

# CABEI Central American Fund Investment Policy for the First Quarter of 2010

February 2010



# Relative Value Analysis



Symbol	Price	Change
高周波	412	▲
日金工	413	▲
治金工	20	▼
山陽	410	0
立金	100	▲
立金	185	▲
立金	17	▲
立金	52	▲
立金	33	▲
立金	35	▲
立金	51	▲
立金	52	▲
立金	37	▲
立金	36	▲
立金	455	▲
立金	377	▲
立金	532	▲
立金	1050	▲
立金	450	▲

## **Global economic situation and outlook**

Economic development in most important countries of the global economy has stabilized over the past months. Meanwhile, China's economy is already at heavy expansion mode again, and domestic politicians now worry more about overheating of some sectors rather than downside risks to economic growth. Other emerging market economies are showing a roughly similar pattern, though economic activity is not rising at the same pace. But one has to acknowledge that some countries are still lagging the country group.

A supportive element for the global economy and financial markets was the accommodative stance of monetary policy in the US and the euro zone. Both central banks have neither changed their interest rate policy, nor did they withdraw any liquidity which they had excessively provided during the heydays of the global crisis. In addition, most comments by central bank officials in the US and Western Europe were rather dovish, aggressive steps by any central bank any time soon are unlikely.

Many emerging economies have benefited from improvement in external accounts. In addition, the positive trend of increasing foreign exchange reserves also remained on track, mostly caused by strong capital inflows and (sometimes) higher commodity prices. Some countries even saw a sharp increase in foreign exchange reserves, driven by heavy interventions of the respective central banks (like Brazil, Russia) to smooth currency appreciation. The process of improvement in external accounts has further reduced external vulnerability.

Fiscal policy has been very expansionary in most countries of the world, which has caused a reasonable increase of fiscal deficits and debt ratios during the past quarters. Some countries still benefit from very low debt ratios, though, putting them in a comfortable position and reduce the risk of any rating action. To add more, many governments in the emerging world have already implemented a shift in fiscal policy, aiming at reducing public spending and lowering the fiscal deficits. This should create positive dynamics in the fiscal accounts and help contain public debt.

Despite the generally positive developments, some events have again highlighted that risks remain, both for specific countries and the global economy. At the end of November, the Emirate of Dubai announced that it wants to restructure most of the debt of its state-owned company "Dubai Holding". This sent shockwaves through global markets, though most segments recovered after the Emirate of Abu Dhabi provided another financial support package to its ailing neighbor. Another factor weighing on markets were headlines about Western European peripheral countries. The focus was clearly on Greece, but Portugal and Spain are having a tough time, too. Given the deterioration of debt indicators of Greece, the sovereign rating suffered from some downgrades.

Finally, the development of China's economy took centre stage in global discussion, again. The latest shift in economic policy in China towards a tighter stance has to be seen in the context of strong economic activity in the country. Apart from exports still suffering from lower global demand, the Chinese economy is already running under full steam, again. Some sectors (like real estate and steel production) even show signs of overheating and excess capacity built-up. Private consumption remains strong, and additional fiscal spending is also contributing positively to GDP growth. This economic development makes a clear case for policy tightening in China, though this shall only take place selectively.

## **Central American economic situation and outlook**

Economic activity was significantly affected by the global downturn in 2008/09. The channel of contagion to these countries was through a decline in world trade, a reduction in wage remittances, weaker foreign direct investment flows and much lower tourism revenues. A number of countries' quasi-fixed exchange rates did not deliver a buffer against negative external shocks.

Inflation shifted from being one of the top economic policy problems in 2007/08 to no longer being a concern due to shrinking demand and lower commodity prices. Net-commodity-importers in Central America and the Caribbean experienced significant relief based on the fact that many generally allow full pass-through of higher international commodity prices to domestic inflation. However, not only inflation moderated, lower import bills were also bound to narrow current account deficits. However, base effects, general economic recovery and a rebound in commodity prices will likely lead to higher inflation again in 2010, not reaching levels seen in 2007/08 though.

