

Research @ Citi Podcast, Episode 41: Riding the Rotation — Latin America's Untapped Potential

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Host: Robert Rowe, U.S. Regional Director of Research, Citi

Guest: Andre Mazini, Director of Latin America Equity Research, Citi

Transcript:

Andre Mazini (00:00)

This year, foreigners have been net buyers of Brazilian equities to the tune of 24 billion reais, local currency, year-to-date and with 45% of this taking place from May onwards. So, it looks like at the margin, indeed, Brazil and other places in the region are being beneficiaries of the rotation trade.

Robert Rowe (00:16)

Hi, everyone. I'm Rob Rowe, U.S. Regional Director of Research at Citi. Welcome to the Research @ Citi podcast. With me on the podcast today is Andre Mazini, who is the head of our LATAM Equity research effort.

And this is a really timely podcast because we're also having our Citi Brazil Equity Conference that starts tomorrow, it's going to be covering the LATAM region as well. And so it's a timely time, Andre, to talk about LATAM markets. Welcome.

Andre Mazini (00:46)

Thanks, Rob. I'm very excited to be here, excited for the conference starting tomorrow as well. Two days. We have 100 strong companies attending and a lot of investors as well, so good to be here with you.

Robert Rowe (00:56)

I got waylaid again, but I wish I could be down there. Let's talk. When we talk about LATAM markets, they've always had a certain intrigue, for potentially high returns but also potential high volatility. And often seen for having diversification benefits as well.

But why don't we talk a little bit about the stock markets in the region and how they compare in terms of valuations with one another, today and vs. their historical averages?

Andre Mazini (01:24)

Yes, sure, Rob. Perfect. So, stock markets in the region have performed pretty well this year, with the Chile and Colombian indices up 21% year to date, Mexico up 17% and Brazil up 14%. This is in local currencies.

The performances are actually significantly better in U.S. dollar terms as most local currencies have appreciated in value this year. So, in USD terms, the EWZ — which is the local market — that's up 24% for Brazil. The Brazilian index, the Ibovespa, it trades at 8.3x forward P/E; that compares to 12x for Chile and Mexico, 13x for China, while India, the U.S., and the UK all trade above 20x.

So, we acknowledge Brazil's equilibrium. Interest rates are higher than most other geographies, which could justify this lower P/E. However, Brazilian companies are delivering nice earnings momentum. The results have been great for the first quarter. And the companies as a group, they are deleveraged as well, different than in prior cycles. So, this could justify some multiples expansion.

So, as we said, the 8.2x Brazil trades, it's one standard deviation below the 10-year historical average, and most of the regions are actually trading above their historical averages. The U.S., for instance, is trading at the 22x we mentioned, this compares to a 19x historical average — 10-year average for the U.S.

Robert Rowe (02:50)

Will policy rates in Brazil also provide a fillip going forward or provide some help on those returns going forward? Is the central bank essentially in a monetary-easing mode?

Andrew Mazini (03:01)

Good question, Rob. Actually, the Central Bank of Brazil, in let's call it post-COVID times, there were kind of contrarian outcomes here in the sense that when the world was easing rates, the Central Bank of Brazil would be tightening rates and the other way around.

So the Central Bank of Brazil actually just hiked rates for what seems to be the last time just last week. Nominal rates right now are at 15%, which is pretty high even compared to Brazil's historicals.

But the central bank, they were very clear, giving forward guidance that they're not going to be hiking anymore. They're just going to be leaving rates at 15% for some time. You know, economists are debating for how long that will be. Some economists

think it's end of this year. You might have some cuts or beginning next year, but there's no more hiking going on. This is what the forward guidance is saying, and then some cutting, be it end of this year or beginning of next year, which could be a catalyst when and if the central bank starts cutting.

Robert Rowe (04:04)

Now, as you said previously, Andre, the returns in a lot of these markets have been really good. What would you say are the main drivers of the global rotation trade, let's call it?

Andrew Mazini (04:19)

Yeah, sure.

So, first of all, the region compared with global indices is kind of on the smaller side. The U.S., as an example, accounts for 70% of most global benchmark indices. Brazil, which is the biggest market in the region, represents just 4% of the MSCI Emerging Markets Index, with other LATAM countries accounting for even less than that. So, any small change to U.S. allocation by global investors can really move the needle for a market like Brazil.

Furthermore, we think LATAM has less geopolitical issues than a couple of other emerging markets. For instance, with China the trade war with the U.S. is probably going to be long-lasting. India is a rather expensive market, and also has geopolitical tensions with Pakistan. And it trades at 20x earnings in India, right? So, another ballpark there in terms of valuations. Russia is out of the radar of various investors. So, all this combined, this mosaic may make the region a beneficiary of this global rotation trade you just mentioned.

