

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

September 2005



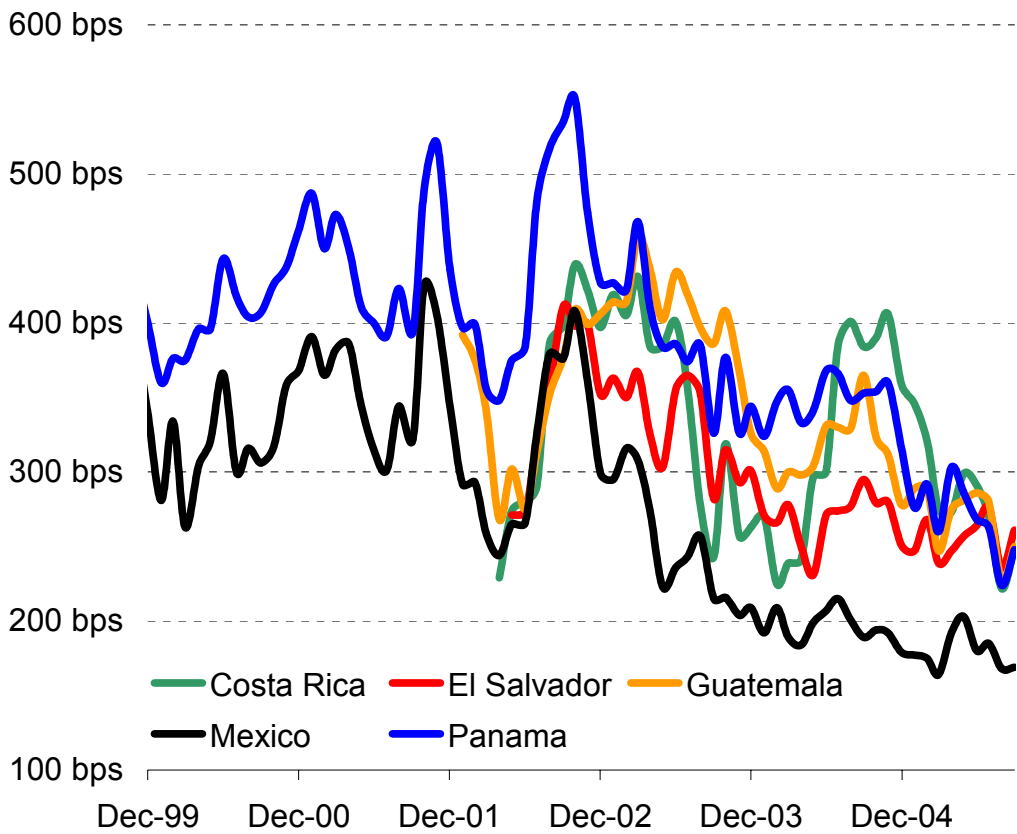
Deutsche Asset Management  
A Member of the Deutsche Bank Group



Economic forecasts in the report have been prepared with the assistance of Gabriel López González from the Chief Economist Office of the Central American Bank for Economic Integrations (CABEI) in Tegucigalpa, Honduras.

# Relative Value Analysis





Source: JP Morgan

Note:

Spreads on Central American sovereign bonds have tightened in July, but widened again in late August. There is still little spread differentiation between the four main Central American issuers, which all trade at 250 basis points on average.

# Country Views





## Argentina (B3/B-/D)

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<b>Economic Indicators</b>	<b>2003</b>	<b>2004e</b>	<b>2005f</b>	<b>2006f</b>
Real GDP, year-on-year change in percent	8.8	9.0	7.1	4.4
Nominal GDP, in USD billions	127	151	182	212
CPI (year-end), in percent	3.6	6.1	11.0	9.8
Fiscal Balance, in percent of GDP	0.5	2.6	1.7	1.6
External Debt, in percent of GDP	129.4	113.3	67.0	58.7
Current Account Balance, in percent of GDP	6.0	2.2	3.5	2.4
Foreign Exchange Reserves, in USD billions	14.1	19.6	28.1	33.9

