

# COGNIZANT

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KEEPING AMERICA GREAT | AFRICA – HAKUNA MATATA? | EMERGING EUROPE ON TRACK FOR CONTINUED GROWTH  
| LATIN AMERICA: RIPE WITH OPPORTUNITY



PRIVATE CLIENT SECURITIES



OLDMUTUAL  
WEALTH

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## **COVER IMAGE – GRAND CANYON**

At 446km long and 1 800m deep, the Grand Canyon in northern Arizona is one of the world's largest canyons. This natural landmark contains some of the oldest exposed rock on earth and many consider it to be one of the Seven Wonders of the Natural World. It was first protected in 1893 as a forest reserve and became an official US National Park in 1919.



# INTRODUCTION

**CHRIS POTGIETER** – HEAD OF PRIVATE CLIENT SECURITIES

Global markets remain difficult to navigate as trade tensions are being amplified by emerging market idiosyncrasies. All indications are that this will persist for the remainder of this year. While severe market swings and uncertainties can rattle even seasoned investors' nerves, the reality is that volatility and uncertainty are part and parcel of investing. In fact, volatility and uncertainty often bring opportunities to invest in great assets at good prices. In such turbulent times, it is vital to remember that successful investing is largely about having a long-term perspective and the discipline not to react irrationally to short-term events.

In this edition of Cognizant, we wrap up our "Around the World in 180 Days" theme, where we provide brief insights into the major economies and trends shaping our collective future. Since our previous issue covered the major economies in the east, our focus now shifts towards the western world and Africa. We kick off in the United States of America, which is currently experiencing an extended economic recovery and period of market strength. While this has been a boon for investors, there are questions around how long the current favourable economic

cycle and bull market will last. In his article, Andrew Dittberner addresses these questions and highlights some fundamental issues that threaten future economic progress in the US.

We then move across the Atlantic to Africa, a continent of great contradictions. Richly endowed, yet largely stuck in abject poverty, Africa has the potential to become an economic powerhouse. Victor Mupunga sheds some light on the progress made over the last few decades, as well as the key challenges that the continent still needs to overcome. Europe is the next stop in our journey, where Moosa Hassim focuses on Emerging Europe, which has transitioned from command to market-based economies. The transition was not necessarily easy and the respective countries faced many difficulties in embracing their economic freedom. As a result, growth was lacklustre and the region was largely ignored by investors. However, this situation has changed and the region appears to be presenting some viable pockets of opportunity.

Our journey comes to an end in Latin America, which last captured investors' attention during the emerging markets

boom, when Brazil soared alongside fellow BRICs Russia, India and China, and Mexico reaped the benefit of signing the North American Free Trade Association with the US and Canada. However, the Global Financial Crisis put an abrupt end to that party. Since then, many have focused on China's resurgence while overlooking Latin America's quieter recovery. But we believe that the region is ripe with opportunity amid rising stock markets, recovering economies and the election of market-friendly governments.

I trust that you will enjoy this issue. ■

All the best,  
Chris



Nestled in the Black Hills of South Dakota, **Mount Rushmore** symbolises freedom and hope for America. Known as the “Shrine of Democracy”, it depicts the faces of US Presidents George Washington, Thomas Jefferson, Abraham Lincoln and Theodore Roosevelt. Led by the sculptor Gutzon Borglum, work on the project began in 1927 and was finally completed in 1941. Over 450 000 tons of rock was removed in order to create the carved structures.

# KEEPING **AMERICA GREAT**

**ANDREW DITBERNER** – CHIEF INVESTMENT OFFICER

Love him or hate him, one thing that Donald Trump has ensured since becoming the 45th president of the United States of America (US) is that there is never a dull moment in American politics. Many times the noise coming from the White House has been dismissed as exactly that, noise. Looking back over the past 18 months, while one might conclude that his bark is bigger than his bite, the days of simply writing off what he says are over.

The list of what Trump might consider his achievements is long and colourful but to highlight a few, they include pulling out of the Paris climate accord, withdrawing the US from the Iran nuclear deal, banning travellers to the US from six mainly Muslim countries, ordering Mexico to build a wall, meeting with Korean leader Kim Jong Un, the list goes on. However, when it comes to Trump, investors should be most concerned about his views on global trade tariffs and immigration, as both have the potential to cause major disruptions to the economic progress of the US. Elected on the back of his “Make America Great Again” campaign, the question that begs answering is why try to make something great, great again?

No country is perfect, yet from an investor’s perspective, America is already great. The current economic recovery is very likely to exceed the longest economic recovery on record. Graph 1 indicates that if the US economy continues to grow for the next 12 months, the recovery will span 123 months, exceeding the previous longest recovery of 120 months from 1991 to 2001. Alongside this, investors in the US stock market have enjoyed the fruits of an extended bull market that began back in the depths of the 2008/9 Global Financial Crisis. So while this environment has been great for investors, there are two high level questions weighing on investors’ minds that require some thought. The first is

when does the current economic cycle come to an end? And the second is how much longer can the current bull market sustain itself?

## **ALL GOOD THINGS COME TO AN END**

While the second question is arguably trickier, if not impossible, to answer, the first can be approached with a little more pragmatism. Graph 2 highlights the market’s movement in and around a recession. The grey shades indicate a US recession. Looking at the graph, it becomes very evident that the US market tends to retreat in the months leading up to a recession, recovering strongly once the recession is in the rear view mirror. Therefore, determining when

the current economic cycle will come to an end can give a broad indication of how much longer the current bull market can be sustained.

One certainty that the US, and the world, faces is that the current US economic recovery will come to an end; the only unknown is the timing thereof. The case for the next US recession to begin in 2020 has been well documented by leading global economists. Some have even gone as far as to say that the timing of it is already baked, with only the outbreak of a geopolitical event having the ability to materially move the date.

The case for the next US recession centres around the fact that the current fiscal stimulus in the form of tax cuts, which will continue to be a tailwind through 2018 and into 2019, will quickly turn into a headwind in 2020 as government spending caps set in. Coupled with this is a Fed chairman who continuously reiterates the strong case for further interest rate hikes on the back of inflationary concerns, and a labour market that continues to tighten. With no clear indications of an imminent inflection point of economic activity appearing on the short-term horizon, we expect the US economy to continue to grow over the

next 18 – 24 months. However, one needs to keep a careful eye on the data and listen carefully to the noise coming out of the White House.

