

News

Emerging Market Spotlight

Rejection of a left-wing constitution reduces risk for equity investors in Chile, but economic problems remain an obstacle



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Given our overweight positions in Mexico and Brazil, why do we not have a position in Chile, Latin America's third-largest market? The answer to that has two parts, each of which is an example of what we consider to be key risks in country-driven emerging market investing.

As we have written before, in recent years Latin America has seen a broad political shift to the left. Chile has been part of this with the 2019-21 cost-of-living protests seeing 1.2m people on the streets of the capital Santiago in October 2019. This led to a hard-fought presidential election in 2021, won by 35-year-old ex-student radical Gabriel Boric with a platform focused on opposition to capitalism and support for social justice and the environment. As well as this electoral shift to more populist politics, Chile has also faced the prospect of a new constitution. A referendum in October 2020 approved the drafting of a new constitution by a specially elected convention, which has since been drafted. The Boric administration has been particularly critical of the mining and forestry industries, as well as calling for the nationalisation of lithium extraction and a large increase in the role of the state in the economy.

Chile's equity market took these developments badly. Previously, the stable and market-friendly nature of Chilean politics had enabled the market to trade at a valuation premium to neighbouring countries, but the forward price/earnings ratio of the IPSA index fell from an average of 15x in 2011-20 to less than 7x in mid-2022.

The first week of September has seen an improvement in the political outlook, with the final popular vote to approve the new constitution rejecting it by 62% to 38%. This means the current constitution

will remain, removing a major source of risk to equity investors and suggesting that President Boric has less room for manoeuvre than when elected.

With reduced risk and valuations at all-time lows, does that make Chile attractive to our investment process? Unfortunately, not at this time, because the economy faces some serious challenges that will need to be overcome before the market can see stronger growth and a lower discount rate.

Followers of our process will know that we consider current-account deficit markets like Chile to be inherently cyclical, with periods of strong growth always followed by crises or slowdowns. Chile has enjoyed strong growth in recent years and is now in the downswing. During the Covid pandemic, the government injected USD 27bn of extra spending into a USD 318bn economy (one of the most generous stimulus packages in the emerging world). This was concurrent with the congress passing legislation allowing the public to withdraw their pension savings early. These two measures combined to drive a consumer boom, with real retail sales in 2021 some 23.6% higher than in 2019.

As is typical for current-account deficit markets with booming domestic demand, both inflation and the current account balance have rapidly become serious problems. Inflation, which since 2010 had not exceeded 6%, has ramped to 13.1% in the year to July; the current account deficit, which had been averaging 3.5% of GDP, expanded to 8.8% of GDP in 2Q 2022.

And, as is almost always the case, the unsustainable inflation rate has caused a sharp currency sell-off (the Chilean peso is down 18.1% against the US dollar since the end of 2019, having at one point in July been down 39.5%), which has in turn required brutal interest rate hikes from the central bank (since mid-2021, the policy rate has gone from 0.5% to 10.75%). Ultimately, the only solution is going to be a drastic slowdown in domestic demand, a higher savings rate and a period of export-led growth to repair the external balance, and we generally seek to avoid being invested in markets that are undergoing slowdown and rebalancing. We prefer those we see as heading into upswings, including Mexico and Brazil.

James Symes, Paul Wimborne and Ada Chan manage the JOHCM Global Emerging Markets Opportunities Fund. Find out more [here](#).

Source: J O Hambro or Bloomberg unless otherwise stated.

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