

Macro Forum insights and perspectives

December 2018

Welcome

Welcome to this edition of our insights and perspectives, the quarterly viewpoint of the Actis Macro Forum.

This edition is published during a period of significant loss of confidence in Emerging Markets. In his introductory article Ewen Cameron Watt examines some of the mostly exogenous factors which have driven a near 180 degree shift in sentiment over the last 12 months.

Endogenous factors, often political, also play a role in the financial markets and economies in which we invest. 2018 was a big year in Latin America with nine elections in all and material changes in leadership and philosophies emerging in the two largest economies. Nicolas Escallon in Mexico City and Bruno Moraes in Sao Paolo look at the new leadership line ups and programs in Mexico and Brazil. We also visit Chile, a bastion of stability in the Southern Cone in the company of Lucy Heintz who oversees some of our investments there.

The electoral focus shifts towards Africa in 2019 with no fewer than nineteen elections there in the next year. Lisa Pinsley and Janet van Niekerk from our South African business outline the challenges facing Cyril Ramaphosa as runs for office in the Spring. We also provide a graphic covering the major elections across the Emerging Market world in 2019.

A final word. Our insights are drawn from colleagues and portfolio companies on the ground - the Street View. Several profitable exits from investments in Brazil and South Africa underpin the value of our network in extracting value in good times and bad from our network. Macro is very much a part of our decision making but in the final count we invest in businesses seeking to improve them over time and with Values driving Value deliver portfolio returns.



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The Long and Winding Road

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If a week is a long time in politics—ask Theresa May— a year can seem like a long time in investment markets. This has certainly been true as for growth (or emerging) markets in 2018. A year ago sentiment was riding buoyant with a seemingly unstoppable rush to force as much exotica into portfolios.

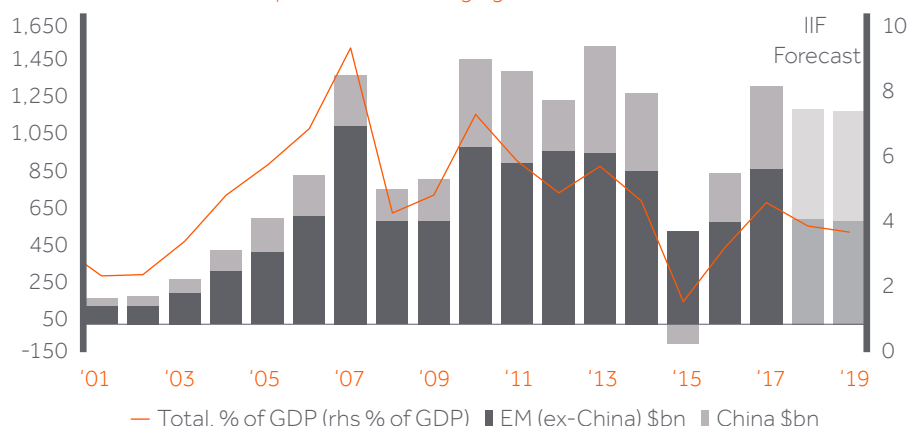
Today everything has changed. EM bonds and currencies have fallen in value, crisis has engulfed Turkey and Argentina and extreme stress has been felt in South Africa, India and Indonesia among others.

What has changed to send sentiment through 180 degrees? And will current fears deepen?

Firstly, the dollar strengthened as US rates rose. This has proved a ghastly cocktail for EM risk in the past and was so again in 2018. In parallel global central banks in total sharply decelerated their balance sheet growth. Cross Border Capital, a leading researcher on global liquidity conditions reckons that global and EM liquidity are now close to crisis levels. Their measure also includes the impact of private sector liquidity which has drained in recent times as activity and demand for funds accelerated. Given that portfolio flows have risen in importance relative to less volatile foreign direct investment the pass through to EM financial assets of 'risk off' is greater than ever.

Our own measures of fair value have seen some currencies become less overvalued than last year. By contrast with a year ago

Exhibit 2: Non-resident capital flows to emerging markets



Source: Institute of International Finance

there are an increasing number which appear quite undervalued including those of China, India and South Korea. Among larger countries with seemingly overvalued currencies are Nigeria, Brazil and Kenya. Whilst our model is there to pick trends rather than timings, we would rather invest with a currency tailwind than headwind.

Secondly Chinese US trade tensions have impacted investor sentiment around the prospects for world trade growth. In our October issue we featured an article written by Dr Ogus of DSG Asia on the background to and causes of trade conflict. Simon argued, and we agree that this is a multiyear issue as far as Sino US relations are concerned. A Democratic House of Representatives may also want to take a critical look at NAFTA 2.0 a treaty which at first sight is quite beneficial for Mexico.

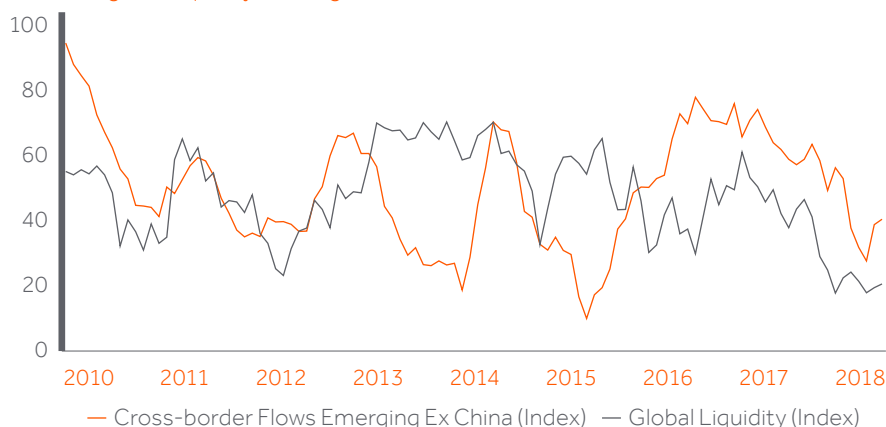
Given such headwinds and tumbling stocks, bonds and currencies one would have expected that cross border flows to Emerging Markets had plunged. Far from it

-as of end October 2018 flows were largely unchanged year on year the Institute of International Finance calculates. This masks the fact that these flows have been dominated by increased exposure to China. Elsewhere inbound flows are down 30% reflecting portfolio reallocation and domestic capital flight. We suspect that much of this is simply a reversal of inflows seen in 2016/17. Whatever the cause the conclusion is simple: - EM countries are having to work harder to attract capital flow. As the tide swings from the quantity to quality of inputs, winning sectors will take increasing flows and countries that do not reform will find it harder to fund deficits. Long term domestic savings movements along with migrant remittance flows become ever more important in this environment.

Politics was a big focus in the last 12 months in Latin America with elections across the region in eight countries including Mexico and Brazil. We take a close look elsewhere in this edition at the elections of Jair Bolsonaro in Brazil and AMLO in Mexico. Both leaders successfully utilised social media to secure election and both have mandates to address corruption and existing business systems. At the same time both believe in central bank independence and have stellar economic leadership teams.