**TRADING PUNCHES**

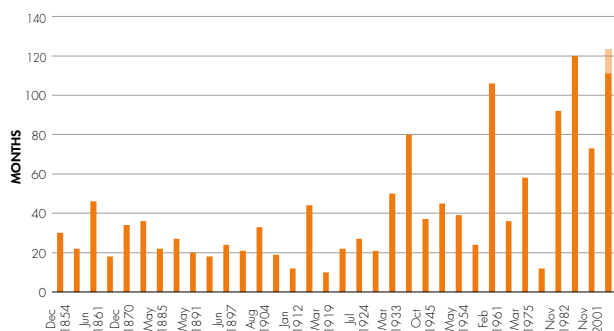
The most obvious geopolitical event that may bring a US recession sooner than anticipated is the onset of a global trade war. With the previous global trade war having taken place in the 1930s amid the Great Depression, there is no institutional memory of the damaging impact that such an event can have on the economy – instead, they are confined to the annals of history. The global connectedness of today’s supply chain adds further complexity to the impact of a global trade war. Therefore, it is extremely naïve for the Trump administration to suggest that the US can easily win a trade war. Rather, there will be no winner, only losers, and the biggest loser could potentially be the US itself.

Not too long ago, the possibility of a global trade war appeared to be fairly small and was viewed very much as a tail risk. Today, that tail risk is getting fatter and fatter, with a 50/50 possibility of the US and China striking a deal. China recently announced that it will send a

delegation to the US to resurrect talks, after they collapsed a couple of months ago. At this stage though, neither side appears to be backing down.

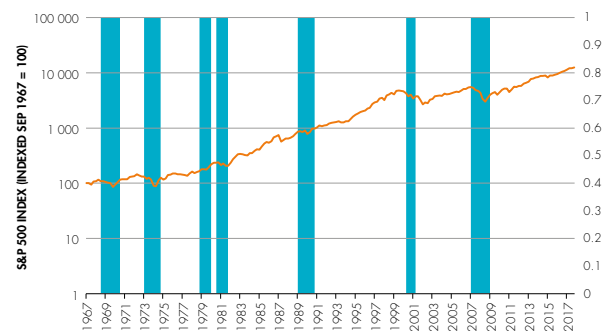
Irrespective of what war it is, there is never a good time to launch one because wars cost money. And in this case, the US consumer may be forced to foot the lion’s share of the bill. The impact of the cost of a trade war is clearly evident when looking at recently introduced tariffs. In January this year a 15% tariff on imported washing machines into the US was introduced. Three months later, according to the Bureau of Labor Statistics, the cost of washing machines had risen by 20%. Given the infrequency of purchasing a washing machine, the consumer may not feel the impact of such a tariff immediately. However, tariffs on more commonly purchased goods will be felt by the consumer through higher prices. Illustrating the point further, motor vehicles constitute about 6% of the US CPI basket of goods. A 15% increase in motor vehicle prices in the US due to imposed tariffs would result in a 1% surge in the overall inflation rate. Such a move would most definitely result in the Fed picking up the pace of monetary tightening at a time that the economy could potentially least afford it.

**GRAPH 1: THE LENGTH OF US ECONOMIC RECOVERIES**



Source: Thomson Reuters Datastream 2018

**GRAPH 2: S&P 500 INDEX AND US RECESSIONS**



Source: Thomson Reuters Datastream 2018

## THE KNOCK-ON EFFECTS

Compounding the matter further is the overly simplistic view that a 10% tariff placed on US\$200bn of trade would only deal the economy a US\$20bn hit. In reality, it is a much bigger hit, as not only will tariffs spill over into US prices, but ultimately, if a trade war goes on long enough, the allocation of capital and resources will start to become inefficient. If the US is better equipped to build aircraft and China is better equipped to build motor vehicles, then there is a comparative advantage in trade. By letting those who are more efficient at building something build it, everyone's living standards are raised. This is the basic principle of global trade and its premise.

The other point that the US may be missing is that by applying tariffs on the world, the rest of the world may end up trading more freely among themselves, leaving the US to be the odd man out. This is already happening, as evidenced by the recent Europe-Japan trade deal. Under this scenario, the US loses while everyone else gains.

Irrespective of the timing around the next US recession, a global trade war will only make it come a little quicker while also potentially making it a little deeper. The Trump administration would be well advised to welcome the impending Chinese delegation and seek out the middle ground.

## BUILDING WALLS INSTEAD OF BRIDGES

A slightly longer-term yet equally concerning issue is that of the US' immigration policies. One of the key constraints in the US today is a declining labour force, which could materially hamper the country's long-term economic progress. The reasons for the

declining labour force include an ageing population, declining fertility rates and reduced net immigration. Beyond enticing Baby Boomers back to work, not much can be done about ageing populations. While education can play an important role in improving productivity and output, adopting progressive immigration policies could address one of the most critical components – reduced net immigration.

Immigration is an extremely emotive topic, with many different angles from which to broach the subject. Looking at the facts, immigrants have contributed towards more



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than half of the growth of the US labour force over the past two decades. Many of these immigrants are entrepreneurs who have brought a high level of innovation to the country. According to the National Venture Capital Association, a third of US venture-backed companies that went public between 2006 and 2012 had at least one immigrant founder, with more than half of the US' unicorns<sup>1</sup> having been founded by immigrants. The importance of immigrants to the US is nowhere more evident than the statistic indicating that while immigrants make up about 15% of the total labour force, they comprise a quarter of the country's entrepreneurs. Companies such as Google, Tesla, eBay, Yahoo, AT&T, Procter & Gamble and

Pfizer all count an immigrant as either their founder or co-founder.

Against this backdrop, the formal proposal issued by the Trump administration to rescind the International Entrepreneur Rule (IER), a regulation that allows entrepreneurs to grow and scale their businesses in the US, comes across as irrational and ill-conceived. The IER was enacted to allow more entrepreneurs to immigrate to the US to start their businesses, and while not perfect, removing it all together will have material negative long-term effects on US economic growth. In 2017, the New American Economy immigration coalition estimated that the IER would create a minimum of 135 000 jobs in the US over the next decade, with the potential to create more than 300 000.