And lastly, on this theme, we've seen it actually, at least in Brazil. This year, foreigners have been net buyers of Brazilian equities to the tune of 24 billion reais, local currency, year-to-date and with 45% of this taking place from May onwards. So, it looks like at the margin, indeed, Brazil and other places in the region are being beneficiaries of the rotation trade.

Robert Rowe (05:42)

Do you think that will continue? Is that dependent upon things like how the tariff negotiations go on, or do you think that the region has its own legs in terms of potential market returns?

Andrew Mazini (05:56)

Yeah, for sure — certainty tariffs would definitely be something that may make this rotation trade. Maybe talking about the trade deals that the region has; of course, the USMCA is in place for most goods, with the exception of cars, steel and aluminum, and now I'm talking only about North America, of course: Mexico, Canada and the U.S. So, cars exported from Mexico into the U.S. are being hit with a 25% tariff on their non-U.S. content. But we estimate that the average Mexican car actually has 40% U.S. parts. So, the ultimate tariff hitting these cars is around 15%, not the 25% we mentioned.

And the U.S. Commerce Department actually has a portal, pretty neat, in which investors can see car by car, what's the U.S. vs. non-U.S. content of each Mexican car.

Robert Rowe (06:43)

Wow.

Andre Mazini (06:44)

And it's sometimes counterintuitive. For instance, the U.S. content of a Mexican-produced Nissan Pathfinder is 50%, and a Ford F-150 has just 45%. Both produced in Mexico, but the F-150 having less U.S. content. So, you know, sometimes it's counterintuitive.

Robert Rowe (07:02)

Right. And I do want to cover Mexico in a sec, but I also want to think a little more about LATAM markets from the standpoint of which countries, in particular, are perhaps less correlated to developed markets or even potentially less dependent on them, that would serve as a great diversification in terms of overall asset allocation?

Andre Mazini (07:23)

Yeah, that's a great question, Rob. So, at least looking at the short-term window, talking about this year, which countries have been less correlated. So, the trading history of this year will show that the Mexican market was actually uncorrelated, almost. And why would we say that?

So, on Liberation Day, which was April 2, most global markets went down pretty precipitously after the event. The Mexican market actually went up after April 2. So, this year, Mexico was pretty uncorrelated, providing those diversification benefits we were talking about. Because again, Mexico was excluded from the reciprocal tariffs when a bunch of other countries got hit by tariffs.

Brazil had a 10% tariff, which is on the lower side because actually Brazil has a deficit, vis-à-vis the U.S., or the U.S. has a surplus vs. Brazil. But there were no reciprocal tariffs for Mexico, so that market went up. I'm talking maybe more long-term for the region as a whole, the markets here are very reliant on commodities for sure. So, if you go back to the early 2000s, the Brazil index was composed 50% of commodity stocks. Now it's less than a third. I mean, still a lot, but way less than it used to be.

So, I think this diversification into other sectors of the economy — industrial companies, banks, what have you — tends to bring these diversification benefits as well and make the region a little bit less exposed to global volatility. Of course, no country's an island, but it's becoming more diversified through the years.

Robert Rowe (08:49)

And going back to Mexico, obviously, that's the first or second-largest economy in the region. How do you see the trade relationship with the U.S.? How would that affect the Mexico stock markets and what do you think are the milestones we need to watch for, as we go forward?

Andre Mazini (09:04)

Yeah, this is table stakes for Mexico, right? I mean, the trading relationship between Mexico and the U.S. is huge. It's super important for Mexico. Eighty percent of Mexico's exports go to the U.S.

So, an old saying would be that when the U.S. sneezes, Mexico catches a cold. There's some truth to that. I think less and less so maybe through time, but it's still super important.

So, we can talk a little bit about the history of NAFTA. It's a long-standing trade deal. NAFTA was initially proposed by President Reagan, influenced by the writings of Milton Friedman back in the day, and then NAFTA was negotiated the first time around by George H.W. Bush and ultimately signed by Clinton in '94. So, this regional integration has been around for a long time.

The successor of NAFTA is the USMCA, that was signed in 2018 by then-presidents Trump, Trudeau, and Peña Nieto in Mexico. And the USMCA was primarily a modernization of NAFTA, namely concerning intellectual property and digital trade. So spheres of the economy which were not around back in '94.

There's a stipulation for the USMCA, which is in place right now, to be reviewed every six years by the three nations, and the limit for the next renegotiation is July 2026. We

think the USMCA renegotiations may start as early as October 1, so ahead of schedule. Most investors have seen this development as positive as it may de-risk any headline risk related to not having a trade deal, but we don't think that's going to be the case.

