

LATAM ELECTIONS: THE LURE OF THE LEFT

Introduction: The Timetable

Three of Latin America's largest economies, accounting for roughly two thirds of the regions by both GDP and population, go to the polls this year. The election results will have profound implications for the economic policies that will be enacted, and ultimately help to determine the fate of the nations in question for several years to come. One issue is set to dominate the election schedule more than any other: corruption.

Colombia is first to the polls with the first round of presidential elections on 27th May. Here we have seen a credible threat from the left emerge for the first time in 20 years, following the end of a bloody conflict with the Revolutionary Armed Forces of Colombia (FARC) guerrilla faction, which has divided public opinion. Could a socialist president be about to return to power after a two decade absence?

Mexico will be next to cast its vote as presidential and congressional elections are scheduled for 1st July. All eyes are on populist leftist Andrés Manuel López Obrador (AMLO), who has not shied away from his criticism of the current administrations energy reforms and the over-dependency of the country's economy on NAFTA. Will his latest bid for the presidency prove to be third time lucky, and if so what fate lies ahead for Mexico?

Finally, Brazil will hold presidential elections in October. Uncertainty remains high: even with corruption charges hanging over former leftist President Luiz Inácio Lula da Silva (Lula) his fan base remain unwavering in their support. Meanwhile, on the other side of the political spectrum, right-wing Jair Bolsonaro, who has been likened to Donald Trump, is garnering strong support. Lula's fate continues to overshadow proceedings at this relatively early stage, but most likely he will be barred from running, opening the door to a new challenger from the left. Will the left still prove to be competitive without its key protagonist?

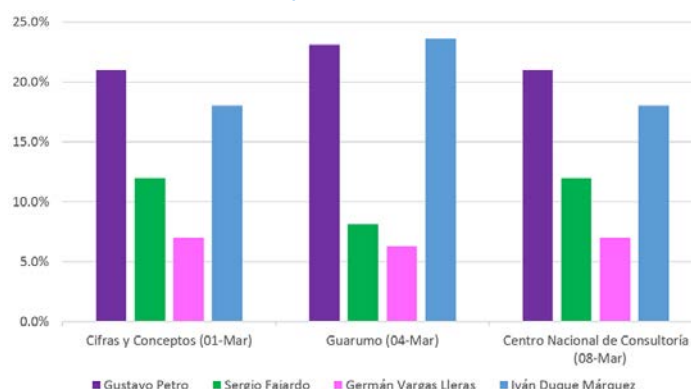
Below we delve deeper into the forces at play in each country, and how we expect them to determine the final outcome; as well as the investment implications of the results.

Colombia: Corruption and Defence the driving forces

The LatAm election season has now officially kicked off as Colombians voted in congressional elections and presidential primaries on 11th March. We now have a clearer picture of the key presidential candidates and the parliamentary support (or lack of) for their presidential mandates. The incoming administration will face a number of challenges, particularly the country's challenging fiscal dynamics in an environment of declining oil reserves and lower-for-longer oil prices.

The two main challengers look to be Iván Duque from the right and Gustavo Petro from the left, who are currently tied in the polls, though Germán Vargas Lleras from the centre-right and Sergio Fajardo from the centre-left are also still in the running.

Colombian Presidential Opinion Polls



Source: Centro Nacional de Consultoría, Guarumo, Cifras y Conceptos

Gustavo Petro has grabbed much of the headlines for his anti-establishment stance and has a number of populist overtones, including nationalization and reducing the country's dependency on oil revenues. In particular, he has capitalised on the public anger towards the ongoing "parapolítica" scandal. This arose during the conservative government of Álvaro Uribe in 2005, in which it was alleged that the government was colluding with the far right militia group United Self-Defense Forces of Colombia (AUC) in its fight against the FARC. Petro is not immune to controversy himself. As a former member of the M-19 guerrilla group, which itself emerged from widely accepted allegations of earlier election fraud, he helped to broker a peace deal that saw him enter politics and become the mayor of Bogotá. As he lacks strong parliamentary support, with his left wing Decentes coalition faring poorly in parliamentary elections, Petro's campaign has, necessarily, relied heavily on the use of social media platforms such as Twitter. He is popular with young voters and is feared

by businesses, who are quick to draw parallels with the late Hugo Chavez in neighbouring Venezuela.

