

# CABEI Central American Fund Investment Strategy for the Third Quarter of 2005

July 2005



Deutsche Asset Management  
A Member of the Deutsche Bank Group



This report contains an assessment of medium-term market prospects for the sovereign debt issued by countries in the investment universe of the CABI Central American Fund. The information in this report is meant to guide and explain investment decisions by portfolio management. Information contained in this report does not represent a credit opinion by CABI and / or DWS.

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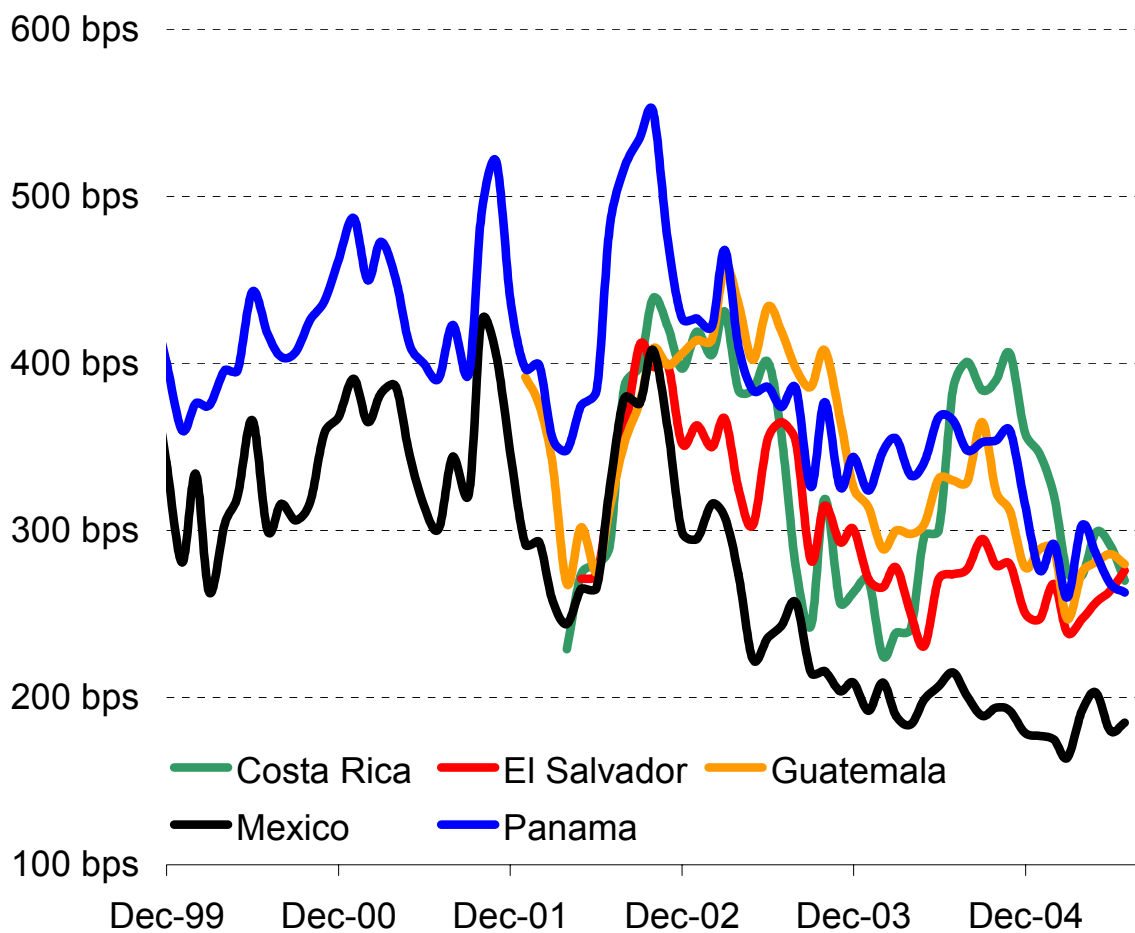
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# Relative Value Analysis





Source: JP Morgan

Note:

Please note the spread compression between the different Central American issuers. Only a year ago, Costa Rica was trading 100 basis points wide to El Salvador, and Guatemala was trading 60 basis points wide to El Salvador. Now the four large Central American issuers are all trading at around 270 basis points.

