Seeking Alpha$^{\alpha}$

Invest In Chile - Latin America's Hidden Investment Gem

Apr. 18, 2016 3:45 AM ET
by: Caiman Valores

Summary

- Chile is Latin America's most developed economy with low degrees of corruption and a high degree of bureaucratic transparency.
- Chile continues to record solid economic growth despite the collapse of commodity prices, in particular copper.
- Once commodity prices recover, its economy will resume growing rapidly with recent weakness offering a handy entry point for Chilean ETFs or ADRs.
- It offers investors considerable investment opportunities without taking on the risk inherent with investing in other emerging Latin American economies.

The sharp collapse in commodity prices and their sustained weakness continues to have a significant impact on the economies of a range of developed and emerging nations that are dependent upon the extraction and export of commodities as a key driver of economic growth.

One country that like its Latin American neighbors is suffering from the ongoing weakness in commodity prices is Chile. Nonetheless, despite the impact this is having on Chile's economic growth I believe that there are a range of reasons for investors to consider adding exposure to Chile to their portfolio.

Understanding Chile's economic development

It wasn't that long ago that Chile was synonymous with terms such as banana republic, military juntas, oppression, torture, narco-trafficking, coups, chronic inflation and protectionism. Then by the late 1980s all of that started to change.

A group of Chilean economists worked to liberalize the economy, privatize stated-owned enterprises and stabilize the economy. Then in 1990, the military junta led by Augusto Pinochet was removed from power and replaced by a liberal democratic elected government.

It was at this point that Chile's economic miracle really took off, with the country recording a GDP growth rate of 8% in 1991 and then 12.3% in 1992, and more importantly this rapid rate of economic growth continues for the next two decades.

In fact, between 1987 and 2015 Chile's GDP grew at an average of 5.2% annually, which is an impressive rate of economic growth and even lately Chile's economy has shown itself to be resilient to the sharp slump in commodity prices.

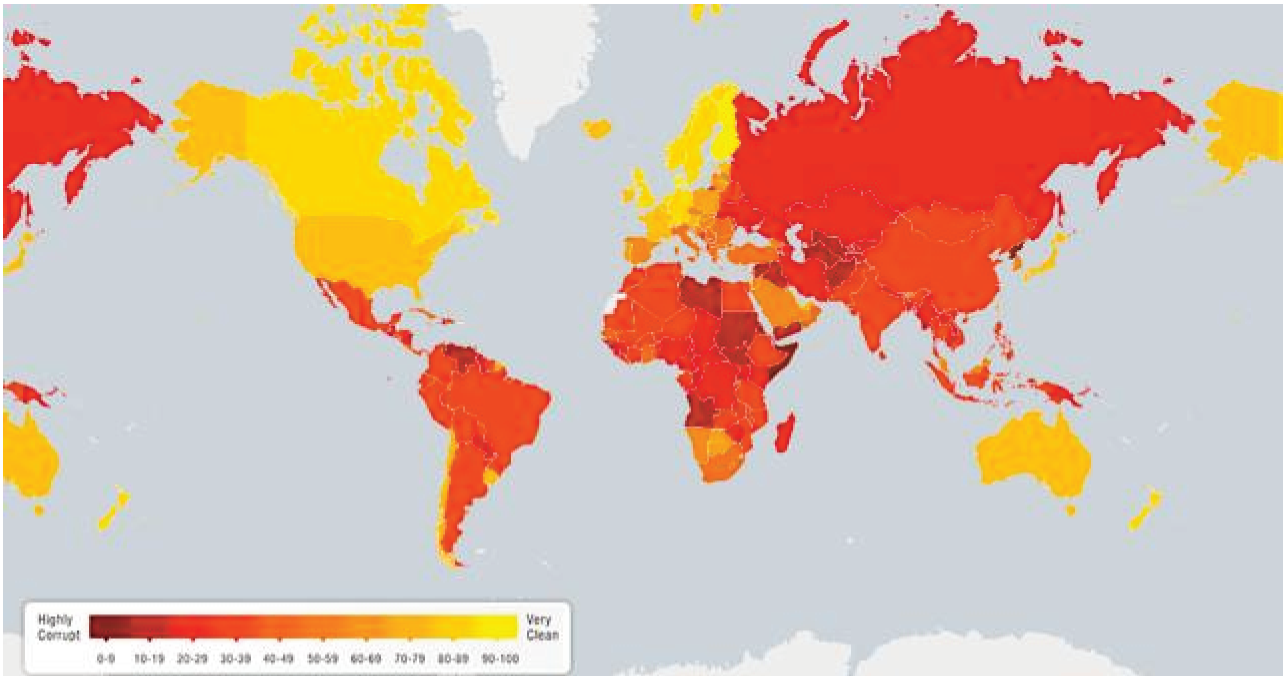
This is despite the extraction and export of commodities to China, particularly copper being an important driver of economic growth. And in part this can be attributed to the degree of diversification coupled with it having a low degree of corruption coupled with open and accessible markets.