The jobs that the US loses by preventing the founder of the next big company from staying in the US through the IER will not disappear; rather, they will go to another country. Again, this is already happening. According to the KPMG Venture Pulse Q4 2017 publication, since the beginning of 2010, global venture capital investment has increased fourfold, yet the share invested in US companies has decreased from around 70% to 51%. Unsurprisingly, the big winner of this trend is China.

## A CHANGE IN STRATEGY

The Trump administration's focus on making America great again is ill placed. If the US wants to maintain its state of global hegemony into the foreseeable future, closing its borders to global trade in both goods and people is not the way to go about it. Keeping its borders open and remaining globally connected is a far superior strategy that will enable future economic progress while also ensuring that America remains great. ■

<sup>1</sup> A unicorn is defined as a start-up business with a value of more than US\$1 billion.



Standing proudly in the Ngorongoro Conservation Area of Tanzania is the **Ngorongoro Crater** – the world’s largest inactive, unbroken and unfilled volcanic caldera. It is also referred to as ‘the Garden of Eden’ due to its dazzling beauty and being a paradise for animals. There are around 30 000 animals ranging from leopard, cheetah, elephant and hyena to warthog, buffalo and impala. It’s also one of the best places to see the endangered black rhino and black-maned male lions. The crater itself is around 610m deep and covers 260km<sup>2</sup> and was enlisted as a UNESCO World Heritage Site in 1979. It is also one of the Seven Natural Wonders of Africa.

# AFRICA – **HAKUNA MATATA?**

**VICTOR MUPUNGA** – RESEARCH ANALYST

There is probably no other region in the world where sentiment towards it regularly see-saws from overly positive to negative as it does for the African continent. Over the last decade, news headlines have ranged from "Africa, the hopeless continent" to "Africa Rising". This should come as no surprise – with 54 countries and over 2 000 languages and dialects spoken across the continent, investors’ short- or medium-term outlook on Africa’s prospects would largely be a function of where they are looking. While we would be the first to acknowledge the perils of making sweeping statements regarding such a vast continent, we also believe there are enough threads running across most African states that allow us to assess the collective progress and long-term prospects of this continent that we call home.



## THE LION'S SHARE OF COMMODITIES

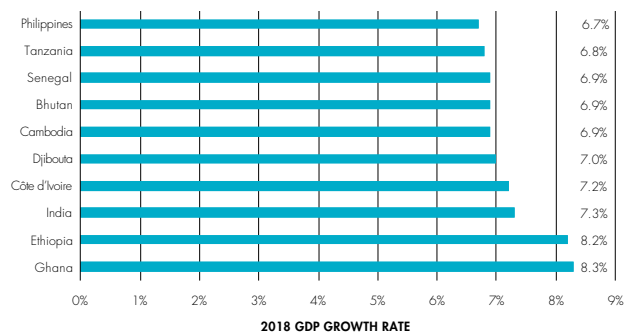
The most obvious common thread running through most African countries is their over-reliance on volatile commodity exports.

A third of the world's mineral reserves, two-thirds of diamond deposits and a tenth of oil reserves can be found in Africa. According to Deloitte, commodity exports make up at least 70% of export earnings

for three-quarters of African countries, with Angola and Nigeria deriving more than 90% of their export revenue from oil. History has shown this to be both a blessing and a curse.

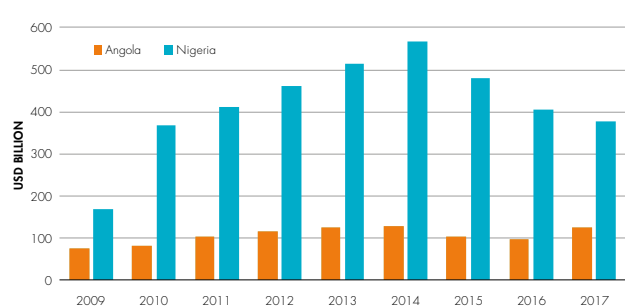
In the 1980s and 90s when commodity prices fell, coups often ensued and civil wars were closely related to discoveries of resource deposits. In contrast, the turn of the century and the Chinese-led commodity boom of the 2000s highlighted the advantages of being a commodity rich region in a world where a rising superpower (China) was industrialising. During this period, African countries performed extremely well and began to rank among the fastest growing nations in the world. A few of the countries that received this initial commodity-infused boost have managed to sustain respectable economic growth rates in the face of weaker commodity prices and, to some extent, even diversified their economies to manufacturing, services and tourism, albeit not enough. Nearly a third of Africa's economic growth still comes directly from commodities. Until the oil price collapse in 2014/5, Angola and Nigeria were experiencing robust growth, with the latter surpassing South Africa as the largest economy on

**GRAPH 1: WORLD'S FASTEST GROWING ECONOMIES IN 2018**



Source: The World Bank

**GRAPH 2: ANNUAL GROSS DOMESTIC PRODUCT (GDP)**



Source: Trading Economics

the continent. Since then both countries have experienced recessions, currency shortages and price controls. This illustrates that much still needs to be done to replace commodity dependence.

**THE PAINS DOWN IN AFRICA**

A common complaint from travellers across the continent is that most parts of Africa still lack decent infrastructure. Bad roads (or no roads at all), a lack of functional public transport systems and unpleasant airports are often cited as examples. While this is all true, perhaps the most dire and economically crippling issue is poor electricity supply due to insufficient power stations. According to the International Energy Agency, nearly half of the African population – i.e. roughly 600 million people – do not have access to reliable electricity. The economic and social impact of this is enormous. Businesses often find alternatives in the form of diesel generators, which come at great operational costs. The World Bank estimates that if there were a continuous energy supply across the region, sub-Saharan countries’ annual GDPs would be 2% higher. But while electricity supply is a major challenge, it is not insurmountable. The cost of

renewable energy (solar panels and wind turbines) has fallen over the last few years, which has seen some major projects becoming viable and being commissioned. However, for now, the lack of adequate infrastructure remains a blot on the African growth story.