# Country Views





## Argentina (B3/B-/D)

Kopf

Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	8.8	9.0	7.1	4.4
Nominal GDP, in USD billions	127	151	180	206
CPI (year-end), in percent	3.6	6.1	10.0	7.4
Fiscal Balance, in percent of GDP	0.5	2.6	1.7	1.6
External Debt, in percent of GDP	94.9	81.8	69.0	60.2
Current Account Balance, in percent of GDP	6.1	2.0	2.0	1.0
Foreign Exchange Reserves, in USD billions	14.1	19.6	26.7	31.2

### Economic and political developments

- On June 10, the Argentine government announced the completion of the exchange of external debt. The issue of new debt had originally been planned for April, but got postponed because of lawsuits in the United States. Argentina issued 5.3 billion Pars and 3.1 billion Discounts in US-Dollars, 5.1 billion Pars and 2.3 billion Discounts in Euro, and further bonds in local currency. The country remains in default on 23 billion US-Dollar in old bonds, which were not tendered into the exchange.
- After Argentina's default in December 2001, JP Morgan kept the non-performing bonds in its market index, at a spread of around 6000 basis points. Following the exchange, the old bonds were replaced by new bonds, which are trading at a spread of around 450 basis points.
- Moody's and Standard & Poor's have raised Argentina's rating to Single-B after completion of the debt exchange. This appears difficult to justify, given that the country remains in default on a large portion of its external debt. Fitch has kept the country's rating at D for default.
- Real yields in Argentine remain low, growth and inflation are high, and the central bank keeps intervening in the currency market in order to stop a nominal appreciation of the Peso. The IMF has pushed back the repayment of a \$ 2.5 billion loan by another year. Politics are dominated by the run-up to parliamentary elections on October 23, which Kirchner regards as an important test for the presidential elections in 2007.

### Risk factors

- Continuous discord between government and IMF.
- Strong fall in commodity prices, especially in soy and oil.

Spread forecast	06/30/05	A	B	C
EMBI Global Diversified Argentina	462 bps	340 bps	410 bps	600 bps



## Colombia (Ba2/BB/BB)

Kopf

Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	4.0	4.0	3.6	3.8
Nominal GDP, in USD billions	80.0	97.5	112.9	108.1
CPI (year-end), in percent	6.5	5.5	4.9	6.0
Fiscal Balance, in percent of GDP	-5.0	-5.5	-6.1	-6.7
External Debt, in percent of GDP	47.6	40.6	35.6	39.0
Current Account Balance, in percent of GDP	-1.3	-1.1	-2.3	-3.6
Foreign Exchange Reserves, in USD billions	10.9	13.5	12.2	12.3

### Economic and political developments

- President Uribe managed to pass a constitutional reform through congress, which allows the re-election of presidents. However, the Solicitor General gave a negative opinion about the legality of the re-election bill. The Constitutional Court probably won't uphold the bill; the ruling is expected for October. Uribe's main contender in the presidential elections on May 26, 2006 is former president Gavaría, who would also be banned from the elections should the Constitutional Court issue a negative ruling.
- The senate passed a watered-down version of the pension reform on June 16. The 14<sup>th</sup> salary will only be cut starting in 2010, and only for new pensioners. The \$ 4000 monthly cap on pension payments will only apply for public servants who have spent less than 15 years in office. Because of these changes, the public social security system will remain in deficit for the years to come.
- In spite of rising tax revenues, the government has been unable to bring the public accounts under control. The central government continues to run a deficit in the order of 6 % of GDP, which is only partially covered by surpluses recorded by state-owned enterprises (Ecopetrol) and local governments.
- Bond spreads remain well-supported by robust external accounts and strong growth in spite of these negative fundamental developments.