In 2019 the focus switches to Africa with elections in South Africa, Nigeria, Egypt and a further 11 countries. These contests are being held after low or no growth in income per capita over the last 4-5 years which suggests that appetite for reforms and restructuring will be high. Elsewhere investors in India will be watching closely in the early spring as Narendra Modi runs

Exhibit 1: Tighter Liquidity, Slowing Flows



Source: Cross Border Capital

for re-election. Elsewhere in this edition is a comprehensive guide to the what and where of 2019 elections.

Governments around the world tend to over promise and under deliver. In part, this stems from the different time horizons of structural reform payback and financial investors attention spans. The Thatcher revolution yielded increasing returns towards the end of her 11-year span in office rather than when first introduced. The same was true for President Reagan and supply side economics. In many EM countries however time is not an affordable luxury. We take a deep dive into the challenges facing South Africa as it heads into a crucial election next spring and conclude that righting the wrongs of the Zuma era is an essential but lengthy process. And our portfolio companies in Brazil and South Africa to take just two examples of difficult economies feel that a little reform can go a long way in helping their operations.

Whilst it is easy to be gloomy, we should remember that we are investing in companies and sectors as much as countries. In 2018 despite the election cycle we were able to successfully list Stone, a Brazilian payments business on NASDAQ in the second largest fintech IPO of the year. In South Africa despite economic challenges very successful portfolio exits have been feasible. The energy sector continues to provide excellent returns and investment opportunities as does renewable energy infrastructure. Opportunities in fintech, healthcare, educational services and logistics align to our desire to invest in above average growth sectors which are contributing to increased economic resilience. A focus on improving governance and operational values is also very much part of the opportunity set. We have written about many of these themes in these pages and will continue to do so in 2019.

Any investment justification which uses the phrase 'in the long term' acknowledges as we do that the short term may be quite challenging. It is also worth recalling that history suggests the best time for EM investing is when currencies are down, and economies depressed. This is certainly true for the multiyear private market investment opportunities which form our opportunity set.

Exhibit 3: Nigeria FX vs FV

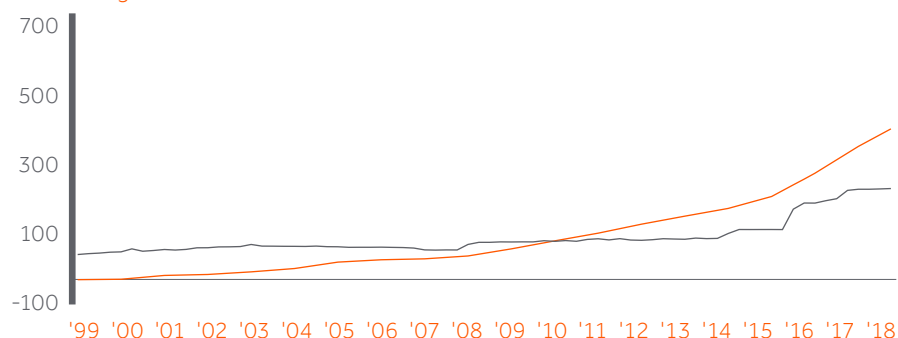


Exhibit 4: China FX vs FV

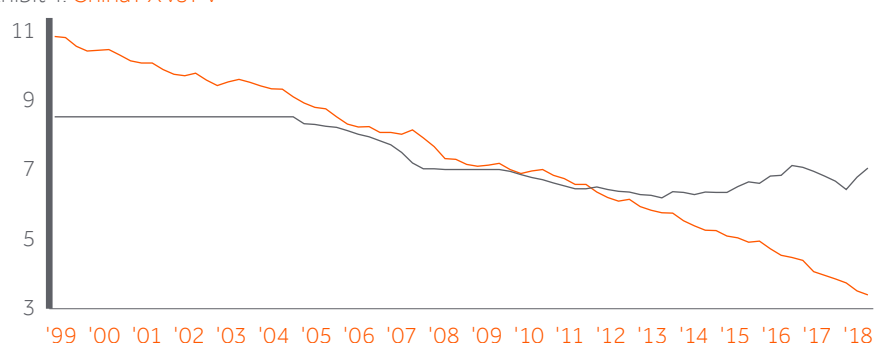


Exhibit 5: India FX vs FV

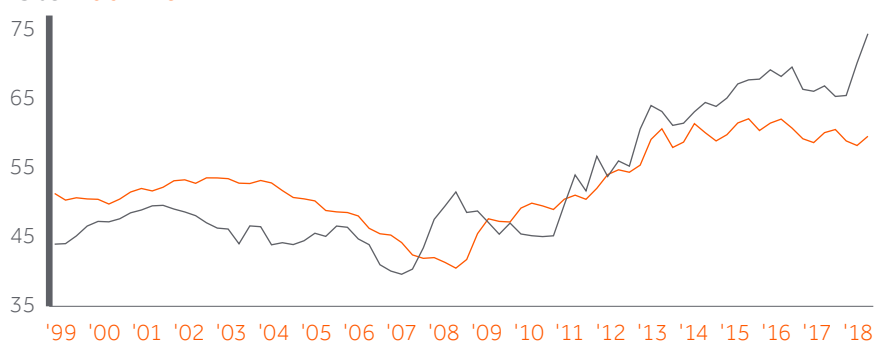
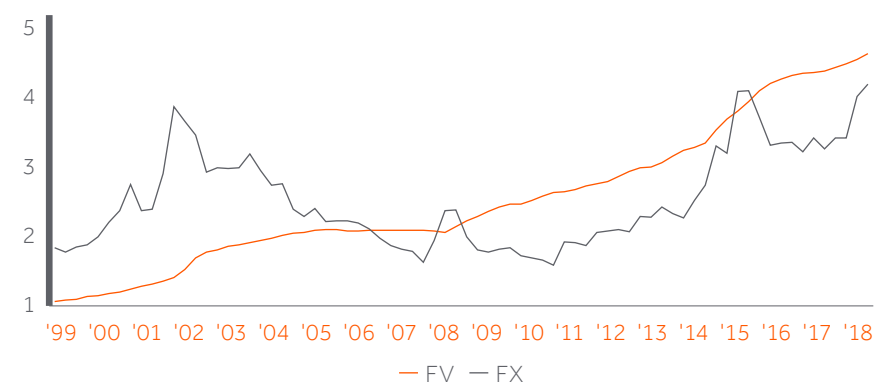


Exhibit 6: Brazil FX vs FV



Source: Bloomberg & Actis methodology for Fundamental Value

Taking the Temperature

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South Africa is the only African country that is a member of the G20 group of advanced nations. As the second largest economy in Africa its fortunes are important both for itself, surrounding countries and general EM sentiment.

After strong progress in the immediate post-apartheid era, the economy and currency stumbled under the leadership of Jacob Zuma. The landscape altered dramatically with the hairpin election of Cyril Ramaphosa in December 2017 and the promise of a wholesale clean up. The rand strengthened along with expectations of future growth. Yet 'Rama-phoria' has since given way to 'Rama-reality' in a climate of economic turbulence and growing impatience and uncertainty on the ground. A critical election is due before the end of May 2019. Meantime, as general EM volatility rises, the country's dependence on portfolio flows to finance substantial twin deficits simply adds to uncertainty.