Understanding the level of risk of investing in Chile

One of the hallmarks of an advanced economy is a low level of corruption coupled with a high degree of regulatory transparency and economic freedom. Chile in these respects is in a league of its own in Latin America.

Transparency International in its 2015 Corruption Perception Index ranked Chile 23 rd globally, placing it ahead of all of its Latin American neighbors except for Uruguay which ranked 21st.

As a matter of fact, at 23rd it is only seven places behind the U.S. and this ranking places it in the same territory as some of the world's most advanced economies, as you can see from the map.



Source: Transparency International.

Such a high ranking illustrates the advanced nature of Chile's economy, the lack of corruption, and the high degree of transparency in its legal, bureaucratic and regulatory infrastructure.

More importantly, in Heritage's 2016 Index of Economic Freedom Chile rated seventh, putting it in the top 10 countries globally, ahead of Ireland but behind Canada. This also saw it rank well ahead of its Latin American neighbors and even the U.S. which came in at 11th.

Heritage's index essentially measures the strength of the rule of law, regulatory efficiency and market openness, which are the hallmarks of a society where the government promotes a mutual sense of liberty for all.

In conjunction with the Transparency International ranking it also highlights just how easy it is to do business in Chile and the openness of its markets.

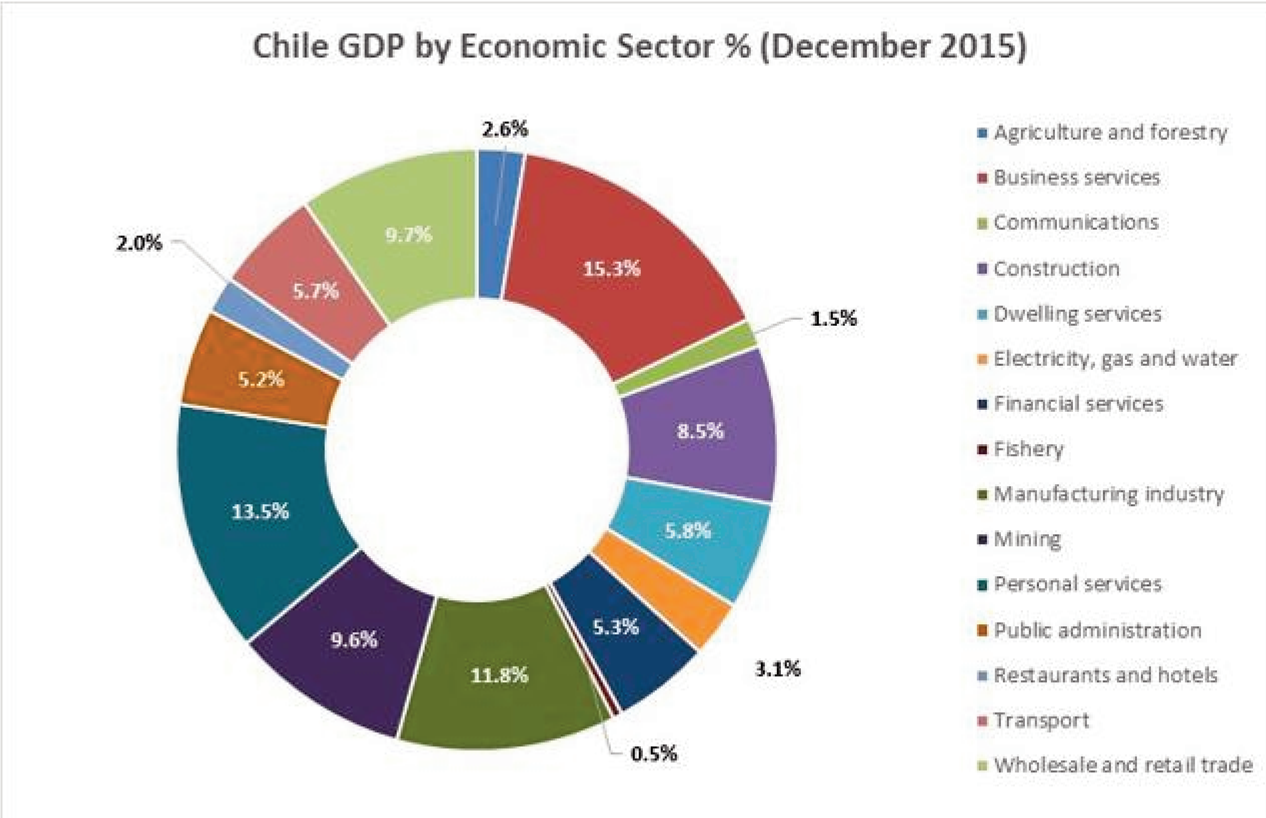
These are important attributes that an investor needs to consider before investing in any emerging market and they indicate that Chile is fast approaching the point where it is not an emerging market but is capable of transitioning to being a developed economy.

