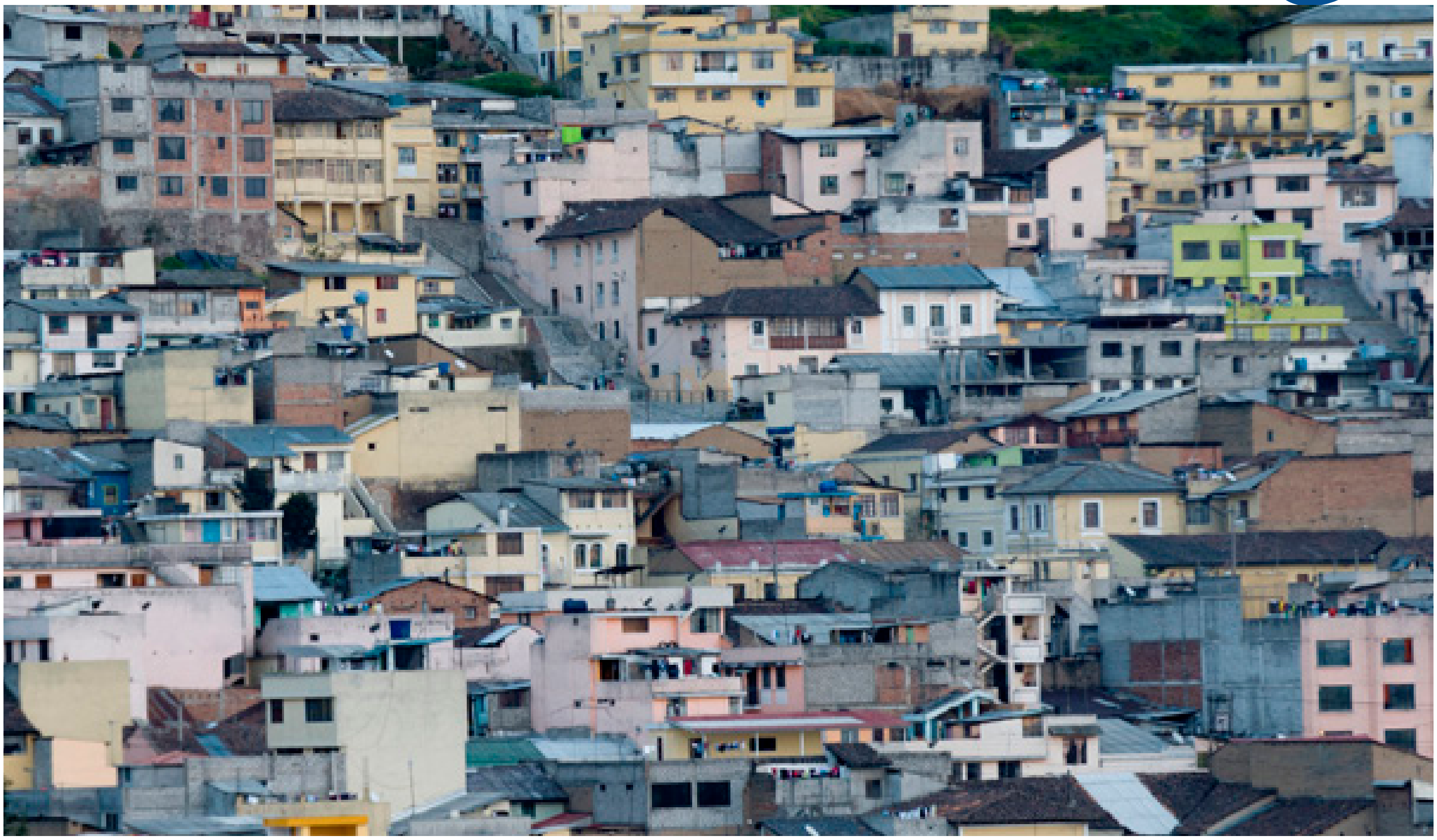

South America Outlook: Recovering trend potential on strengthening commodities demand

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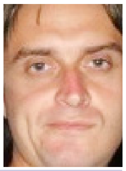

As the global economic recovery moves forward, most of the media attention remains focused on the debt situation in Europe and this year's manufacturing prospects in China. But there are other regions for investors to consider when looking to gain exposure to emerging market assets, and recent events in South America present some interesting scenarios for long-term positions. Growth deceleration for the region in 2012 is now seen preventing economic overheating and domestic imbalances, providing investors with an opportunity to buy into South American stocks at cheaper levels.

As regional production capacity shows signs of recovery, there is an increased likelihood that South American economies will perform at levels more in line with historical trend potential. Reduced fiscal space and the relatively tepid global recovery have created some potential risks for investments in these areas. But as long as policy reforms are approached in a conservative and prudent manner, many of these risks should be avoided, and this creates a positive scenario in regional investments for the remainder of the year.