### **Economic and political developments**

- Argentina continues to grow at a solid pace, driven by strong investment demand and fiscal stimulus. The GDP grew 10% year-on-year in the second quarter, after expanding 8% in the first three months of 2005.
- The primary surplus will remain at around 3.5% of GDP, but as the government is now paying interest again on a larger part of its debt, the overall fiscal balance will decline by about 1% of GDP. The government is planning to cover its borrowing requirements in the domestic market and through borrowing from Venezuela's president Chávez.
- The government and the Central Bank continue to purchase dollars in the foreign exchange market, in order to prevent an appreciation of the Peso. These transactions are not fully sterilized, and the resulting increase in money supply is contribution to a high level of inflation. In other words, as the government does not allow the foreign exchange market to correct the undervaluation of the Argentine Peso, inflation is doing the job.
- On October 23, one third of the Senate's and half of the Lower House's seats will be up for grabs. President Kirchner's candidates are expected to do well in this election, which could give him a majority in the Senate and put him in the pole position for re-election in 2006.

### **Risk factors**

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

<b>Spread forecast</b>	<b>09/15/05</b>	<b>A</b>	<b>B</b>	<b>C</b>
EMBI Global Diversified Argentina	397 bps	340 bps	390 bps	550 bps



## Colombia (Ba2/BB/BB)

Kopf

Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	4.0	4.0	4.2	3.7
Nominal GDP, in USD billions	80.0	97.5	123.5	130.5
CPI (year-end), in percent	6.5	5.5	4.9	4.5
Fiscal Balance, in percent of GDP (C.G.)	-5.0	-5.5	-5.5	-5.9
External Debt, in percent of GDP	47.6	40.6	32.8	32.9
Current Account Balance, in percent of GDP	-1.2	-1.0	-1.4	-3.9
Foreign Exchange Reserves, in USD billions	10.9	13.5	14.1	14.6

### Economic and political developments

- The ongoing nominal appreciation of the Peso is subject to a great public debate in Colombia these days. The Central Bank interventions have done little to stop this trend, which is due to higher export earnings, FDI and portfolio flows. The finance minister has labeled the situation a "foreign exchange hurricane", and is trying to counter it with the buy-back of external debt and increased issuance of local-currency securities.
- Meanwhile, excess liquidity from the expansionary monetary policy is driving up all sorts of asset prices: the stock market is up 56% year-to-date, the bond market has delivered a total return of 20% and real estate prices continue to bubble along.
- Stronger consumption and higher exports have led to an acceleration of the economic expansion in the second quarter; GDP growth is now expected to top 4% in 2005.
- The consolidated public sector posted a small surplus of 0.8% of GDP in the first half of the year, due to surging tax revenues. On the back of this number, a government agency has revised down the full-year forecast for the central government deficit to 1.6% from 2.5% of GDP in early September. The consolidated public sector is now expected to run a deficit of 5.5% of GDP in 2005 (down from 6.1% of GDP).
- The Constitutional Court will probably rule against Uribe's reelection project in October. This would open the race for a candidate from the Liberal party, who would probably have to run against Uribe's hand-picked independent candidate in the presidential elections on May 26, 2006. However, as there is strong public consensus for continuing Uribe's policies, the elections may turn out to be less of an issue.

### Risk factors

- Structural deterioration in public finances, which is now over-shadowed by strong cycle.
- Burst of the asset price bubble.

Spread forecast	09/15/05	A	B	C
BSCAX Colombia	220 bps	200 bps	280 bps	380 bps



## Costa Rica (Ba1/BB/BB)

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<b>Economic Indicators</b>	<b>2003</b>	<b>2004e</b>	<b>2005f</b>	<b>2006f</b>
Real GDP, year-on-year change in percent	6.8	4.2	3.0	3.0
Nominal GDP, in USD billions	17.5	18.4	19.6	20.3
CPI (year-end), in percent	9.9	13.1	12.8	9.8
Fiscal Balance, in percent of GDP	-4.5	-4.5	-4.0	-4.2
External Debt, in percent of GDP	32.0	32.6	32.1	32.0
Current Account Balance, in percent of GDP	-5.3	-4.9	-3.7	-3.3
Foreign Exchange Reserves, in USD billions	1.8	1.9	2.2	2.2

