



## The Latin American Adviser

### Overview: *The Shoe Finally Dropped*

General Motor's and Ford's day of reckoning finally arrived. Both were down graded by S&P to junk status. S&P cut General Motor's credit rating two notches to BB. Ford's credit rating was reduced one notch to BB+. To make matters worse, there was a negative outlook for both companies. The reverberations from the downgrade were limited. The yield on the 10-year Treasury declined to 4.15% and the JP EMBI+ was flat. Although the magnitude and scope of the downgrades were larger than expected the market's reaction was muted. The downgrades were anticipated for almost a year. The rise in energy prices was a death knell to American auto producers. Ford and General Motors made fortunes during the 1990s selling SUVs and light trucks. The collapse in oil prices made these vehicles very appealing, despite their low fuel efficiency. Unfortunately, the tide turned with the sharp rise in oil prices after the invasion of Iraq. The handwriting was on the wall since 2002, but many people hoped that increased production from Iraq would drive oil prices lower. They did not. The reason was the ascendancy of India and China. High energy prices are here to stay and household are adjusting their consumption patterns to reflect the new reality. The downgrade of the auto producers should help end the debate whether higher commodity prices are recessionary or inflationary. Had it not been for higher oil prices, consumers would still be gobbling up gas-guzzling behemoths. However, they are stitching to smaller and more efficient vehicles, much of them made by the Japanese. What does this mean for the emerging markets? There will be some initial technical implications. Some cross-over investors will refocus their trading activities on the new two entrants to the high yield market. Otherwise, not much will happen. The decline of the U.S. coincides with the ascendancy of Asia. As the first derivative of Asian economic activity, Latin America is poised to win.

GM '33s are trading in line with Ecuador '30s, even though the U.S. car company is rated two notches higher. One, or both, credits may be mispriced. The knee-jerk reaction is that GM is too cheap and Ecuador is too expensive. However, let's not be hasty. GM's problems are huge. First, it has the wrong product line for the current (and foreseeable) environment. It has a product line that was designed for a world with low energy prices. This was the same problem it confronted during the early 1980s, when the Japanese made huge inroads into the North American automobile market. In order to climb out of the hole, GM was forced to undergo a huge investment program and retool its product lines. During the 1980s, GM had the balance sheet to do so. Unfortunately, it no longer has the flexibility to repeat this strategy, which leads us to the second point. GM's total liability structure is unsustainable. It is not so much its balance sheet liabilities, as its off-balance sheet obligations. GM spends more on retiree health benefits per car than it does on steel. Unfortunately, the prices of both inputs are growing at huge multiples—which helps explain why GM's profit margins are being squeezed. Normally, companies in similar situations could easily resolve the problem. GM has three major groups which have claims on its assets—workers, pensioners and creditors. Of the three groups, the latter should feel the most at ease. Unfortunately, GM is a highly visible company and the government will surely play a major role in adjudicating the outcome. This means that creditors will probably bear the brunt of the adjustment. That is why the bonds are trading so cheap. Meanwhile, the situation in Ecuador is different. Ecuador's political situation is a mess, but the economic picture is not so bad. There is a tussle among major political parties, undermining the country's stability. President Palacios is very weak, and like Kirchner, he is trying to hold on to power by resorting to a populist agenda. Normally, this is a recipe for disaster, given the dollarized nature of the Ecuadorian economy and its reduced access to the international capital markets. However, a closer look at the Ecuadorian numbers reveals that situation is not so dire. Dollarization, for once, induced competitiveness, given the recent decline of the dollar. This provided a much needed competitive boost to Ecuadorian exports. Likewise, buoyant oil prices improved Ecuador's fiscal performance. In 2004, Ecuador posted a primary surplus of 5.3% of GDP, against interest payments of 2.6% of GDP—leaving it with an operational surplus of 2.7% of GDP. The Ecuadorian government said that it has the financial resources to all of meet its interest, amortizations and buyback obligations for 2005 and 2006. The soundness of Ecuador's economic picture is reflected in bank deposit levels, which remain stable. Therefore, Ecuador appears to be in much better financial shape than GM. Both credits are dicey, but the new trend of higher oil prices and a weaker dollar bodes better for Ecuador.