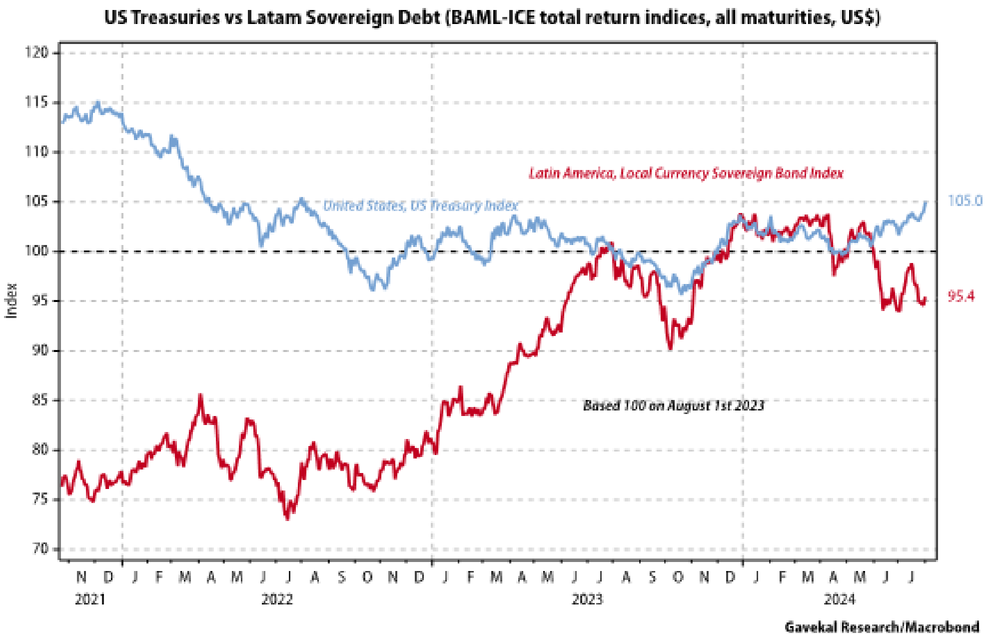
Louis-Vincent Gave, *CEO Gavekal* | August, 2024

Commemorating the first anniversary of our LarrainVial Gavekal Latam Local Currency Debt Fund

The LarrainVial Gavekal Latam Local Currency Debt Fund has just celebrated its first year. And there is much to celebrate. Firstly, the fund outperformed its benchmark of reference(*); a testimony to the hard work of Alexandre and Gonzalo, the two co-PMs of the strategy. Secondly, and thanks to the terrific support of a number of investors, the fund has raised some US$80m.This support from clients means that the fund is commercially viable. Against that, the one darker cloud in this first year has been the relatively poor performance of Latin American Debt markets, especially in recent weeks. Indeed, coming into the launch of the fund on August 1st, 2023, Latin American local currency debt had been delivering cracking returns. Then, from August 2023 to March 2024, Latin American debt essentially delivered the same performance as US Treasuries, if with a higher volatility. However, starting in March, Latin American debt pulled back aggressively, even as US Treasuries, for several reasons.



The first shock to Latin American debt markets came from Brazil. When President Lula fired the CEO and CFO of Petrobras, it triggered a high level of anxiety amongst foreign and domestic investors for whom the previous pillaging of the Brazilian oil giant remains an open wound. Lula's intervention in the running of Petrobras also fed into fears that the Brazilian president intended to have a much more interventionist stance on the Brazilian economy. In consequence, all Brazilian assets, including the currency, sold off.

The second shock to the system came from Mexico, where president-elect Claudia Sheinbaum, and her Morena party, did much better in elections than the markets initially anticipated. Suddenly, the market feared that the left-leaning president, and her party, would be able to run roughshod over parliament and increase regulations, increase taxes, perhaps nationalize key assets, blow out budget deficits etc… The Mexican Peso and Mexican assets duly fell.