Iván Duque has emerged as the candidate of the right, the protégé of former conservative President Álvaro Uribe, he has been able to benefit from the former president's continued popularity. Duque's campaign is centred on a pro-business and pro-security programme which would look to cut taxes and roll back the most controversial aspects of the FARC peace deal. Unlike Petro, Duque has a strong campaign machine behind his candidacy and strong parliamentary support in the form of the right-wing Centro Democrático (CD) party.

Germán Vargas Lleras from the centre right Cambio Radical (CR) party, also remains competitive, with strong parliamentary support, promising a pro-business stance of increased infrastructure investment and lower corporate tax.

Finally, Sergio Fajardo, former mayor of Medellín, from the centre-left, despite also lacking parliamentary support, in the form of his centre-left Coalición Colombia, remains popular amongst voters; arguably precisely because he is not tied to the mainstream political parties. Fajardo has also promised fiscal prudence, resisting the temptation to promise tax cuts, yet still plans to increase investment, funded by a crackdown on tax evasion. His record as Mayor of Medellín, however, does not bode well for his promise of fiscal prudence.

Senate composition



Lower house composition



Source: Eurasia Group

With polls showing a split of support across the four main candidates it is highly unlikely that any candidate will secure a majority in the first round at the end of May. However, should the strong support for both Petro and Duque be maintained, which we believe likely, they are set to contest the second round on 17th June, though Fajardo and Vargas Lleras still cannot be ruled out. Petro's candidacy remains a wild card, but our base case is that economic and security concerns will win out, particularly given the economic woes in neighbouring Venezuela, with Duque better positioned than Petro to win over voters supporting the more centrist candidates in the first round.

In summary, Petro's progression to the second round may well unnerve many investors, but ultimately victory should fall to Duque, resulting in, *ceteris paribus*, a favourable outcome for the Colombian Peso as, despite the potential for some delay, fiscal consolidation will move to the centre of government policy.

Mexico: AMLO and behold

The electoral race in Mexico has already grabbed the attention of the global media, principally due to the rise of leftist candidate Andrés Manuel López Obrador (AMLO); however, with over three months to go, the attention has yet to intensify, with official campaigning set to begin on 30th March.

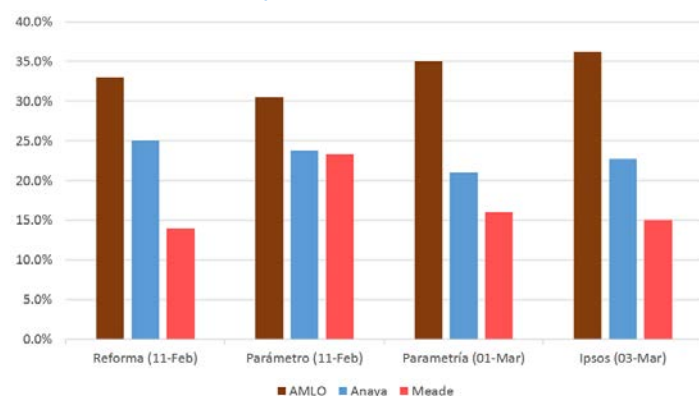
AMLO is the candidate of the leftist Movimiento Regeneración Nacional (MORENA) party, which he himself founded in 2014, and is closely associated with populist policies which have historically included government austerity, progressive taxation, agricultural subsidies and job creation. AMLO is also a strong critic of the electoral system, having previously accused the PRI party, without success, of electoral fraud in both his earlier presidential campaigns. This combination, together with a strong social media presence, has helped AMLO to tap into the widespread public anger against the established parties, and hence cement his place as the anti-establishment candidate in Mexico, and currently leads the polls by a healthy margin.