With this in mind, we recently convened a brains trust of Actis investment professionals drawn from across our energy, private equity and real estate franchises. We took time to pool our thoughts drawing on our local knowledge and the experience of our portfolio companies. This 'Street View' drawn from nine corporates employing over 30,000 people throws up some interesting contrasts with the general macro gloom.

So what's the problem?

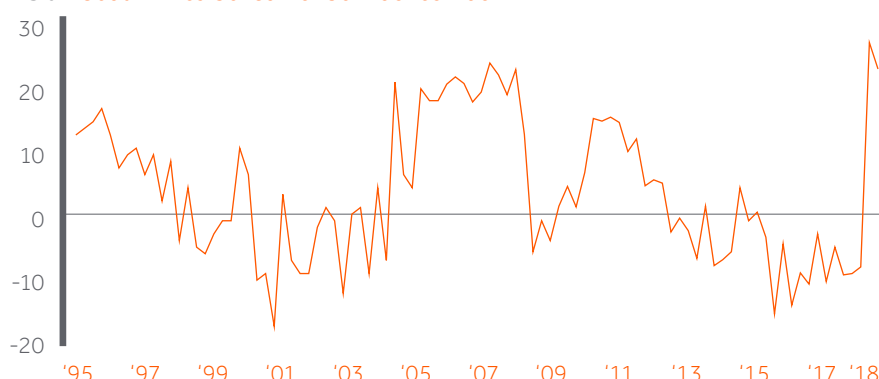
Our primary concerns are the lack of growth - in the economy, in productivity and in tackling deep problems of inequality and poverty. In 2018 South Africa dipped into recession with the economy shrinking by 2.6% in Q1 and a more modest 0.7% in Q2. Whilst some recovery is expected after the drought impacted H1, estimates for 2019 stand at a tepid 1.4%, insufficient to tip the balance of per capita growth

Exhibit 1: South Africa Business Confidence Index



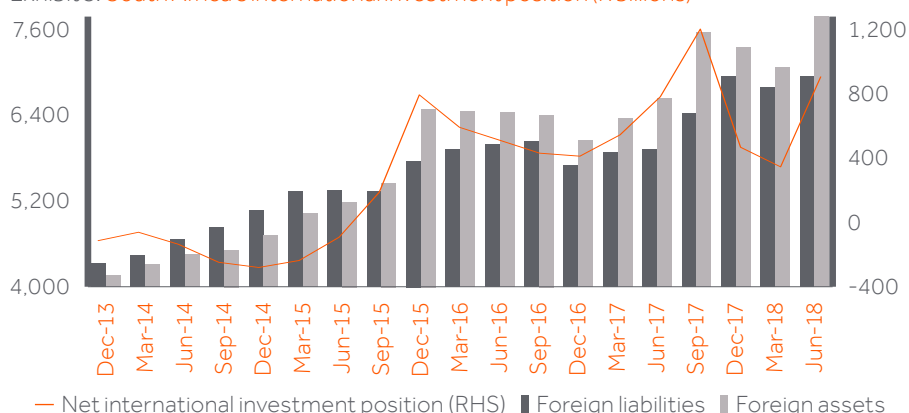
Source: Bloomberg

Exhibit 2: South Africa Consumer Confidence Index



Source: Bloomberg

Exhibit 3: South Africa's international investment position (R billions)



Source: SARB

into positive territory. This continues the lacklustre trend of recent years with the last year that GDP exceeded 2% being back in 2013. Breaking out from here requires tackling structural reforms head-on, including the inefficient state-owned sector and an inflexible policy mix.

Agriculture, struck down by recent droughts, should see recovery, yet

stagnates in part because of uncertainties over the application of ANC land ownership reforms. Land reform is a pressing issue in the challenge of tackling inequality. Ramaphosa's March 2018 announcement that he intends to accelerate land reform by instituting expropriation without compensation raises important questions. Soon after the March announcement Ramaphosa made early attempts to

calm investors with statements claiming that applying land reform in practice will not hinder food security, growth and stability. This ongoing pattern of trying to calm investors was illustrated with the recent statements to the visiting German president that “There will be no land grabs. Investors should have no fear”. However as long as lack of policy and implementation clarity remain, investor concern will remain.

Fixing underlying structural issues after a decade of misallocation takes longer than the attention span of many public market and currency investors. Yet progress is hampered by Ramaphosa’s perceived lack of a full power base within the ANC, plus pre-election harrying by the opposition EFF and Democratic Alliance parties. This makes the election a crucial point along the road, and we expect Ramaphosa will accelerate progress after the poll.

Cleaning the Stables

First up in the line-up of reform progress is addressing the problem of ravaged state-owned companies. Ramaphosa instituting commissions of enquiry and appointing new boards is central to progress. The recent replacement of Revenue Services Commissioner, Tom Moyane, who has been named as a key figure in State Capture (translation rake off) is a case in point, as is the resignation of Home Affairs Minister Gigaba. Our expectation is that reforms in this area will reduce fiscal leakage and improve overall productivity, albeit that such benefits will take a while to emerge.

Other current and future measures focus on stimulus and investment, positive in themselves but with considerable implementation time lags. September 2018’s Economic and Stimulus Plan includes measures on visa reform to attract skilled workers, finalising the mining charter and increasing telecoms broadband spectrum allocation. It also calls for reallocation of existing budgets rather than increased spending or borrowing, hardly surprising given a fiscal deficit approaching 5% of GDP and ever-increasing social welfare liabilities. A well-publicised investment conference in October 2018 led to announcements of an extra R290 billion in private sector investment commitments as well as an additional R400 bn pledged by local and international businesses. Our strong sense is that such uplifts only arise in practice as business confidence recovers and are

hence intertwined with governmental and election progress.

Emerging Market Tensions don’t help

Rand volatility seems to be an ever-present factor impacting borrowing costs, confidence, hard currency returns and inflation. Some of the swing from 11.55 to the US dollar in February to a low of 15.42 in September and back below 14 as year-end approached stems from endogenous sources. In addition a considerable part is also down to the drop in global investor sentiment towards Emerging Markets in general and in particular those reliant on portfolio flow funding. South Africa is vulnerable to reversals in portfolio flows given that 41% of the government bond market is foreign owned and foreign direct investment only represents around 20% of total inflows. That said with an average duration of 12 years in government debt and less than 10% of all debt foreign currency denominated, South Africa is hardly a Turkey or Argentina. Our bottom up experience is that corporates are

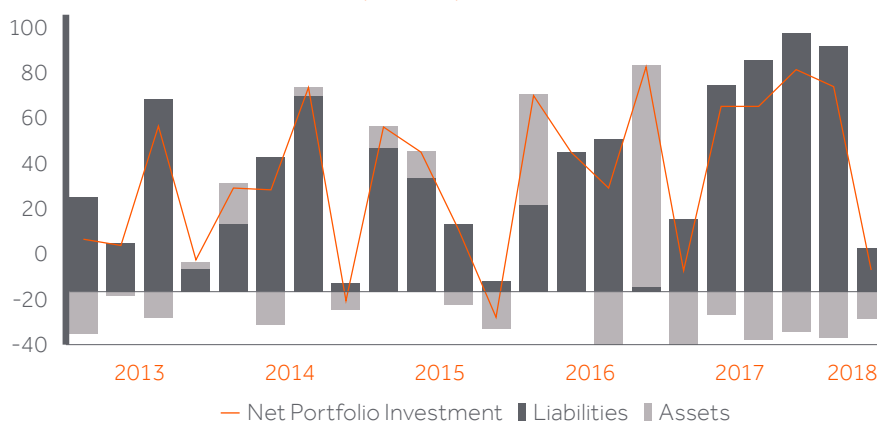
acutely aware of risks on hedging and timing relating to investments as are we.

