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

June 2010

DWS
INVESTMENTS

# Relative Value Analysis

## Global economic situation and outlook

Concerns about debt sustainability in industrialized countries, especially Western European economies, only recede at a slow pace. At the beginning of June, euro area finance ministers agreed on the details of the European Financial Stability Facility (EFSF). The vehicle will provide EUR 440 billion of bilateral loans to member states in fiscal difficulties. In addition, the European Central Bank (ECB) started buying government bonds of euro area countries - a significant shift in the ECB policy stance. Nevertheless, negative rating momentum for peripheral Western European countries and negative headlines on Spain (especially the banking system) let investors stay cautious.

The US economy remains on a solid but not spectacular recovery track, which is expected to persist over the first years of this expansion. In the past, severe downturns were usually caused by Fed tightening, and once the Fed relented, the economy rebounded like a coiled spring, fueled by the venting of large pent-demands. This recession was caused by the bursting of a housing/credit bubble whose effects may linger, delaying and diluting the venting of pent-up demands.

Emerging market economies mostly continued to deliver positive news. Economic growth is still surprising to the upside. Inflation is not an issue of concern in most countries, and the central banks are currently able to keep interest rates on hold amid the balanced macroeconomic outlook and some concerns about growth in industrialized countries. Another supportive factor is the strong positive momentum in capital flows to many emerging market countries. More and more global fixed income investors acknowledge the sound standing of those markets and allocate a higher share of their investments to this country group. As a consequence, the external balances of many emerging market countries look very healthy, and the central banks are able to further accumulate foreign exchange reserves. The latter also adds to the latest improvement in rating momentum: some countries (Panama) have lately achieved "investment grade" status, and other (Indonesia, Turkey) are getting closer to that.

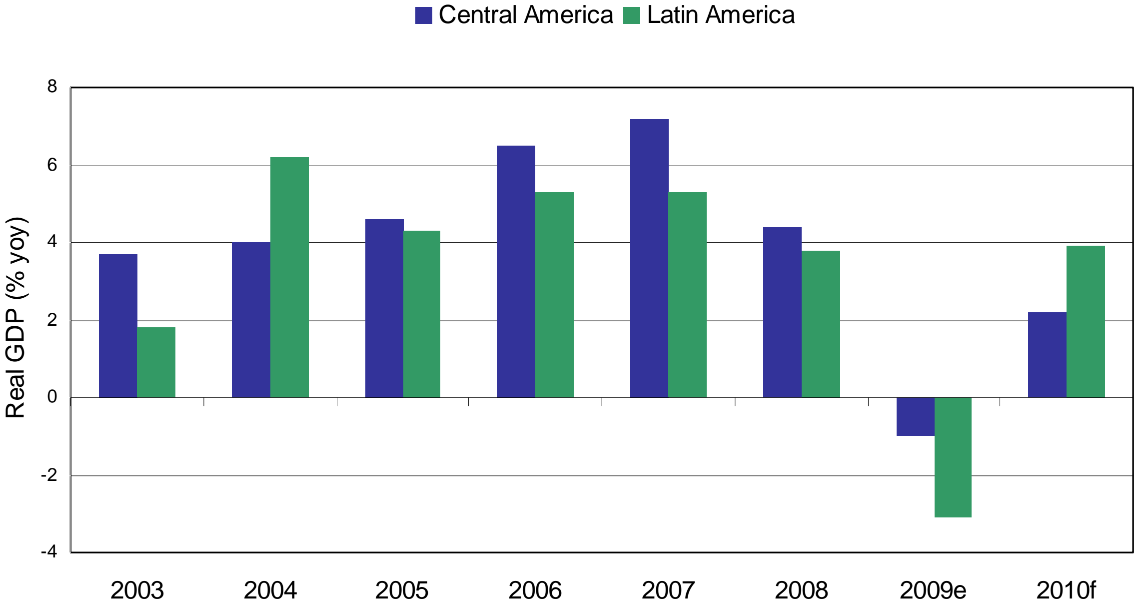
## Central & Latin American economic situation and outlook