AMLO's main challenger is Ricardo Anaya of the Partido Acción Nacional (PAN), which despite occupying the centre-right ground has formed a coalition (Por México al Frente) with the centre left (and former party of AMLO) Partido de la Revolución Democrática (PRD). The alliance is rather questionable given the ideological differences between the two parties, with the rationale for the alliance built solely on having a competitive presidential candidate. Anaya's campaign is focussed on providing a mainstream alternative to the ruling Partido Revolucionario Institucional (PRI) party, yet at the same time drawing in moderate leftists, fearful of AMLO.

The third main candidate is José Antonio Meade, from the ruling PRI party. Meade is looking to distance himself from the corruption allegations that have dogged incumbent President Enrique Peña Nieto (EPN), resulting in the lowest approval ratings for any modern sitting president. Unfortunately for Meade, the stigma of the PRI will be difficult to shake off given the level of public distrust and desire for change.

Finally, a number of independent candidates will be permitted to run for the first time, following recent electoral reforms. We don't expect the independent candidates to be competitive, but they could well influence the results for the main candidates.

Mexican Presidential Opinion Polls



Source: Reforma, Parámetro, Parametría, Ipsos

Corruption, above all else, has defined the presidential race in Mexico to date. Both Anaya and Meade have been drawn into a corruption allegations. For Meade it is his association with former PRI ministers accused of financial irregularities that is damaging his credentials. For Anaya the allegations go deeper, directly implicating him as the beneficiary of a money laundering scheme. Whilst it difficult to know how these investigations will turn out, the accusations alone are likely to damage both candidates engaged in smear campaigning, with AMLO set to benefit further as a result. Anaya also faces a threat to his core supporter base from independent, former First Lady and PAN member, Margarita Zavala. Though Zavala is unlikely to challenge for the presidency she may well draw votes from Anaya given her loyal supporter base. As a result, despite the uncertainty that remains, with potential for a late surge in mainstream support, we expect AMLO to secure the presidential vote this time given the extent of negative public sentiment towards the traditional party candidates.

Despite concerns surrounding AMLO, we do not believe that investors should panic. AMLO has moderated his policies significantly over the years, partly in order to make himself more electable, but also in recognition of the limits he will likely encounter in Congress. Despite AMLO's appeal also translating to strong support for MORENA, they are unlikely to secure a majority, let alone the two-thirds required to overturn constitutional reforms. Hence, despite earlier rhetoric, a reversal of Mexico's energy reforms is highly unlikely, particularly given the benefits espoused by Pemex, with its increase in profitability helping to ease the fiscal pressure on the government. AMLO has also moderated his stance towards NAFTA, recently vocalising support for the agreement, though he is likely to push hard for better terms for the agricultural sector.

In aggregate, we expect volatility to increase as the election campaign intensifies, with some investors likely to disinvest from Mexican assets in the event of an AMLO win. However, we expect to see policy continuity on a number of measures including NAFTA and energy reforms clarified early on in his presidency. This will likely see investors return to Mexico, particularly given a combination of cheap asset prices, declining inflation and the removal of policy uncertainty.

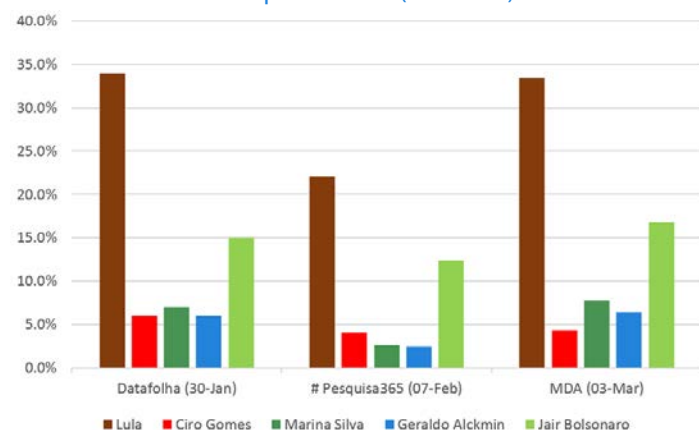
Brazil: Lula conviction set to leave a political chasm

