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POLAR CAPITAL

Companies not politicians are shining the light at the end of the LatAm tunnel

We recently took a 10-day research trip meeting with companies, economists, policymakers and, perhaps most importantly, local consumers of the products/companies we invest in across Mexico City, Buenos Aires and São Paulo.

Reflecting on this, a mixture of contrasting thoughts and emotions come to mind, perhaps reflective of the contrasting macro and micro narratives of the time. We saw the juxtaposition of some truly excellent companies with seemingly unavoidable macroeconomic and political risks.

Perhaps better put, the glass is half full in terms of finding long-term investment opportunities, but half empty in terms of a lack of near-term positive catalysts for the broader markets, dictated as they are by negative macro news, to rerate in the foreseeable future.

That said, history has shown the fortunes of Latin American economies and markets can change very quickly. Although perhaps tricky to imagine now, should Mexico succeed in placating Trump, avoiding overly harmful tariffs and revising the USMCA (US-Mexico-Canada Agreement) agreement with favourable terms, the country's investment case could look very different in a few months' time.

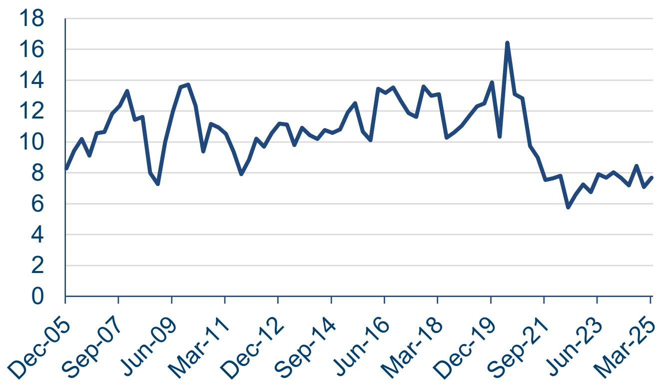
Similarly, Brazil is a high-beta market that is by nature very sensitive to global liquidity conditions. Should the global economic backdrop improve, with the Fed showing credible signs of keeping inflation in check, bringing the prospect of further rate cuts back on the table, a weaker US dollar would be a particularly strong tailwind for the local market. If this were to combine with improving prospects of a credible challenger to President Lula (Luiz Inácio Lula da Silva) in 2026, the local market could very well be off to the races. In the words of BTG Pactual's CEO, should São Paulo State Governor Tarcísio de Freitas win in 2026, we will see "the mother of all rallies" in Brazil.

Indeed, given just how cheap the Brazilian and Mexican markets currently are, it would not take much positive news for the markets to rally, as shown by how quickly the Brazilian markets move when data on Lula's declining approval ratings is published.

The MSCI Brazil and MSCI Mexico indices, at 7x and 11x P/E respectively, are both currently trading more than one standard deviation below their long-term average P/E multiples (10x and 14x respectively).

MSCI Brazil

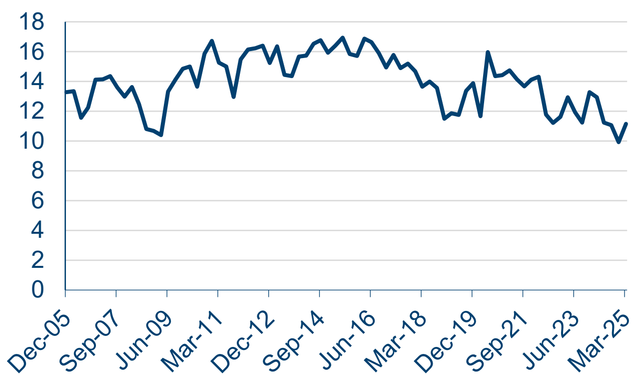
Only twice in the past 20 years (in 2008-09 and 2022) has the Brazilian market been more discounted than it is currently, on P/E multiples



Source: Bloomberg, 17 March 2025.

MSCI Mexico

Only once in the past 20 years (in 2008-09) has the Mexican market been more discounted than it is currently, on P/E multiples



Source: Bloomberg, 17 March 2025.

Polar Capital LLP 16 Palace Street, London, SW1E 5JD
T +44 (0)20 7227 2700 E investor-relations@polarcapitalfunds.com polarcapitalfunds.com
For further information please contact your Polar Capital representative

Mexico

Great quality companies, dominated in the short term by Donald Trump's tariff policy

As is unfortunately the case all too often with investing in Latin America, top-down macroeconomic/political developments trump (pun very much intended) bottom-up fundamentals. One thing that was clearly notable in almost all my conversations with company management was Trump's tariffs and his rhetoric on tariffs will continue to drive investor sentiment and the local market's fortunes.

Tariffs themselves would likely plunge the Mexican economy into recession and given Trump's 'will I/won't I?' approach, business and consumer sentiment has taken a substantial hit. At the time of writing, it is still unclear what form (if at all) the tariffs will take, or whether the US/Mexican administration will reach a compromise in the final hour of negotiations (in true *Art of the Deal* style[1]).