Our direct experience is rather better- The key Street View

We place a great deal of emphasis in our views on what we see bottom up-the “Street View”. Our investment teams’ constant conversation with portfolio companies reveal some important differences with headline gloom.

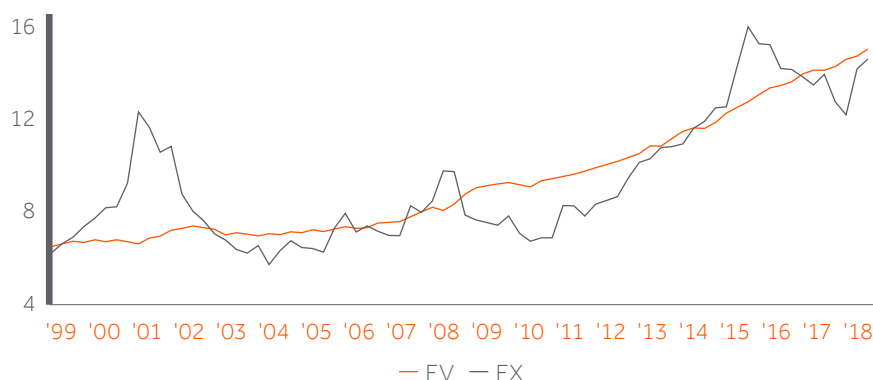
Our Private Equity investors note continued international interest in well invested South African PE portfolios. Despite the consumer being under pressure, we are seeing growth in the furniture and appliances sector and some up-tick in same store sales in our retail business. Market leadership positions are being rewarded, with CSH our credit bureau company seeing earnings growth of over 20% this year. A recent exit from Tracker, Africa’s leading provider of data analytics solutions for the personal auto and fleet telematics markets illustrates that genuine value can be created for

Exhibit 4: Portfolio Investment Flows (R billions)



Source: SARB

Exhibit 5: South Africa FX vs FV



Source: Bloomberg & Actis methodology for Fundamental Value

investors in US dollars despite unpromising macro conditions.

In energy we believe that the close of Round 4 renewables deals and the August issuance of the draft Integrated Resources Plan ('IRP') for public comment represent an unpicking of the Zuma log jam. The draft IRP outlines a future based on a least cost basis, cutting proposed nuclear developments, reducing reliance on coal and increasing renewables, gas and possibly storage technologies. While the domestic energy supply sector suffered several years of pause in adopting alternative power sources, we now see moves towards the next round of renewables bidding and an active secondary market with both foreign and domestic interest in operating assets.

Our real estate investment team faces a challenging environment with uncertainties over land reform and ownership rights piled on top of the weak macro environment. We remain cautious but can see some specific opportunities under the overhang of policy uncertainty. In the industrial space we are still seeing positive demand for higher quality developed space albeit in smaller deal sizes, as some logistics providers seem to be streamlining their operations. As would be expected at this juncture prices of serviced land parcels have reduced as well as transactions that deal with sale and leaseback resulting in some tempting buy opportunities.

Last Words-Election Focus

Elsewhere in this issue we focus on elections across Africa in 2019. In South Africa the outcome is central to investor confidence and flows. If the South African electorate looks beyond current difficulties and backs a renewed mandate for Ramaphosa, today's hard times become tomorrow's opportunities. Like many other African voters going to the polls over the next year, South Africans will be anxious to turn around the trends of declining per capita incomes and rising levels of poverty inequality and unemployment. Unlike others to the north, the financial system is sound, debt rollover risks low and many of the major problems fixable without widespread social upheavals. 2019 promises to be a pivotal year.



New Face, Old Challenges – Bolosonaro's Brazil

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The Karaoke Presidency

Taking office on January 1st 2019 Jair Bolosonaro is Brazil's third President in less the official four year-term mandate. Japan's frequent leadership changes of the last two decades deserved the title Karaoke government-everybody can have a go. Brazil's new President owes his election in part to the political chaos of the last few years which allied with a deep recession has fuelled a desire for change. Yet despite the change of face the nation's problems and opportunities remain unchanged and deep set.

How we arrived here

Its worthwhile briefly rehashing the last three years if only to understand why Brazilian electors are so focussed on changing the leader. Within two years of her 2014 re-election Mrs Rousseff faced impeachment arising from the unprecedented corruption scandal surrounding her predecessor and mentor Lula. With Dilma impeached and her vice president Michael Temer stepped up, launching a transformational plan focussed on reducing government spending, privatising unprofitable state-owned enterprises and promoting social security reform. This hopeful start though

which included strong congressional support was wrecked by the May 2017 allegations of Temer's involvement in the Car Wash scandal. The consequent loss of support led to a period of inertia which dominated the remainder of his Presidential term. Meanwhile as a backdrop the country suffered a severe recession with GDP contracting by over 8% during the 2016-17 period, 13 million job losses, an inflation spiked at 11% and a climb in public indebtedness from 60 to 80% of GDP.

The Electorate Answers Back

Deeply disillusioned Brazilians headed to polling stations on October 21st and 28th to elect lower house seats, 1/3 of the senate, state governors and a new president. The electorate delivered a damning rebuke to the status quo. Nearly 50% of Lower House members have changed, the biggest turnover rate in the last 20 years, only eight of 32 Senators seeking re-election survived and of course Bolosonaro a polarising figure was elected to the Presidency. Brazil following Chile (Sebastian Pinera), Paraguay (Mario Benitez) and Colombia (Ivan Duque) in choosing right wing government in part because of economic failure or disillusionment.

The new man and his finance guru

Brazil's new leader first emerged in the 1990's as a member of the Lower House where he has sat now for 28 years. During