Achieving Regional Growth Potential

After posting two years of output deceleration, broad-based economic figures for a majority of Latin American economies began to turn positive at the end of last year.

This came largely as a result of the recovery in Brazil after its previous period of stagnation. For 2012, GDP growth in Latin America averaged 3.2% after posting 4.3% growth for 2011. This downtrend will likely end in 2013, however, and if output returns to the potential seen in larger growth trends, South America will regain its position as the world's second strongest continent (in terms of annual growth), behind only Asia.

The first indication of a positive turnaround in the region was seen in Venezuela (the only Latin American country to produce GDP gains in 2012). The Venezuelan economy benefited from election-related spending and stable oil prices, which continue to trade at elevated levels compared with long-term historical averages. Positive results were seen in Chile as well, as expansionary monetary conditions helped growth rates return to more appropriate trend levels.

In the last two years, stalling in Brazil has been the largest drag on the regional economy. The lack of progress came as a result of mistakes in monetary policy direction,

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inappropriate currency volatility, and a lack of foresight in addressing needed structural changes. Rising inflation was another issue, as price pressures in both Brazil and Mexico were the most problematic in the region and inhibited consumer spending on a domestic level. For the rest of the continent, however, inflation rates have held steady. As data in Mexico and Brazil continue to show signs of stabilizing, it is starting to look like price pressures will not be as much of a hindrance in 2013.

The Positive Side of the Slowdown

While this might seem counter-intuitive to some, there can actually be long-term positive effects when an economy shows slowing momentum. In Latin America, the recent slowdown has given the region an opportunity to adjust structural imbalances that were created by stimulus programs enacted after the global financial crisis in 2008. These positive adjustments can be added to the fact that government accounts in the largest Latin American (LatAm) economies remain well positioned as favorable commodity revenues continue to be supportive.

Monetary policy throughout the region is accommodative, even as adverse conditions have neutralized. Because of this, most LatAm economies are back on track to operating at capacity, and a few have started producing above the projected potential rates (while only Argentina and Brazil have yet to match these potential projections). These flexible policies have generated excess demand, and this puts pressure on imports and price levels in the region's economies that are performing above trend potential (Mexico, Chile, and Peru).

Recoveries in Production Capacity

When assessing the potential near-term performance in South American markets, production capacity is an important area to watch. This is a critical determinant of the region's likely GDP output. In 2012, stronger foreign demand helped Latin America replace the production capacity it lost after the 2009 recession. This recovery improves chances the region will return to its potential output rates before the end of this year, and with domestic demand now seen as the area's main growth engine, it is clear that Latin America is finding new ways to compensate for external risks and weakness in some export markets. These trends, combined with structural reforms aimed at strengthening consumption, have

gone far to create sustainable sources of Latin American growth that are more permanent in nature.

Recovering Trend Potential

The 2008-09 global recession led to losses in production capacity but activity this past year has shown that most of these losses have been recovered. The recessionary period also resulted in reductions in regional investments (equal to -2.5% of GDP), and an investment-output ratio that dropped to its lowest point (21%) in 2009. Prudent reform measures, fiscal discipline, and supportive commodity prices have enabled LatAm governments to generate countercyclical strength through public savings and restored production capacity, and this has helped erase most of the damage created during the recessionary period.

By 2011, South America had already returned to the investment-output levels seen in early 2008 (when market sentiment was overtly bullish). The investment ratio numbers seen in 2012 held at 23.5%, which is roughly in line with the levels seen before the 2009 contractions. The combination of these improved factors puts the continent in a position to generate GDP growth of roughly 5% for 2013, with most of the risks seen external (if declines are seen in important export markets).

Regional Outlook: Argentina and Brazil

A large portion of the overall outlook depends on Brazil, which is the region's largest economy. Into the end of 2012, Brazil began to show positive trends in the economic data, and these changes have been largely attributed to central bank policy measures that more actively address areas in need of fiscal stimulus. These positive trends should build in momentum for the remainder of 2013, and a significant proportion of the expected increase in infrastructure development will be funded by external investments in anticipation of the 2014 World Cup.

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The long-term nature of these policies and actions will likely bring renewed strength and a more sustainable growth rate for the remainder of 2013. This year's projections for GDP in Brazil are now topping the 5% mark. This will be viewed favorably by investors after the very weak 1.6% figure that was posted in 2012. For the remainder of the year, monetary conditions should normalize, as inflationary pressures created by changes in interest rates start to even out.