### Risk factors

- Political uncertainty if Uribe can't get re-elected.
- Continuous deterioration of public finances.

Spread forecast	06/30/05	A	B	C
BSCAX Colombia	278 bps	250 bps	340 bps	440 bps



## Costa Rica (Ba1/BB/BB)

Kopf

Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	6.8	4.3	3.2	3.0
Nominal GDP, in USD billions	17.5	18.6	19.5	20.3
CPI (year-end), in percent	9.4	12.3	13.0	11.5
Fiscal Balance, in percent of GDP	-4.0	-3.6	-3.9	-4.1
External Debt, in percent of GDP	28.3	27.5	26.7	26.2
Current Account Balance, in percent of GDP	-5.5	-4.8	-4.3	-4.1
Foreign Exchange Reserves, in USD billions	1.8	1.9	2.0	2.0

### Economic and political developments

- Servicing the Central Bank's domestic debt of 13 % of GDP is creating a quasi-fiscal deficit of around 1.5% of GDP. By not fully sterilizing the debt service, the Central Bank is putting a floor on inflation. The IMF has recommended recapitalizing the Central Bank, but the government doesn't have the resources to do this. Therefore, the monetary policy remains ineffective.
- The government has reduced its deficit by 0.4% of GDP during the first months of the year through expenditure restraint. It remains to be seen whether the government can continue along this road in the run-up to presidential elections.
- High oil prices and stagnant domestic demand, which is suffering from lower public investments, have brought down economic growth.
- After the election of Gerardo Gonzalez as president of congress, there is renewed hope for the planned tax reform. The reform would increase tax revenues by about 1.5 % over the medium term. As the public sector is running a primary deficit of 0.5 % of GDP, this would be insufficient to stabilize public debt.
- Former president and Nobel laureate Oscar Arias is still ahead in the polls for presidential elections on February 5, 2006.

### Risk factors

- No tax reform, turmoil in the run-up to elections in 2006.
- CAFTA ratification could become problematic.

Spread forecast	06/30/05	A	B	C
BSCAX Costa Rica	261 bps	275 bps	320 bps	350 bps



## Dominican Republic (B3/B/B-)

Kopf

Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	-1.9	1.9	3.3	4.2
Nominal GDP, in USD billions	16.5	18.4	25.6	23.5
CPI (year-end), in percent	27.5	51.5	13.7	8.2
Fiscal Balance, in percent of GDP	-2.1	-2.9	0.0	1.2
External Debt, in percent of GDP	42.4	40.1	25.3	22.6
Current Account Balance, in percent of GDP	5.2	7.6	3.0	0.8
Foreign Exchange Reserves, in USD billions	0.5	0.9	0.8	0.8

### Economic and political developments

- The Eurobond restructuring was completed in May 2005, and has resulted in a lengthening of maturities by five years. Coupon payments will be partially capitalized, and the bonds will amortize over the last five years of their life. These generous conditions have led to a participation rate in excess of 93%. Prices of the new bonds have risen by about 6% after the exchange, whereby those who participated in the exchange actually got a better deal than the holdouts.
- The Paris Club will probably reschedule bilateral debt falling due in 2005 as well, without insisting on another bond restructuring. The government has also been able to complete a restructuring of commercial bank loans, and is now planning to pay down a loan owned to Union Fenosa with the proceeds of a new issue.
- All three rating agencies have upgraded the Dominican Republic to Single B after completion of the debt restructuring.
- The IMF review has been postponed to late July. Apparently, the tax reform will only be submitted to congress after the elections in May 2006. The government will have to request a waiver for non-observance of this commitment. On the other hand, the quantitative performance criteria have been met with a comfortable margin. During the first four months of the year, the government has recorded a fiscal surplus of \$ 285 m, while the IMF program was calling for a deficit of \$ 315 m over the entire year.
- Bond spreads have fallen from 1700 bps in July 2004 to about 420 bps, and the debt appears to be fairly valued now.

