



# ASSET ALLOCATION UPDATE

## Outperformance of LatAm equities may be set to end

- **Equities in Latin America have generally returned more than those in the rest of the world so far this year for US dollar-based investors willing to shoulder the currency risk. We think that is set to change.**
- The total return in US dollars from the MSCI Emerging Markets Latin America Index (LatAm Index) has been ~14% in the year to date, a better performance in common-currency terms than those of MSCI's other developed and emerging market regional indices outside North America. The LatAm Index has almost kept up with a resurgent USA Index, after outperforming it substantially in 2022. Admittedly, the LatAm Index has lost some ground in Q3. But it has still delivered a healthy return so far in 2023. (See Chart 1.)
- There are two reasons why the LatAm Index has done nearly as well as the USA Index in common-currency terms so far this year. The first is greater dividend income, which has been the norm in recent years. The second is gains in the currencies of its key constituents. Although the greenback has recovered in general, the Brazilian real and the Mexican peso in particular have rallied against the US dollar, building on gains in 2022 that came after large falls earlier in the pandemic. (See Chart 2.) (Brazil and Mexico account for nearly 90% of the market capitalisation of the LatAm Index.) These boosts have helped to offset small drags on the LatAm Index vis-à-vis the USA Index from a renewed decline in its relative valuation and less impressive growth in (expected) earnings per share. (See Chart 3.)
- As far as valuations are concerned, the price/12m forward earnings ratio of the LatAm Index slumped between mid-2020 and end-2021 when that of the USA Index held broadly steady. (See Chart 4.) This partly reflected the different composition of the indices, with "growth" firms in sectors that dominate the USA Index generally faring better than "value" ones that feature heavily in the LatAm Index. (See Chart 5.) The story changed in 2022, as the valuation of the USA Index came under pressure at a time when that of the LatAm Index was depressed and had limited room to fall more. The gap has only grown a little in 2023, despite a recovery in the valuation of growth sectors in the US amid enthusiasm about the prospects for AI.
- We cover the outlook for economies in [Latin America](#) and the [US](#) on our macroeconomic services. The big picture, in our view, in Latin America is that growth will falter and be weaker in 2024 than most expect. Inflation has come down a long way and price pressures should continue to ease, paving the way for some central banks to start easing policy soon – albeit more gradually than most anticipate. Meanwhile, we think that falling inflation in the US will allow the Fed to ease policy in 2024 by more than discounted in the markets, even if the economy there avoids the mild downturn that we envisage. Against this backdrop, we doubt equities in the LatAm region will continue to outperform those in the US in common-currency terms.
- **For a start, we forecast that major currencies in the LatAm region will struggle again.** For example, we think the Mexican peso – which has benefitted from "carry" trades – is very overvalued and could fall substantially against the greenback if, as we anticipate, appetite for risk wanes amid a faltering US economy. (See [here](#).) We also foresee the Brazilian real coming under pressure for similar reasons. (See [here](#).)
- **What's more, we suspect waning appetite for risk will put renewed pressure on the relative valuation of LatAm equities.** While the unobservable risk premia of equities differ from those of bonds, 5-year sovereign credit default swaps in the region, for example, have tumbled to quite low levels. (See Chart 6.)
- **Finally, the comparatively large weight of the energy and materials sectors in the LatAm Index (~30% versus ~7% in the USA Index) reflect the importance of commodities to the region. With that in mind, the marked slowdown in China's economy (see [here](#)) poses an additional relative threat to the LatAm index**, even if this is greater to equities in Brazil than in Mexico, given the latter's closer ties to the US. (See Chart 7.) Admittedly, unlike before the Global Financial Crisis, the LatAm Index didn't outperform its USA counterpart during the pandemic when commodity prices *soared*. (See Chart 8.) But this was partly because the USA Index benefited from a surge in growth stocks in 2020 and 2021.