Economic outlook remains upbeat

The sharp slump in commodities is playing havoc with a range of developed and emerging economies that are dependent upon the extraction and export of commodities as a driver of economic growth. This is no different for Chile, with copper being its top export with refined copper making up 27% of the value of its total exports in 2015, this was then followed by copper and other ores making up 25% then by fruit, fish and wood pulp.

Exports accounted for 15% of Chile's total economic output in 2015 and this in conjunction with its primary export partner being China, followed by the U.S. and Japan, illustrates just how vulnerable its economy is to a slowdown in China.

Despite this vulnerability, Chile's economy has demonstrated considerable resilience to weaker commodity prices, with it growing by 2.1% in 2015, which was a 30 bps improvement compared to 2014. This can be attributed to the diversified nature of Chile's economy with mining only making up 9% of its GDP, with the majority of economic growth being generated by the burgeoning services sector.

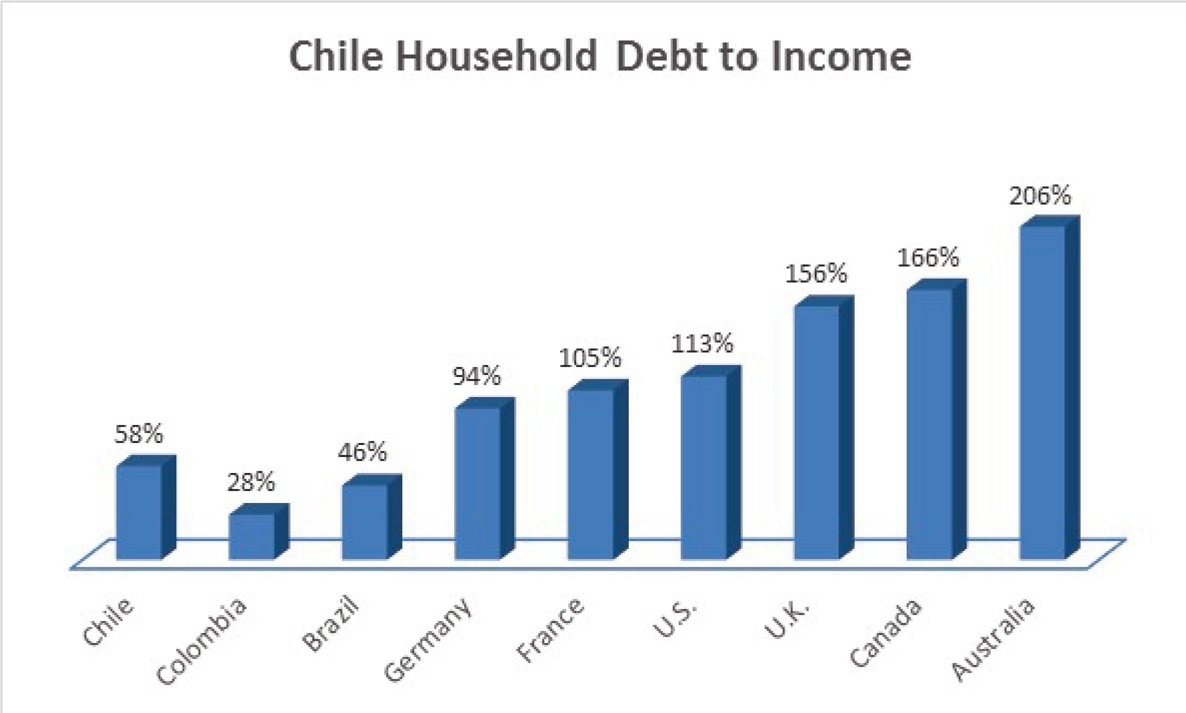


Source: Banco Central de Chile.

As the graphic highlights the services sector is responsible for generating around a third of Chile's GDP and it is growing rapidly, with its share of GDP having increased by almost 5% since the end of 2010. Whereas, the contribution of mining continues to decline with its contribution to GDP having fallen from 17% in 2010 to only be 9% at the end of 2015.

This in part can be attributed to the sharp drop in commodity and in particular copper prices but is also evidence of the growing maturity of Chile's economy. I would expect this solid growth in the services sector to continue with Chile's middle-class growing rapidly in size and demanding a greater range of products and services for consumption.

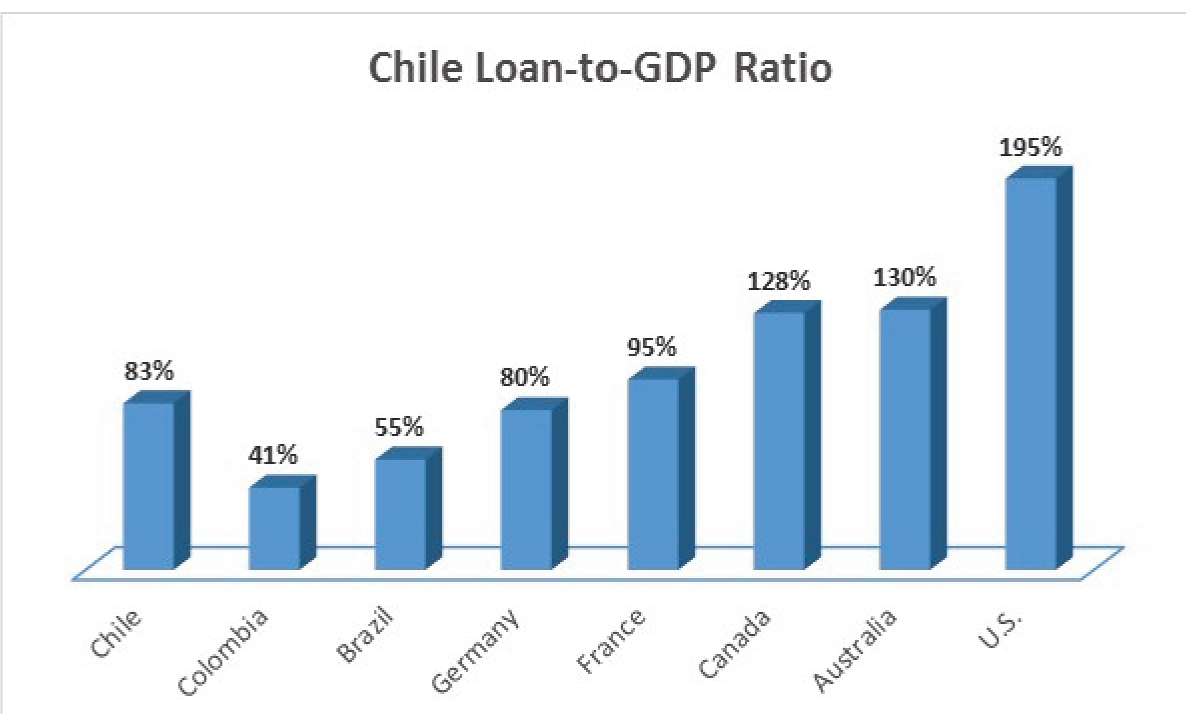
It is this that helping to underpin economic growth and transition the economy away from being overly dependent on mining. There is also considerable opportunity for this growth to continue with Chile's households having a modest debt to income ratio of 58%, well below the majority of developed economies.