During the latest crisis, Central America fared much better than the Latin American average in terms of economic performance. Some governments were able to implement countercyclical policies, and most countries additionally received financial assistance from institutions like the IMF, CABEI, IADB and CAF. In late 2009, the region started showing a drive to recover. Exports are about to rebound, and domestic demand gains momentum. The pace of recovery is largely dependent on the evolution of the US economy. In all countries, the recession hammered tax revenues, leading to a deterioration of fiscal balances. Stronger growth in 2010 will let revenues increase again and, coupled with spending cuts, provide relief to the overall budget. Although there are no significant demand-driven inflation pressures expected, consumer prices will likely move up as a result of higher energy and food prices as well as unfavorable base effects. Amid economic improvement and the reversal in commodity prices leading to higher import values, current accounts in the region are expected to deteriorate. Hence, it is all the more important to attract foreign direct investment inflows to cover the deficit.

Overall, Costa Rica, Guatemala and Panama are expected to show a faster recovery compared to the regional average. In contrast, El Salvador, Honduras and Nicaragua face bigger challenges, and it will take the three countries longer to recover.

In Latin America, a year of economic recovery is underway. Nevertheless, the recovery will turn out uneven across the region. Domestic demand is about to pick up most rapidly in Brazil, Peru and Chile but also gains momentum in other countries. In turn, Mexico and Colombia will likely remain laggards due to less fiscal flexibility and the countries' close trade connections to the US. Improving international trade, especially Asian demand, supports Latin America's more open economies, primarily its commodity exporters. Last year's larger-than-expected narrowing of current account deficits is likely to reverse in 2010/11. Sound fundamentals coupled with a good business environment in a number of countries will attract foreign direct investment, with Brazil and Colombia likely seeing the largest amount of flows. Fiscal accounts are expected to experience some relief on the back of increased revenues amid the rebound in GDP growth. Inflation is accelerating, still far from becoming worrisome though in most countries. Brazil's central bank already resumed a monetary tightening cycle as the output gap moves into positive territory. Although economic activity does not (yet) show any signs of overheating, monetary authorities in Peru and Chile also started to increase policy rates.

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




Sources: JP Morgan, DWS

**Costa Rica** continues to lead the recovery in the region. The manufacturing sector and related exports, especially high-tech goods, are the main drivers of the economic rebound. Although the outlook for 2010/11 is generally brighter, the recovery in tourism is likely to take

somewhat longer. Additional stimulus is likely to come from the telecommunications and insurance sectors. While core inflation remains under control, headline inflation started moving up amid rising administered prices. President Laura Chinchilla took office on May 8 and is expected to follow a pro-market policy stance. Although spreads and absolute yields of Costa Rican external debt have reached relatively low levels, we still like the bonds of the country due to its sound economic outlook coupled with good prospects for a rating upgrade in the next 12 to 18 months.

**El Salvador's** economic recovery remains fragile and growth is still in negative territory. Domestic demand is constrained by delinquency weighing on investment. On the external front, remittances and maquila exports are also expected to stay weak. Although President Funes targets a fiscal reform, the political environment is not overly supportive for passage of comprehensive reforms. Hence, the government continues to face substantial fiscal challenges and has hardly any room to stimulate the economy by higher spending. Ongoing tensions between President Funes and his FMLN pose the general risk of resulting in a lack of governability. More positively, the IMF announced an agreement on a three-year USD 800 million Stand-By Arrangement to help the country mitigate adverse effects of the crisis. Authorities plan to treat the new agreement as precautionary. On the back of comparably weak fundamentals and deteriorating fiscal dynamics, we remain cautious on El Salvadorian external debt and prefer to eventually increase exposure on a tactical basis only.

