Latin America: Another Region, Another Index

Most of our primal urges, by design, are linked to our survival both as individuals and as a species. We can add indexation, linked to reduction of career risk by investment managers, to this list despite the strong warning given here in July 2011's *Weighting For Correlation*, "Don't get into the business of index management."

But lemmings follow their impulses to march off cliffs, exchanges follow their impulses to launch spread-based contracts and index providers keep on launching indices, including the subject at hand, the Bloomberg-J.P. Morgan Latin American Currency index (LACI). This is the cousin to the Bloomberg-J.P. Morgan Asian Dollar index discussed in November 2012's *Schadenfreude Is Not An Asian Shtick*. The weights of this index are presented in the table below.

Bloomberg-J.P. Morgan Latin American Currency Index

Brazil	BRL	33%
Mexico	MXN	33%
Chile	CLP	12%
Argentina	ARS	10%
Colombia	COP	7%
Peru	PEN	5%

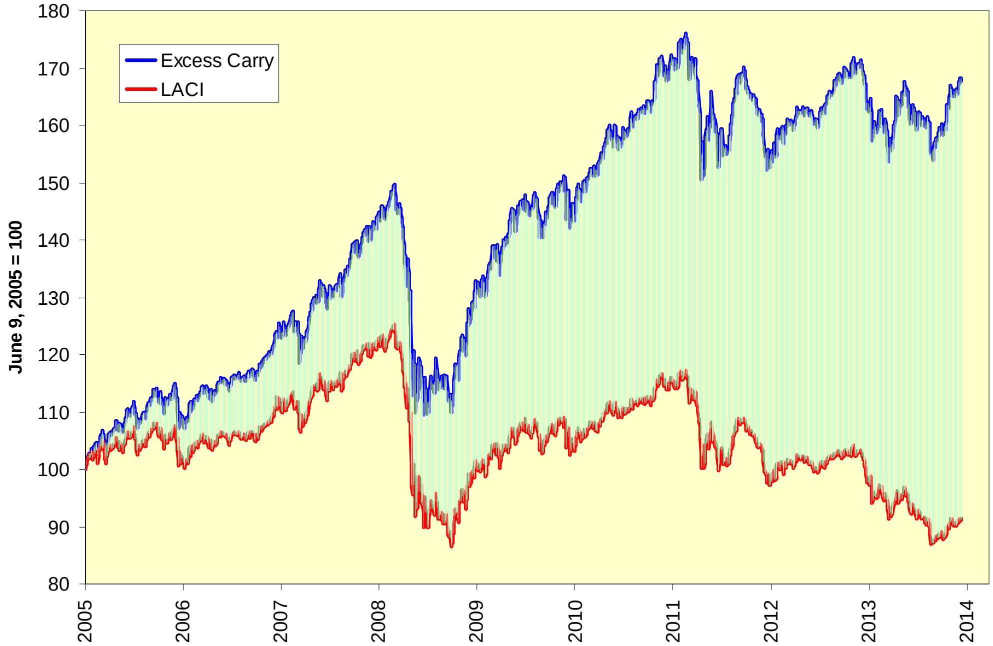
Wide Interest Rate Gaps

Each of these six currencies has been discussed here both in terms of a common framework and with unique national characteristics highlighted:

- Mexican peso: *Who's Your Padre?*, February 2007;
- Brazilian real: *The Stronger Real: Don't Blame It On Rio*, April 2007;
- Chilean peso: *Chilean Peso Makes Exceptions To Currency Trading Rules*, April 2010;
- Colombian peso: *Colombian Peso, The Richest Kind*, June 2010;
- Peruvian sol: *Is The Peruvian PEN Mightier Than The Sword?*, March 2012; and
- Argentine peso: *Argentina Cannot Get Its ARS In Gear*, August 2013