Source: OECD.

This can be attributed to Chile's economy being under banked despite its advanced stage of development. It is estimated that only 63% of the population has a bank account and that a mere 31% have a credit card.

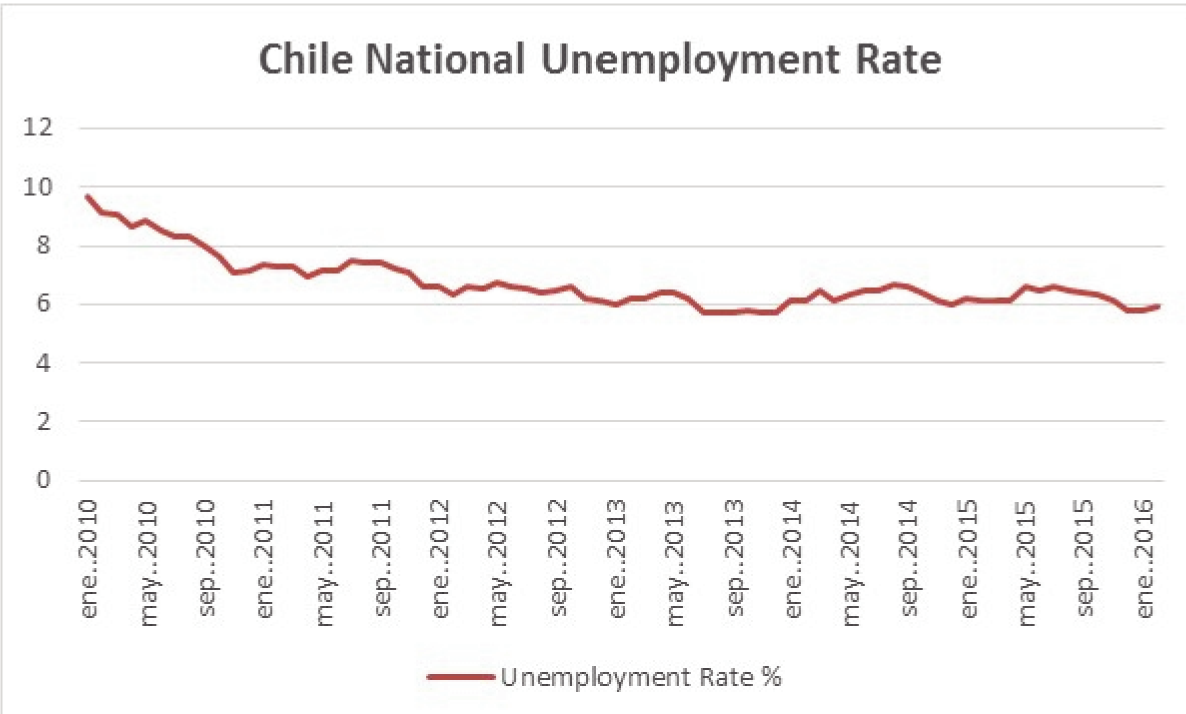
The under banked nature of Chile's economy becomes even more apparent when comparing the country's debt to GDP ratio with other developed economies such as the U.S., Canada and Australia.



Source: World Bank.

Both of these factors indicate that there is plenty of room for consumption to grow as Chile's economy continues to expand and this will be a boon for the services sector. It will also further reduce the country's reliance upon mining and the export of copper as important drivers of economic growth.

