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ASK FORSTRONG: SPECIAL REPORT

POSTCARD FROM SOUTH AMERICA

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Introduction

This past year, this researcher travelled to several South American countries — Columbia, Uruguay, Chile, and Argentina, and a few other Central American nations. Though I have visited some of these on business trips (also Brazil) in the past, this time I was mixing both a personal vacation and business interests. I was wanting to learn more about these countries.

Although I have been investing and pursuing business interest in these nations for decades, much of Latin America remained an enigma for me. If you share my curiosity, you no doubt may have the same general questions. Why is it that the Latin American countries have been so prone to corruption, suppression and chaos over past centuries?

From Peru to Chile, all have checkered histories. Yet, all of them are of the same general vintage as the nations the colonialists founded in North America … namely, of course, Canada and the United States. All the New World countries in the Americas were formed by European nations (beginning with their discovery way back in the late 1400s). Over time, all were seen to be bountiful and full of opportunities. And, true enough, tremendous riches and attractions were there for the taking.

Canada and the United States (though not having been without the occasional challenge) have become prosperous and stable nations with high income per capita. These countries managed to co-exist peaceably for 200-plus years.

But why is this experience not the case in the Central and South Americas? Geopolitical and social aspects of the region generally remain volatile. Think of all the bombastic news affecting this swathe of American nations in recent times.

Brazil is again on the ropes. President Jair Bolsonaro has been breaking some his main election promises. He was swept into power as a "populist" promising much reform. Only a year after his inauguration, the budget deficit is expanding sharply. Extremely high poverty levels are being met with cuts in support payments.

Next door, Venezuela remains a basket case with two supposed presidents … Juan Guaido and incumbent Nicolás Maduro (the U.S. is backing Mr. Guaido). This nation has been through an economic and societal melt-down that will make for classic case studies. Frankly, it is frightening to see a one-time prosperous nation such as Venezuela, totally crumble to pieces as it has this past decade.

Last fall, public uprisings gripped Chile. Millions marched in downtown Santiago. Demonstrations were violent, triggering police intervention. Thousands were arrested; thousands more were injured and there were numerous casualties. During my three days in Santiago in late January, protesters were still active. Several downtown squares were the focal point of these gatherings. Fires were still being started.

The entire city is covered with political graffiti, also evident everywhere else in Chile from Valparaiso to Puerto Montt in the outback … though perhaps not as concentrated as in Santiago. But why should Chileans be so unhappy today, demanding the resignation of President Piñera? The answer, it appears, is found partly in the country's history.

Post-Augusto Pinochet, the former president ousted in 1990 after leading an oppressive regime (allegedly eliminating an estimated 3,000 people and torturing many more), Chile has won much praise for its reforms. Above all, the nation has been held up as the South American posterchild of progressive pensions. Chile put in place a privately managed pension system in the early 1980s. However, this system is not meeting expectations in recent years. It is a new day and past laurels no longer carry much weight.

Based on my somewhat anecdotal discussions with people, my take-away is that Chileans are deeply disgruntled. Many households have a tough time making ends meet. Protests are likely to re-emerge. As it was, it was a relatively innocuous increase in transit fares that triggered the violent protests.

In the meantime, Argentina is again battling to avoid another default on its debt. Erstwhile president Mauricio Macri lost his bid for re-election in October 2019. President-elect Alberto Fernandez, who took office in December, is making a U-turn back to Peronism (pro-labor emphasis).

Again, the Argentinian currency has collapsed. The dollar price, in pesos, has quadrupled over the last four years and Macri's currency restrictions stopped greenbacks from flowing out of the central bank. This surely was one reason why he lost the recent election.

Nevertheless, currency restrictions continue, a measure that has been part of Argentina's economic crisis tool kit since the 1930s. The Argentine peso today is worth about one forty-seven-trillionth of what it was worth in 1940, compared to the U.S. dollar.

No wonder that hyperinflation is a sad fact of life in Argentina. Carmen Reinhart, a Harvard University economist, counts seven defaults in Argentina's history. As already opined, another one may be at the doorstep.

Not surprisingly, Argentina is a nation of currency watchers. People look at the exchange rate daily like the stock market. They do not trust their governments and currency. Too often, savings have been wiped out. Infamously, in 2003, the central bank unilaterally converted USD bank balances into Argentinian pesos at a very unattractive rate. As mentioned, last year the central bank again clamped down on USD transactions. Presently, Argentinians may only purchase a maximum of $200 USD per month and must pay a tax on these transactions.

This history of relentless currency and financial instabilities has ingrained the response of Argentinians … in fact, for Latin America as a whole. Since their money is prone to devaluation, the response is to spend money right away; before prices go up or the currency is devalued. It creates a circular response, leading to inflationary vulnerability.