Relative to the rest of the region, Argentina is expected to struggle for the remainder of the year but still improve on its 2012 results. Government controls and regulations were ramped up in 2012, and this has helped to reduce capital flight in the short term. Government spending has been curtailed and with a large portion of the economy devoted to agriculture, it will be encouraging to see grain prices remain at historically elevated levels. As long as we do not see any major downside surprises in commodity prices, Argentina's growth forecasts are likely to remain near 3.5%, which will be a stable improvement from the 2.3% GDP number that was seen in 2012.

Outlook in Chile and Peru

The wider story in Chile has been one of the recent success stories, which started expanding above trend potential in 2012. Some of this activity will moderate this year as reverse policy adjustments are made in an attempt to normalize conditions and prevent excess demand from threatening macroeconomic stability. GDP figures are expected to moderate slightly to 4.6%, after posting one of the strongest rates in the region last year (5%).

Part of this moderation will come as a result of tighter monetary conditions, as the Chilean central bank aims to move interest rates back to the neutral levels. But the moderation should be viewed as a healthy change because the slowdown in momentum will be policy-induced, and not a consequence of economic overheating. Inflation levels are now projected to remain inside the central bank's target rate despite increased price pressures in some parts of the region.

In 2012, Peru was another of the region's star performers as a national mining boom together with strong macroeconomic fundamentals have created a solidly bullish climate for business. Fiscal stimulus programs and low interest rates add to this positive scenario, and all of these

factors have helped to largely shield Peru from the external negatives in a sluggish world economy. Fiscal and monetary policies are expected to remain supportive in 2013. This has led to growth forecasts of nearly 6% for Peru in 2013. Inflationary pressures have eased (with declines in food and energy prices) and should remain contained within the country's target rate of 1-3%.

Outlook in Colombia and Mexico

The outlook in Columbia is another of the region's more positive stories, with this year's growth forecasts expected to show expansion that is in line with historical trend potential. Most of this expansion will be based on favorable terms of trade and domestic demand, which continues to show steady improvement. The country's booming mining and energy industries will continue to drive foreign investment and

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domestic consumption. Potential risks can be found in the rapid appreciation of the Colombian peso, and external weakness in important export markets.

To combat these risks, the central bank has reduced policy rates, taking some upside pressure off the currency. With consumer inflation rates under control, the central bank has room to make additional interest rate cuts if necessary. With an accommodative fiscal policy in place, domestic demand will be supported in 2013, with yearly growth forecasts now seen at 4.7% (a small increase from the 4.5% seen last year).

In Mexico, the period of deceleration seen into the end of 2012 has bottomed out in the first quarter of this year as newly elected political leaders restructure the federal budget and implement new policies for private investment. The economy is expected to show leveling growth in 2013, with yearly rates of 3.5%. This is one of the lower-end forecasts in the region, as Mexico's rising inflation is likely to weigh on output figures. The country's new government might be forced to raise interest rates in order to stabilize consumer prices, but the overall prospects for reform under the new leadership look encouraging.

Venezuela after Chavez

In Venezuela, the changes enacted since last October's elections have resulted in substantial decreases in government spending, and with oil prices elevated, the fiscal deficit has returned to manageable levels. Currency devaluations and cuts in government spending have accompanied major changes in the political infrastructure. The recent death of Hugo Chavez ended a 14-year presidency that has left investors questioning whether or not the next administration will be able to reverse the substantial declines in oil exports that were seen during the Chavez era. Near-term political uncertainties are likely to generate volatility in the Venezuelan oil sector. But when looking at larger time horizons, most analysts expect new regimes to show motivation in promoting the oil sector to strengthen international trade relationships and build revenues.

Still, it is still common knowledge that there is phenomenal potential value in the Venezuelan oil sector. For example, the country's Orinoco Belt is the world's number two tar sands

reserve and the world's number one conventional oil reserve, according to reports from BP. During the Chavez presidency, we saw significant setbacks in Venezuela's once-thriving oil markets. Even as the country contained 18% of the world's known oil reserves, total output in Venezuela has dropped by over 20% since 1998 (currently at 2.5 million barrels per day). Increased state control in the oil sector and other questionable energy policies during the Chavez presidency created a scenario where oil subsidies drove domestic oil consumption from 36% to 47% of total output, and this significantly reduced the supply available for sale on the global markets.

Chavez relied heavily on oil revenues to fund most government spending programs. State-owned companies (such as Petróleos de Venezuela) became classic examples of mismanagement, inefficiency, and

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underinvestment. Many of these companies were only able to remain active after loans from the Chinese government. Petróleos de Venezuela has seen a ten-fold increase in debt (at nearly $35 billion) as company revenues were used to fund social programs rather than being re-invested in the infrastructure of the energy sector.

Great Potential Ahead Through Reforms

All of this means that there is incredible upside potential for the region if reforms are directed at inviting foreign investment and at increasing the level of state investment in new production. According to studies from the U.S. Geological survey, Venezuela's Orinoco Belt might contain greater oil reserves than can be found in Saudi Arabia, and a $233 billion plan to develop pipelines; refineries and oil fields in these areas will be a critical step for the next administration in maximizing the potential for these resources. In the most favorable scenario, Chavez's successors will allow Venezuela to return to its peak oil production while maintaining policies that encourage foreign investment.