Surprisingly, the protracted downturn in commodities has yet to have a sharp impact on employment and wages. For February 2016, the unemployment rate inched higher by 10 bps month-over-month to 5.9% but impressively this represents a 30 bps fall year-over-year.



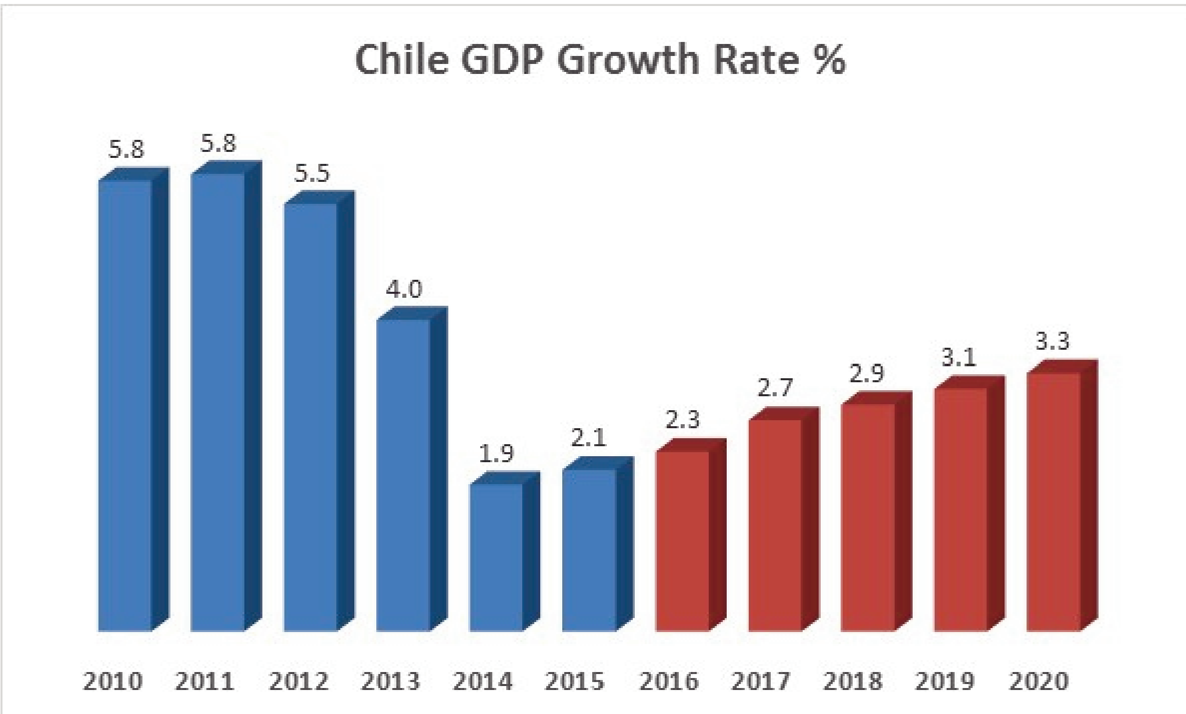
Source: Banco Central de Chile.

Wages have also continued to grow with the general wage index up by 5.5% year-over-year as the chart illustrates.

Source: Banco Central de Chile.

This will help to sustain the ongoing expansion of the services sector and domestic consumption, thereby offsetting the impact of the protracted slump in commodities.

Each of these factors will certainly help Chile's economy to keep growing and it is expected that a general economic recovery will start in 2016 and continue to gain momentum through to 2020. These will see Chile's GDP grow by 2.3% this year with it continuing to increase to 3.3% by 2020 as the chart highlights.



Source: Banco Central de Chile, BBVA, IMF, OECD, World Bank.

**All columns in red are estimations and forecasts only based upon the outlook for Chile's economy.*

Key to any broad-based economic recovery is the price of copper. Goldman Sachs believe that copper is caught in a protracted bear-market and this will last until 2018, when prices will start to recover with a sustained rally expected in 2020. This pessimistic view comes from concerns over China, its slowing rate of economic growth and its transition away from investment led growth to domestic consumption, with it being the world's largest consumer of the metal.