### Risk factors

- Failure to secure IMF support.

Spread forecast	06/30/05	A	B	C
BSCAX Dominican Republic	427 bps	340 bps	400 bps	550 bps



## El Salvador (Baa3/BB+/BB+)

Kopf

<b>Economic Indicators</b>	<b>2003</b>	<b>2004e</b>	<b>2005f</b>	<b>2006f</b>
Real GDP, year-on-year change in percent	1.8	1.8	2.2	2.6
Nominal GDP, in USD billions	14.9	15.9	16.8	17.8
CPI (year-end), in percent	2.1	4.5	3.3	3.0
Fiscal Balance, in percent of GDP	-3.7	-2.4	-3.0	-2.5
External Debt, in percent of GDP	57.6	55.8	55.9	55.7
Current Account Balance, in percent of GDP	-4.9	-3.9	-4.2	-4.2
Foreign Exchange Reserves, in USD billions	1.9	1.9	1.9	2.0

### **Economic and political developments**

- El Salvador issued a 30-year, \$ 375 m Eurobond in early June at 345 bps over Treasuries. Together with \$ 140 m in loans from multilaterals, this issue will cover the government's financing requirements for 2005.
- Early indicators point to a modest pickup in economic activity, but El Salvador's trend growth remains quite low. In spite of dollarisation, inflation is running at close to 4%, which is mainly due to high oil prices (60% of the country's electricity come from thermal power generation). El Salvador continues to lose competitiveness, and the maquila industry is migrating to Honduras and Nicaragua.
- Congressional elections have been scheduled for March 12, 2006. A victory of the left-wing opposition party FMLN is becoming more and more likely; this would further reduce president Saca's room to maneuver.

### **Risk factors**

- Continuously weak economic growth and the associated problems for debt sustainability.

<b>Spread forecast</b>	<b>06/30/05</b>	<b>A</b>	<b>B</b>	<b>C</b>
BSCAX El Salvador	249 bps	220 bps	250 bps	300 bps



## Guatemala (Ba2/BB-/NR)

Kopf

<b>Economic Indicators</b>	<b>2003</b>	<b>2004e</b>	<b>2005f</b>	<b>2006f</b>
Real GDP, year-on-year change in percent	2.1	2.7	3.2	3.1
Nominal GDP, in USD billions	24.5	28.4	31.6	33.4
CPI (year-end), in percent	5.9	8.7	6.0	5.0
Fiscal Balance, in percent of GDP	-2.3	-1.0	-1.8	-1.5
External Debt, in percent of GDP	14.2	13.6	12.8	12.8
Current Account Balance, in percent of GDP	-4.5	-4.1	-4.0	-3.9
Foreign Exchange Reserves, in USD billions	2.8	3.5	3.7	4.0

### **Economic and political developments**

- The external accounts continue to improve. Guatemala ran a trade deficit of \$ 4.6 bn (17% of GDP) in 2004, while the service account recorded a surplus of \$ 3.4 bn, mainly due to tourism and worker's remittances. The resulting current account deficit of 4.4% of GDP was more than matched by capital inflows in the order of 6.6% of GDP. Most of these capital inflows were related to the return of money previously held in offshore accounts of Guatemalan banks. As a result of the surplus capital inflows, international reserves have increased by about \$ 600 m last year.
- Central Bank interventions to stem the currency appreciation are only partially sterilized, which is contributing to a rise in inflationary pressures. The Central Bank is trying to counter this through a restrictive monetary policy, which leads to even higher inflows. During 2005, the Quezal has only strengthened by 2% in nominal terms, but taking into account the inflation differential, the real appreciation of the currency is quite strong.
- The export performance shows no deterioration of external competitiveness yet, but this is mainly due to a positive terms-of-trade shock from higher coffee prices.
- The fiscal policy remains restrictive, and low tax revenues (below 10% of GDP) remain the Achilles heel of Guatemala's economy. On the other hand, government debt is very low, and the country enjoys strong solvency.
- The IMF program has been discontinued, as the government does not need financing.