Chart 1: Continuously Compounded Returns From MSCI Equity Indices, US\$-Basis, 2023 YTD (%)

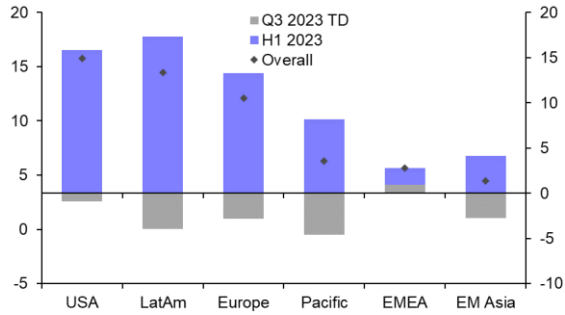


Chart 2: Brazilian Real & Mexican Peso Vs. US Dollar



Chart 3: Cumulative Continuously Compounded Return Gaps: MSCI LatAm Less USA Indices (Local Weights, %)

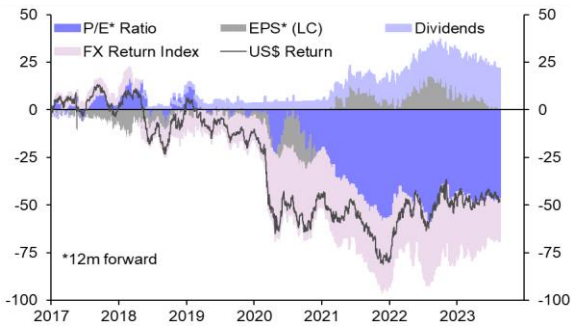


Chart 4: MSCI Index Price/12m Forward Earnings Ratios, USA, LatAm, & Gap

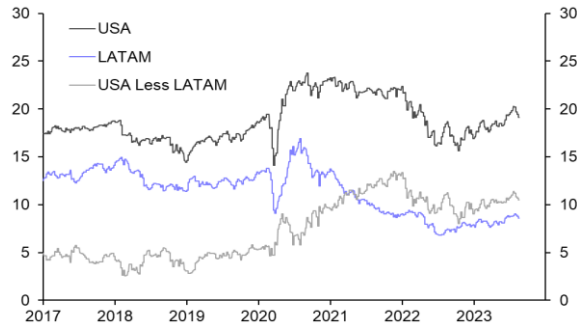


Chart 5: Differences In MSCI LatAm & USA Equity Index Returns (US\$-Basis, 2023 YTD) & Latest Weights

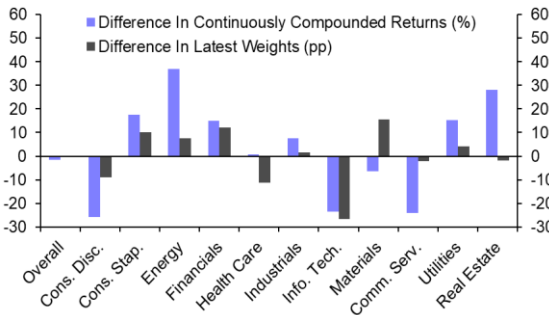


Chart 6: 5-Year Sovereign CDS Premia Of Selected MSCI LatAm Country Constituents (bp)



Chart 7: S&P 500 Less CSI 300 5Y Monthly Correlation Coefficients For MSCI ACWI Index Constituents (\$)

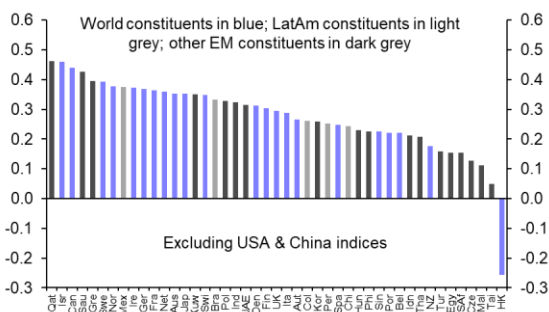
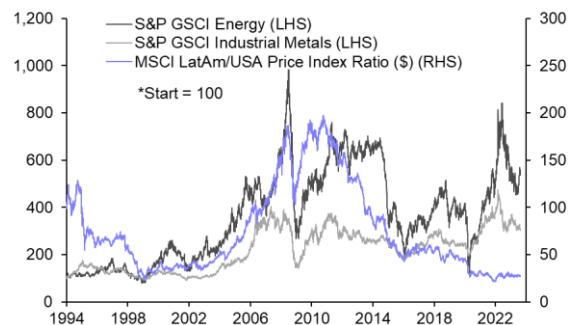


Chart 8: S&P GSCI Commodity Indices & Relative Price Performance Of MSCI LatAm & USA Indices (\$)\*



Sources: Refinitiv, Capital Economics



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