The downturn was uneven across the region of Central America and the Caribbean. Guatemala, Costa Rica and Panama were best-prepared to stem a severe slowdown. Guatemala's and Costa Rica's solid fiscal balances had equipped the government with the flexibility necessary to stimulate the economy. Panama benefited from its individual growth story, to a large degree related to the Canal expansion project. Due to its heavy dependence to the United States, especially via remittances and trade, El Salvador was hit extremely hard. In the Dominican Republic, lower tourism and remittances became a drag on the country. Authorities in the latter two countries also had less fiscal resources available to provide support to the economies.

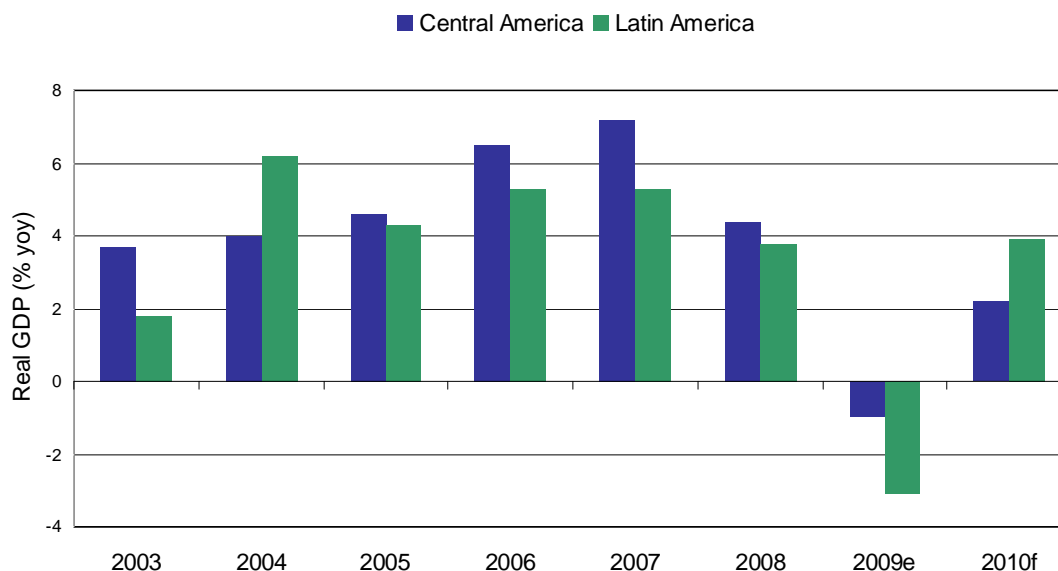
In all countries, recession hammered tax revenues. Underperformance was primarily caused by dependence on tax collection from international trade, tourism and services. The latter coupled with increased public spending caused a generalized deterioration in fiscal balances. However, broad financial support by international institutions prevents too severe damage to occur. Almost all the countries signed pre-cautionary agreements with the IMF over the past months. Thereby, they do not only have access to IMF money but it also opens the door for loans from other financial institutions (e.g. IADB, CAF). 2010 will likely be marked by tighter fiscal policies. Improved economic activity will naturally increase revenues. However, cuts on the spending side will also be necessary in order to lower fiscal deficits.

During the recession, growth in Central America and the Caribbean fared better than the Latin American peers. During the recovery, however, the region will likely underperform the Latin American average. After last year's fiscal deterioration, adjustments and reforms will be at the top of the discussion agenda in 2010, likely putting a cap on growth. Some countries have already started sending fiscal reform proposals to the respective congresses. On the positive side, fiscal accounts will experience some relief due to economic rebound boosting tax revenues. External debt ratios will likely stay relatively stable as higher growth partly offsets increased borrowing. Current accounts in the region are expected to deteriorate again, amid economic improvement and the reversal in commodity prices leading to higher import values. Hence, it is all the more important to attract foreign direct investment inflows to cover

the deficit. The reversal in commodity prices, along with less-favorable base effects and stronger domestic demand, will also lead to increases in inflation.

Overall, Costa Rica, Guatemala and Panama are expected to show a faster recovery compared to the regional average. In contrast, El Salvador and Dominican Republic face bigger challenges, and it will take the two countries longer to recover. In general, the pace of recovery in the region will largely depend on the evolution of the US economy.

