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Latin America: Robust domestic demand to support growth in 2013

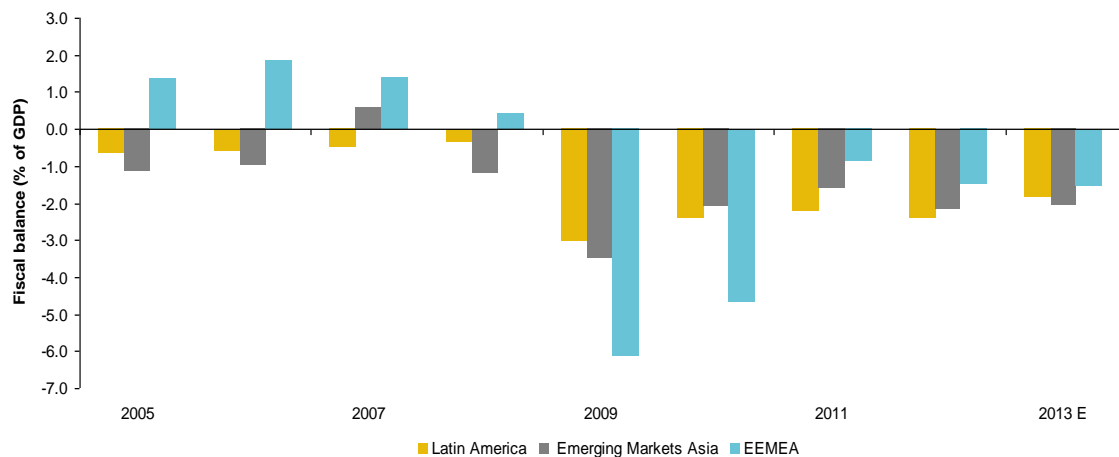
In a world starved of growth, the healthy outlook for Latin American economies is likely to prove attractive. We anticipate robust growth in 2013 in the major economies of Brazil and Mexico, as well as in some of the minor markets.

We are not alone in this belief. The International Monetary Fund's (IMF) latest World Economic Outlook (published in October 2012) projects growth of 3.9% for Latin America in 2013, up from 3.2% in 2012. By comparison, the IMF projects growth of just 1.5% for the developed world. Prospects in Brazil, the biggest economy in Latin America, are improving as domestic demand picks up. Indeed, we anticipate an expansion of between 3% and 4% in Brazil in 2013, up from likely growth of under 2% in 2012. Turning to the supply side of the economy, the government has announced new concessions for roads, railways and airports, which should jumpstart infrastructure spending and boost economic growth. Moreover, the huge building programme ahead of the 2014 World Cup and the 2016 Olympic Games will also help to drive growth in the coming years.

The Brazilian bank Itau Unibanco expects the World Cup to boost overall GDP significantly. Brazil will spend around US\$20.6 billion to construct the roads, stadiums, airports and other projects required to host the tournament, a level of investment that will create 250,000 new jobs. The government is spending a further US\$11 billion on infrastructure for the Olympic Games. Yet despite this heavy spending, the government's finances remain healthy. The IMF, in its recent annual review of the Brazilian economy, anticipates that government will continue to run a surplus on its primary balance in 2013. Indeed, the situation in Latin America contrasts starkly with the heavily indebted state of the public sector in the developed world as figure 1 below highlights.

