Latin America Research: Currency Risk

Mid-Year 2016

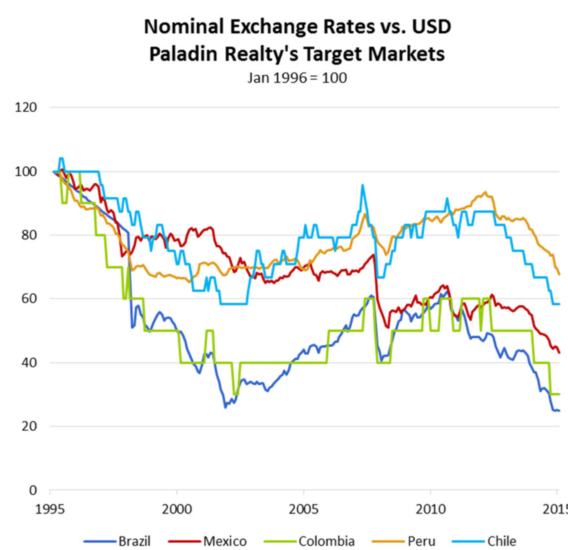
Driving While Looking in the Rearview Mirror – Evaluating Currency Risk in the Emerging Markets Today

Over the past five years, U.S. dollar-based investors in most emerging markets, including Latin America, have experienced substantial paper losses driven largely by a significant depreciation in local exchange rates. A natural reaction in the wake of such an event is to retreat and assume that the negative trends of the recent past will continue indefinitely into the future, regardless of the fundamentals. In doing so, investors would be committing a classic investment blunder – looking at the road ahead through the rearview mirror – at precisely the wrong time.

Instead of looking backward, investors would be well advised today to adhere to three time-tested principles of prudent investing: (1) fundamental analysis, (2) dollar-cost-averaging and (3) diversification. Indeed, based on today's currency levels, as well as solid mid- to long-term macroeconomic and real estate fundamentals, Latin America offers one of the most compelling investment opportunities available to U.S. dollar-based investors today compared to any time in the last fifteen years.

- Currencies in the key markets that are closely tracked by Paladin Realty – Brazil, Mexico, Colombia, Peru and Chile – have become quite cheap in relative terms
- Market-oriented, investment-friendly economic policies are on the rise in these markets
- Positive demographic trends remain in place that will provide tailwinds to growth over the next 15-20 years
- Supply-demand balance for investment capital favors investors

With strong local management teams and operating partners, combined with prudent investment selection and seasoned underwriting, investors who deploy U.S. dollar-measured capital over the next two to three years in Latin America real estate are likely to realize superior risk-adjusted returns on both a relative and absolute basis.



Currency Fundamentals are Attractive Today

Several factors suggest that today's foreign currency exchange rates in Latin America will, at worst, have a neutral bias or be more likely to provide positive tailwinds to U.S. dollar-based investors over the next several years. These positive fundamentals for stable or appreciating exchange rates include:

1) Local currencies appear undervalued on a purchasing power parity (PPP) basis
2) Current account deficits are shrinking
3) Commodity prices appear to be stabilizing, as supply has decreased in the wake of lower global demand
4) Real exchange rates are near decades lows and should revert to the mean over time
5) Interest rate differentials are stimulating capital inflows to the region
6) Improved visibility on the political front as investor-friendly leaders take office

The balance of this paper examines each of these points individually.

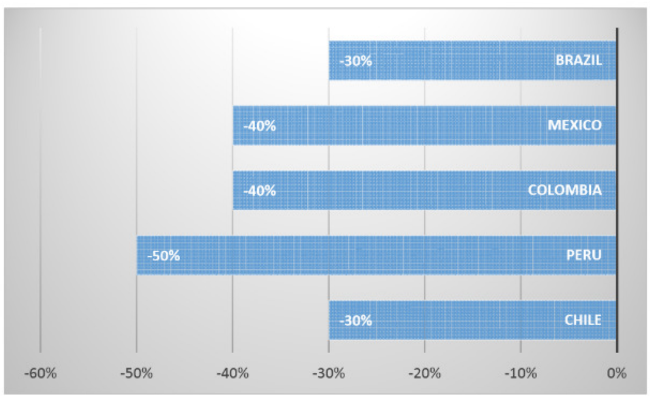
Local Currencies Appear Undervalued on a Purchasing Power Parity (PPP) Basis

It's important for global investors to understand the distinction between *nominal* exchange rates, which generally move in line with inflation differentials between countries, and *real* exchange rates, which are a measure of the relative purchasing power of one currency against another. Real exchange rates are often expressed on a *purchasing power parity* (PPP) basis, where the cost of a basket of goods or services in one country (priced in its local currency) is compared to the cost of a comparable baskets of goods and services in another country. Real estate investments generally provide an inflation hedge, which can provide a certain level of protection against swings in nominal exchange rates due to inflation differentials. Changes in the underlying real exchange rates, on the other hand, present a greater risk to global investors.

