Eyes on South American Debt

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The investment case for South America is one of relative stability in a particularly turbulent global macro and geopolitical environment—but there will likely be regional winners and losers, and sectors that perform better than others. Here's our breakdown.

The Big Picture

Broadly speaking, South America has benefited from improved terms of trade due to high commodity prices and central banks being ahead of the curve in responding to supply chain disruptions and a global inflation shock. High nominal interest rates have also supported local markets in the region, which has four of the five top-performing currencies, year-to-date, against the U.S. dollar on a total return basis.

One area of concern in the near term is external balances, which would be hurt by a decline in commodity prices stemming from lower global growth.

Another concern in the near term is persistently high inflation. The region did not escape the rapid increase in global inflation that occurred during the post-pandemic recovery period, and we are only now beginning to see monetary tightening take effect.

In the longer term, inequality, unemployment, and dissatisfaction with government could drive an increase in political volatility. Voters in recent national elections have tended to vote left of center, and it will be challenging for policymakers to meet the demands of voters while maintaining a positive structural reform trajectory.

The outlook for inflation over the longer term is promising. South American central banks responded much more strongly than global peers. Cumulative hikes among the top five local markets were nearly three times as large as the average of other emerging markets (EMs) and developed markets. As a result, consensus expectations for inflation across the region's major markets are for a steady decline over coming quarters, with inflation rates nearing central banks' target levels by the end of next year.

Currency stability is another key factor supporting our more positive long-term outlook for the region.

The Regional Outlook

In terms of regional winners and losers, we believe that the biggest headwinds will be in countries with challenging political environments, such as Chile and Peru.

While Peru has been resilient, this is largely due to strong initial conditions, and our view of the country's overall political trajectory is negative. This holds for Chile as well, where attempts to rewrite the country's constitution create institutional risks.

In the case of Colombia and possibly Brazil, we believe that it's too early to call the impact of the politics given the wide range of potential outcomes. Although we've seen a shift to the political left in Colombia, and believe Brazil could follow, it is important to watch how pragmatic these countries' leaders are compared to their campaign rhetoric.

We believe that the potential winners from an investment perspective will be countries with more stable political environments that can benefit from capital reallocation from more troubled places. Argentina, for example, could be on an improving trajectory following next year's elections.

The Corporate Outlook

While Latin America has diverse corporate debt sectors and myriad issuers, particularly in Mexico and Brazil, the current environment will pressure some sectors more than others.

We believe that the consumer and technology, media, and telecommunications (TMT) sectors across most countries will see more weakness as priorities for disposable income shift and competitive pressures rise.

We believe that the industrial sector, which is quite global in many countries, will likely see a slowdown, although this slowdown could be somewhat offset by lower local currency costs.

Financials are likely to see some credit deterioration as growth slows and nonperforming loans rise, although capital ratios are still solid (albeit lower than pre-pandemic levels).

While commodity prices are off their highs, they are still significantly above cost structures, so credit quality should still be strong for issuers in the oil and gas and metals and mining sectors—particularly the larger, more diversified issuers. Political shifts in South America caused additional uncertainty in the sector, but it seems like the most extreme political proposals will not come to fruition.

As is the case elsewhere in the world, the utilities sector is working through energy transition goals. Given sovereign-level commitments, we believe it should still be well supported. Higher natural gas costs have tended to impact South America less than Europe because South America's energy matrices are more diversified.

We do, however, believe that credit quality for Latin American issuers as a whole likely peaked earlier in 2022, and sector winners and losers should become more apparent as we head into 2023.

Select Opportunities

While we believe that credit risks have risen in the EM debt universe and expect this trend to continue in the near term, we see select opportunities among hard currency bonds.

First, we like Ecuador and Argentina—in particular, some of the higher-quality Argentine provinces. There, we estimate that prices are lower than our recovery-value scenario expectations.

Brazil could also be a bright spot, although much depends on its political and economic policy trajectory following upcoming elections.

Colombia is also getting more attractive from a valuations vs. fundamentals perspective, and we like Bermuda because it screens attractively against comparable credits in the region.

We also see select opportunities in Central America and the Caribbean, such as El Salvador, which we believe is also trading below eventual recovery value and could remain current on its debt payments longer than many think.

A Word About ESG

Lastly, South American debt issuers are well aware of the importance of environmental, social, and governance (ESG) metrics and commitments, and as ESG frameworks, both investment and regulatory, have taken clearer form, South American issuers have been keeping up with global standards. Disclosure and dialogue continue to improve, with materiality of ESG factors varying by sector and issuer. And improving issuer ESG policies should lead to better scoring.

However, attainment of commitments and reaction to ESG-related incidents will be the true test for issuers and will only be seen over time.

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