**Chart: Central America outpaced the rest of Latin America in 2009 but will likely lag the regional average in 2010**



Sources: JP Morgan, DWS

High dependence on external demand let **Costa Rica** feel the pinch of the global downturn. Tourism and imports sharply plunged. Since the decline in imports substantially outpaced the decrease in exports, the current account deficit saw a significant contraction. Driven by the slowdown in economic activity and relatively lower oil and food prices, inflation has been on a consistent downward trend since October 2008. Compared to other countries, Costa Rica had applied prudent economic policies during previous years. The latter allowed the government to implement countercyclical fiscal policies during the crisis in order to avoid too severe damage. Therefore, Costa Rica is also expected to recover faster than other countries in the region. The manufacturing sector already shows signs of improvement, especially due to direct investment in the high-tech devices sector. In contrast, the recovery in tourism is likely to take longer. In February 2010, Costa Ricans elected Laura Chinchilla of the governing National Liberation Party (PLN) as the country's first female president. Mrs. Chinchilla won with an even larger cushion than predicted by opinion polls ahead of the election. In general, policy continuity is expected, helping Central America's second biggest economy recover from the downturn experienced in 2009. However, she was less successful at the Congres-

sional level, the PLN's overall performance was sub-par in the election. Hence, consensus building and political negotiations are key in the new fragmented Congress in order to pass important proposals. Although spreads and absolute yields of Costa Rican external debt have tightened already heavily we still like the bonds of the country due to its sound outlook.

Due to the country's strong links to the US, **El Salvador's** economy was sharply hit by the global recession. Remittances and maquila exports suffered most. Dollarisation and weak fiscal accounts provided little room for countercyclical policies. Although President Funes targets a fiscal reform, the political environment is not overly supportive for passage of comprehensive reforms. Increased tensions between President Funes and his FMLN face the general risk of degenerating into lack of governability. Like in Costa Rica, weak domestic demand and some relief in commodity price pressures resulted in lower inflation. Overall, El Salvador will likely take relatively more time to recover due to still weak labor market conditions in the US keeping remittances at subdued levels. On the positive side, the IMF announced an agreement on a three-year USD 800 million Stand-By Arrangement. Authorities plan to treat the new agreement as precautionary. Anyway, it will trigger additional loans by the IADB and World Bank for USD 1.3 billion. Amid substantial financing needs in 2010, deteriorating fiscal dynamics and a weaker debt profile, we are generally cautious on El Salvadorian external debt and prefer to hold tactical positions instead of strategic exposure.

In general, **Guatemala** was relatively less affected than regional peers due to its less open economy. In addition, sound macroeconomic policies applied during prior years let the government implement expansionary countercyclical measures. Recent data suggest that the country has already started to recover. Assuming a rebound in commodity prices but also import volumes, the current account deficit is likely to increase again. In line with the rest of countries in the region, public finances deteriorated during the crisis. The resulting fiscal deficit is expected to improve in 2010 on the back of economic recovery prompting a rise in tax revenues. Currently, the tax collection ratio represents around 10% of GDP, one of the lowest figures in Latin America. Hence, Guatemala has some room to raise taxes and was also advised by the International Monetary Fund to do so. The solid economic outlook makes us stick to our exposure in bonds of Guatemala.

**Panama** turned out to be one of the most robust countries in all of Latin America in 2009. Despite the fact that Panama did not enter the stage of recession, though, its economy also slowed down substantially. Construction, the economy's most dynamic sector, faced lower demand and tighter credit conditions. As a result, some private construction projects had to be suspended. Public construction, on the other hand, maintained its momentum, specifically investments around the expansion of the Panama Canal. In addition, Canal revenues increased due to higher traffic fees. Consumption continued to grow in 2009, to a large degree because of immigration of upper middle class families. The fiscal position deteriorated in the course of the economic slowdown. In September 2009, the first part of the fiscal package was approved by Congress, aimed at increasing tax revenues. The second is expected to be submitted, after some delay, in February 2010. Latest economic indicators suggest that the country has already entered a recovery mode. In addition, S&P recently placed a positive outlook on the country's rating. Hence, there is a substantial chance that Panama will be granted investment grade status in 2010/11. Based on the sound fundamental development of the country, we are aiming at increasing exposure.