### **Economic and political developments**

- The economy is expanding at an annualized rate of around 2% to 3%, held back by high energy prices and a restrictive monetary policy. The base rate stands at 15.5%.
- The Central Bank has recently changed its 2005 inflation target to 12.7% from 10%. The high oil price and increased domestic liquidity from portfolio inflows are contributing to the upward pressure on prices. The Central Bank is trying to mop up the excess liquidity with open market operations, and has already grown international reserves by more than \$ 300 million this year. In addition to this, reserve requirements have been raised to 15% from 12% during the last quarter.
- Hopes for a passage of the fiscal reform before next year's election are fading, as the governing PUSC and the opposition PLN continues to fight over amendments to the original text. However, Finance Minister Federico Carrillo is trying to keep the fiscal accounts under control and managed to reduce the Central Government deficit during the first half of this year. It remains to be seen whether the government can continue along this road in the run-up to presidential elections.
- President Abel Pacheco remains reluctant to send the controversial CAFTA agreement to congress for ratification, in spite of growing support from private sector workers.
- 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.

<b>Spread forecast</b>	<b>09/15/05</b>	<b>A</b>	<b>B</b>	<b>C</b>
BSCAX Costa Rica	213 bps	245 bps	260 bps	300 bps



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

Kopf

Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	-0.4	2.0	2.8	3.0
Nominal GDP, in USD billions	16.2	19.5	30.5	28.6
CPI (year-end), in percent	42.8	28.7	5.8	9.4
Fiscal Balance, in percent of GDP	-3.5	-7.0	-3.8	-3.0
External Debt, in percent of GDP	51.8	40.5	26.2	30.1
Current Account Balance, in percent of GDP	5.3	7.0	3.9	2.8
Foreign Exchange Reserves, in USD billions	0.5	0.7	0.7	0.8

### Economic and political developments

- The economy continues to recover from the 2003 banking crisis: inflation has declined rapidly and domestic demand is strong.
- The current account surplus is fading fast, due to stronger import demand and the high oil price. There has been some pressure on the Dominican Peso lately, mainly related to seasonally high import demand.
- Congress has ratified the DR-CAFTA trade agreement on September 6<sup>th</sup>. Government revenues will be negatively affected by the implementation of the treaty in January 2006, as import duties will be cancelled. According to economic estimates, revenue losses associated with CAFTA could amount to as much as 3.5% of GDP. In order to deal with this shortfall, the government has committed itself to a tax reform in the current program with the IMF. After several delays, President Fernandez now expects this reform to be passed by Congress in December. The review of the IMF program has been postponed again, and the fund is now waiting for a revised letter of intend from the government. In spite of this delay, the IMF issued a favorable press statement in late August, pointing to the out-performance of quantitative economic performance targets.
- As a result of the Eurobond restructuring as well as the Paris Club and commercial bank debt rescheduling, scheduled amortization payments in 2006 are almost entirely with multilateral lenders. As long as the IMF stays on board, the government won't face liquidity problems in the coming year.
- Bond spreads continue to grind tighter, and the debt appears to be fairly valued now.

### Risk factors

- Failure to secure IMF support.

Spread forecast	09/15/05	A	B	C
BSCAX Dominican Republic	321 bps	300 bps	350 bps	450 bps



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

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Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	1.8	1.5	2.5	3.0
Nominal GDP, in USD billions	14.4	15.3	16.4	17.5
CPI (year-end), in percent	2.5	5.4	4.2	4.0
Fiscal Balance, in percent of GDP	-3.7	-2.4	-3.0	-3.0
Public External Debt, in percent of GDP	32.6	31.3	31.0	29.8
Current Account Balance, in percent of GDP	-5.0	-4.4	-4.2	-4.1
Foreign Exchange Reserves, in USD billions	1.9	1.9	1.95	2.1

### Economic and political developments

- The external sector is contributing to somewhat higher growth this year, mainly due to higher prices for coffee (+42% in the first half of 2005) and sugar (+28%). On the other hand, the garment industry is facing problems due to increased competition from China, and domestic demand is held back by high energy prices.
- After congress approval, the remaining financing needs for 2005 will be covered by loans from the World Bank and the IADB, and the government will not return to the international capital markets this year.
- Tax revenues have increased by about 0.5% of GDP so far this year as a result of the tax reform. However, the fiscal deficit is still projected to increase to 3% of GDP (including expenses due to the transition to a capital funded pension system). The government seems to have relaxed expenditure restraint in the run-up to congressional elections. It remains to be seen whether the government will be successful in bringing down total public debt to 40% of GDP from the current level of 43% of GDP, as required by the Fiscal Responsibility Law.
- Despite wide-spread public discontent with the current economic situation, the ruling Arena party could do well in the mid-term congressional elections which have been set for March 12, 2006, as factions within the FMLN are weakening the opposition.