To gain greater comfort on Mexico's investment case from a top-down perspective, we need to see some resolution to this tariff drama and progress towards a renegotiation of the USMCA, expected towards the end of this year. So far the new Mexican government has shown a very pragmatic stance towards dealing with Trump and a willingness to engage and concede to his demands (sending more troops to the border; extraditing high profile 'narco' drug lords; slapping tariffs on Chinese goods that pass through Mexico to the US etc).

Source: Own photo; Mike Pompeo (Trump's former Secretary of State and CIA Director) discussing the world outlook under 'Trump 2.0'. He stressed to the audience that tariffs were simply a negotiating tactic for Trump against Mexico (only time will tell if he is right and tariffs are indeed more bark than bite, February 2025).

That said, as bottom-up stock pickers, it is almost impossible to deny that Mexico is home to some extremely compelling structural growth stories.

One highlight is the hard discount operator Tiendas 3B (BBB Foods). A combination of excellent management, a first-mover advantage, a beautifully simple business model and an extremely low penetration of the hard discount format within Mexican grocery retail, create what we believe to be a very promising runway of growth for the business.

It is also worth stressing that, should the worst case Trump tariff scenario materialise, and the Mexican economy experiences a significant growth hit, the hard discount format is by its very nature counter-cyclical. As consumers 'trade down' to the cheapest prices on the high street, they typically shop more frequently at hard discount stores.

We have observed and admired the fortunes of hard discount peer BIM in Turkey (the model which Tiendas 3B was originally inspired by), and we believe it should see a similar growth path in Mexico.

Another key micro-level insight was that our meetings with public and private financial companies in Mexico helped strengthen our conviction that both MercadoLibre and Nubank will ultimately be successful in exporting their business models to other geographies across Latin America. Both have been doubling down on the Mexico opportunity, making this market a key area of focus. In our view, the under-penetration of financial services in the country represents a 'blue ocean' of growth potential and a phenomenal opportunity for these companies to play significant roles in the financial inclusion of the unbanked population. According to the World Bank, only half the adult Mexican population currently has a bank account.

Withdrawal symptoms

Latin America is making progress on banking the unbanked

Source: World Bank; The Economist, 20 November 2024.

Whenever we travel to the region, we try to corroborate the speech of company management with the views and behaviour of locals on the ground. For example, during our visit to the Tiendas 3B store, we engaged in conversation with several shoppers and asked what brings them so frequently to the store and how the assortment/price offering compares to other supermarkets in the neighbourhood. Similarly, when we met with locals who had recently opened a Nubank account (and received their first ever credit card), we asked what brought them to Nubank rather than others and how they would rate the service so far. These, more informal 'boots on the ground', insights can be extremely valuable when shaping our analysis of a company's competitive moats and growth prospects.

1. Authored by Donald Trump; first published in 1987.

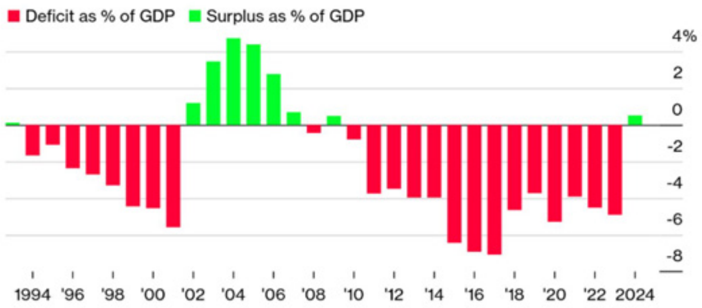
Argentina

President Javier Milei has surprised everyone in his first year, though a tougher second year beckons

Milei has had a formidable start to his administration, defying all expectations with his ability to achieve the country's first fiscal surplus in 14 years and slash inflation. However, he goes into year two of his term with a much more tricky setup and several stars that will have to align to avoid stalling in momentum – (1) avoiding further fallout from the recent 'crypto gate' scandal; (2) securing an IMF deal, crucial to allow for capital restrictions to be lifted; and (3) holding a majority in the parliamentary elections in October. Any one of these obstacles could damage Milei's momentum, political capital and thus his ability to achieve further structural reforms.

Argentina first budget surplus in 14 years

Argentina posts first annual budget surplus since 2009



Source: Bloomberg, 17 January 2025.

Inflation has fallen rapidly

Source: BTG Pactual, January 2025.

Although the opposition's calls for impeachment following 'crypto gate' are not likely to materialise, it is undeniable that a degree of the shine has been taken off Milei's until-now stellar momentum from his first year.

In the astute words of our taxi driver from Buenos Aires airport, this scandal more than anything has shown Milei's susceptibility to politically costly scandals. Even if he ultimately emerges unscathed from this one, it serves as a reminder of how scandal-prone he is, and the opposition will certainly feel emboldened going into October's crucial mid-term elections.