**THE RHINO’S HORN**

Despite the aforementioned challenges, few would dispute that over the last two decades, the continent has made great strides. Poverty across the region has fallen and the middle class has grown rapidly. For instance, Standard Bank estimates that Ethiopia’s middle class has grown tenfold over the past decade. As seen in other African countries, new entrants into the middle class are likely to urbanise and start purchasing basic consumer goods and services at a higher marginal propensity than consumers in more developed regions.

With the exception of South Africa, the median age of sub-Saharan Africa is below 25. Literacy rates continue to improve along with life expectancy. Supported by relatively high birth rates, the continent’s population is forecast to double to 2.4 billion by 2050. These numbers are simply too large and attractive for any

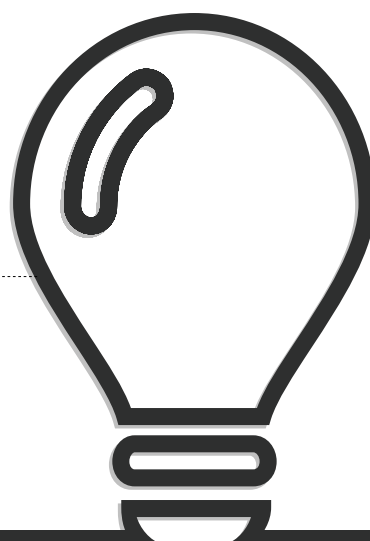
global business to ignore. However, in order for the continent to fully benefit from this demographic tailwind, it needs to operate more like a single market of 1.2 billion consumers rather than the current model of 54 independent states with limited intra-African trade.

This lack of intra-continental trade is perhaps why the continent has failed to create large multinationals that serve the entire continent. However, what the continent has lacked in the form of dominating conglomerates, it has somewhat made up for in the form of smaller innovative companies that meet the needs of their specific market or country. Take for instance mobile money transfers, which were popularised by Safaricom’s M-Pesa. About 35% of adults in sub-Saharan Africa now use the technology, with Kenya leading the way with 60% penetration. For countries that are largely unbanked (Graph 3), this is a great solution that meets their specific needs.

While M-Pesa is the most well-known technology start-up, it is certainly not the only one. M-Kopa, a financing platform that also sells solar systems, has been dubbed “the most successful African firm innovating on top of mobile technology”.

**GLOBAL ELECTRIFICATION RATE**

<b>WORLD</b>		
Urban: 96%	Rural: 73%	Total: 86%
<b>AFRICA</b>		
Urban: 77%	Rural: 32%	Total: 52%
<b>NORTH AFRICA</b>		
Urban: 100%	Rural: 99%	Total: 100%
<b>SUB-SAHARAN AFRICA</b>		
Urban: 71%	Rural: 23%	Total: 43%



Source: International Energy Agency

Another is Milvik, a life insurance firm that operates in four countries and allows customers to pay daily premiums of about 2 US cents via mobile phone top-ups. In South Africa, SA Taxi, a subsidiary of Transaction Capital (which serves the taxi industry and sells related insurance differently to traditional banks), is another case in point.

Outside of the formal economy is a seemingly bustling informal sector. According to the International Labour Organization, the African informal economy is largely understated and it is estimated to represent over 40% of sub-Saharan Africa's GDP. South Africa is at the lower end of that range (under 30%) with Nigeria, Tanzania and Zimbabwe at the upper end (about 60%). This is mainly made up of enterprising traders, who in some regions are efficient enough to make it difficult for large corporations to dominate. This highlights some of the continent's innovation, resourcefulness and wits, all of which should stand the region in good stead.

### A LEOPARD CHANGING ITS SPOTS

Perhaps the most significant positive change on the continent over the past

decade or so is that wars and civil dissension have declined dramatically. While there are still the occasional incidents (South Sudan, Somalia and Egypt), they are nowhere near the severity of the civil wars and coups of prior decades. Closely linked to this development is the advent of democracy across many countries. It is startling to note that in the 1980s only three African countries had democratically elected governments. Today, the majority of African countries enjoy some form of democracy and regularly participate in elections, albeit not always perfect.

### CORRUPTION: THE ELEPHANT IN THE ROOM

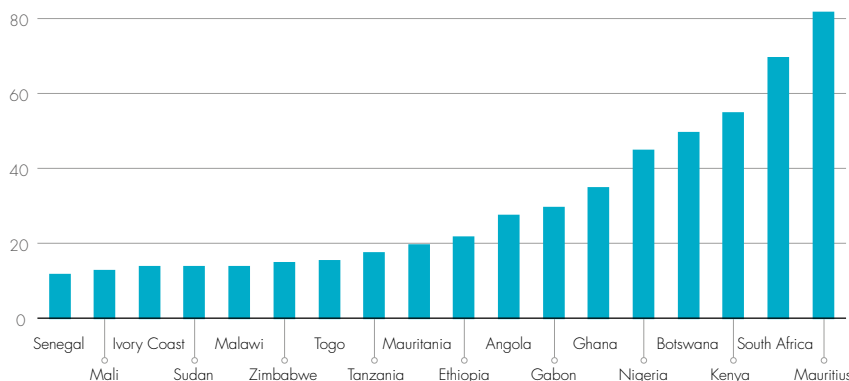
Despite all the good, one cannot be oblivious to some dreadful aspects that weigh on Africa's improved prospects. Chief among them is the scourge of corruption that is often cited as one of the continent's greatest impediments to progress, and rightly so. As a case in point, it is estimated that corruption could cost Nigeria 37% of its GDP by 2030 if current trends continue – up to US\$8 billion is estimated to be siphoned out of the economy every year. Sadly, the story is very similar in many African countries. Ghana, the fastest growing

country in Africa and the world, is estimated to lose around US\$3 billion every year to illegal activities. These are all much-needed funds that could be directed to infrastructure development – schools, hospitals, power stations and roads. The uneven spread of wealth (high inequality) and low rankings on ease of doing business are some other obvious consequences of corruption, both being key challenges facing the continent.