(*) Return net fees as of 31-07-2024

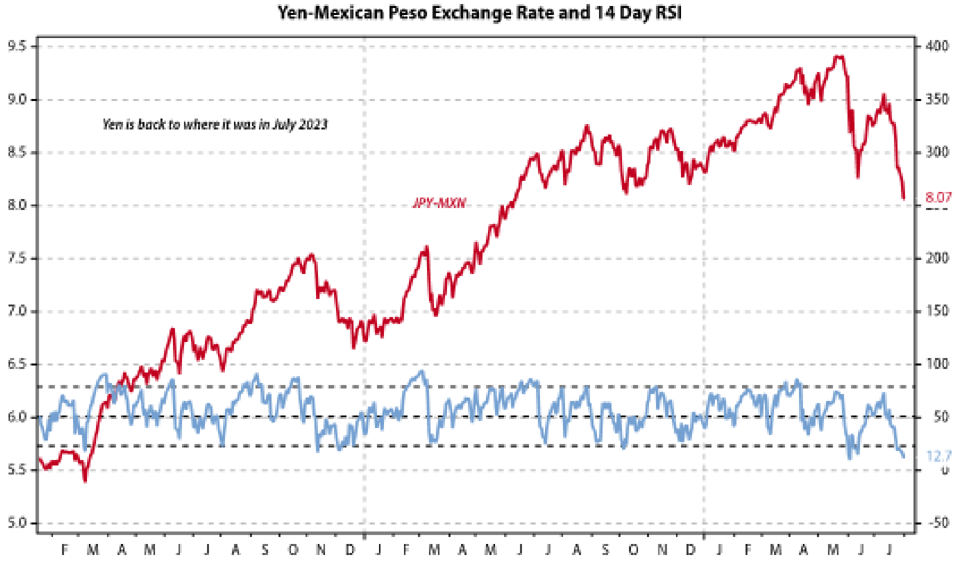
The third shock to Latin American debt and currency markets was the sudden sharp roll-over in a number of commodities, not least of which copper. Part of the reason for the roll-over in commodity prices were disappointing economic data points out of China, and a Third Plenum that left investors underwhelmed. Copper fell from close to US$11k per metric-ton in mid-May to less than US$9000/metric-ton today. Copper is of course a key export for Chile and Peru and historically, the CLP is often impacted by fluctuations in the metal's price. And sure enough, as copper prices rolled over, so did the Chilean Peso:

Copper Prices & CLP-US$ Exchange Rate

Gavekal Research/Macrobond

Finally, the last shock, one that is unfolding as we write, is the squeeze in all the Yen carry trades. Indeed, in the past few weeks, the Japanese Yen has rebounded very strongly. This means that Japanese investors who, until now, had felt comfortable buying Mexican and Brazilian bonds, and delighted in the higher yields, suddenly find themselves looking at months of accumulated gains disappear in seconds. In just a few trading sessions, the Yen has rallied back to where it stood in July 2023. One year's worth of FX gains obliterated in a few trading sessions. This has most likely triggered some margin calls and forced some speculators to cover positions.

Yen-Mexican Peso Exchange Rate and 14 Day RSI



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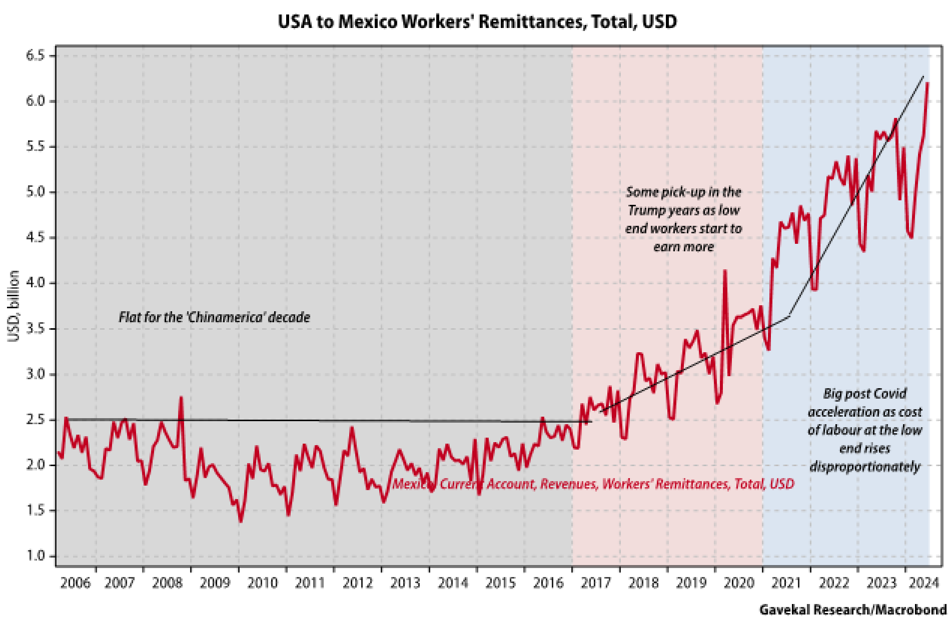
So, does all of the above represent a big enough shift in the local macro picture? Or is this a good 'dip to buy'? Unsurprisingly, we will argue the latter, for the following reasons:

- Brazil: following the politically inspired sell-off, Brazilian assets today offer very compelling value. Starting with Brazilian inflation indexed bonds (which have been a stalwart of the portfolio since its launch). Today, Brazilian Tips offer roughly 6% real returns. An exceptionally compelling investment proposition.

- Mexico: clearly, Mexican assets are currently in the line of fire linked to the JPY carry-trade deleveraging. However, forced-selling in markets does not last forever. And on the other side of the liquidation and margin call selling remains the fact that no single country is better positioned than Mexico to benefit from the unfolding China-USA rift. Firstly, because an ever increasing number of Chinese companies are now setting up factories in Mexico. Secondly, because US companies continue to outsource more work to Mexico. Another key advantage for Mexico is that rising minimum wages in the US, along with the past four years explosion in immigrants into the US, means that remittances from the US to Mexico have exploded from roughly US$2bn/month to over US$6bn/month over the past few years. This constant flow supports both the currency and local asset prices:



- Chile: the worse fears of a leftist rewriting of the constitution have by now abated and Chile is back to what it very often is: a play on global copper prices. With a few added bonuses, namely the fact that rainfall has been plentiful this winter is great for the production of hydro electricity. This should mean fewer nat-gas imports and a better trade balance. All this against a backdrop of a very undervalued CLP on a purchasing parity basis.

- Colombia: there are still two years to go until the next Colombian presidential election so the market will likely not get too excited about Colombia's near term prospects. Unless, of course, oil prices start to rally. For now, this does not seem to be on the cards and so Colombia languishes along. Still, investors are 'paid to wait' with double digit yields on local debt that actually do not reflect the optionality of both the COP, and Colombian assets, should oil prices break above US$100/bl, for whatever reason (a civil war in Venezuela? An amplification of the war in the Middle-East? A pick-up in China....)?

- Peru: Peru remains the 'low-beta' trade of the region. A well managed country, cranking up its production of copper, silver and rare earths. Benefitting from the energy transition. Even last year's political mayhem with an attempted coup from the sitting president was not enough to shake the country's steady performance.

Beyond the region's behemoths also lie a number of smaller countries, or smaller issuers, who today are doing a terrific job keeping their domestic finances on a steady path and being rewarded for it by debt re-ratings. This is the case of Paraguay, of Uruguay, of Costa Rica, of the Dominican Republic… Of course, these countries do not capture the media attention of an Argentina, or a Venezuela, both massive countries with so much potential that have been tragically mismanaged in the recent decades. But the fund maintains hefty positions in the above countries as their returns tend to be uncorrelated and the yield capture remains more than attractive.

In short, the region remains awash with opportunities and perhaps the one comforting development of the past year has been how many regional issuers have been able to blaze their own trail, and deliver steady returns, even as the region's behemoths such as Mexico and Brazil temporarily hit the skids. This is a great sign for the future. Having the ability to build genuinely diversified portfolios across the region should make the coming years ever more interesting for both (rapidly growing) domestic capital, as well as foreign investors.

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