Brazil

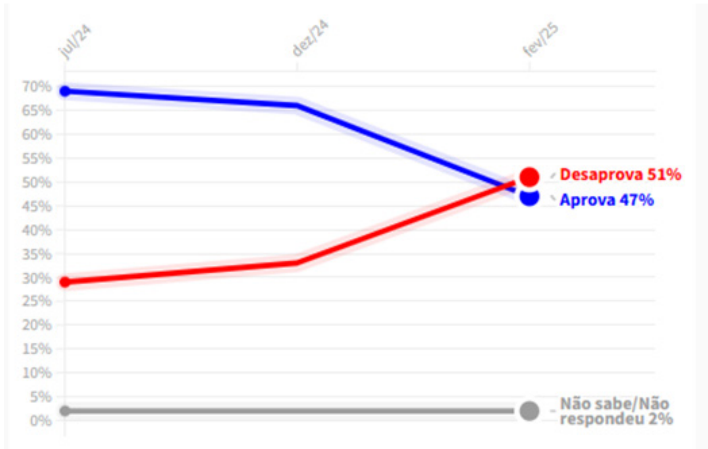
Business confidence will rise if next year's election brings meaningful change

To sum up our key reflection on Brazil's investment climate in one sentence – things are looking bleak as long as President Lula holds power. Local investors have seemingly capitulated given ongoing outflows/fund closures, the fiscal situation looks the most precarious in years, inflation and inflation expectations continue to rise, and Lula, faced with unprecedented low approval ratings, looks set to pump fiscal spending even further in the months ahead.

While it is far too early to make any predictions or investment decisions in anticipation of an election outcome in October 2026, the latest data on Lula's approval/disapproval ratings could potentially offer some hope, however distant, of regime change. His disapproval rating (desaprova) is growing strongly, even in his traditional stronghold states in the north of Brazil such as Bahia and Pernambuco, as a result of a deteriorating economy and rising inflation.

Approval of Lula's government in Bahia

Disapproval of Lula's government grows in BA and PE and exceeds 60% in 6 states | CNN Brasil



Source: CNN Brazil, 26 February 2025

The next few months will be crucial to see how Lula reacts to being backed into a corner – he has typically resorted to even more fiscal irresponsibility – and whether a credible opposition candidate can build their campaign over the course of this year and next. Key opposition candidates to watch include Tarcísio and former president Jair Bolsonaro.

As its neighbour to the south Argentina has shown, when politics in South America shifts from the far left to the far right, it often leads to a more business/market-friendly climate. With everything else looking pretty bleak in Brazil on the macro front, this potential shift seems to be a glimmer of light at the end of the tunnel.

At the company level, we would highlight what we see as compelling bottom-up investment cases for the long term, namely Nubank, VTEX and MercadoLibre, the latter an Argentinian company but with the majority of its growth coming from Brazil. Indeed, looking out on a 3-5-year time horizon, we believe these companies will see a significantly positive EVA delta, with strong earnings growth and positive margin and ROIC inflections. They have time-tested business models and management teams that have shown themselves capable of allocating capital through turbulent times and emerging stronger, with greater market share. We have faith that they will successfully navigate their companies through the turbulence and emerge stronger than ever.

In the words of BlackRock's Latin America Strategist, despite the macro challenges "there is no ignoring the value being created by Brazilian companies."[2]

Conclusion

Looking back at everything we learned on our trip, we will put our necks out and say that it is the companies themselves that offer the most hope against a troubling macro backdrop (Tiendas 3B in Mexico, Nubank and VTEX in Brazil, MercadoLibre in Argentina).

Being long-term, bottom-up stock-pickers, this is arguably a favourable scenario for us, having found or strengthened our theses on compelling long-term-minded businesses, currently trading at extremely discounted valuations. Our portfolio holdings include management teams with proven ability to withstand and even grow stronger through the volatility so inherent in these markets.

Meeting both companies and consumers of their products on the ground is a refreshing perspective needed to maintain a balanced, patient and thoughtful long-term approach to investing. For example, we spoke to companies in Brazil who had just switched to VTEX's software solution from US-based peers; we spoke to local Mexicans who had received their first ever credit card from Nubank and others who were convinced that doing their daily shop for everyday essentials at Tiendas 3B was the best value-for-money option available for them; we spoke to locals in Brazil who continue to increase their shopping frequency/loyalty on MercadoLibre despite the arrival of cheaper substitute goods from Chinese cross-border players.

Although the day-to-day volatility of investing in Latin America can be daunting at times, we very much believe that a focus on fantastically run, high-quality businesses, offering exceptional products to their users, with enduring moats and management teams focused on long-term capital allocation, will ultimately be rewarded.

Jasper Wright, Fund Manager

Polar Capital Emerging Markets & Asia Team

26 March 2025

2. Brazil Journal: BlackRock sees divergence between emerging markets and value in Brazil (BlackRock vê divergência entre os emergentes e valor no Brasil - Brazil Journal).

Contact Us

London
16 Palace Street
London
SW1E 5JD

E investor-relations@polarcapitalfunds.com
W polarcapitalfunds.com
T +44 (0) 20 7227 2700
F +44 (0) 20 7227 2799

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