### TIA – THIS IS AFRICA

Where will Africa be in a decade from now? Will the sceptics be proven right or will the aspirations of over a billion Africans be closer to being realised? Needless to say, we are optimistic on the continent's long-term prospects. However, we will add the proviso that it will take time. As the old adage goes, "There is no hurry in Africa." It takes generations to expunge destructive practices such as bribery, fraud and violence. So while the road ahead will likely present some obstacles, judging from the past two decades, we are on the right track. Furthermore, we would go as far as to say that many of Africa's challenges can be overcome by having the right leaders in place. How else would one explain the anomaly that the continent with the most arable land has to import food or that the continent with the richest mineral wealth has the poorest people? ■

**GRAPH 3: PERCENTAGE OF POPULATION WITH A BANK ACCOUNT (% OF TOTAL)**



Source: The World Bank



Situated in the northwest of the country on the **Vltava River**, **Prague** is the capital and the largest city of the Czech Republic. This magical city of bridges, cathedrals, gold-tipped towers and church spires is also the 14th-largest city in the European Union and is home to about 1.3 million people. Since the Middle Ages Prague has cherished the reputation of being one of the most beautiful cities in the world as well as the political, cultural and economic centre of Central Europe.

# EMERGING EUROPE **ON TRACK** **FOR CONTINUED GROWTH**

**MOOSA HASSIM** – INVESTMENT ANALYST

“It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the spring of hope, it was the winter of despair.” This opening line of Charles Dickens’ ‘A Tale of Two Cities’ immediately comes to mind when considering Europe, which is still very much a tale of two realities. On the one hand you have the developed, capitalism-entrenched Western European bloc that, over an extended period of time, has delivered strong growth and returns for investors. On the other you have Emerging Europe (comprised of Central and Eastern European countries), which has gone through the enormous change of moving from command to market-based economies. This transition has not been easy, with the respective countries facing many difficulties in embracing their economic freedom. As a result, growth was lacklustre and the region was largely ignored by investors. However, this situation has changed with the passing of time and the region appears to be presenting some viable pockets of opportunity.



**THE HISTORY OF EMERGING EUROPE**

This year marks 29 years since the world changed with the fall of the Berlin Wall. As the wall came down, so too did the entire Soviet power structure (i.e. closed borders and economic oppression) and a large number of previously closed and stagnant economies across Central and Eastern Europe, the Former Soviet Union and Central Asia burst into life. The events of 1989 ensured that political tyranny, crippling central planning, weak output and shortages finally came to an end. While the road was fraught with challenges, the affected countries began the process of transitioning into market-based economies.

The opening of trade with the West and the freeing of prices was a relatively easy and quick fix. This ended the queuing for limited resources, improved the quality of goods and services and increased consumer welfare. However, there were many complications that could not be solved with 'quick fixes'. Much of the old capital stock became junk, the labour force was in dire need of new skills and working habits, the legal and administrative systems and tax and social

benefit structures needed transformation, and distributive and banking networks had to be rebuilt. The travails of the transition caused real GDP growth in Emerging Europe to fall, with GDP only moving into positive territory from the mid-90s and growing modestly up until the Global Financial Crisis (GFC) in 2008.

**DIGGING DEEPER INTO THE NUMBERS**

Emerging Europe has been growing strongly over the last few years, with latest GDP growth figures now at pre-GFC levels. But how sustainable is this rate of growth and how closely is it linked to the strong European Union (EU) economy?

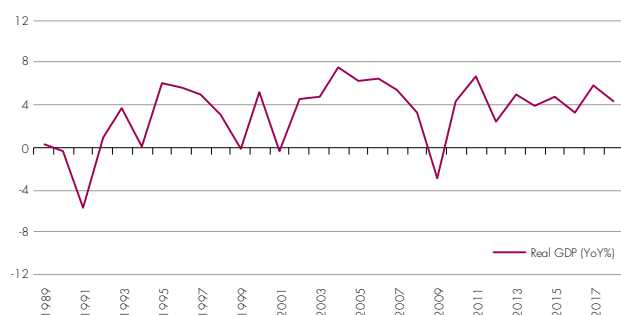
Emerging Europe has a very open economy with its main trading partner, the EU, who takes up around 75% of all its exports. As the EU economy has gained momentum, it has boosted exports from Emerging Europe. The other key factor contributing to the higher growth in Emerging Europe is that these countries are recipients of EU structural funds. The EU has allocated funds with the aim of strengthening economic and social cohesion in Europe by reducing the differences in development between the

regions. These funds are predominantly used to support infrastructure projects and invest in small and medium enterprises. However, the relationship with the EU does not explain the entirety of the region's strong growth as the countries have idiosyncratic factors.

There are currently two other key factors contributing to growth: fiscal and monetary policy. Since 2015 Emerging Europe governments have taken an expansionary stance. This has seen these governments increasing spending in order to boost growth. We can see evidence of this in Graph 2, which shows how certain countries' budget deficits as a percentage of GDP have significantly increased over the past few years. This trend is likely to continue going forward, given the future plans announced by these governments.

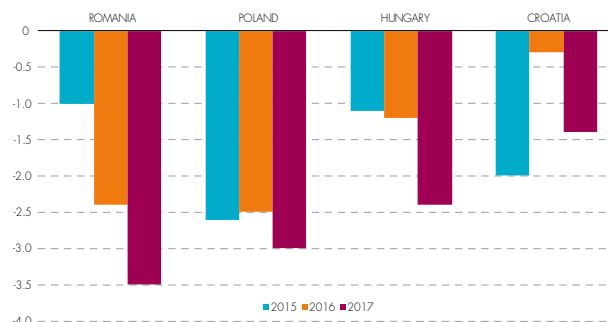
Regarding monetary policy, benchmark interest rates in most Emerging Europe countries are at all-time lows, which has the effect of supporting demand in the economy. The low interest rates incentivise individuals and businesses to borrow and spend, thereby boosting demand and driving growth. However, given the strong growth in economic activity

**GRAPH 1: REAL GDP IN EMERGING EUROPE (1990 – 2016)**



Source: IMF data

**GRAPH 2: CYCLE-ADJUSTED DEFICIT\***



Note: \* Cycle-adjusted deficit is a measure that eliminates cyclical factors from the deficit's calculation (e.g. corrected for the fact that expenditure on unemployment benefit is higher in a recession than during expansion). Source: Based on data from the IMF

and wages, and the expansionary fiscal policy, inflation is expected to increase at a faster rate than originally predicted. Rising inflation could force monetary authorities to raise interest rates sooner than expected in order to stop the economies from overheating. Despite this, the consensus among analysts and international institutions is that these regions are likely to continue growing strongly in the future. However, growth will ease somewhat should the monetary authorities begin to withdraw the current stimuli.