Real exchange rates in Latin America today appear to be quite undervalued on a PPP basis. This is perhaps best illustrated by the "Big Mac Index" created by *The Economist* magazine as a crude measure of the relative purchasing power across various currencies using the cost of McDonald's iconic hamburger for comparison. The price of a Big Mac is currently 30-50% cheaper in the Latin America markets tracked by Paladin Realty compared to its price in the United States. Similarly, the World Bank's PPP conversion rates, which compare a much larger basket of goods and services to U.S. dollar prices, show similar-sized real exchange rate discounts across the region: 30% in Brazil and Chile; 40% in Mexico and Colombia; and 50% in Peru.

World Bank PPP Conversion Rates

Local prices of a basket of goods and services compared to USD prices (%)



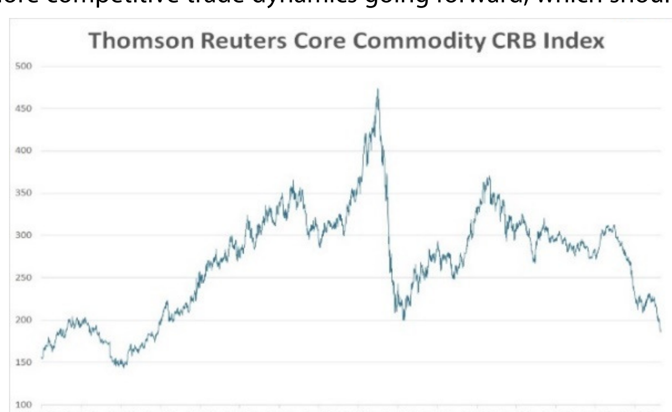
Source: World Bank

Why are cheap goods and services in Latin America evidence to support potential future currency gains on U.S. dollar-based investment returns in the region over the next several years? Economic theory of efficient markets and common sense postulate that such pricing disparities will eventually revert to equilibrium over time, as consumers and businesses engage in a pricing arbitrage, stimulating demand for these cheaper goods and services, which, in turn, will stimulate demand for and appreciation in the value of local currencies.

Real Exchange Rates Have Declined Sufficiently to Begin Resolving Current Account Deficits

A current account deficit means that a country is spending more on foreign trade than it is earning, generally resulting in a weaker currency. In recent years, the sharp fall in the global prices of hard and soft commodities has contributed to growing current account deficits in Latin American countries that are net exporters of commodities. In Colombia, for example, oil exports accounted for about half of that country's total exports in 2013. As the price of oil fell in recent years, so did the value of Colombia's exports, creating a current account deficit. As a result, the reduced demand for Colombian pesos caused that currency to weaken against the U.S. dollar. Similar dynamics have played out in other Latin America countries like Peru, Chile, and Brazil.

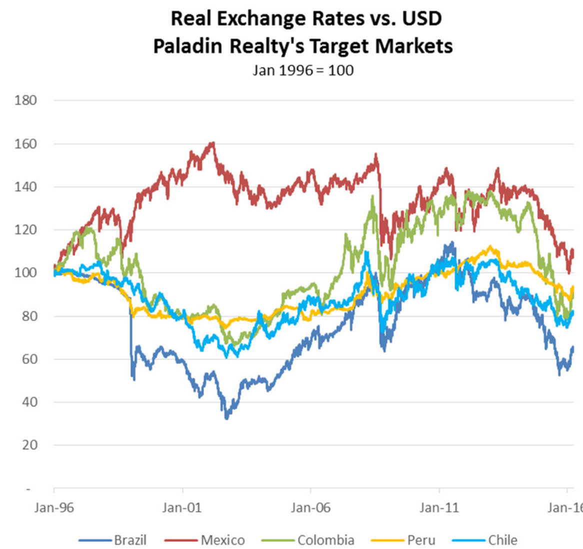
Today, Latin American currencies are sufficiently low in real terms to depress local demand for imports (which have become more expensive in local currency terms) and stimulate foreign demand for exports (as the relative prices of Latin American goods and services have declined). This corrective mechanism is rooted in the principle of purchasing power parity, as mentioned above. Cheap real exchange rates in Latin America have set the stage for more competitive trade dynamics going forward, which should stimulate growing demand for its currencies. To be sure, this correction is expected to be gradual, since consumption habits take time to shift. However, the narrowing of current account deficits in the region is already beginning to (?) manifest; Brazil's current account deficit dropped from 4.7% of GDP in February 2015 to 2.7% a year later.



Commodity Prices appear to be Stabilizing

Commodity prices are near multi-year lows and, in most cases, currently trade below 2008 levels. Indeed, the Thomson Reuters Commodity Index is 64% below its 2007 peak. While lower prices stimulate demand, since demand for commodities tends to be relatively inelastic, a much more important variable to price stabilization is the supply-side outlook. At today's prices, many commodities trade below their marginal production cost for higher cost producers. As conditions at the higher end of the cost curve become uneconomic, production shuts down which reduces supply. Whether it be tar sands in Canada, shale oil in the United States, or sugar in India, investment in production has dropped sharply in recent years and supply is clearly contracting. Despite the difficulty in predicting commodity prices in the near-term, the fundamentals of the commodity cost curve do provide a floor value to prices and suggest a positive medium- to long-term outlook. From a currency perspective, stable and cheap commodity prices currently provide a positive tailwind.