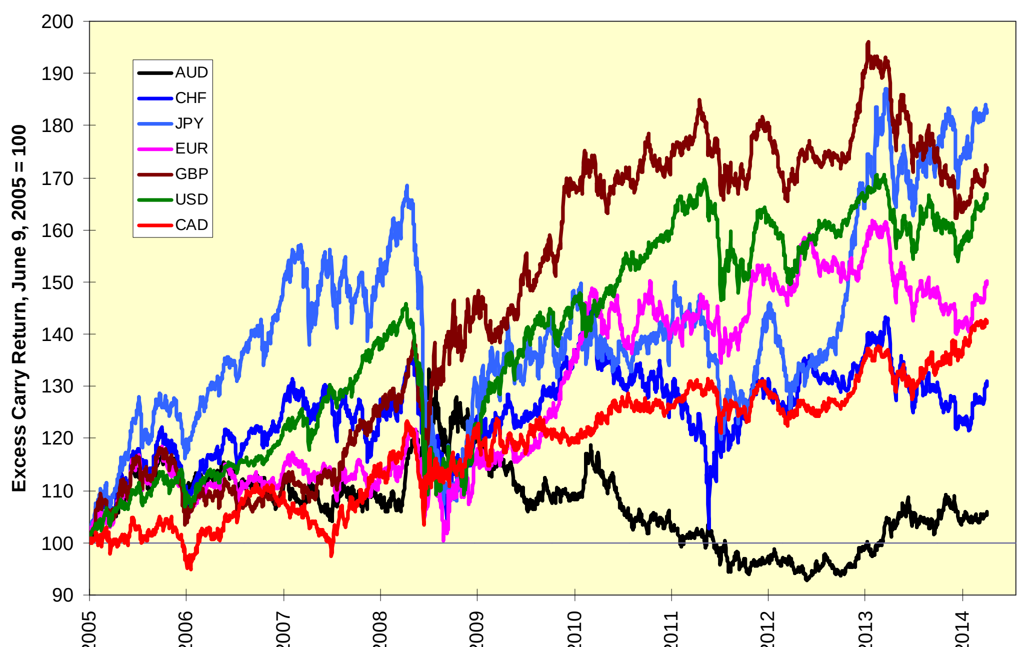
The one common thread is all of these countries have had much higher interest rates than has the USD since the LACI's June 2005 starting date. Indeed, if we map the weighted sum of the excess carry returns between the USD and the these currencies against the spot index itself, a yawning gap emerges and forces the conclusion these currencies depend on high interest rates to forestall a crash in their spot value. To paraphrase Orwell, all economies are mismanaged, but some are more mismanaged than others.

Wide Interest Rate Differentials Produced Gap Between Excess Carry Returns & Spot Index



We can replicate the excess carry return from the USD into the LACI with a set of other major currencies. The ranking provides a neat narration of currency markets before, during and after the financial crisis. The deliberately weakened and low-rate JPY has the highest excess carry return, followed by the QE-diminished weak and also low-rate GBP. Japan's 2012-2013 assault on the yen is quite visible. The AUD, which has been a relative strong and high-rate major currency, has had the lowest excess carry return into this index.

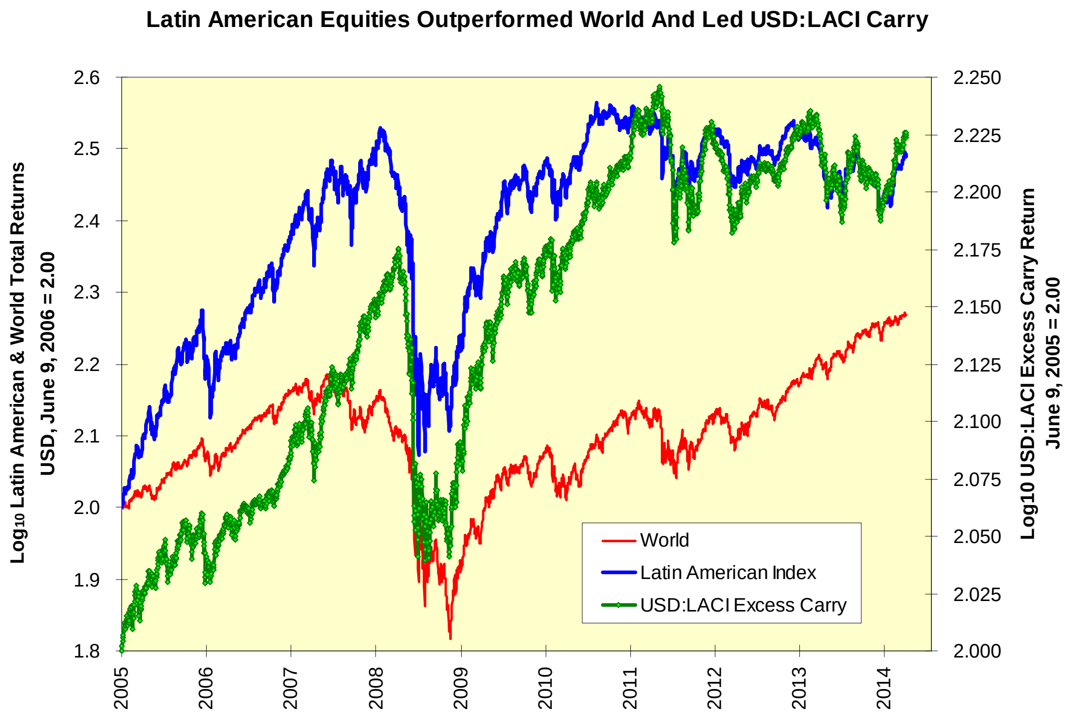
Excess Carry Returns Into The Latin America Currency Index