### HAVE THE MARKETS FOLLOWED?

From a macroeconomic perspective, Emerging Europe seems attractive and has grown strongly over the past few years. But while there is often a correlation between GDP growth and stock market returns in the long term, there are plenty of examples of stock markets being disconnected from the real economy in the short term. Therefore, prospective GDP growth is not a guarantee of stock market returns.

In 2017 both the FTSE 100 and the S&P 500 were firmly in the spotlight

for record-breaking performance. However, as Graph 3 shows, the MSCI Emerging Markets Europe Index actually outperformed both of these indices. One-year performance to the end of January 2018 saw the index gain 26%, superior to both the S&P 500 and the FTSE 100, which posted returns of 23.91% and 19.95%, respectively.

This year has, however, been a different story, with the moral being that one needs to be aware of the risks of investing in volatile emerging economies. To the end of July 2018, the MSCI Emerging Markets Europe Index was down 7.78%, while the FTSE 100 was down 2.26% and the S&P 500 was up 5.34%.

While this year's performance might be concerning, one needs to be cognisant of the fact that performance is quoted in US dollars and the strong dollar has been a dominant theme in all emerging market economies. While there are valid concerns around certain emerging economies (i.e. Turkey), these concerns in theory should not extend to other markets. However, during periods of uncertainty, investor sentiment can cause large movements in asset prices across

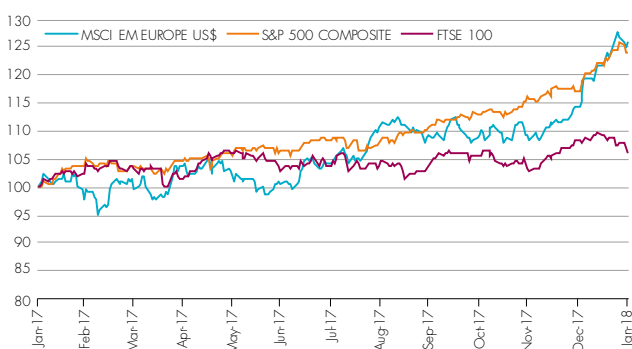
borders as risk aversion takes precedence. This, for the discerning investor, may present buying opportunities for high quality investments.

While the effect of currency fluctuations on returns cannot be ignored, over the long term, exchange rates move in the direction suggested by economic fundamentals. It is only during shorter periods that their behaviour is often more chaotic and displays greater volatility than the underlying fundamental economic variables may imply – this is especially true for emerging market currencies.

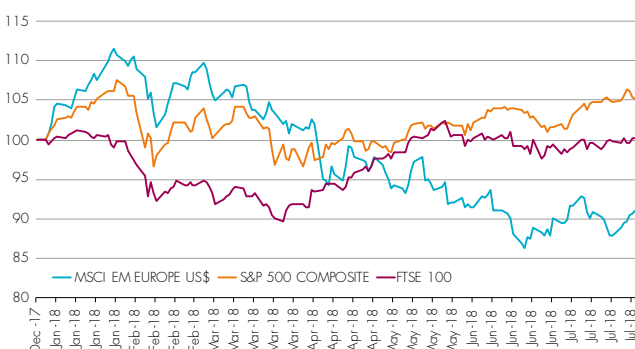
### HEADED TOWARDS THE BEST OF TIMES

After almost 30 years since the fall of communism, Emerging Europe as a region continues to transform. The road may not be smooth, but the countries are heading in the right direction. With strong economic growth, a highly skilled and cheap labour force, and budding optimism among its citizens, it would be remiss not to consider the region as an investment opportunity. ■

**GRAPH 3: INDEX RETURN COMPARISON (2017)**  
TOTAL RETURN




**GRAPH 4: INDEX RETURN COMPARISON**  
(JAN 2018 - JUL 2018)



# LATIN AMERICA: **RIPE WITH OPPORTUNITY**

**CHRIS POTGIETER** – CHIEF EXECUTIVE OFFICER

What comes to mind when you think of Latin America – the region starting with Mexico and stretching over 10 000 kilometres to Cape Horn at the southern tip of South America? Latin America's history is obscure or, at best, difficult to comprehend as a whole to most casual observers. It appears composed of snippets of ancient Aztec, Mayan and Inca history, gold and the Spanish conquests, modern dictatorships, drug wars, soccer fanaticism and Carnival. In April this year, The Economist cited this region as accounting for 8% of the global population, but 38% of global homicides. "Don't cry for me Argentina" certainly seems a bit out of place in this context.



Located in **Venezuela's Canaima National Park**, **Angel Falls** is the world's highest uninterrupted waterfall, with a height of 979m and a plunge of 807m. Put into perspective, it is three times as tall as the Eiffel Tower and 19 times the height of Niagara Falls. During warmer and drier seasons, the water of Angel Falls evaporates even before it touches the ground, forming a mist. During the rainy season, it may divide into two separate waterfalls and when the water level is high, it is possible to feel the spray up to over a kilometre away.

Latin America is a region of immense contrasts. Much like Africa, it has vast reserves of natural resources but still suffers from severe social inequality and economic volatility. Ineffective governments appear to thrive in a region celebrated worldwide for its unique cultures and the creativity of its people. What does one make of the nascent revival in Argentina under President Mauricio Macri, which has been interrupted by yet another currency crisis this year? How does one believe that the clean-up of corruption in Brazil will be more than skin deep and what will the October 2018 general elections deliver? Will Mexico be the biggest loser in President Trump's mission "to right the wrongs" of trade imbalances and immigration? What's going on in Venezuela? On the surface, crises seem to have dominated Latin American politics and economics in recent centuries. In this context, investors may be justified in questioning whether the continent is in fact "investible".