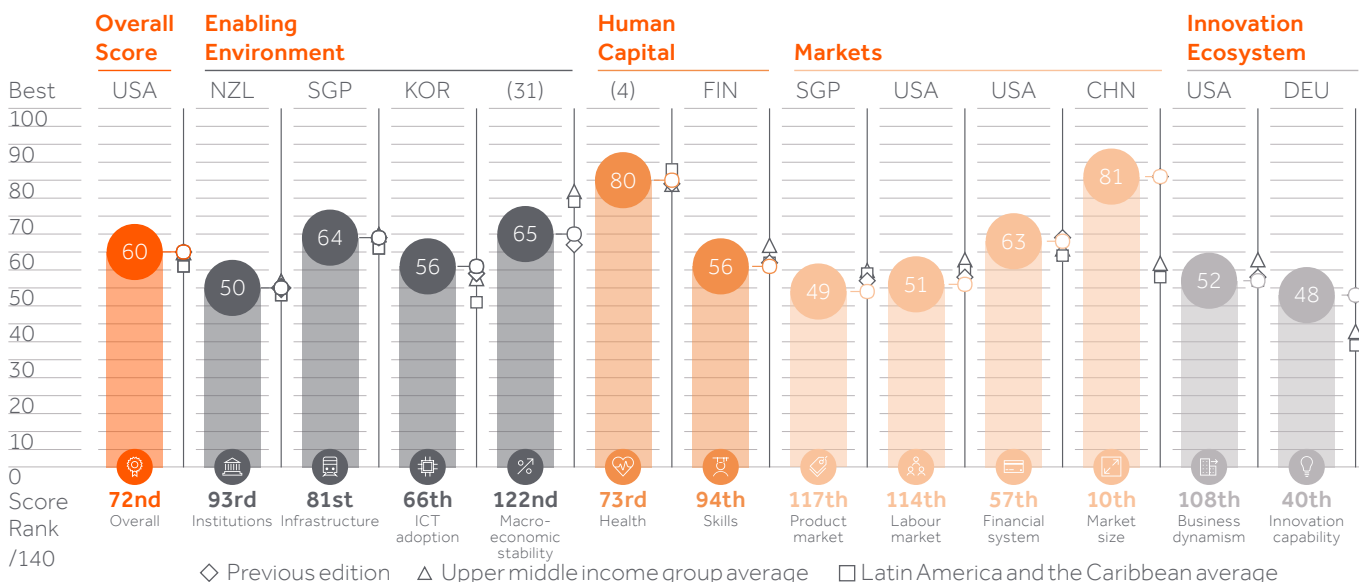
this time, Bolosonaro a retired military officer adopted a conservative position on social affairs and a centre-left bias in economic affairs (of which he protests limited knowledge). He voted against privatisation and the Real plan designed to combat rampant inflation yet later on supported the Labour reform and public spending caps proposed in the Temer administration, signalling a shift towards the right which later became the motto of his Presidential campaign.

Bolosonaro's presidential ambitions surfaced in 2016 when Dilma's impeachment allowed air time for those disillusioned with the political community. His espousal of conservative social policies and zero tolerance for corruption quickly attracted political support, becoming a social media celebrity. In turn this popularity caught the attention of Paulo Guedes, an economist from the University of Chicago with a distinguished financial sector resume including being a founder of BTG Pactual a leading local investment bank and later on as a private equity player investing in education. Between them, Guedes and Bolosonaro, devised a libertarian market friendly economic plan focussed on reducing the size of government and tackling fiscal deficits through reform and privatisation.

A new style election and line up

The election itself was marked by high turnout and heightened use and awareness of social media-over 53%

Exhibit 1: Performance overview 2018



Source: World Economic Forum

of Brazilian adults use social networks according to 2017 estimates from the Pew Research Centre. In the election there was clear evidence that social media was highly effective in gathering votes at all levels. Bolsonaro had only 34 seconds of TV time yet gathered over 55 million votes via social media. The new framework to control election corruption and spending saw the winner spending only R1.5 million on his candidacy in contrast to the R34m of the runner up and the R1.5 billion spent to elect Dilma including corruption practices unveiled by Car Wash.

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Particular focus has fallen on the Guedes team who will shape economic policy. They include Joaquim Levy also from the University of Chicago who was Chief Financial Officer of the World Bank and Minister of Finance during Dilma's second term leaving prior to the impeachment process. Mansueto Almeida, an MIT economist, has been retained as Secretary of the Treasury and Roberto Campos Neto formerly Head of Treasury for Santander Bank has taken over as President of Brazil's Central Bank (note there is a state-owned bank called Banco do Brasil that is a different institution).

Currency and financial markets have initially at least liked what they see with the real rallying sharply to apparently overvalued levels below 3.8 after the election and the Bovespa index exceeding its previous record. Bonds too rallied with the sovereign spread contracting initially by 50 basis points despite declining sentiment towards emerging markets.

How long a honeymoon?

Paraphrasing Ronald Reagan, 'it's the economy stupid' answers the question. The good news is that inflation expectations are well anchored allowing some room for manoeuvre on the monetary front. There is also some modest recovery in domestic demand, always the driver of the economy. Against this the Institute of International Finance, a leading research institution believes that

it is rare for an Emerging Market country to recover lost output and growth rates for 8-10 years after a recession of the severity experienced in 2015-16. In turn this puts the spotlight on fiscal imbalances with a yawning and growing social security deficit driven by an ageing population and decades of under provision. Barring structural reform succeeding and given potentially anaemic growth the chances of government debt rising sharply from an already elevated 80% of GDP are material. Putting this in perspective, the tensions between Italy and the EU over a 2.4% fiscal deficit would be met in Brazil with cries of delight with a deficit nearly 2.7 x larger.

Raising productivity is essential to delivering sustainable long-term growth rates sufficiently and to avoiding a debt trap. The Lula/Dilma legacy is inward looking as far as trade relationships and therefore increased investment and productivity are concerned. The number of state-owned companies-418- is the highest in the OECD which has crowded out investment in areas like infrastructure and education. This is reflected in Brazil's lowly ranking in a series of world business metrics.

Matters are hardly helped by the external environment with Argentina in recession and China's changing growth agenda away from capital intensive led expansion. On the other hand Brazilian exports to China expanded in 2018 at a faster rate than before.

Long-term investors are still cautious on Brazil despite the short-term recovery signs, the heightened volatility observed in EM currencies markets doesn't help

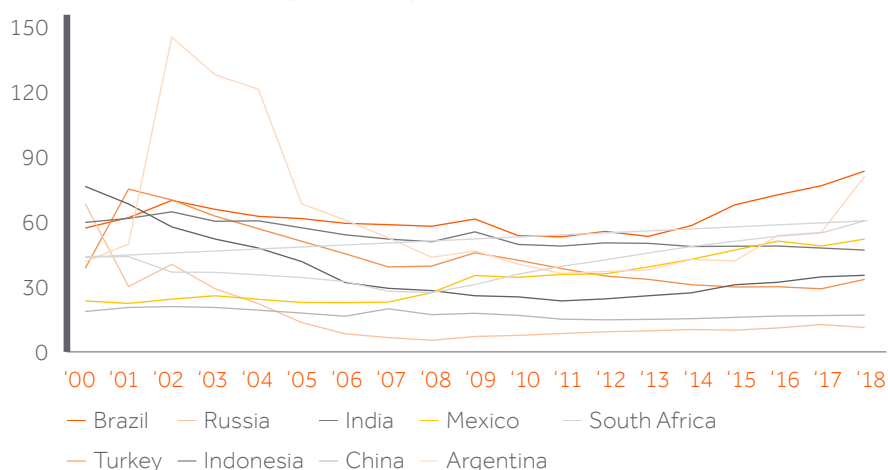
too. In the local infrastructure market, even though the fundamentals are supportive, the availability of sources for long-term financing is a question mark with decreasing activity from development banks coupled with an incipient local capital market traditionally focused on short-term, in this context the anchored inflation and maintenance of low interest rates are key. Consumer-driven investment theses are also dependent from more sustainable and concrete actions able to promote sustainable growth and boost productivity, at the moment investors haven't removed the perception that recent recovery may have been a chicken flight.