**Guatemala** proved to be one of the most resilient countries during the crisis, posting positive growth even in the year of 2009. According to recent data, the recovery is already underway, at a moderate pace though. Real GDP growth in 2010 is likely to stay below the average rate seen during the period ahead of the crisis. Improvement of business climate to attract foreign direct investment remains a major challenge. In line with the rest of countries in the region, public finances deteriorated during the crisis. However, the resulting fiscal deficit has already started to improve again in 2010. The rebound in economic activity lets tax revenues rise. Moody's recently raised the FC long-term rating of Guatemala by one notch to "Ba1", only one notch below "investment grade". Moody's cited the country's prudent and fiscal policies as major factors contributing to a stable macroeconomic environment. In turn, the agency also highlighted some remaining weaknesses, like challenges in raising taxes and substantial social and infrastructure needs. Currently, the tax collection ratio is around 10% of GDP, one of the lowest figures in Latin America. Hence, Guatemala was already advised by the International Monetary Fund to raise taxes. Public debt is well below 30% of GDP. In general, bonds of Guatemala continue to look attractive compared to regional peers.

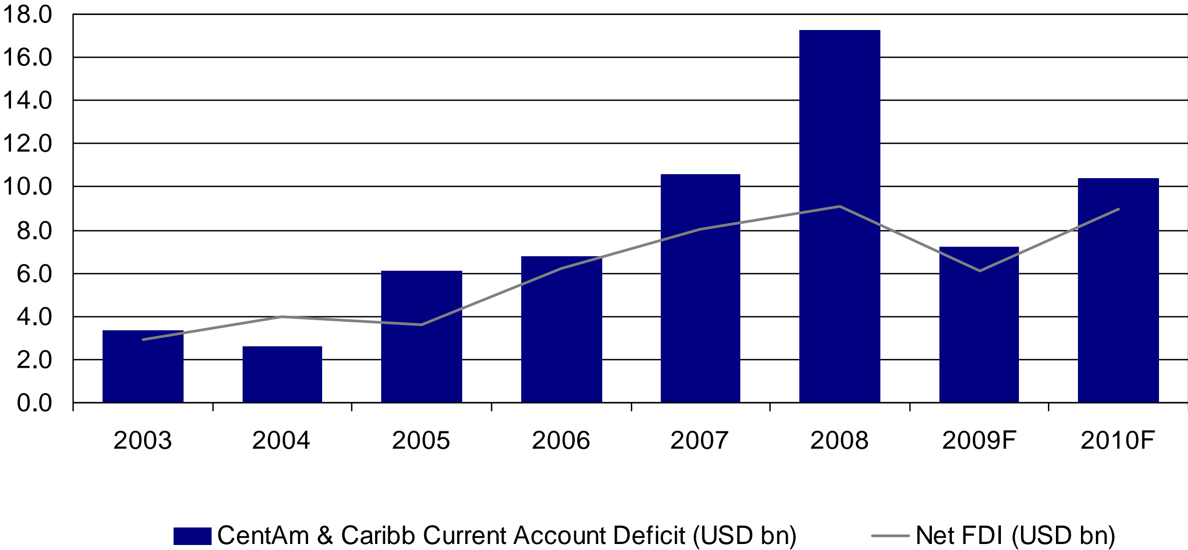
**Panama** was not fully insulted against the crisis but showed impressive resilience. Real GDP registered an expansion of 2.4% yoy, and growth was mostly driven by capital formation and net exports. In 2010/11 economic activity will largely take place in the area of public investment. The government starts its ambitious five-year investment plan and in addition, the construction of the third set of locks of the Panama Canal is due. Consumption is also expected to be strong this year, to a large degree because of immigration of upper middle class families. The second stage of the fiscal reform was approved by the National Assembly. The major tax adjustments include an increase in the sales tax rate on goods and services from 5% to 7% and a reduction of income tax rates for individuals and companies. Over the past few months, the three major rating agencies raised Panama's sovereign credit rating to invest-

ment-grade space. Based on the sound fundamental development of the country, we consider its bonds as core holding and aim at increasing exposure, most likely via new issues.