If one may be candid, it would not be too extreme to say that many South American countries are authoritarian by nature and are run by a small number of oligarchs who rely on political corruption and crony capitalism to preserve their wealth. Yet, the dance goes on. Every now and then a reformer takes the helm and the populace's hopes rise … only to be dashed again at some point. The oligarchs remain. In a nutshell, that seems to generally define the region.

Experiences of a Canadian Traveler

My travels leave with me several impressions. As a Canadian, one is likely to feel some affinity towards Argentina. I certainly do. The European influence offers an appeal. Buenos Aires, the capital, has an infectious vibe. Argentina has awe-striking natural beauty, as does Chile, as these two nations are situated side by side. The southern region, Patagonia (meaning the "land of the big-footed people" and spanning both Chile and Argentina) is a virtual heaven for outdoor and nature-lovers. The Andes mountain range is stunning, paralleling the Canadian Rockies. The Argentinian outback — the pampas — reminds of Alberta with its large cattle ranching operations. And, the polar south parallels the polar north of Canada. Like Canada, these features are awe inspiring. But these areas, like the Canadian shield, have little economic nor strategic value beyond canoeing and portaging.

General Outlook

Given my general knowledge, I would have only modest expectations for most South American nations over the long-term. Nevertheless, there indeed are opportunities. Though my generalizations here will gloss over some of the exceptions, virtually all of these nations have the Dutch Disease, showing very little manufacturing depth. Brazil represents an exception in this lot with its fairly large manufacturing base. South American countries are more likely to be dependent upon commodity and agricultural exports (i.e. copper, aluminum, coffee and soybeans).

Will these nations ever have a big middle class? This would be doubtful as long as slow economic growth and extreme wealth concentration persists. The Gini ratios are chronically high everywhere in Latin America. As such, populations are caught in a bind … with little upward mobility. This will be accentuated as world GDP growth remains moderate.

The preponderance of Latin American countries have experienced long periods of oppression and corruption. These perspectives are deeply ingrained in the populace. Politicians are not trusted and for the most part are seen as stooges for the elites. Politicians often campaign, promising relief for the poor. Perhaps intentions are heart-felt, but centuries later the plight of the poor in these New World countries has not lessened.

Why invest in South America?

It is a tall order to identify a strong growth story in Latin America. It suffers adverse demographic trends as is the case in many countries. However, value will be found from time to time, we believe.

There are several tactics to pursue.

Given the relatively high volatility of South American financial markets and currencies, the corollary must be that there will be attractive opportunities. Currently, Argentinian and Chilean financial markets, have sold off, although for different reasons. Common to both is slow economic growth and, in the case of Argentina, is actually experiencing a recession. We currently hold an investment in Chile, symbol ECH, in the Opportunity partitions of our balanced portfolio mandates. Not only are equity markets reasonably priced, so are the currencies. Without a doubt, the Argentinian peso is very cheap, but ofcourse does come with higher than average risks. If one does not have the stomach for an investment in Argentinian pesos, definitely consider taking a vacation there. Canadian tourists may lament how little the Canadian dollar purchases in Europe or Japan or virtually everywhere else. However, tourists will definitely be gratified by how much the Canadian dollar can purchase in Argentina. One cab ride (three kilometers or so) cost me $1.50.

Other tactical strategies seem to be on offer every now and then, mainly driven by the circularity of the general South American political cycles. These can contribute to huge swings in currencies, budget deficits, trade balance shifts and monetary policies. Canadian investors can find much higher interest rates and rather stupendous bond market returns (think of the experience in Brazil in recent years). Again, these strategies come with higher risk and may require currency hedges.

There are also strategic opportunities from time to time. The emergence of China as the second largest economy in the world (and the world's biggest trader) has been beneficial for Latin America overall in recent decades. Should the world again experience a commodity upcycle, (including agricultural output), this would be very stimulative for economic growth of the major South American countries.

Any rejuvenation of China's prospects will flow through to improving exports from South America. We do expect that an economic up-cycle will again emerge … though not nearly as colossal as which occurred during the heyday of China's economic boom of the1970s through to early in the millennium. More recently, China has been the epicenter of the COVID-19 outbreak. This has slowed Chinese economic activity rather abruptly; and has contributed to a steep drop in coal and oil prices. On the optimistic presumption that COVID-19 will be successfully contained, we would most certainly expect Chilean equities to have a sharp recovery. As such, we continue to hold this security.

In conclusion, while long-term strategic themes may not be plentiful on is southern continent, we still anticipate that there will be special investment situation and tactical opportunities. We will continue to monitor these countries for opportunities in the future.