The Final Word-Carnivals don't last forever

Time is short for the Bolsonaro team not least to harness the support currently enjoyed in Congress. Bolsonaro's political ability to preserve such support will be detrimental for the success of his mandate, moving away from the polarising narrative that dominated the Presidential campaign and adopting a conciliatory approach.

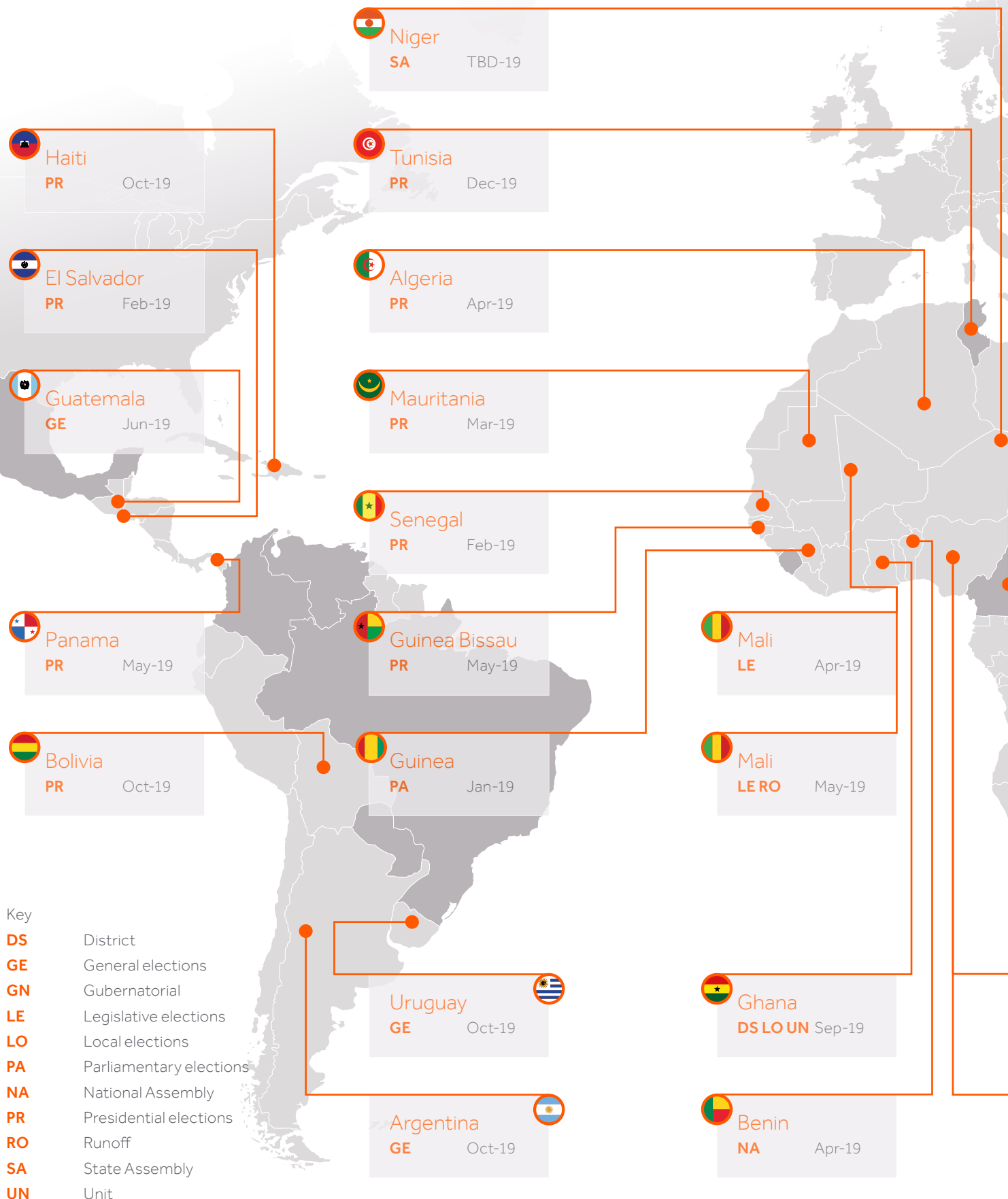
The two key areas-tackling the fiscal deficit and boosting productivity are inter dependent. Short term fixes arising from privatisation won't solve the longer-term growth puzzle. Lack of success would see a deep fiscal challenge as the Bolsonaro government seeks to accomplish reforms and attract the investment essential to solve deep seated productivity problems.

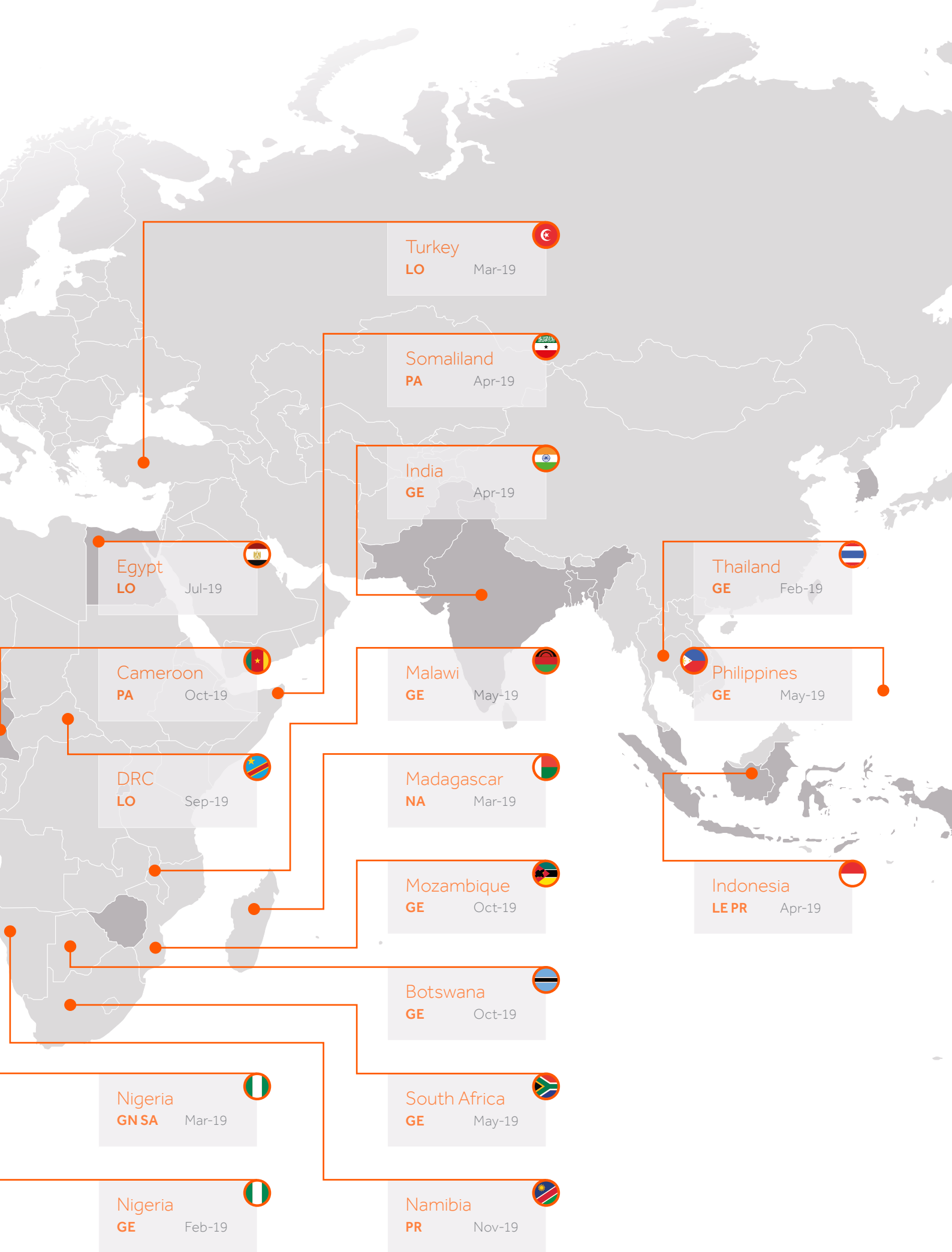
Exhibit 2: Gross Public Deficit (as% of GDP)