**Dominican Republic** really surprised on the upside last year. Positive performance in the telecommunications, agricultural and financial services prompted much better-than-expected GDP growth in 2009. Countercyclical monetary policies implemented by the Central Bank led to an increase in private sector credit. In addition, public spending was increased after the government had signed a Stand-By Arrangement (SBA) with the IMF in November 2009. Consequently, Q4 real GDP registered an expansion of 7.6%. Recent indicators also point to a fast recovery, to some degree due to Haitian reconstruction activity. USD paper of Dominican Republic is still attractively valued.

The global recession combined with political instability badly hurt **Nicaragua's** economic performance. The deceleration was broad-based, with construction, manufacturing, financial services and commerce being affected most. Although the economy touched bottom, the outlook for 2010 remains cloudy. Investment will likely continue to contract, as the difficult political situation and the lack of legal soundness bring 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. The last revision under the three-year Poverty Reduction and Growth Facility (PRGF) arrangement with the IMF was positive. The government shows willingness to follow IMF recommendations and to implement prudent economic policies.

**Chart: Attracting FDI flows necessary in order to finance current account deficits**



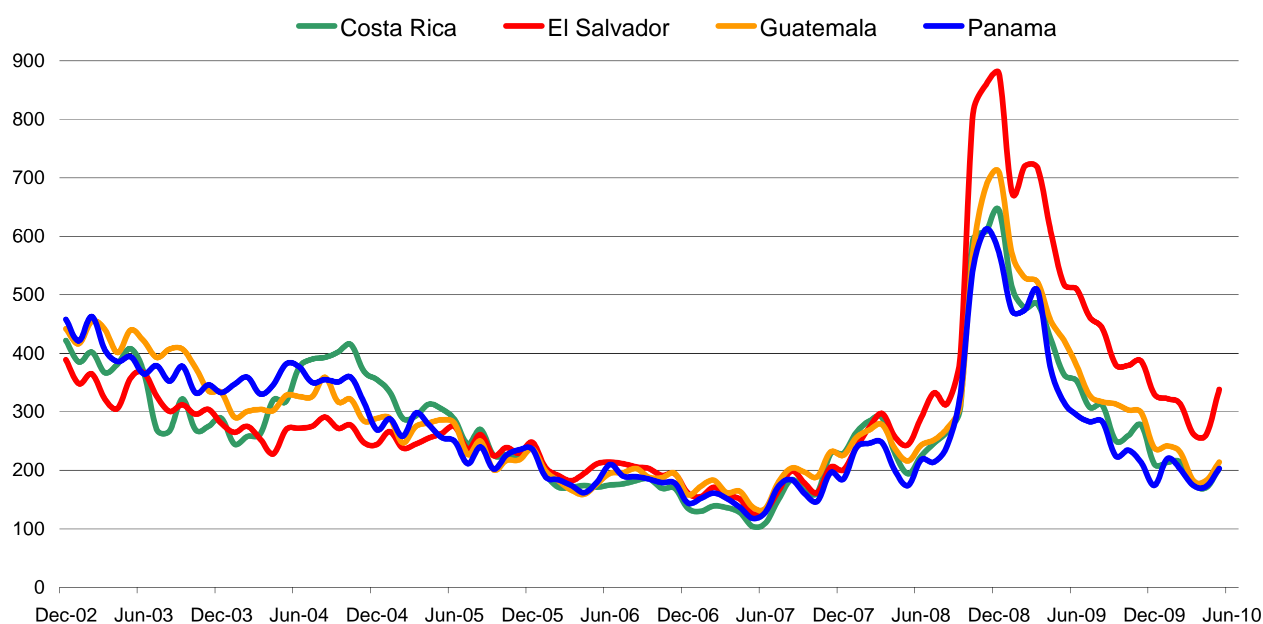

Sources: JP Morgan, DWS

**Sovereign spreads**

Global investors put increased focus on the asset class of "Emerging Markets fixed income". The interest is driven by both the sound economic development in a large number of coun-