Later in the year, attention will shift to Brazil, as in October 2018 the population will elect a new President, as well as all 513 members of the Lower House, governors and state assembly members, and 54 out of 81 members of the Senate. The focus of media attention has been on the leading presidential candidates, namely Luiz Inácio Lula da Silva (Lula); however, the composition of the next Congress will also be key, as the new representatives will need to renew their focus on the much needed pension reform in 2019. Given what is at stake for the future of the reforms and, therefore, the country, the next six months will be key for Brazil, and clearly a potential source of volatility. A market friendly outcome will require a government that is willing to stick to reform in order to generate a strong primary fiscal surplus and to help stabilise the debt trajectory.

The leading candidate at this early stage is the decidedly investor-unfriendly, yet highly popular, former President Lula of the left wing Partido dos Trabalhadores (PT). Lula's popularity can be traced back to his time as President during which, despite countless corruption scandals, he oversaw a period of economic prosperity, particularly in his second term. Lula was able to unshackle the economy from austerity in 2006 by unleashing a huge wave of investment, during which time the economy was already performing strongly, on the back of strong commodity demand (and thus, higher prices) from China. This approach saw Brazil pass through the global financial crisis relatively unscathed, but the hangover came in 2014, after Lula's tenure ended, as the end of the stimulus programme coincided with a slump in Chinese commodity demand.

Despite his strong popularity, Lula's presidential bid is now looking highly tenuous. In March 2016 as part of Operação Lava Jato (Operation Car Wash) Lula was detained by police surrounding allegations that he lobbied the large private conglomerate Odebracht for government contracts and used discounted state financing to fund such projects. Lula was convicted in July 2017 yet remained free pending his appeal. At the end of January 2018 the appeals court upheld Lula's corruption conviction and went even further by increasing his prison term from 9 to 12 years. Yet, Lula can still appeal to further delay the ruling, stretching the process long enough to register his candidacy by the August 15th deadline. If allowed to run, Lula would lead the race comfortably in the first round and would likely beat every other candidate in the second round, assuming that he failed to secure 50% in the first round.

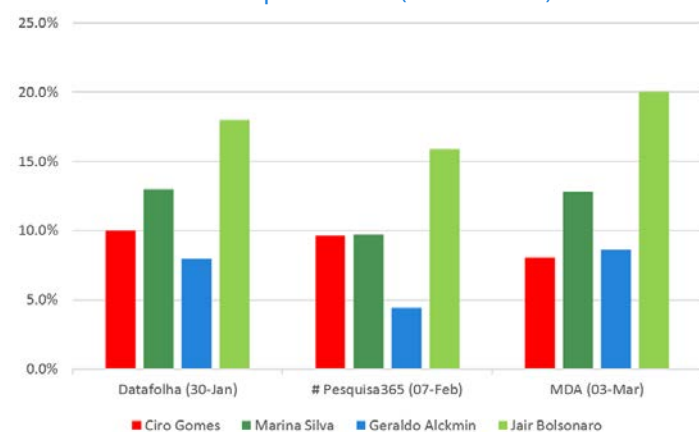
Brazilian Presidential Opinion Polls (with Lula)



Source: Datafolha, # Pesquisa365, MDA

Our base case, however, is that Lula will be barred from running. In this scenario the field looks to be a lot more open. At this early stage there is still uncertainty regarding the full list of presidential candidates; particularly regarding any potential replacement for Lula, should he be imprisoned before the registration deadline; as well as the potential candidacy of current Finance Minister Henrique Meirelles and a number of potential independent candidates, including former Supreme Court Justice Joaquim Barbosa.