Economic volatility in many Latin American economies has been much fiercer








than in most of the world and this has damaged investor confidence. Fuelled by the commodity boom, the region enjoyed strong GDP growth until the global financial crisis hit in 2008 and has subsequently struggled to sustain economic momentum. Falling commodity prices, fiscal crises, political turmoil, insufficient public and private investment, and declining consumption all contributed to recession. All of this was then compounded by market turmoil. While countries such as Brazil and Argentina experienced major setbacks, others, such as Chile, Colombia and Peru, continued to grow, albeit at slower rates. Although Latin America still generally underperforms other emerging markets, the picture is starting to improve. Brazil and Argentina are showing signs of recovery and according to the International Monetary Fund, GDP growth across the region is projected to average 2.7% through to 2021.

#### GEARED FOR GROWTH

Latin America possesses a number of assets that make it an attractive growth market. The region has a combined

nominal GDP of around 8% of the global economy, the same as its proportion of the global population. For comparison, the USA represents 23% of the global economy and China 16% using the same measure. Therefore, on this basis, Latin America's entire economy represents half of China, but is almost the size of Japan and Germany combined. Looking at it from the perspective of emerging economies, it is greater than that of the ASEAN (Association of Southeast Asian Nations) economies, India, and the Middle East plus Africa. It is also a US\$3.5 trillion consumer market with per capita annual private consumption that is higher than in China or Russia. Since 2009, the middle class in this region has grown from 28% to 35% of the population.

The table below takes a closer look at how the major economies in Latin America compare with each other on a Purchasing Power Parity (PPP) basis. The largest economy, Brazil, makes up one-third of the region on this basis and Mexico one-quarter. These two economies have historically dominated the economy

LATIN AMERICA AND THE CARIBBEAN BY ESTIMATED GDP (PPP)*					
Rank	Country	GDP (PPP) in USD Millions	GDP	Population in Millions	GDP (PPP) per Capita in USD
	Total	10 070 343	100%	650	Av. 15 493
1.	 Brazil	3 330 461	33%	209	15 919
2.	 Mexico	2 498 202	25%	125	20 028
3.	 Argentina	952 464	9%	45	21 370
4.	 Colombia	747 024	7%	50	14 993
5.	 Chile	472 413	5%	19	25 425
6.	 Peru	449 153	4%	32	13 963
7.	 Venezuela	373 119	4%	32	11 723
8.	Other	1 247 507	12%	139	8 970

\*International Monetary Fund. "Report for Selected Countries and Subjects". World Economic Outlook Database, October 2017

of the region. However, average living standards, as measured by GDP (PPP) per capita, paint a different picture, with Chile and Uruguay topping the list.

Latin America also has the unique advantage that 95% of the population speak Spanish or Portuguese and share similar values and cultures. This helps businesses to collaborate and engage with customers across borders.

Latin America remains rich in natural resources, accounting for 14% of the world's agricultural land, 21% of forests, 28% of available water, 54% of copper production, 15% of oil reserves and 66% of lithium reserves. Lithium is a key component of most modern batteries found in anything from cell phones to electric vehicles.

### **A SPIRIT OF RESILIENCE AND INNOVATION**

A resilient private sector is arguably among Latin America's most valuable assets. The region offers many examples of companies that, despite being conceived in tough local conditions, have flourished into formidable competitors on the international stage. Swiss immigrant Joseph Villiger founded Companhia Cervejaria Brahma in 1888 in Rio de Janeiro. The brewer initially produced about 44 thousand hectolitres (1 hectolitre = 100 litres) of Brahma beer per year and grew into a household name in Brazil. In 1999, the company merged with Companhia Antarctica Paulista, producer of the equally popular Antarctica beer and soft drinks to form the Companhia de Bebidas das Américas (AmBev). AmBev grew to dominate the market for beer and soft drinks in South America. Through the successive mergers of AmBev with Interbrew from Belgium and Anheuser-Busch from the United States, Anheuser-Busch InBev (AB InBev)

was formed in 2008. Then in 2015, AB InBev acquired multinational competitor SABMiller to form the world's largest beer producer. AB InBev currently produces over 600 million hectolitres of beer per year on a worldwide basis. This represents growth of 8% each year since its founding in 1888. The company has built a reputation of uncompromising efficiency, which is a requirement to compete in a segment where margins are thin and economies of scale a prerequisite for sustainable and profitable growth.



**A RESILIENT PRIVATE SECTOR IS ARGUABLY AMONG LATIN AMERICA'S MOST VALUABLE ASSETS. THE REGION OFFERS MANY EXAMPLES OF COMPANIES THAT, DESPITE BEING CONCEIVED IN TOUGH LOCAL CONDITIONS, HAVE FLOURISHED INTO FORMIDABLE COMPETITORS ON THE INTERNATIONAL STAGE.**



Brazilian aerospace conglomerate Embraer, founded in 1969, is the world's third-largest producer of civil aircraft after Airbus and Boeing. Another Brazilian multinational, Vale, is not just one of the largest logistics operators in Brazil, but is also the largest producer of iron ore and nickel in the world. Mercadolibre (free market in Spanish) is an Argentine company that competes in e-commerce and online auctions. While it may not be as well known as Amazon or e-Bay, it is Latin America's most popular e-commerce site by number of visitors, serving one in four people. Kroton Educacional is not just Brazil's largest education company, it

happens to be the largest listed educational company in the world.

Innovation is also thriving in Latin America. For instance, Brazil's Braskem recently developed a recyclable polyethylene plastic produced from ethanol sugarcane, a renewable raw material. This technology enabled Braskem to establish global leadership in bioplastics. It is noteworthy that Lego recently announced that it will start using Braskem's Green Plastic to produce certain toy building parts this year.

### **RICH IN NATURAL RESOURCES**

Brazil is a significant player in global beef and soy production and could benefit significantly from the tariffs China is imposing on US soy imports. Listed Brazilian farmland owner SLC Agricola was a significant beneficiary of this sentiment during the past year. Mexico and Argentina are also significant global exporters of animal protein.