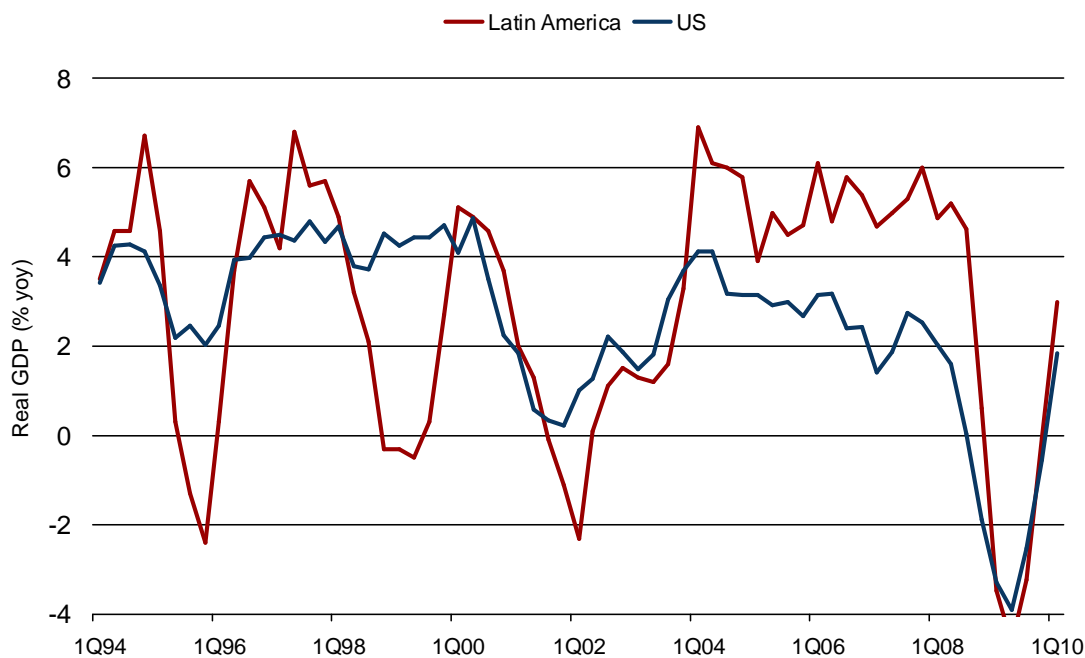
**Dominican Republic's** tourism and construction sectors experienced a significant contraction. However, positive performance in the telecommunications, agricultural and financial services prompted better-than-expected 2009 overall GDP growth. Countercyclical monetary policies implemented by the Central Bank led to an increase in private sector credit. In contrast, the fiscal authorities had no room to conduct fiscal measures due to the sharp deterioration in tax revenues. However, the encouraging news is that the Stand-By Arrangement (SBA) recently signed with the IMF will allow the application of more expansionary fiscal measures in 2010. Recovery is expected to be slow based on the delay in government support and tourism likely remaining depressed due to weak international labor conditions. Short-dated USD paper of Dominican Republic is most attractively valued.

The global recession combined with political instability badly hurt **Nicaragua's** economic performance. The deceleration was broad-based, construction, manufacturing, financial services and commerce were affected most. The outlook for 2010 appears similarly challenging. Investment will likely continue to contract as the difficult political situation brings weak business climate. In addition, the government has little room to provide fiscal stimuli to the economy. Hence, financial support from multilaterals is key for the economic recovery of the country. In the last revision under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement with the IMF, the fund recommended the Nicaraguan government to implement a reform that broadens the tax base.