Outlook for the Region

Trends in personal savings for the South American region continue to show improvement. For the most part, these savings have supported the domestic market and it is unlikely that recent price corrections in commodities markets will prevent central banks in the region from enacting countercyclical policies (as a means for protecting against another economic crisis). With economic growth expected to remain sluggish for most of this year, policy reforms will likely move away from a reliance on the engine of external exports and toward growing domestic sources.

These deepening structural changes provide the best approach for strengthening the region's resilience to external shocks and to create sources of growth that are more sustainable over the long term. Newly elected administrations are focused on implementing programs aimed at improving levels of productivity, enacting technological change, and supporting investment. Reforms directed in these areas offer the best chance for LatAm economies to expand their production capacity and to post growth performance that consistently outpaces most of the world.

Latin America Equity Fund

For investors looking to gain exposure to these positive trends, an excellent choice can be found in the Aberdeen Latin America Equity fund (NYSE: LAQ), which looks to generate long-term capital appreciation by investing in the Latin American equity securities; it is trading at a 7.9% discount to NAV. Macroeconomic factors that are supportive for the fund's holdings can be seen in the accelerating economic activity in Mexico in the fourth quarter, and the jobless rate in Chile (which is now at a six-year low). In addition to this, Mexico's ruling party recently voted to allow private investment in the oil industry, which is a move that may end the monopoly of the state-owned oil company and allow for expansion in the private sector.

In company-specific news, Vale (which makes up 8.5% of the fund's holdings) posted encouraging fourth-quarter earnings as healthy iron ore sales supported sales. The outlook for the company remains positive as demand for these metals is expected to increase this year (along with global manufacturing surveys). In other fund sectors, Multiplan (which makes up 3.6% of the fund) released its latest earnings report, which showed that profits rose on stronger rental revenues. Broader activity at Multiplan has been positive, as the company continues to improve on data expectations and expand its capacity levels.

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One of the things that make LAQ look particularly interesting is its focus on Chile; the country's infrastructure is well ahead of most of its peers. This development has come as a result of sound government strategy and official partnerships with private firms for infrastructure projects. The Chilean government recently unveiled a nationwide plan to construct a new port as well as upgrade roads and railways. These long-term improvements are supportive for the nation's exporters and will help these companies remain competitive in an environment of rising labor costs and a strengthening currency. LAQ is trading toward the lower end of its historical range, and with the upper valuations seen just below $60 per share; there is significant upside potential in the fund given the positive expectations that can be seen for the region as a whole.

Chile Fund

For investors looking to gain regional exposure that is more country-specific, a solid choice can be found in the Aberdeen Chile Fund (NYSE: CH), which currently trades at a 4%

discount to NAV. The fund focuses primarily on Chilean securities, but has some approaches to investment that are similar to those seen in LAQ. The fund has already made substantial progress in closing its NAV discount but developments in some of the fund's stock selections suggest that these trends have further to run.

To start this year, Chilean stock markets have posted steady gains against the improved global backdrop. This includes resolutions in the US Fiscal Cliff negotiations, the dissipation of Eurozone tensions, and consistent strength in global economic data. All of these factors are supportive for Chilean export markets (with the services, mining and retail sectors posting some of the best performances in contributing to national GDP figures).

Recent upgrades in Chile's debt rating show that the prospects for these markets have received a seal of approval. These upgrades were based on the country's economic resilience (even in unsupportive environments) and healthy fiscal accounts (which are broadly viewed as a model for the region). Supportive factors for the fund can be seen in most of the company-specific news for its holdings. IT services provider Sonda posted solid earnings results for the fourth quarter, in a move that matched similarly encouraging results from beverage company Coca-Cola Embonor. The positive results were boosted by margin expansions created by robust volumes and higher sales prices. All of these factors can be taken into account in the improving macroeconomic picture for the region, and this suggests additional upside for CH going forward.

Look for Strong Returns in Latin America

The South American continent has experienced many significant structural changes in recent years. These reforms have strengthened the region's resilience to external shocks and have created sources of growth that are more sustainable over long-term time horizons. The country's rich commodities sector is often overlooked along with its strong potential for growth when compared to some of the more highly publicized emerging markets. Changing factors in Latin America are likely to get more attention in the later portions of this year. However, as newly elected administrations maintain a focus on implementing programs geared toward improving productivity levels and attracting global investment.

Excellent fund choices that can be used as a vehicle for investment in these areas include the Latin America Fund and the Chile Fund, since both are well positioned to benefit from emerging market growth in these areas. ■