tries and broad diversification across regions. In addition, many investors are in search of alternative opportunities amid latest developments in core European countries. Accordingly, emerging market bond funds continue to register significant inflows. The strong investor sentiment is reflected in significant spread tightening. Central American bonds also performed strongly over the past months. After the setback in May due to generally increased risk aversion on the back of developments in Greece, the “trend” resumed and spreads compressed further. Overall, in the second quarter of 2009 spreads of Costa Rica, Guatemala and Dominican Republic moved tighter while spreads of El Salvadoran paper increased and those of Panama stayed flat. Going forward, we generally expect spreads to continue compressing, as the general investor demand for emerging market bonds should support the asset class across the board. However, higher volatility and temporary setbacks cannot be ruled out given the situation in Europe. Over the next couple of months, the most solid names like Costa Rica, Panama and Guatemala will likely follow a steady trend towards spreads below 200 basis points. Lower-rated and higher-yielding credits like El Salvador and Dominican Republic, on the other hand, might be laggards but will nevertheless also see tighter spreads.

**Chart: Significant spread tightening**




Source: JP Morgan

**CABEI Central American Fund: Investment strategy**

Fund management’s focus on strategic positions in countries with sound economic fundamentals (Costa Rica, Guatemala, Panama) has paid off well so far in 2010. The fund nicely profited of Panamanian bonds’ good performance on the way to the country’s upgrade to “investment grade”. In addition, both local and international investors demonstrated significant interest in USD paper of Costa Rica and Guatemala. In El Salvador, overall exposure was kept unchanged but spread duration was extended by switching from 2011 bonds into 2035 paper. Amid Dominican Republic’s positive growth surprise in 2009, we took the opportunity to participate in the new bond issue maturing in 2021, thereby increasing total holdings

in the country. Fiscal challenges and significant debt issuance in 2010 let us take a cautious stance towards external debt of Colombia. After the rally in USD-bonds of Mexico bottomed out, we shifted from external debt into local debt of the country. Rates have been well supported since then, and the Mexican Peso also continues to bear substantial appreciation potential. 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).

Uncertainties regarding core European countries continue to drive global financial markets. It is not only debt problems of periphery countries that make investors follow a more cautious stance. In addition, broad-based fiscal consolidation programs across euro zone member countries dampen expectations about the future growth outlook in Europe. Fund management closely follows economic developments in Europe and the US and also monitors trends in global risk sentiment. Currently, we do not intend to add exposure in higher-yielding and comparably more volatile names like El Salvador or corporate issuers. However, when the dust settles, we will also take a closer look at these investment opportunities again.

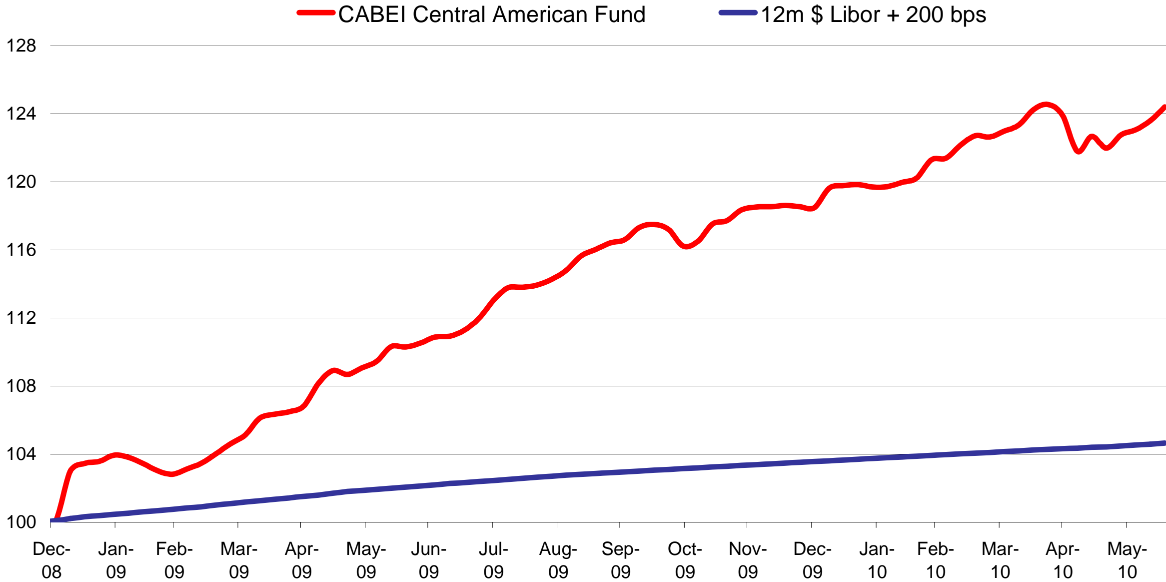
**CABEI Central American Fund: Performance**