Source: Oxford Economics

2019 upcoming political events









Chile – The Beautiful South



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Macro Forum Live

Chile

Lucy Heintz

Chile is, by growth market standards, a stable economy, rated A1 by Moodys and AA- by S&P. Chile is a part of Latin America in terms by geography but European in most other ways. Whilst nature has placed Chile in the far south of the Americas she has also endowed the country with fabulous mineral wealth on and offshore.

Metals and minerals are over 50% of Chile's global exports, with fresh fruit (including the on-trend avocado), salmon, pulp and paper also important contributors. Copper demand however, is the major driver of the economy, and Chile's share of the global copper market is 26%. That means that Chile's economic performance tends to be governed by the global commodity cycle, and in recent years, demand for the red metal from China in particular. Before the new Pinera government took office in April 2018 Chile had been through a low growth spell with annual GDP growth from 1.3% to 1.5% in 2016 and 2017, due to reduced copper demand from Asia. Strenuous efforts have been made to diversify exposure to copper, and with the global electric vehicle revolution seeing more intense demand for lithium, of which Chile has over 40 per cent of world

reserves, the importance of copper should be diluted over time.

The Chilean peso though directionally linked to copper is far less volatile than the metal price. This partly reflects high credibility in Chile's institutional structures. Crucially for long term investors too is the size of the domestic pension industry with assets equivalent to 72% of 2017 GDP. By contrast the figure for the US is barely higher at 82%. This makes domestic asset managers natural buyers of assets being sold by foreigners, a safety net rarely available in other EM countries. Whilst foreign currency private sector debt appears high at 48% of GDP (EM average is around 20%) almost all is debt held by multi nationals in FDI programs and matched by revenue streams. Domestic banks are profitable well capitalised and well run institutions.

In many respects Chile feels like an attractive place to do business – ranked 26 / 180 by Transparency International in its corruption perceptions index and with strong participation of private enterprise across the economy – the electricity sector was among the first to be liberalized globally in 1983 and is 100% privately owned.

Actis is the 2nd largest renewable investor in Chile, across 3 funds, Actis Energy 3 (the Aela Energia wind platform), Actis Energy 4 (the pan Americas Atlas solar platform) and ALLIF (the Pelicano solar project), with around 600MW of renewable energy assets in construction and operations.

Yet it's not all wine and avocados. The combination of a remote global location, a highly sophisticated and educated civil society, and a passion for regulation, can still make for some challenges in implementing electricity projects. Regulation is a real factor in many sectors. As an example the Pinera government recently implemented an e-commerce transaction tax on the foreign digital economy including AirBNB, Netflix and Spotify.

What this means for Actis in implementing our energy strategy in Chile, is that we need to understand not just the regulatory environment, but also the institutions that make it a reality. One has to focus on stakeholder engagement at multiple levels, whether at the Ministry of Energy, the distribution companies, the grid operator, the Environmental authorities or the local communities. At the project level this means community investment programmes focused on long term transformational impact through capacity building, entrepreneurship and skills development. Getting these aspects right is what secures a licence to operate and build sustainable value. There is a well-known and somewhat apocryphal story in the Chilean renewable energy market, of another development group with a wind farm project, who failed to engage with the community before they started digging holes for their geotechnical work. The goats of the local farmers fell into the holes, and when the community sought redress from the developers for the loss of their goats, they were offered construction of a golf course. Perhaps not surprisingly, the project has suffered some delays.

Chile has a formidable resource endowment, particularly on the solar side in the Atacama Desert, and the opportunity to migrate its energy sector to achieve its stated policy of 70% renewable by 2050. Recent policy talk has even mooted 100% renewable, including hydro, by 2040, which really would be a highpoint of the global renewable energy revolution.

Chile stands out within Latin America and the growth market universe as a stable place to make long term investments. Whilst this is a well known story and in consequence often reflected in the relative price of investment opportunities such stability provides effective diversification for long term investing.

Changing the Guard – Mexico's Transformational Election



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Macro Forum Live

Mexico

Nicolas Escallon

December 1st, 2018 was a historic moment in Mexico. Political power passed from the duopoly which had dominated politics for nearly 100 years to the Juntos Haremos Historia ("Together we Will Make History") coalition and its creator, Andres Manuel Lopez Lopez Obrador, better known as AMLO. How did this change arise and what comes next?

'What's on Your Mind' - The Changing Mood of Latin America

2018 was a busy political year across Latin America, with elections in eight separate countries. Change was a constant theme, not least because of the evolution of electorates. For the first time in history, the majority of voters were drawn from the middle class, replacing the old rich/poor divide in Latin America. In tandem, levels of debate and electoral scrutiny rose alongside widespread adoption of social media as an electoral tool, mimicking trends seen in elections and referendums in developed countries.

Two connected themes stood out. Pent up anger and zero tolerance for corruption, stemming initially from the Lavajato scandals in Brazil, spread like wildfire across the region. In turn, this led to the emergence

of profound disenchantment with traditional political parties who were seen to embody embedded corruption.

This was particularly so in Mexico, where the PRI's virtual monopoly of power of the last 100 years was dismissed.

Why?

Headline numbers for the Mexican economy portray a country which has grown modestly but steadily over the last 30 years at around 2.5% per annum, enough to raise average per capita incomes over the period (the disaster of 1994's Tequila Crisis and forced devaluation now seems like an age ago to many). But this obscures the 'two speed economy' of Mexico. The prosperous North and Central regions represent 90% of output, driven by a dynamic industrial and manufacturing export powerhouse. In contrast, the economy in Southern Mexico is worn down by poverty, underinvestment, and declining productivity has seen its economy shrink. A famous remark by an ex Minister of Finance captures this dichotomy describing Mexico as 'a country with plenty of poor people, but not a poor economy'.

This inequality and rampant corruption levels, personified by an alarming rise in homicide levels across the nation, delivered the desire for material change. AMLO drew upon this to secure election as President on his third attempt.

AMLO's Program - Shaking the Tree

AMLO is well known to Mexicans. His three attempts to gain election as President mean his whimsical and gregarious personality, his origins in the PRI party, his subsequent shift to the left, and his record as Mayor of Mexico City are familiar stories. However, since election in July a new facet has emerged, AMLO the statesman and President Elect (Mexico has a 5-month transition from President elect to actual

leadership). Two clearly distinct, albeit pre-existing, features emerge.