Figure 1: The strong fiscal position of Latin America

Within emerging markets, Latin America has the soundest fiscal position



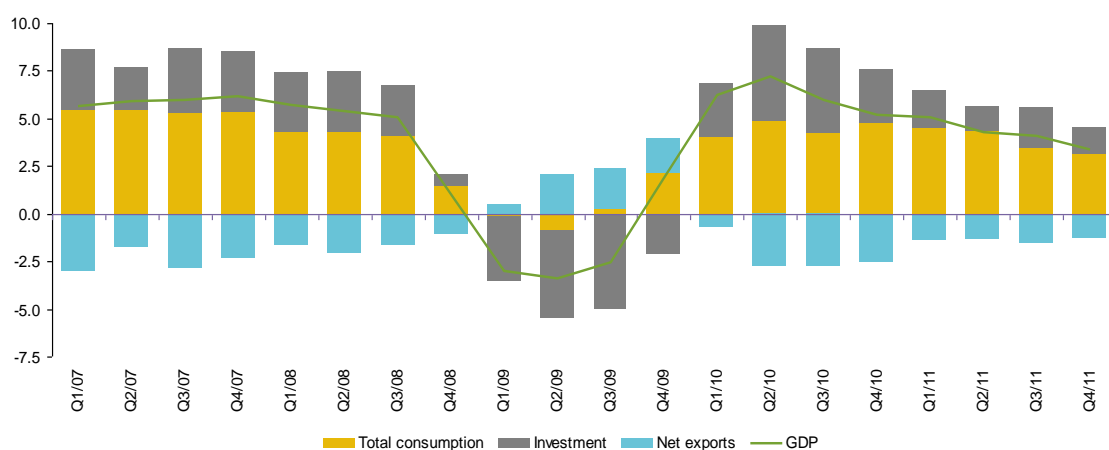
Source: JP Morgan as at October 2012

In Mexico, Latin America's second largest economy, the outlook is even brighter. GDP has grown by around 4% in each of the past two years and is on course to achieve a similar expansion in 2012. However, Mexican president Enrique Pena Nieto, who took charge on 1 December, aims to do even better. He is seeking to lift annual economic growth to 6% in the long run by overhauling Mexico's labour market, state-run oil sector and fiscal base.

Moreover, Mexico should benefit from the recovery underway in the US economy – the latter accounts for around 80% of its exports. Indeed, Mexico is the largest trading partner for nearly 30 US states. In addition, the wage gap between China and Mexico has been closing so that China's competitive advantage has eroded significantly. Over the longer term, Mexico will also benefit from its advantageous demographics – it has a young population, and a steady flow of new workers into the labour market should help to contain wage costs.

Figure 2: Latin American growth driven by domestic demand

GDP growth yoy % by component



Source: UBS, Haver as at 21 May 2012

In terms of investments, we are focusing upon a number of themes. We particularly like companies that can benefit from rising domestic consumption as these economies grow and living standards rise. We like stocks in this area in Brazil and Mexico but also in smaller markets, where opportunities are admittedly more limited, such as Peru and Colombia.

Examples would include the department store Lojas Renner and the food company M Dias Branco, both in Brazil, which is the leading supplier of biscuits and pasta in the country with a 25% market share, double that of Nestle and Kraft combined. Lojas Renner recently reported strong Q3 2012 earnings results with same store sales' growth of over 13%.

In Mexico, we also favour companies geared towards the US economic revival as well as those that will benefit from the new government's reforms. Stocks geared towards the American recovery include Alfa, the world's largest producer of aluminum engine heads, which will benefit from the revival in auto demand north of the border, and Cemex, the largest cement maker in the Americas, which is benefiting from a recovery in the US

housing market and a pick-up in construction. The Mexican petrochemical firm Alpek and the chemical company Mexichem are among the businesses we expect to benefit from the reform drive.

We can find also attractive opportunities among companies that will profit from the infrastructure theme - in terms of the roads, railways and airport concessions – as well as the huge building programme ahead of the 2014 World Cup and the 2016 Olympic Games. Examples in this area include CCR, Brazil's biggest toll-road operator, and the Peruvian cement-maker Cementos Pacasmayo. The latter company is benefiting from the robust growth of the domestic economy and heavy investment in infrastructure by the government and private sector.

Financial services, apart from credit cards, have relatively low levels of penetration in Latin America and this is another theme that we are exploring. The mortgage market, for example, is undeveloped in most countries apart from Chile. Yet as more and more people move into the middle classes, demand for these products will rise sharply. Credicorp, the largest financial holding company in Peru, and Santander Mexico, the Mexican arm of the Spanish bank, are prime beneficiaries of this trend.

Finally, we also like areas of the Latin American economy that offer protection from the threat of inflation. Thus we are attracted to businesses where contracts are index-linked to inflation and these can be found among commercial property, shopping mall and toll road operators. We are particularly concerned that inflation could resurface in Brazil in the second half of the year and in this respect favour Brazilian companies such as BR Malls, the biggest operator of shopping malls in Latin America, and BR Properties, the commercial property (mainly offices) operator.

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