#### **Latin American economic situation and outlook**

The global financial crisis exacted a heavy toll on Latin growth in 2009. The collapse of world trade caused most of the damage, but diminishing financial flows and falling remittances also weighed on the region. Regarding Latin America's outlook, activity is about to recover relatively faster in the more resilient countries like Brazil, Chile, Peru and Uruguay. Fiscal discipline in previous years had resulted in vast financial resources. The latter were used in the crisis to stimulate the faltering domestic economies. In addition, growth in Chile and Brazil is rather driven by consumption and investment and less by net exports. Mexico and Colombia will likely lag the recovery due to being more dependent on developments in the United States. Countries marked by unorthodox policies (Venezuela, Argentina, Ecuador) are likely to struggle even more, though. In general, the recovery in Latin America will likely become both a cause and effect of renewed capital flows into the region, in the form of foreign direct investment and portfolio investment. Central banks are expected to normalize monetary conditions over the course of 2010. Politics will start playing a bigger role and might lead to some volatility. In Colombia, not the election outcome itself but rather the potential referendum allowing President Uribe to run for a third term will be subject to some noise. In Brazil, volatility could pick up a bit more as there are a number of uncertainties about the candidates as well as their goals. In Argentina and Venezuela, political noise promises to remain high anyway.

**Chart: Latin America to recover faster than the US**

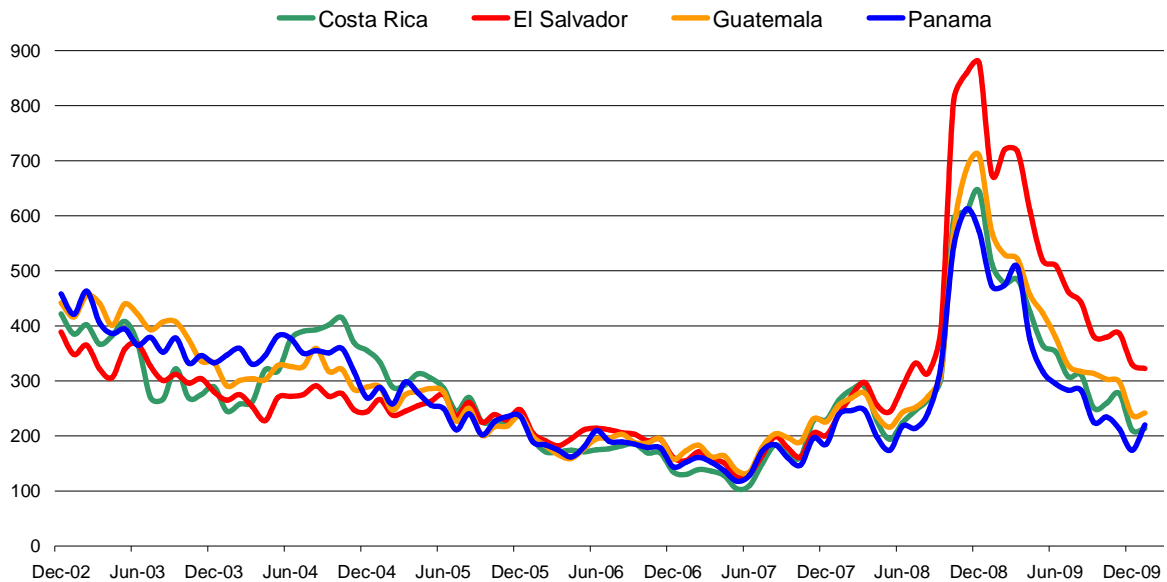


Sources: JP Morgan, DWS

### **Sovereign spreads**

Over the course of 2009, Latin American bonds were strongly supported by investor's increased risk appetite and generally good interest in "Emerging Markets Fixed Income" as an asset class. Spreads tightened massively and liquidity improved significantly in the past few quarters. The bulk of spread compression happened in the first six months of 2009, but the trend continued until year-end. Colombia and Mexico were the first countries to experience significant spread compression after the peak of the crisis in autumn 2008. With some delay, Central American & Caribbean countries followed. Spreads of El Salvador tightened around 550 bps in 2009, only topped by Dominican Republic. The latter's spreads decreased from extremely distressed levels of about 2200 bps to 700 bps. Spreads of Costa Rica and Guatemala compressed roughly 450 bps last year, while those of Panama fell 400 bps. Generally speaking, spreads have converged to more normal levels again. While we expect external debt of Central America to continue its move towards tighter spreads, volatility will likely increase in 2010. The events of Dubai showed that the financial crisis still has some victims unaccounted for. In addition, investors' sentiment toward global economic recovery and the pace and effect of the removal of stimulus by policy makers in developed countries is expected to cause some spikes in risk aversion.