Real Exchange Rates are Near Decades Lows and Should Revert to the Mean Over Time



Local currencies for Brazil, Mexico, Colombia, Peru, and Chile are trading at or near historic lows in real terms. This is compelling by virtue of pattern recognition, alone (see chart to the right). Historical data bears out the fact that real currency levels revert to the mean over time. An analysis of real exchange rates versus the U.S. dollar going back 20 years shows that today provides one of the more compelling entry points for mean reversion.

Interest Rate Differentials Are Stimulating Capital Flows in the Region

The disciplined monetary policies of central banks in markets studied are supportive of stronger currency levels. Latin American countries have adopted prudent monetary policies by raising local interest rates to control inflation. For example, in Brazil, the Selic rate has increased from 7.5% in December 2012 to 14.25% today, a difficult policy to implement during the country's deepest recession in nearly a century. However, these measures also provide evidence of central bankers' strong commitment to maintain price stability. As inflation comes down, the real return differentials between the U.S. dollar and local currencies will become sufficiently attractive to stimulate a carry trade into these local currencies, supporting and perhaps appreciating their values.

Improved Visibility on the Political Front

One reason why recent currency declines overshot in real terms was the political uncertainty that has been prevalent in certain markets like Brazil and Peru. Much of this uncertainty comes down to the perceived risk of populist/leftist political parties pursuing policies that might have potentially destabilizing economic consequences, such as inhibiting free trade, increasing economic distortions related to transfer payments or cost subsidies, pursuing inflationary monetary policies, raising taxes, or otherwise weakening institutions and property rights.

Over the past decade or more, Brazil, Mexico, Colombia, Peru and Chile have pursued sound, market-friendly economic policies compared to the more leftist regimes of Argentina and Venezuela. More recently, populist movements in these latter two countries appear to have largely exhausted themselves, as their leftist regimes ran out of money and corruption or clientelism (a quid-pro-quo type of patronage) surfaced. For example, Argentina recently rejected the Peronist populist party of Cristina Fernandez de Kirchner in a watershed election that elevated market reform-minded Mauricio Macri to the Presidency. Macri has taken advantage of his mandate to roll-back economic distortions and re-establish Argentina's ties to the global financial system. His commitment to opening trade borders is a beacon to other countries in the region, not least of which is Brazil, a fellow member of the trade bloc known as Mercosur. The recent Presidential election in Peru decisively rejected a populist candidate Veronika Mendoza, who had styled herself after Venezuela's Chavismo movement. With the violence and human misery in Venezuela increasing by the day, that populist movement is no longer a symbol of egalitarianism, but rather a cautionary tale.

In Brazil, the removal from office and pending impeachment of former President Dilma Rousseff has been widely regarded as a positive event on the political and economic front, prompting the currency to rally by 15% this year against the U.S. dollar and Brazil's stock market to rally 30% since its January 2016 lows. While newspaper headlines about corruption investigations in Brazil and other Latin America countries feed negative investor sentiment, the public disclosure and outcry over such scandals also demonstrate progress towards stronger political, business and legal institutions in these markets over the long term. As these scandals are exposed through the free press and social media, and catalyze civil society to protest, voters and governments are responding, which eventually will lead to stronger and better governed societies.

Strategy Implications

Due to the significant decline in the value of Latin American currencies in recent years, as well as other market related factors, prime commercial real estate assets in certain markets (particularly Brazil) can be acquired today at or below replacement cost, and well below where U.S. dollar values were three to five years ago. Additionally, less competition from investors and operators has resulted in land for residential projects becoming cheaper in certain markets, while a huge regional housing deficit continues to grow due to demographics tailwinds. Current market conditions, combined with a low-levered investment approach, should provide downside protection to invested capital and great potential for appreciation.

Given where local currencies are today and the positive fundamentals supporting current values, the next few years should prove to be an optimal time for U.S. dollar-based investors to deploy capital in Latin America through select real estate strategies. The five key markets discussed in this reportcontinue to offer investors an attractive, conservative investment approach to target opportunistic returns (20%+ Gross IRRs) with good visibility, superior project-level economics, low leverage and downside protection – either as part of a global diversification or tactical growth strategy. The region represents one of the more compelling long-term and large scale growth opportunities in the world today, with attractive demographics and a population exceeding 400 million in Brazil, Mexico, Colombia, Peru and Chile. In addition, Brazil's stagnant economy, distressed public homebuilder sector, high interest rates, and over-supplied Class A+ office market are creating unique near-term distress opportunities.

Consistent with the analysis above, and honed from nearly two decades of experience in Latin America, Paladin Realty's investment platforms continue to follow these guiding principles:

- Target investments with high profit margins and low leverage, with visible and sustainable demand drivers
- Preserve control, deal flow, scalability, efficiency and alignment of interests through programmatic joint venture structures with proven and long-standing local operating partners
- Utilize the deep real estate development and operating experience of regional investment teams through rigorous asset management and select direct investments
- Maintain diversified portfolio construction by geography, product type and partner

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