| | 2010 year-to-date | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|
| **Performance** | 5.29% | 18.44% | -13.78% | 4.72% | 9.02% |

Sources: Bank of Ireland, DWS

As of 21 June 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 |
| 23/06/2010 | 23/06/2011 | 0.25% | 15% | 70% | 15% |

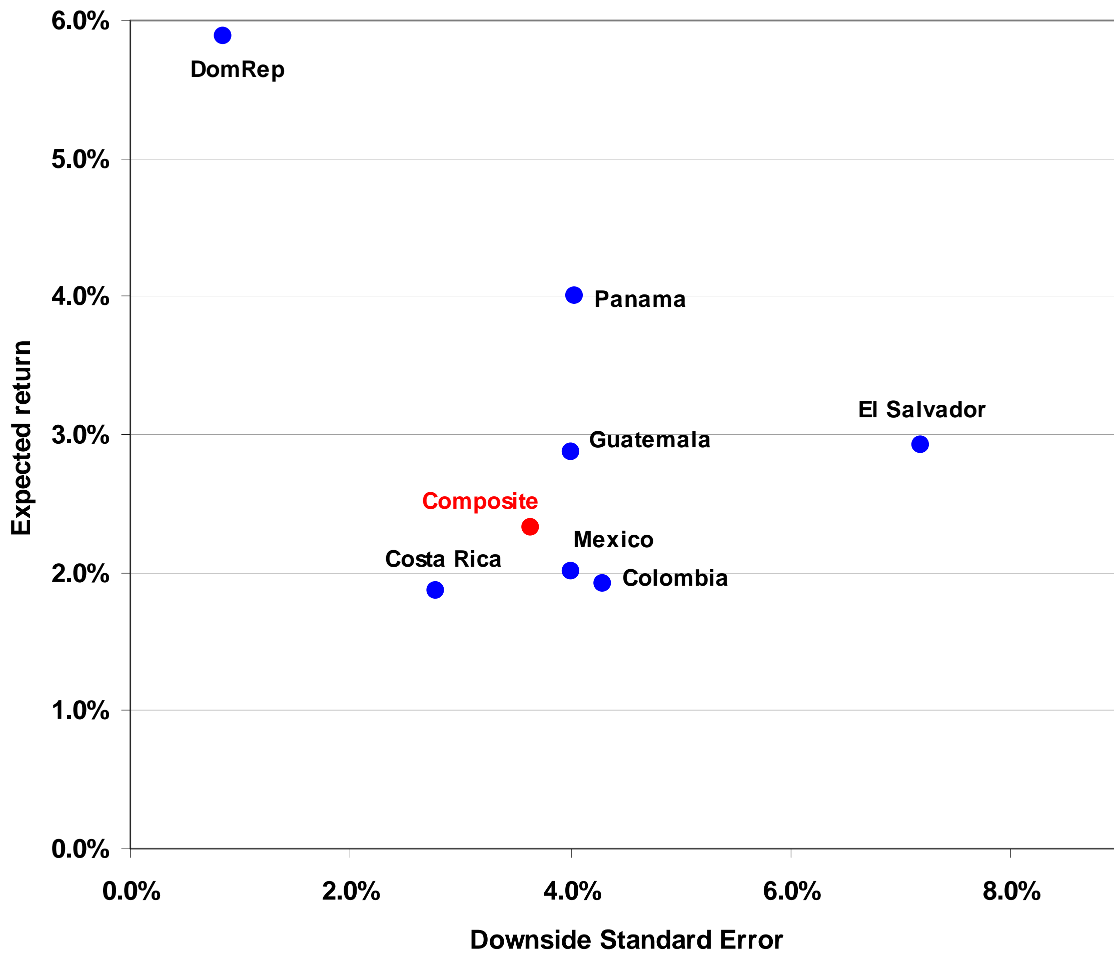
| Country | CACI Weight | Stripped Spread | Spread Forecast A | Spread Forecast B | Spread Forecast C | Expected Total Return A | Expected Total Return B | Expected Total Return C | DSSE |
|---|---|---|---|---|---|---|---|---|---|
| Belize | 0.3% | 854 bps | 900 bps | 1100 bps | 1700 bps | 7.5% | -5.7% | -45.2% | 18.3% |
| Colombia | 5.5% | 216 bps | 160 bps | 180 bps | 400 bps | 5.3% | 3.9% | -10.8% | 4.3% |
| **Costa Rica** | 19.0% | 210 bps | 150 bps | 160 bps | 450 bps | 3.7% | 3.4% | -6.9% | 2.8% |
| **Dominican Republic** | 1.0% | 555 bps | 410 bps | 490 bps | 700 bps | 10.0% | 6.7% | -1.9% | 0.8% |
| El Salvador | 42.0% | 335 bps | 230 bps | 290 bps | 600 bps | 10.5% | 5.8% | -18.3% | 7.2% |
| **Guatemala** | 15.5% | 225 bps | 150 bps | 170 bps | 450 bps | 6.1% | 5.0% | -10.1% | 4.0% |
| Mexico | 13.0% | 205 bps | 130 bps | 170 bps | 350 bps | 6.6% | 3.6% | -10.1% | 4.0% |
| **Panama** | 3.8% | 217 bps | 130 bps | 160 bps | 350 bps | 8.6% | 6.1% | -10.2% | 4.0% |
| **Composite** | **100.0%** | **270 bps** | **185 bps** | **224 bps** | **499 bps** | **5.6%** | **4.1%** | **-9.2%** | **3.6%** |