Effects Of Dollar And Yen Carry Trades

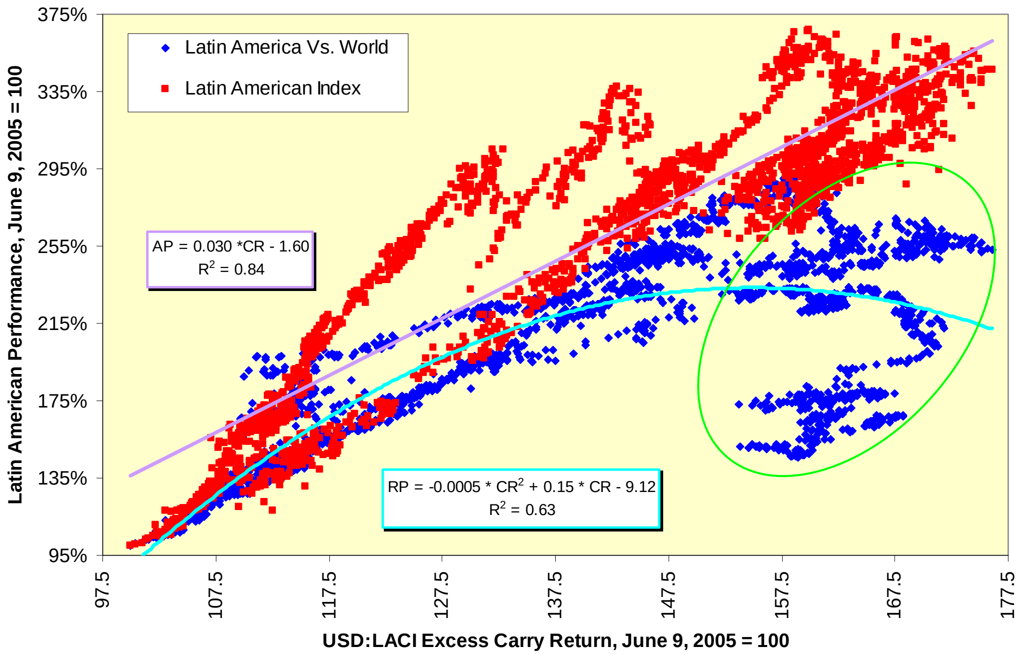
The two principal funding currencies outside of Eastern Europe where the Swiss franc has been used (see *How Eastern Europe Got Carried Away*, October 2009) have been the USD and JPY (see *The Long, Awful Life Of The Dollar Carry Trade*, and *Requiem For A Carry Trade*, January and February 2012, respectively). If we construct an equity index in the composition and weights of the Latin American currency index, how does it relate to the carry trades from the USD and JPY into the currency basket?

The total return for this weighted equity index has outpaced that of the MSCI World index by 66.7% since June 2005, with the absolute return for the Latin American index tracking the weighted excess carry return from the USD into the LACI closely. The r^2, or percentage of variance explained between the two indices has been a very robust 0.842, demonstrating once again how currency trading and equity investing have converged in a low-rate world: Funds flow into/out of currencies whose associated equity markets are rising/falling.