And we actually ran a survey asking investors, "What will drive the Mexican market outperformance over the next 12 months?" And 90% of the respondents were saying that it's the USMCA renegotiation. So that's going to be taking a lot of risk off the table, right? If it indeed happens — and we think that's the most likely outcome, that the renegotiation should take place soon-ish.

Robert Rowe (11:00)

Andre, here's a two-pronged question. One is, there was obviously a big surge in what was called near-shoring a few years ago. Do you think that trend will continue? And then, the second part of that question is, "What has China's influence been in the region?" Because I know that China has tried to make some forays into the region, tried to be influential there.

Andre Mazini (11:33)

So we think COVID really provoked a seismic shift in how companies think about supply chains. Pre-COVID, it was all about efficiency and almost exclusively about efficiency, right?

Supply chains would be located whatever it was the cheapest, with little considerations of supply-chain resiliency or potential disruptions. Decision-makers, companies, C-suites, they were under-pricing this risk. Of course, easier to say post-fact, but this risk was being underpriced.

So during COVID, the disruptions came about, the risk materialized. During COVID, shipping routes were severely disrupted with freight costs going up 6x — long queues at ports, some straits like the Suez Canal being blocked for longer than a week. So therefore, post-COVID, much more attention is being given to supply-chain resiliency. The resiliency is front and center, making the supply chains now a little bit shorter and located in geopolitically aligned or friendly countries.

So given all this, we think nothing really will beat Mexico's geography and friendly relations toward the U.S. So we do think nearshoring is to continue going forward, yes. As we said, we think a likely outcome of the USMCA renegotiation may be tightening of the rules of origin, which are the criteria needed to determine the national content of a product.

For instance, a car has to be 75% manufactured in North America so that it's deemed to be a North American car, and it's shipped, back in the day, tax-free. There are temporary taxes on autos, but that could go back to lower tariffs. So, these rules of origin could be increased, and that could spur even a little bit more near-shoring going forward.

And on the second part of your question, China, they are investing heavily in the region. Mostly FDI, and not so much in the financial markets. Buying equities, but really FDI.

There's a huge port just north of Lima, which is the biggest port in the region, being constructed by the Chinese. The Chinese have the Belt and Road Initiative, which is their investment-over-the-world initiative so they can pretty much have sway and influence in various different regions in the world. And some countries in the region are big recipients of these investments.

And of course, what I think North American policymakers don't want is that Mexico is a last-mile touchpoint for Chinese product, right? So, the increase in the rules of origin that we were mentioning before, it's a policy that will try to counterbalance that. The U.S. has tariffs toward China, you don't want the Chinese circumventing the tariffs through Latin America. So, this is going to be going to be something to watch and see what the policymakers are going to be doing on that front.

Robert Rowe (14:18)

Andre, I wanted to ask a question about Argentina because we haven't discussed challenges and opportunities for their economy. Can you touch briefly on that, and also the election cycle in the region?

Andre Mazini (14:31)

Yes, sure. So the economy there has been rebounding after years of very, very high inflation. They have the Milei government, which came to power in 2024.

So, a big adjustment happening there, a big disinflationary adjustment. Which is, of course, sometimes hard on the population. But Milei is very popular, actually. We did have some elections for the municipality of Buenos Aires, which are normally smaller elections, but investors were keeping an eye on this because it was the first election post-Milei. And his political movement did well in these June elections, and then you also had elections in October.

So, the market had a huge rebound in 2024. This year, investors are taking a little bit of profits, but it's interesting to see Argentina coming back to investors' radar, since this change of government that we mentioned.

For the other regions, actually we have a bunch of elections coming up. We have the Chilean election that's scheduled for November. The current incumbent cannot be re-elected. That's Gabriel Boric.

And that's the same thing in Colombia. Gustavo Petro, he cannot go for a second term. The Colombian elections are in May 2026. And then the Brazilian elections are a little bit after that in October 2026. But here in Brazil, Lula, who is the sitting president, he can go for a second term. So probably he'll try to go for his second consecutive term. He had two terms back in the early 2000s, so it will be his fourth term.

So, a lot of politics in the region as well, Rob.

Robert Rowe (16:08)

Fantastic. Arigato, Andre!

Thank you very much for the call today. I'm sure our clients and our listeners will enjoy the podcast.

Andre Mazini (16:16)

Thank you so much, Rob. Good to talk to you.

Robert Rowe (16:18)

This podcast was recorded on June 30, 2025. Be sure to join us for our next Research @ Citi podcast, which features Max Layton, our Global Head of Commodities, with a look at the current state of commodities in today's marketplace.

Disclaimer (16:32)

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