**Chart: Significant spread tightening**



Source: JP Morgan

### **CABEI Central American Fund: Investment strategy**

After the global financial market turmoil in autumn 2008, investor sentiment and hence risk appetite continuously improved over the course of 2009. Increased demand for riskier assets let Central American & Caribbean debt markets experience a strong recovery.

In 2010, fund management will generally continue its strategy of focusing on strategic positions in fundamentally sound countries (Costa Rica, Guatemala, Panama). Nevertheless, amid relatively better liquidity in bonds of Panama, compared to Costa Rica and Guatemala, holdings in Panama will be adjusted more dynamically. In El Salvador, Mexico and Colombia, good liquidity conditions also support investments on a tactical basis. On the back of worries about periphery countries of the European Monetary Union expected to cause risk aversion to rise, fund management has stayed away so far from adding exposure and increasing spread duration in El Salvador. Fiscal challenges and significant debt issuance in 2010 lead to a cautious stance towards external debt of Colombia. In contrast, appreciation potential of the Colombian Peso, driven by strong foreign direct investment, makes investments in the country's local market look attractive. After USD-bonds of Mexico significantly rallied once the (awaited) rating downgrade was announced, valuation does not appear too compelling anymore. Hence, fund management intends to shift external debt into local debt of the country as rates are well supported and the Mexican Peso bears substantial catch-up potential after turbulences experienced in 2009. In Dominican Republic, holdings in the country's 2011 bond are kept for the time being, since it still pays a nice yield compared to yields of its rating-peers. Once risk appetite has stabilised again, fund management is likely to either switch into 2018 paper or to participate in a new issue if available. There is currently no intention to build up a position in Argentina as political and economic uncertainty is still considered very high.

Corporate exposure is low and primarily focused on less-correlated names (like ICE-linked note or Guatemala's electricity company). Furthermore, the fund holds a defensive CABEL-security that pays a nice spread over Libor and has an appealing amortizing structure.

As long as uncertainties regarding Greece continue to drive global financial markets, fund management remains cautious in its investment approach. However, once the dust settles, it intends to raise positions in higher-yielding names (El Salvador, Dominican Republic) and local markets (Mexico, Colombia).

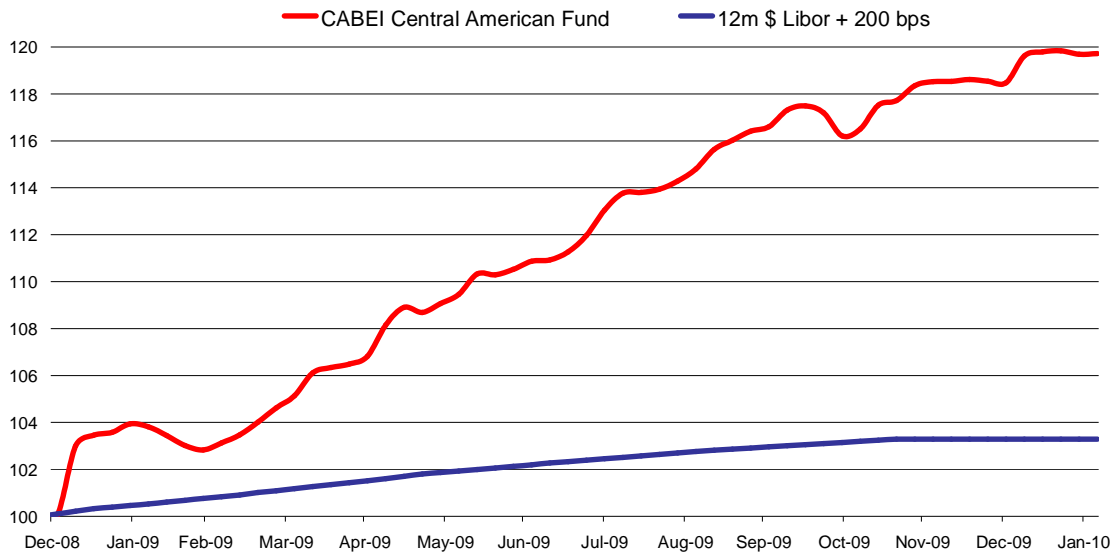
**CABEI Central American Fund: Performance**