### Risk factors

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

Spread forecast	09/15/05	A	B	C
BSCAX El Salvador	223 bps	200 bps	225 bps	280 bps



## Guatemala (Ba2/BB-/NR)

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Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	2.1	2.7	3.2	4.0
Nominal GDP, in USD billions	24.8	27.7	30.7	33.8
CPI (year-end), in percent	5.9	9.2	7.5	6.0
Fiscal Balance, in percent of GDP	-2.3	-1.1	-2.0	-1.7
Public External Debt, in percent of GDP	14.0	13.8	12.6	11.6
Current Account Balance, in percent of GDP	-4.2	-4.4	-3.8	-3.6
Foreign Exchange Reserves, in USD billions	2.9	3.5	3.9	4.4

### Economic and political developments

- The monthly index of economic activity is pointing to a slight acceleration of economic growth (+3.4% year-on-year in July), driven in part by rising exports.
- CAFTA got ratified by the Guatemalan congress, and the government managed to expand the preferential access to the European markets for another year; both should contribute to stronger export performance going forward.
- Consumer price inflation is still running at close to 10%, well above the Central Bank's target range of 4% to 6%. As in Costa Rica, this is due to higher oil prices and increased domestic liquidity due to portfolio inflows into the banking system (mainly from asset repatriation).
- Tax revenues are growing faster than inflation, but remain well below the goal of 12% of GDP, as required by the 1996 peace plan. This is not enough to finance much-needed public investment in infrastructure projects and education. Also, limited public resources are creating a security problem, as the policy is unable to control the violent *mara* gangs. The administration seems to be planning to increase the VAT to 13% from 12% in order to increase tax revenues.

### Risk factors

- The planned privatization of public services, a reduction of energy subsidies and tax increases could reduce President Berger's public support.
- Current account deficit and dollar deposits make the banking system vulnerable.

Spread forecast	09/15/05	A	B	C
BSCAX Guatemala	199 bps	190 bps	210 bps	270 bps



## Mexico (Baa1/BBB/BBB-)

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Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	1.3	4.2	3.5	3.6
Nominal GDP, in USD billions	608	645	714	738
CPI (year-end), in percent	4.0	5.2	3.8	4.0
Fiscal Balance, in percent of GDP	-2.5	-1.8	-2.2	-2.6
External Debt, in percent of GDP	26.7	24.9	23.0	22.7
Current Account Balance, in percent of GDP	-1.4	-1.1	-0.9	-1.5
Foreign Exchange Reserves, in USD billions	59.0	61.1	71.1	78.2

### Economic and political developments

- The economic expansion in Mexico is decelerating, due to tight monetary conditions and a drag on exports to the United States.
- Headline inflation has fallen to 3.95% in August, bringing it into Banco de México's target range of 2% to 4% for the first time since end-2003.
- Banco de México has allowed a reduction in the overnight rate by 25 bps to 9.5% on August 26. At the same time, the Central Bank has left its old policy instrument, the corto, at 79 million, indicating that it will move gradually to a policy target regime. With the benign inflation data, Banco de México should lower the overnight rate again on September 23 and October 28.
- The Peso remains strong, 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	09/15/05	A	B	C
BSCAX Mexico	103 bps	100 bps	120 bps	160 bps



## Panama (Ba1/BB/BB+)

Kopf

Economic Indicators	2003	2004e	2005f	2006f
Real GDP, year-on-year change in percent	4.1	6.2	3.8	3.0
Nominal GDP, in USD billions	12.9	13.7	14.6	15.4
CPI (year-end), in percent	0.1	1.5	2.5	2.4
Fiscal Balance, in percent of GDP (ex Canal)	-4.7	-5.0	-3.6	-3.0
External Debt, in percent of GDP	279.2	285.0	276.9	273.8
Current Account Balance, in percent of GDP	-3.4	-2.0	-1.5	-1.5
Foreign Exchange Reserves, in USD billions	0.9	0.5	0.5	0.4