Brazilian Presidential Opinion Polls (without Lula)



Source: Datafolha, # Pesquisa365, MDA

To date, the right-wing Congressman Jair Bolsonaro of the, somewhat misnamed, Partido Social Liberal (PSL), would lead in a first round vote without Lula. Bolsonaro is a controversial character, having advocated far-right views on a number of social policies. Bolsonaro has benefitted from a polarization in the Brazilian political landscape and disillusionment with democracy, and used his strong-man image (with some commentators branding him Brazil's answer to Donald Trump) to forge a strong social media following. Despite this, Bolsonaro's economics team, headed by Paulo Guedes, would likely pursue a number of liberal economic policies including privatisation and tax simplification. Nevertheless, despite his strong first round polling, we believe that Bolsonaro would struggle in the second round as his divisive nature will prevent him from appealing beyond his narrow supporter base.

Meanwhile, back on the left hand side of the political spectrum Ciro Gomes from the Partido Democrático Trabalhista (PDT) looks poised to try to capitalise on Lula's downfall, as he could receive support from Lula's party should his candidacy be blocked. Gomes has already run for the presidency twice, in 1998 and 2002, finishing 3rd and 4th, respectively. Gomes strongly opposes privatisation, and would likely obstruct the path to, or else dilute the impact of, pension reform. Despite a potential endorsement from a Lula-less PT, we do not expect Lula's votes to transfer well to Gomes, partly due to the high fragmentation of parties on the Left.

Another Leftist challenger is Marina Silva of the Rede Sustentabilidade (REDE) party. Like Gomes, she is a former presidential candidate, running in 2010 for Partido Verde (PV) and for the affiliated Partido Socialista Brasileiro (PSB) in 2014 after the tragic death of its candidate Eduardo Campos, failing to make the second round after finishing third in the first on both occasions. Silva's platform is a pro-environmental one, opposing the deforestation of the Amazon. Like Bolsonaro, Silva also has a strong social media presence, with strong support amongst younger voters. However, again, like Gomes, we do not believe votes would easily transfer to Silva in the event of Lula's exclusion, partly due to the narrowness of her manifesto.

Last, but not least, of the notable candidates confirmed to-date, is centre right, São Paulo Governor, Geraldo Alckmin of the Partido da Social Democracia Brasileira (PSDB). Alckmin is a clear reformist and a clear proponent of pension reform. Alckmin's centrist position would enable him to form coalitions across a fragmented parliament, and hence he would likely muster enough support to follow through on the reforms initiated by his predecessor. Alckmin, again is a former presidential candidate, losing out to Lula in 2006.

We are inclined to downplay the importance of opinion polls in Brazil at this early stage as campaigning has yet to start, hence voter recognition alone can play a significant role. So despite Alckmin's currently poor polling results, should the improvement in the economy of late continue, with falling unemployment and low inflation, voters could begin to favour a candidate that represents the continuity of the current economic policy. Hence, we expect Alckmin to be competitive against both Gomes and Silva in facing Bolsonaro in the second round. Should Alckmin make it to the second round, we expect him to prosper as he has the broadest appeal of all candidates.

Clearly, the uncertainty surrounding Brazil's election is highest amongst the three countries, particularly with regards to Lula's candidacy status, and hence our overall conviction is lower. However, we also believe that expectations surrounding a market friendly candidate succeeding are already low, with potential for a positive surprise coming from Alckmin's bid. Hence, our investment stance towards Brazil is currently one of caution, yet with greater potential for upside in the event of a strong Alckmin campaign.

Conclusion: Risks rising, but reforms should be resilient

So, as we approach the height of election season in LatAm we believe that the reform agenda will survive beyond the political turbulence, yet differentiation remains key. Despite the structural fiscal challenges that Colombia faces we believe the election outcome should provide a government well positioned to address these challenges head-on. In Mexico, despite the anti-establishment campaign rhetoric from AMLO we do not believe that he will jeopardise the reform agenda. The risks are clearly highest in Brazil, where we believe caution is the most justified; nevertheless, it is also where there is the most time for a pro-reformist candidate to flourish.

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