First, he has a distinctly pragmatic approach, previously sighted during his tenure as Mayor of Mexico City. His new Cabinet and team are drawn from across the entire political spectrum. His economic team brings together ex World Bank leaders with left leaning academics and practitioners. He has stressed central bank independence, nominating as his first board member an Ivy League educated PhD. His team have fully supported signing of USCMA, perhaps better described as NAFTA 2.0, crucial to Mexico's future growth and productivity. He is committed to a primary fiscal surplus with expansionary welfare promises funded by aggressive cost cutting and corruption slashing efficiencies. Bond markets will be watching the publication of his 2019 budget in mid-December closely, in order to test the validity of these commitments; an important jury given that over 40% of Mexican government debt is held by cross border investors.

In parallel he has sent some critical messages of political style. His strong mandate and control of both chambers of congress provide a basis for an accelerated agenda. Top of the list is the fight against corruption. Markets and the business community were taken aback by this manifesting itself in the controversial cancellation of the new Mexico City airport project. The use of a perhaps less than kosher process involving a public referendum has understandably shaken confidence in the nature of the decision-making process. On the other hand, the project involved was controversial, seen as extremely costly and a potential source of rake off. Markets though have condemned the process sending the peso down by 5%, the stock market by 15% and credit spreads wider by 50 basis points in the weeks following the decision.

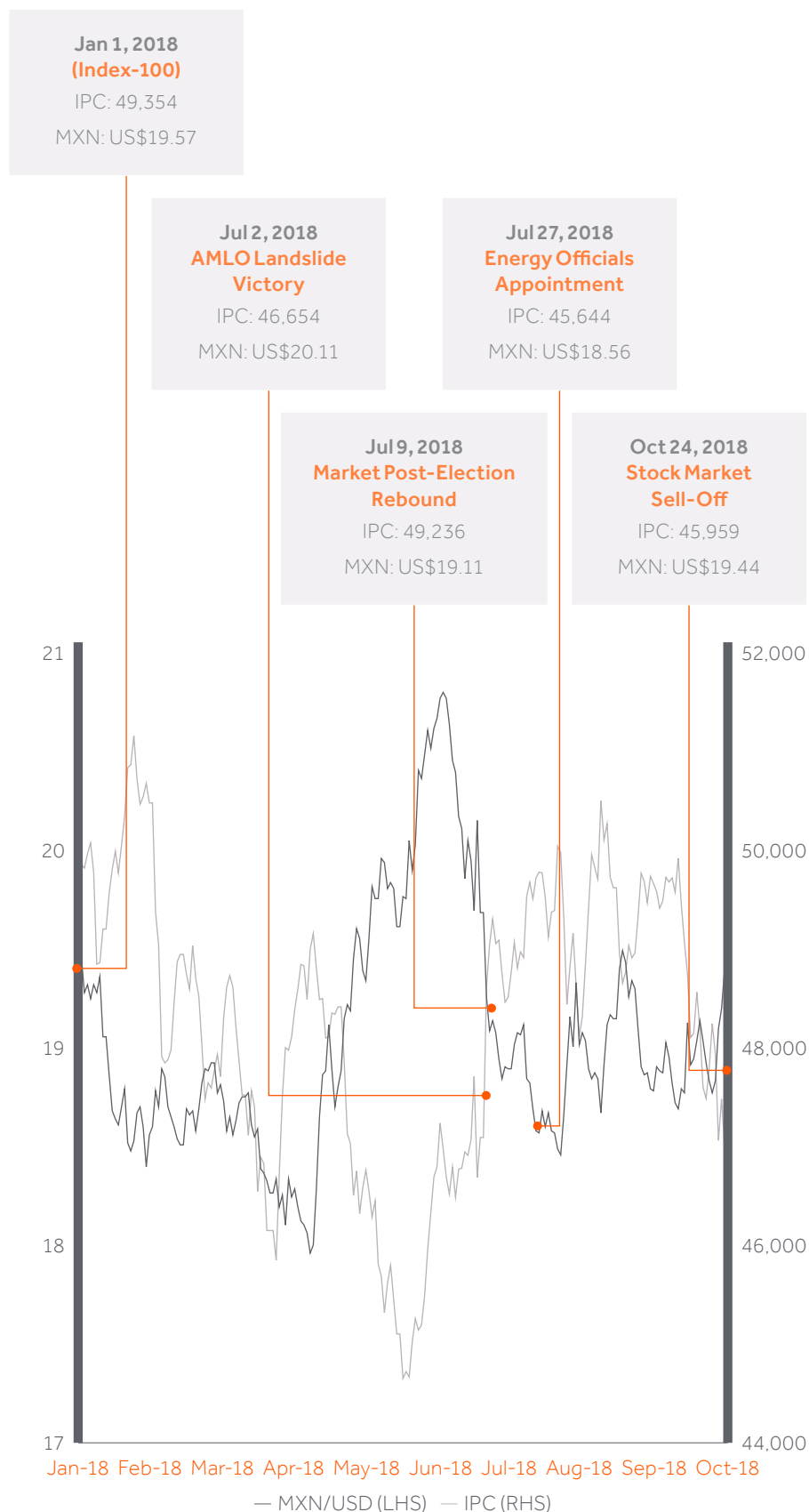
Mexican Stock Market and FX performance through election cycle

Here lies a potential pitfall. Mexico has a highly open and globally integrated economy (other than of course its Southern region). Foreign ownership levels of the bond and equity markets are high, the Mexican Peso is the most highly traded EM currency in the western hemisphere, and the country boasts a record-number of free trade agreements. What works for AMLO with his domestic electorate may not be so convincing to foreign suppliers of capital, and the government would be wise to balance its act to please both crowds. Long-term and private capital is more patient and creative in finding ways to work with AMLO and his program, yet not entirely disjointed from the public markets. The formation of a private sector advisory council, headed up by AMLO's Chief of Staff and conformed by some of Mexico's leading industrialists, is an opening of this conversation. Value will continue to be formed and found by investors in Latin America's second largest economy, but the tactics will shift.

The Future...

AMLO's strong opening hand includes a strong economy, low unemployment, declining inflation and balanced fiscal accounts. The exogenous threat posed by NAFTA renegotiation has abated (although a Democrat majority in the US Congress still poses a threat to ratification). His political mandate delivers a firm base with which to tackle corruption, to deepen and diversify political institutions and begin to address a huge inequality gap. A pragmatic approach to the problems in his in tray also augurs well. Sustaining confidence with all stakeholders as to methods as much as aims will be critical in defining the outcome for Mexico in this new regimen.

Exhibit 1: Mexican Stock Market and FX performance through election cycle



Source: Bloomberg

Regeneración

NUEVA ÉPOCA

El periódico de las causas justas y del pueblo organizado

ANDRÉS MANUEL LÓPEZ OBRADOR

PRESIDENTE



VAMOS POR LA MAYORÍA EN EL CONGRESO Y EN LOS ESTADOS

ESTE 1 DE JULIO
JUNTOS HAREMOS HISTORIA
VOTA POR



morena
La esperanza de México





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