### Economic and political developments

- As can be seen from our economic projections above, the tax reform, which was passed earlier this year, will have a substantial impact on the fiscal deficit in the years to come. In fact, with this year's double-digit increases in tax revenues, the Torrijos administration is on track with achieving a meaningful fiscal consolidation. This was much-needed after the excesses of the previous government, but won't be enough to give the country the perspective for an investment grade rating.
- In spite of his majority in congress, President Torrijos had to delay the Social Security reform back in May. The consultative process which was started to build a societal consensus for the reform will come to a close in early October, but the parties do not seem to be willing to reach a compromise on the reform project. Further strikes by CSS employees are becoming more likely, and it is unclear whether President Torrijos will be able to move along with his reform proposal.
- Failure to reform the CSS would force the government to subsidize the dedicatory social security system, which could have negative implications for sovereign creditworthiness in the future. It could also make it more difficult for the government to get approval for and finance the planned expansion of the Panama Canal.
- Otherwise, the economy is growing at a strong pace, driven mainly by the Colón Free Zone and the Panama Canal. Exports could be negatively affected by hurricane Katrina in the second half of the year.

### Risk factors

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

Spread forecast	09/15/05	A	B	C
BSCAX Panama	183 bps	160 bps	180 bps	280 bps

# Scenario Analysis

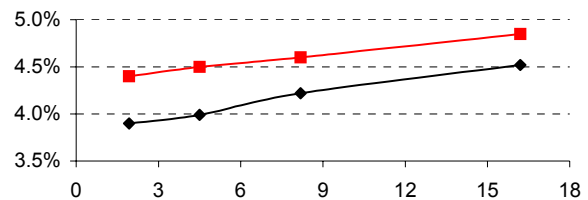




Time of Analysis		Risk-free Rate	Probabilities		
Start	Horizon		A	B	C
9/15/2005	9/15/2006	3.50%	15%	70%	15%