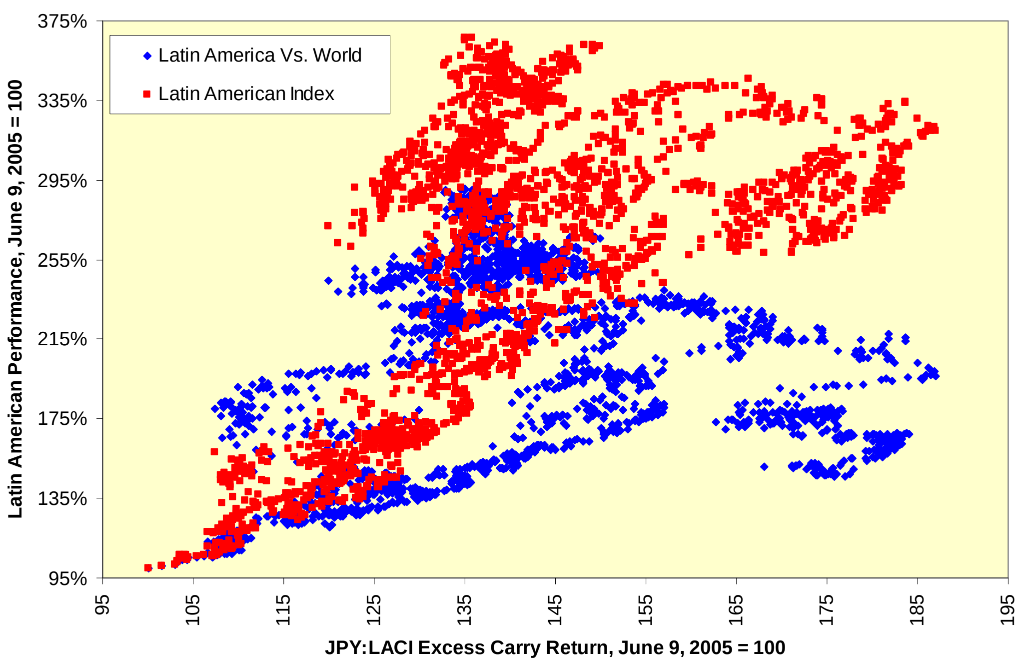
We can illustrate the principle for the dollar carry with a combined scatter plot of the weighted Latin American index against the USD carry into the LACI on both relative and absolute bases. Absolute performance has been a linear function of the excess carry return since June 2005, but relative performance has been more of a quadratic function as noted by the two trendlines. The largest divergence between relative and absolute performance, noted with the green oval, occurred after anticipation of QE3 started in June 2012. This pushed the MSCI World index higher while the Latin American index declined. The effects U.S. money-printing shifted from boosting Latin American equities during the QE1-QE2 eras to boosting the U.S. and European markets during the QE3 era.

Relative And Absolute Performance Diverged After QE3 Era Began



The JPY:LACI excess carry return has not been a significant factor for Latin American equities over this period, nor should we have expected that to have been the case. The yen's long uptrend between July 2007 and September 2012 and Japan's two attempts to drive the yen lower with an expansion of QE after September 2012 made the yen a very risky funding currency. Why risk borrowing the yen when it might rise under disinflationary pressures when you can borrow the dollar with little risk of sudden appreciation? As a result, a comparable set of scatter charts for the yen looks very different from its dollar counterpart.

Yen Carry Not A Significant Factor For Latin American Equities



The Unanswered Question

Finally, let's ask the impolite question of why anyone thought grouping these six Latin American currencies together was a good idea. Mexico's economy is tied to the U.S., with remittances from Mexican expatriates being its second-largest foreign exchange source; Brazil is a diversified commodity export powerhouse with a large domestic market; Peru has been an economic backwater forever; Chile has adhered more to market-based economic principles than the others but still has a strong dependency on copper; Colombia is still wracked by domestic political strife and the long-running distortions of the illegal drug trade and Argentina is a poster child for the squandering of a natural patrimony. They speak Romance languages and are located in the Western Hemisphere; this is a reason to group their currencies? At least in the case of the Eurozone the economies are linked closely and in the case of East Asia the general economic models are similar.

As much as anyone south of the Rio Grande hates to admit it, the region's currency and equity markets have moved up and down as a function of differentials to the U.S. and are dependent on the maintenance of high interest rates. This was true before the financial crisis and has been true since the financial crisis. It is a good bet it will be true twenty years from now, too.