| Treasury Benchmark bonds | Yield at Start | Yield at Horizon | Modified Duration |
|---|---|---|---|
| **2yr UST** | 0.69% | 1.60% | 2.0 |
| **5yr UST** | 1.95% | 2.80% | 4.5 |
| **10yr UST** | 3.16% | 3.70% | 8.0 |
| **30yr UST** | 4.10% | 4.50% | 16.0 |



**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 4.3% on average. This will lower the positive return delivered by the running yield and expected spread tightening.




Belize was left out, as it has a high outcome for DSSE (13%) and negative expected return (-3%), which would distort the chart.

# Allocation Ranges

| Country | Index 05/20/10* | CABEI Fund 05/20/10 | Minimum** | Maximum** |
|---|---|---|---|---|
| Argentina*** | 0.00% | 0.00% | 0% | 5% |
| Belize | 0.25% | 0.00% | 0% | 5% |
| Colombia external | 5.50% | 0.00% | 0% | 10% |
| Colombia domestic | 0.00% | 0.00% | | |
| Costa Rica external | 19.00% | 20.54% | 15% | 30% |
| Costa Rica domestic | 0.00% | 4.13% | | |
| Dominican Republic*** | 1.00% | 5.32% | 0% | 10% |
| El Salvador | 42.00% | 25.33% | 15% | 40% |
| Guatemala | 15.50% | 20.88% | 10% | 30% |
| Mexico external | 13.00% | 3.47% | 5% | 15% |
| Mexico domestic | 0.00% | 5.01% | 0% | 10% |
| Nicaragua*** | 0.00% | 0.71% | 0% | 5% |
| Panama | 3.75% | 8.63% | 5% | 15% |
| Supranationals | 0.00% | 1.24% | | |
| Cash | 0.00% | 2.90% | | |
| Duration | 6.1 | 5.2 | 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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