	<b>2010 year-to-date</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>
<b>Performance</b>	0.99%	18.44%	-13.78%	4.72%	9.02%

Sources: Bank of Ireland, DWS

As of 10 February 2010

**Chart: CABEI Central American Fund performance 2009 & 2010 year-to-date**



Sources: Bloomberg, DWS

# Scenario Analysis



## CABEI Fund - Spread Forecast and Scenario Analysis

Time of Analysis		Risk-free				Probabilities			
Start	Horizon	Rate				A	B	C	
1/29/2010	1/29/2011	0.25%				15%	70%	15%	
Country	CACI Weight	Stripped Spread	Spread Forecast			Expected Total Return			DSSE
			A	B	C	A	B	C	
Belize	0.3%	1101 bps	1000 bps	1400 bps	1900 bps	18.0%	-8.3%	-41.2%	17.6%
Colombia	5.5%	219 bps	140 bps	180 bps	400 bps	7.7%	5.0%	-9.8%	3.9%
<b>Costa Rica</b>	19.0%	262 bps	150 bps	180 bps	450 bps	5.8%	4.8%	-4.8%	2.0%
<b>Dominican Republic</b>	1.0%	387 bps	300 bps	330 bps	700 bps	8.0%	6.7%	-8.4%	3.4%
El Salvador	42.0%	312 bps	230 bps	270 bps	600 bps	9.8%	6.6%	-19.0%	7.5%
<b>Guatemala</b>	15.5%	227 bps	150 bps	170 bps	450 bps	6.8%	5.7%	-9.4%	3.7%
Mexico	13.0%	177 bps	130 bps	160 bps	350 bps	5.6%	3.3%	-11.2%	4.4%
<b>Panama</b>	3.8%	211 bps	130 bps	160 bps	350 bps	9.3%	6.7%	-9.5%	3.8%
<b>Composite</b>	<b>100.0%</b>	<b>266 bps</b>	<b>183 bps</b>	<b>217 bps</b>	<b>500 bps</b>	<b>6.5%</b>	<b>4.8%</b>	<b>-8.5%</b>	<b>3.4%</b>