Latin America has a rich history of mining activities. It can be traced back to early civilisations in Central and South America. The legend of El Dorado was borne out of the riches encountered by Spanish explorers. Silver and gold from the New World enabled Spain to become the first global empire in history and the world's most powerful empire during the 16th and early 17th centuries. While the Spanish conquests left a trail of destruction, they also left an indelible mark on the future identity of this part of the world. Current major mining activities are centred in Chile and Brazil. National petroleum companies Petrobras (Brazil) and Pemex (Mexico) own some of the largest petroleum reserves globally.

Latin America also presents a low cost production base for many global companies due to low labour costs and relatively good education and skills levels,

especially in Mexico. While the Trump administration's policy actions are important to Mexico, two-way trade between the US and Mexico is enormous and is important to both countries. Trade in both directions is heavily geared towards machinery and manufactured goods, especially vehicles and parts. Mexico is Latin America's top producer of vehicles, the seventh-largest vehicle producer worldwide, and has a number of free trade agreements with many other countries. In this way, the US is not Mexico's only market.

### **RIISING ABOVE CHALLENGES**

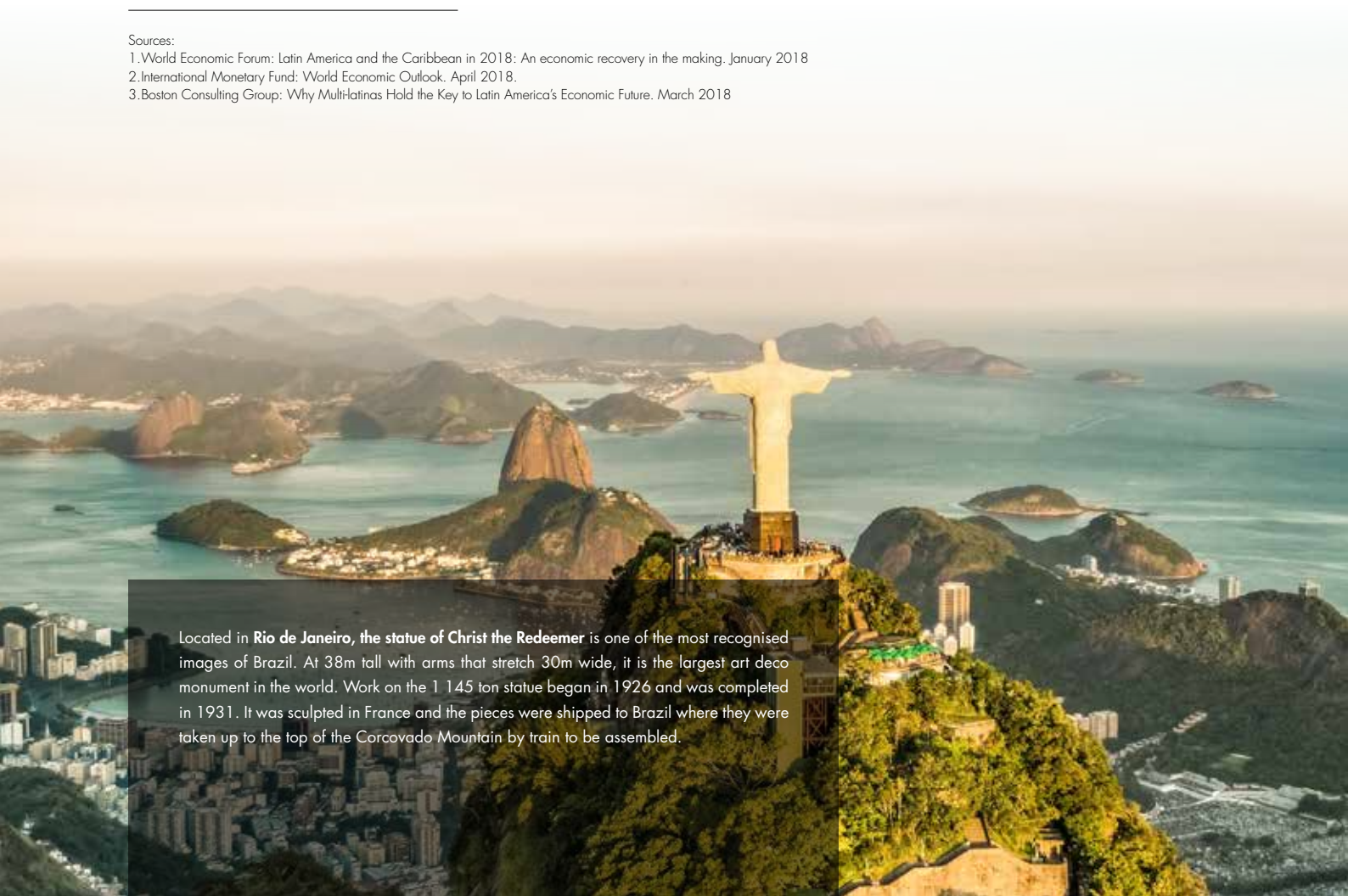
Latin America is just starting to get its act together. The growing commitment to trade and investment liberalisation by some governments, despite growing protectionism in the US and elsewhere, favours the region and its multinationals.

The region's recent tilt towards openness is expected to help increase both imports and exports, which have grown by roughly 30% since 2009. Greater openness is also making Latin America an attractive destination for foreign direct investment (FDI). From 2014 through 2016, the region drew an average of nearly US\$200 billion in FDI annually, which is close to China's level and is significantly larger than other emerging economies such as ASEAN and India. Investors cannot disregard this region of the world despite the political uncertainty and economic volatility. From this region has emerged some formidable multinational companies, forged in tough conditions and inspired to greatness, and all indications are that this will continue. ■

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#### Sources:

1. World Economic Forum: Latin America and the Caribbean in 2018: An economic recovery in the making. January 2018
2. International Monetary Fund: World Economic Outlook. April 2018.
3. Boston Consulting Group: Why Multi-latinas Hold the Key to Latin America's Economic Future. March 2018



Located in **Rio de Janeiro**, the **statue of Christ the Redeemer** is one of the most recognised images of Brazil. At 38m tall with arms that stretch 30m wide, it is the largest art deco monument in the world. Work on the 1 145 ton statue began in 1926 and was completed in 1931. It was sculpted in France and the pieces were shipped to Brazil where they were taken up to the top of the Corcovado Mountain by train to be assembled.

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