### **Risk factors**

- Social unrest because of the planned privatization of public services and the reduction of energy subsidies.
- Current account deficit and dollar deposits make the banking system vulnerable.

<b>Spread forecast</b>	<b>06/30/05</b>	<b>A</b>	<b>B</b>	<b>C</b>
BSCAX Guatemala	252 bps	220 bps	260 bps	310 bps



## Mexico (Baa1/BBB/BBB-)

Kopf

Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	1.3	4.2	3.5	3.0
Nominal GDP, in USD billions	608	645	710	738
CPI (year-end), in percent	4.0	5.2	3.7	3.6
Fiscal Balance, in percent of GDP	-2.5	-1.8	-2.2	-2.6
External Debt, in percent of GDP	26.7	24.9	22.8	22.1
Current Account Balance, in percent of GDP	-1.4	-1.5	-1.7	-1.7
Foreign Exchange Reserves, in USD billions	59.0	64.2	65.0	67.0

### Economic and political developments

- President Fox has brought the legal affair surrounding Mexico City's Mayor Andrés Manuel López Obrador to an end. The Attorney General has stepped down, the juridical case has been brought to rest, and AMLO will be able to run in the presidential elections on July 2, 2006. He is still leading in the polls, but the victory of now-opposition party PRI in two state elections in early July shows that the race is still open.
- The Central Bank has driven the overnight rate to a level of 9.75% over the past months, but has stopped tightening monetary policy at their meeting on June 24. The overnight rate will probably start to come down in September, either through *corto* cuts or through the introduction of an official target rate.
- The Peso continues to appreciate, which is mainly due to foreign portfolio investments in the Mexican bond market. This trend should come to an end later on this year, as the interest rate difference between Mexico and the US continues to narrow.

### Risk factors

- Recession in the United States
- Rapid fall of oil prices
- Widening of US corporate bond spreads.

Spread forecast	06/30/05	A	B	C
BSCAX Mexico	137 bps	110 bps	140 bps	180 bps



## Panama (Ba1/BB/BB+)

Kopf

<b>Economic Indicators</b>	<b>2003</b>	<b>2004e</b>	<b>2005f</b>	<b>2006f</b>
Real GDP, year-on-year change in percent	4.1	6.4	5.8	3.6
Nominal GDP, in USD billions	12.9	13.8	14.8	15.5
CPI (year-end), in percent	1.7	2.5	1.7	1.6
Fiscal Balance, in percent of GDP	-1.5	-4.5	-3.3	-1.9
External Debt, in percent of GDP	279.2	285.0	277.6	276.1
Current Account Balance, in percent of GDP	-3.2	-3.3	-5.0	-5.1
Foreign Exchange Reserves, in USD billions	1.1	1.1	1.1	1.1

### **Economic and political developments**

- While president Torrijos has been successful in passing an important tax reform in January, he is facing severe problems with the planned pension reform now. There is widespread resistance against moving the retirement age to 65 years for men and 60 years for woman. The government now plans to discuss the reform project in a national dialogue with different groups; this approach has already killed off all reform projects of the previous administration. The government would start facing large additional expenditures some years down the road, should it fail to reform the current system.
- A referendum to approve the Panama Canal expansion is to be held in November. Approval of this multi-billion-dollar project will be another important test for Torrijos' popularity.
- The external financial requirement for 2005 has already been met.
- Panamanian sovereign bonds have been trading at a spread of roughly 130 bps over Mexico over the past couple of years. This yield difference has halved since Torrijos took office, as his reform agenda (higher taxes, lower expenditures, social security reform and large public investment projects) will improve the government's capacity to pay over the medium term. The conflict over social security reform has now led to a moderate widening of Panamanian spreads vis-à-vis Mexico.

### **Risk factors**

- Failure of Torrijo's reform agenda (social security reform, Panama canal expansion).