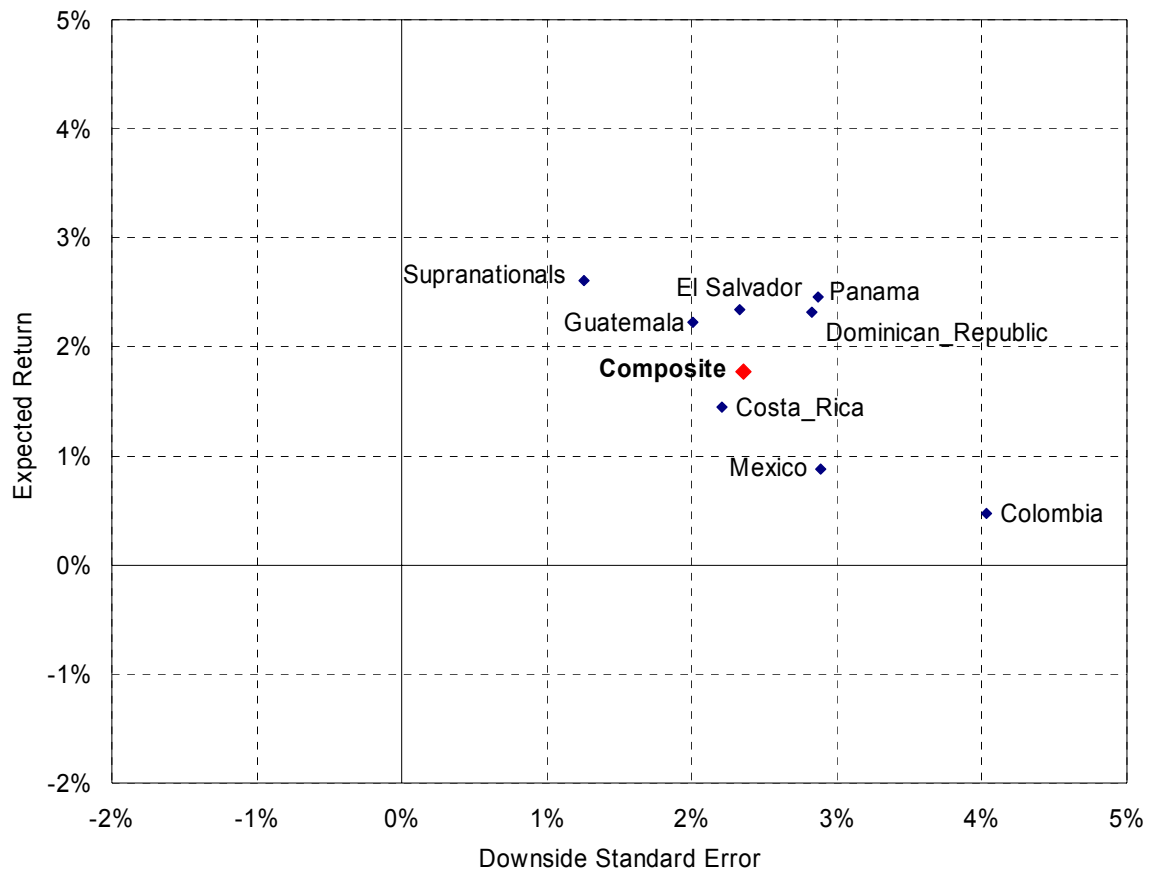
Country	BSCAX Weight	Stripped Spread	Spread Forecast			Expected Total Return			DSSE
			A	B	C	A	B	C	
Belize	0.1%	847 bps	900 bps	1000 bps	2000 bps	7.9%	2.8%	-48.3%	20.1%
Colombia	4.7%	220 bps	200 bps	280 bps	380 bps	5.0%	0.6%	-4.9%	4.0%
Costa_Rica	22.0%	213 bps	245 bps	260 bps	300 bps	2.4%	1.6%	-0.4%	2.2%
Dominican_	0.7%	321 bps	300 bps	350 bps	450 bps	6.0%	2.8%	-3.7%	2.8%
El Salvador	33.3%	223 bps	200 bps	225 bps	280 bps	5.1%	2.8%	-2.3%	2.3%
Guatemala	14.8%	199 bps	190 bps	210 bps	270 bps	3.9%	2.6%	-1.3%	2.0%
Mexico	18.5%	103 bps	100 bps	120 bps	160 bps	2.5%	1.1%	-1.7%	2.9%
Panama	3.4%	183 bps	160 bps	180 bps	280 bps	4.8%	3.3%	-3.9%	2.9%
Supranation	2.5%	138 bps	130 bps	140 bps	180 bps	3.5%	2.9%	0.6%	1.3%
<b>Composite</b>	<b>100.0%</b>	<b>192 bps</b>	<b>188 bps</b>	<b>212 bps</b>	<b>265 bps</b>	<b>3.8%</b>	<b>2.1%</b>	<b>-1.8%</b>	<b>2.4%</b>

Treasury Benchmark bonds	Yield at Start	Yield at Horizon	Modified Duration
2yr On-the-run Treasury	3.90%	4.40%	1.9
5yr On-the-run Treasury	3.99%	4.50%	4.5
10yr On-the-run Treasury	4.22%	4.60%	8.2
30yr On-the-run Treasury	4.52%	4.85%	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 year, we expect US Treasury yields to rise, which would result in a loss of 3.0% on average. The loss would be over-compensated by the running yield and, in some cases, by an expected spread tightening.



# Allocation Ranges



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

<b>Country</b>	<b>Index</b>	<b>09/15/05</b>	<b>Minimum</b>	<b>Maximum</b>
Argentina *	0.0 %	3.2 %	0 %	5 %
Belize	0.1 %	0 %	0 %	0 %
Colombia	4.7 %	3.8 %	0 %	10 %
Costa Rica	22.0 %	18.0 %	10 %	25 %
Dominican Republic *	0.7 %	1.5 %	0 %	5 %
El Salvador	33.3 %	24.1 %	25 %	35 %
Guatemala	14.7 %	29.3 %	20 %	30 %
Mexico (external)	18.6 %	8.0 %	5 %	15 %
Mexico (domestic)	0 %	0 %	0 %	10 %
Nicaragua *	0 %	0 %	0 %	5 %
Panama	3.4 %	8.6 %	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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