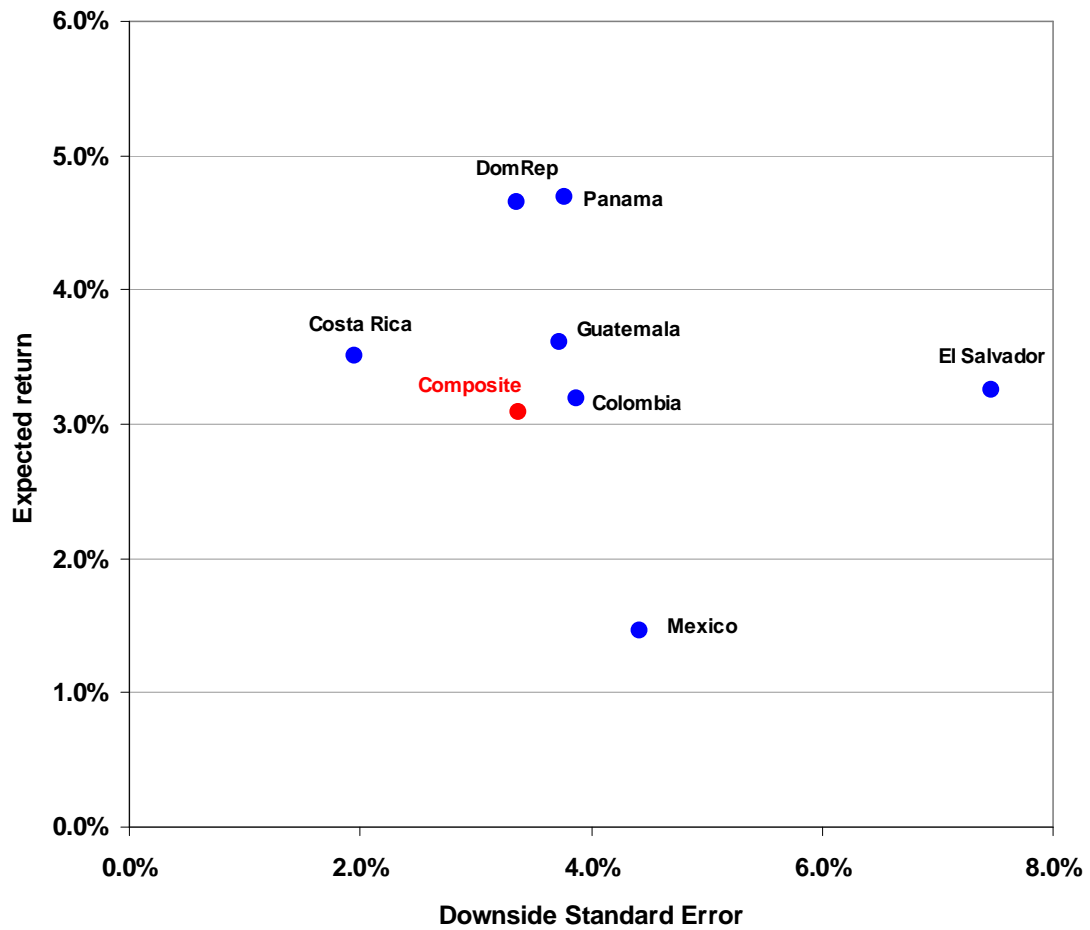
  

Treasury Benchmark bonds	Yield at Start	Yield at Horizon	Modified Duration
2yr UST	0.85%	1.70%	2.0
5yr UST	2.31%	3.10%	4.5
10yr UST	3.62%	4.00%	8.0
30yr UST	4.55%	4.90%	15.9

**Note:**

This table shows the expected return of CABEI Fund's benchmark over a twelve-month horizon under three different spread scenarios. We expect US Treasury yields to move higher in the next 12 months, which would result in a negative return contribution of 3.5% on average. This will lower the positive return delivered by the running yield and, in some cases, by expected spread tightening.



Belize was left out, as it has a high outcome for DSSE (18%) and negative expected return (-9%), which would distort the chart.

# Allocation Ranges



<b>Country</b>	<b>Index 01/29/10*</b>	<b>CABEI Fund 02/10/10</b>	<b>Minimum**</b>	<b>Maximum**</b>
Argentina***	0.00%	0.00%	0%	5%
Belize	0.25%	0.00%	0%	5%
Colombia external	5.50%	2.40%	0%	10%
Colombia domestic	0.00%	0.00%		
Costa Rica external	19.00%	17.65%	15%	30%
Costa Rica domestic	0.00%	3.38%		
Dominican Republic***	1.00%	3.70%	0%	10%
El Salvador	42.00%	26.45%	15%	40%
Guatemala	15.50%	23.02%	10%	30%
Mexico external	13.00%	5.51%	5%	15%
Mexico domestic	0.00%	4.67%	0%	10%
Nicaragua***	0.00%	0.60%	0%	5%
Panama	3.75%	6.20%	5%	15%
Supranationals	0.00%	2.47%		
Cash	0.00%	3.93%		
Duration	6.1	4.0	3.0	9.0

\* JP Morgan provides a customised version of its new Central America and Caribbean Index which is very similar to the previous modified BSCAX, but is based on fixed weights.

\*\* In February 2010, the upper bound of Argentina's policy ranges was decreased from 10% to 5%.

\*\*\* The combined allocation to Argentina, the Dominican Republic, and Nicaragua should not exceed 20% of the fund's assets.

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