<b>Spread forecast</b>	<b>06/30/05</b>	<b>A</b>	<b>B</b>	<b>C</b>
BSCAX Panama	220 bps	190 bps	210 bps	310 bps

# Scenario Analysis

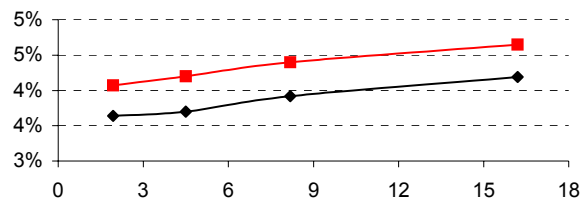




Time of Analysis		Risk-free	Probabilities		
Start	Horizon	Rate	A	B	C
6/30/2005	6/30/2006	3.50%	15%	70%	15%

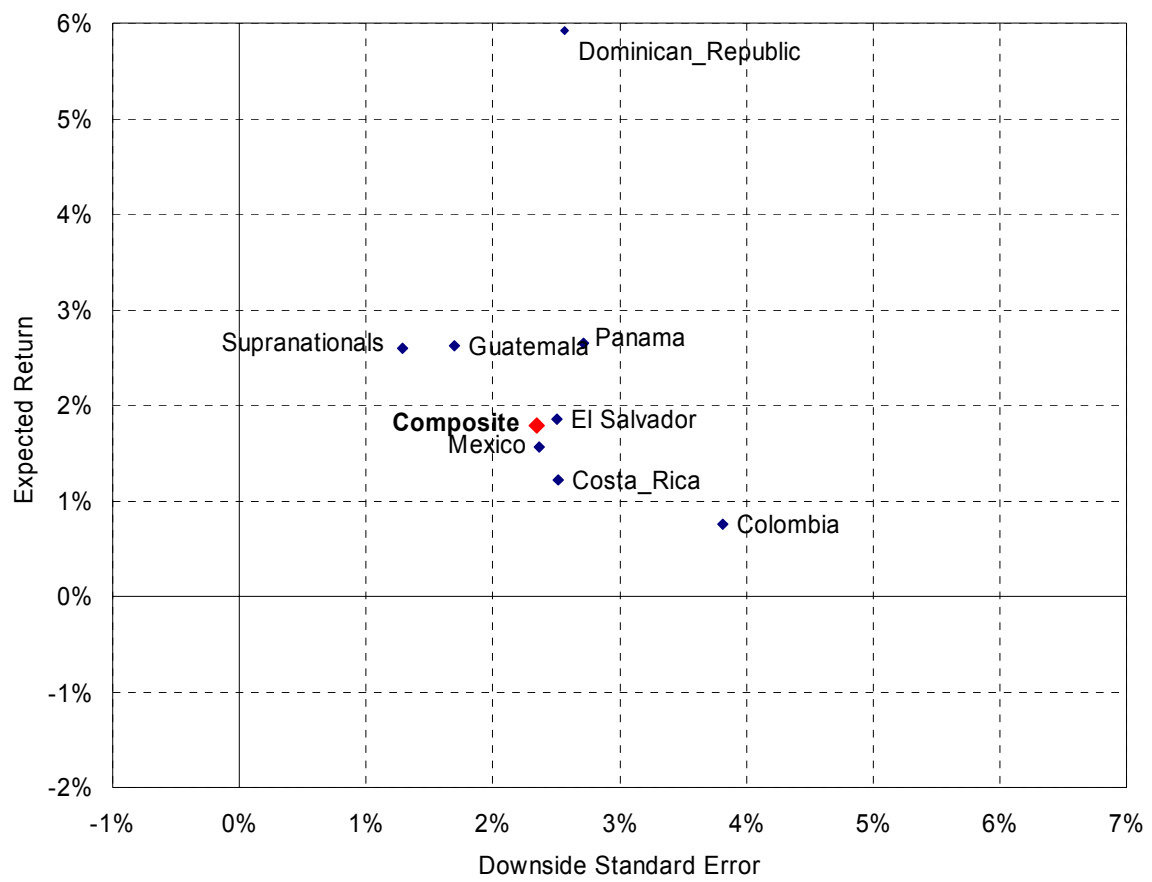
Country	BSCAX Weight	Stripped Spread	Spread Forecast			Expected Total Return			DSSE
			A	B	C	A	B	C	
Belize	0.1%	1097 bps	900 bps	1500 bps	2500 bps	22.7%	-6.8%	-55.9%	24.5%
Colombia	4.4%	278 bps	250 bps	340 bps	440 bps	5.7%	0.8%	-4.5%	3.8%
Costa_Rica	21.9%	261 bps	275 bps	320 bps	350 bps	3.4%	1.1%	-0.4%	2.5%
Dominican_	0.7%	427 bps	340 bps	400 bps	550 bps	10.8%	6.8%	-3.1%	2.6%
El Salvador	34.6%	249 bps	220 bps	250 bps	300 bps	4.7%	2.1%	-2.2%	2.5%
Guatemala	14.4%	252 bps	220 bps	260 bps	310 bps	5.3%	2.7%	-0.5%	1.7%
Mexico	18.4%	137 bps	110 bps	140 bps	180 bps	3.8%	1.7%	-1.1%	2.4%
Panama	3.2%	220 bps	190 bps	210 bps	310 bps	4.9%	3.5%	-3.5%	2.7%
Supranation	2.5%	147 bps	130 bps	140 bps	180 bps	3.5%	2.9%	0.5%	1.3%
<b>Composite</b>	<b>100.0%</b>	<b>231 bps</b>	<b>211 bps</b>	<b>248 bps</b>	<b>296 bps</b>	<b>4.4%</b>	<b>1.9%</b>	<b>-1.5%</b>	<b>2.3%</b>

