the SELIC (Brazil's central bank overnight lending rate) to be at 11.5% by the end of this year although the market is more aggressive at 13%.

FX INTERVENTION HELPS STABILITY The growth scenario and the monetary tightening cycle will continue putting appreciatory pressures on the Brazilian real. However, intervention in FX markets should help to avoid a sharp appreciation of the currency; for example the Central Bank intensified dollar purchases when the exchange rate dropped below the 1.75 mark. The increasing current account deficit should also create a self-correcting mechanism to limit pressures for appreciation. We expect the exchange rate to be at 1.76 by the end of the year, close to its equilibrium value. With an election in October this year we expect some volatility in the meantime.

The robustness of the Brazilian economy in the coming years is expected to create a wide variety of opportunities to invest in Brazil.

Although in principle there are no restrictions for the participation of

foreign capital in national activities in reality there are various barriers.

Some activities such as postal services, health services, sanitation and nuclear energy are restricted to foreign investors. Also there are restrictions on foreign capital investing in financial institutions, insurance companies and in the media sector. In some specific sectors, such as oil for example, the increasing activism of the public sector could crowd out foreign capital. Brazil also has a complex system of corporate taxation, with taxes levied from all directions – the federal, state and municipal governments which create a less than friendly business environment.

And of course we cannot forget that since the end of 2009, financial inflows into the country are charged a 2% tax.

FOREIGN DIRECT INVESTMENT However, this tax hasn't deterred investors as FDI flows to Brazil have been high. In 2009, in spite of the world crisis, these flows reached $31bn. US and European countries such as Netherlands, Spain and France remain among the main contributors for FDI flows. Financial services, metallurgy, mineral extraction, food processing and energy are among the sectors benefiting most from foreign capitals inflows in recent years. Among the companies that have recently announced plans to invest in Brazil are Pepsico, Shell, Heineken, and Ford. A recent trend regarding FDI flows is the increasing importance of Chinese capital, for example, the State Grid Corporation, a Chinese utilities company, has announced the purchase of seven Brazilian transmission companies controlled by Spanish energy firms for US$1.7 bn.

The recovery in the Chilean economy is also under way. The earthquake in February caused significant temporary damage to most sectors, from infrastructure to manufacturing. Private and public investment for reconstruction will be the main growth factor over the next few years. The initial uncertainty about the method of public financing for the earthquake reconstruction (around $9bn over the next four years) was a source of concern and understandably caused volatility in the markets. However, the diverse financing programme designed by the government is considered appropriate and will minimise potential impacts on the exchange rates, interest rates and GDP growth. Official interest rate rises are on the cards as inflation expectations have been increasing. We expect the Central Bank to react aggressively in the coming months with official interest rates at 3% by year end (with the market pricing in a less aggressive reference rate at 2.75%).

We expect the CLP (Chilean peso) to appreciate to 510 pesos/USD by the end of 2010.

INCREASING GROWTH Peru's economy is recording an increasing growth pace aided by an upturn in private expenditure. As growing economic activity is becoming less dependent on stimulus policies; it is more self-sustained. GDP growth forecast for 2010 is well above the regional average at 5.7%. Given the cyclical recovery of tax revenues, we expect the fiscal deficit in 2010 to drop from 2.1% to 1.4% of GDP and the ratio of public debt to GDP to resume its downward trend, falling to 24.0% by the end of this year and to 20.2% by 2012. We foresee moderate current account deficits between 0.5% and 2.0% of GDP for 2010-2012, which will be largely financed by long-term capital inflows, mainly foreign direct investment. In order to prevent the transitory increase in inflation from contaminating expectations and affecting economic growth, the Central Bank will continue to remove the monetary stimulus and will take the policy rate to 2.5% by the end of this year. To avoid appreciation pressures on the Peruvian currency, the Nuevo Sol or PEN, that would force the Central Bank into more significant foreign exchange purchases, fiscal stimulus will be withdrawn early and gradually. We forecast an exchange rate of around 2.76 at the end of the year. Risks are on the downside due to European/global contagion.

Foreign investment will be attracted in particular to the mining (Anglo American, Xstrata, and Shougang), oil and gas (Pluspetrol, Hunt Oil, Petrobras, SK Energy, Repsol), communications (Telefónica and América Móvil), and electricity (Enersur GDF Suez) industries.

EXPANSIONARY POLICIES PAY OFF Recovery in Latin American has been gaining momentum due to the expansionary policies implemented during the crisis, the robust dynamism of the Asian economies (7% of trade is with Asia, or 15% excluding Mexico), the rebound in commodity prices and the increasing contribution of domestic demand to growth.

However, it is not all full steam ahead as several countries could see their exit from the crisis slowed due to a sharp rise in uncertainty in recent weeks and in the absence of significant inflationary pressures (excluding Brazil) this could mean a reluctance to withdraw stimulus – which of course would help to sustain growth.

The Latin American region has registered huge capital inflows and high currency appreciation pressures; although this has moderated recently due to contagion from Europe and possible reduced demand in China.

As the global risk aversion dissipates, we expect the region's currencies to strengthen due to strong fundamentals, higher growth prospects and capital inflows. It is also anticipated that the G3 economies will keep their "low for long" monetary stance. LatAm countries are well placed to benefit given their relatively low (trade and financial) exposure to the European Monetary Union, a stronger set of fundamentals with lower fiscal and external imbalances compared to most of their emerging market peers, and a consumer base with huge potential.

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