Clearly, with copper being Chile's key export any recovery in its price will help to drive economic performance even higher but because of the pessimistic outlook I have not accounted for this when estimating its economic growth between now and 2020.

Inflation also remains a challenge with the sharp collapse of the Chilean peso which is down by 8% against the U.S. dollar over the last year but there are signs that inflation is cooling with the March 2016 inflation rate at 4.5% or a 20 bps decrease compared to February. This is certainly a positive aspect for investors with Chile not suffering from the same runaway inflation that many other Latin American countries that are dependent on the export of commodities suffered from due to a sharp devaluation of their currencies as commodity prices fell.

An example of this is South America's fourth largest producer of crude Colombia, which saw its currency plunge by 17% over the same period because of the collapse in commodities. This caused inflation to spike to 8% for March 2016, or a 30 bps increase compared to February.

How to invest in Chile

The easiest way to invest in Chile is through the only ETF available the iShares MSCI Chile Capped ETF (NYSEARCA:ECH), which is down by almost 13% over the last year. Its top 10 holdings reflect a broad cross section of the Chilean economy with its largest holdings being utilities along with considerable exposure to the rapidly growing services sector through Banco Santander Chile (NYSE:BSAC) and Chile's largest retailer Falabella.

Top Ten Holdings

1. Enersis Americas SA	ENERSIS 10.30%
2. Empresa Nacional de Electricidad SA	ENDESA 8.58%
3. Empresas COPEC SA	COPEC 8.19%
4. SACI Falabella	FALABELLA 6.33%
5. Banco Santander Chile	BSANTANDER 5.96%
6. Empresas CMPC SA	CMPC 5.10%
7. Cencosud SA	CENCOSUD 4.80%
8. Colbun SA	COLBUN 4.48%
9. LATAM Airlines Group SA	LAN 4.31%
10. Soc Quimica Y Minera Chile B Common Stock Npv	4.08%

Source: ETFdb.com

It also has very little exposure to the troubled mining sector with exposure of only 6% to basic materials. The broad composition of ECH's holdings will see the ETF bounce quite solidly as Chile's economy improves and its currency also strengthens against the U.S. dollar.

Another way to gain broad-based exposure to Chile's economy is to invest in one of the country's major banks with Banco Santander Chile the largest bank by assets representing the best opportunity. It is well positioned to take advantage of increased demand for credit as Chile's economy recovers, while the low level of penetration of banking and financial services will help to drive organic growth.

The bank also possesses a solid balance sheet and is currently undervalued by the market with fears over the direction of copper prices causing it to be irrationally valued. For further information and a detailed analysis of Banco Santander Chile see my latest article " Banco Santander Chile: Unloved Because Of Its Association With The Santander Stable And Chile".

There are a range of other opportunities available with the full list of NYSE listed ADRs below.

Company	Ticker		Industry
Banco de Chile	(NYSE:BCH)	Banks	
Banco Santander Chile		Banks	
Cencosud	(NYSE:CNCO)	Food &Drug Retailers	
Compania Cervecerias Unidas	(NYSE:CCU)	Beverages	
Itau CorpBanca	(NYSE:ITCB)	Banks	
Embotelladora Andina - A Shares	(NYSE:AKO.B)	Beverages	
Embotelladora Andina - B Shares	(NYSE:AKO.A)	Beverages	
Endesa-Empresa Nacional de Electricidad	(NYSE:EOC)	Electricity	
Enersis	(NYSE:ENI)	Electricity	
Latam Airlines Group	(NYSE:LFL)	Travel & Leisure	
Soc. Quimica y Minera de Chile - B Shares	(NYSE:SQM)	Chemicals	
Vina Concha y Toro	(NYSE:VCO)	Beverages	

Final thoughts

Chile's economic story has been nothing short of miraculous and the country certainly stands out as being one of the best locations for investors in Latin America. Its solid rate of economic growth, strong growth prospects, low levels of corruption and high level of economic freedom, make it equivalent to investing in a developed economy. This sees it providing investors with the ability to access impressive rates of economic growth that have exceeded developed countries and will continue to do so in the future once the copper price rebounds.