Treasury Benchmark bonds	Yield at Start	Yield at Horizon	Modified Duration
2yr On-the-run Treasury	3.64%	4.07%	1.9
5yr On-the-run Treasury	3.70%	4.20%	4.5
10yr On-the-run Treasury	3.92%	4.40%	8.2
30yr On-the-run Treasury	4.19%	4.65%	16.2



**Note:**

This table shows the expected return of CABEL Fund's benchmark over a twelve-month horizon under three spread scenarios. Over the coming months, we expect US Treasury yields to rise, which would result in a loss of 3.4% on average. The loss would be over-compensated by the running yield and, in some cases, by an expected spread tightening.



# Allocation Ranges



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**The investment committee has agreed on the following policy ranges for the country allocation of the CABEL Fund for the third quarter of 2005:**

<b>Country</b>	<b>Index</b>	<b>06/30/05</b>	<b>Minimum</b>	<b>Maximum</b>
Argentina *	0.0 %	3.4 %	0 %	5 %
Belize	0.1 %	0 %	0 %	0 %
Colombia	4.4 %	5.6 %	0 %	10 %
Costa Rica	21.9 %	14.2 %	15 %	25 %
Dominican Republic *	0.7 %	1.3 %	0 %	8 %
El Salvador	34.6 %	26.8 %	20 %	30 %
Guatemala	14.4 %	29.8 %	20 %	35 %
Mexico (external)	18.4 %	7.2 %	5 %	15 %
Mexico (domestic)	0 %	0 %	0 %	10 %
Nicaragua *	0 %	0 %	0 %	5 %
Panama	3.2 %	7.9 %	5 %	15 %

\* The combined allocation to Argentina, the Dominican Republic, and Nicaragua should not exceed 10 % of the fund's assets.

Duration (after hedge)	7.0 yrs	6.5 yrs	2.0 yrs	7.0 yrs
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## Contact

Christian Kopf, CFA  
DWS Finanz-Service GmbH  
Mainzer Landstrasse 178-190  
60612 Frankfurt, Germany

Phone +49 69 71909-8554  
Fax +49 69 71909-3006  
Email christian.kopf@dws.com

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