

November 25, 2013

Elections in Chile

N.B. Due to the Thanksgiving Holiday, the next edition will be published Dec. 9th

On November 17th, Chileans went to the polls to vote on a new president and parliament. Polls correctly forecasted that Michelle Bachelet, who was president from 2006-10, would win a plurality. She won a whopping 47% of the vote, beating seven other candidates handily. The second place finisher, Evelyn Matthei, won 25% of the vote. These two women, who are friends from childhood, will face each other in a runoff election on December 15th.

In this report, we offer short biographies of the two candidates, focusing mostly on Bachelet. From there, we will provide a short history of Chile, primarily to highlight the tensions between the forces of liberalization and reaction. An examination of the Allende-Pinochet period will detail the factors that have affected Chile's political structure over the past five decades. Recent student protests frame a significant demographic change that is affecting Chilean politics and moving the country beyond the issues experienced in the 1970s. As always, we will conclude with market ramifications.

Michelle and Evelyn

Bachelet's father was a general in the Chilean Air Force as was Matthei's dad. The two became friends in the 1950s, when their fathers were young officers stationed together. However, their lives took

dramatically different paths during the Salvador Allende presidency and the subsequent coup by Gen. Augusto Pinochet. Bachelet's father was a member of the Allende regime; he was arrested after the coup and died of a heart attack in 1974, reportedly caused by being tortured. The following year, Bachelet and her mother were detained and tortured as well. In contrast, Matthei's father was a member of Pinochet's junta that ruled Chile from 1973-90.

Bachelet remained in custody until January 1975, when she was exiled to Australia to live with her brother who had moved there prior to the coup. According to reports, sympathetic military officers arranged her release. Later that year, Bachelet moved to East Germany, got married and studied medicine. She returned to Chile in 1979 and completed her medical studies in 1983. She added a Master's degree in military studies in the late 1990s.

Although politically active among leftist groups, she did not run for office until 1996, running for mayor of a Santiago suburb. She was appointed minister of health in 2000 during the presidency of Ricardo Lagos. Two years later, she was appointed defense minister, the first woman in Latin America to hold that role. In 2006, she ran for president, winning the runoff election. She is the first woman to win the presidency in the region who was not the wife of a former president. The Chilean constitution prohibits presidents standing for consecutive terms, so Bachelet could not run when her term ended in 2010.

Matthei's life was less tumultuous, given her father's role in the Pinochet government. She entered politics in the late 1980s, holding various offices, usually representing conservative parties. She is an economist by training and considered a fiscal conservative.

Barring an unusual event, it is highly probable that Bachelet will win the upcoming runoff. As we will discuss below, Chile is shifting to the left politically, and Bachelet is considered a more attractive candidate. Investors should be prepared for a shift to the left from this election.

A Short History of Chile

Chile was discovered by Spanish explorers in the 16th century, although it attracted little initial interest. The area held little gold and silver which was the focus of Spain's attention. It took over a century for Spain to extend its reach into the region, taking advantage of its base metal and agricultural resources. In the early 1800s, when independence movements dominated the region, Chilean demands for independence grew as well. For the most part, the struggle for independence was between loyalist and independent elites. The independence movement began in earnest in 1810 and ended with the surrender of the last Spanish troops in 1826. Chile did oust the Spanish in 1810, but the inability of factions to unify led to a civil war, allowing Spain to reconquer the territory in 1814. By 1817, a new independence movement had emerged and it steadily gained territory, gaining full control nine years later.

From 1826 to 1891, there was a series of governments that mostly vacillated between liberal and authoritarian regimes. As is common with many Latin American nations, the social stratification that developed during the colonial period remained a

feature of Chilean society, regardless of the political persuasion.

In 1891, Chile developed a conservative parliamentary government with a weak executive and a Congress dominated by landed elites. Although this period has been considered one with little growth, for the most part, the government was stable during this era. In fact, suffrage expanded and, gradually, political life became more inclusive.

In the early 1920s, the middle and working classes elected a reformist, President Arturo Palma. Although Congress stifled his plans to pass social reforms, he was able to get some measures passed after the congressional elections in 1924. However, young military officers, unhappy with the slow pace of change, led a series of coups that lasted until 1932. A new constitution, that gave the president greater powers, ended this period of unrest. Out of this period, the Radical Party, mostly representing the urban middle class and rural elites, dominated the political landscape for the next two decades.

The 1964 presidential elections brought the center-left Christian Democrat Eduardo Frei to power. He embarked on a broad program of social and economic reforms, increasing government spending on housing and education, and agrarian reforms. However, the left opposed Frei, believing he was not radical enough, while the right found his reforms excessive. It is important to remember that this period was dominated by the Cold War. The Soviet Union and the U.S. were embroiled in a race to influence nations and both sides were more likely to support fringe elements. A more moderate politician like Frei was almost doomed to fail just from outside pressure alone.

In the 1970 elections, Chile moved decidedly left, electing Salvador Allende to the presidency. The avowed Marxist won a plurality of 36%. At that time, the Senate would hold the runoff election. Although considered a mere formality in earlier periods, the Senate vote was highly contested. It included the murder of the Army's commander in chief and the refusal of Christian Democrats to stand against Allende.

Allende began an aggressive socialist program to restructure the economy. In his campaign, he made it very clear that he intended to expropriate and nationalize key industries. Once in office, he did what he promised. In addition to nationalizing and expropriating businesses in the copper, coal, iron and other metals sectors, he adopted price freezes and enforced wage increases along with tax changes that were quite progressive. Initially, the economy soared—GDP rose 8.6%, inflation fell from 34.9% to 22.1% and unemployment decreased to 3.8%. Of course, such programs create significant economic distortions. Private investment fell, capital flight soared and even banks faced a run on deposits, fearing the Allende government would seize these accounts. Production subsequently fell and shortages developed. As often occurs with these programs, the eventual outcome is lower growth, low investment, significantly higher inflation and currency depreciation.

Politically, Allende clearly aligned Chile with the Communist Bloc. Cuba reportedly was sending arms to Chile. The president had a personal KGB advisor and KGB files indicated that the Soviets wanted to reorganize the country's government and military to more closely tie these institutions to the KGB and Soviet interests.

These moves triggered a response from the Nixon administration. The CIA actively supported opposition groups and the U.S. implemented economic sanctions against the regime. In the Cold War era, the U.S. had little tolerance for the creation of a Soviet client state in the Western Hemisphere.

By 1973, the country had become polarized. Military groups opposing the government began to develop. There was a failed coup in June 1973 but in September 1973, Gen. Augusto Pinochet, Commander of the Army, launched a successful coup against the regime. Allende committed suicide on September 11th and a junta, led by Pinochet, took power.

The new regime had two primary characteristics. First, the junta engaged in severe political repression. Thousands of Chileans were jailed, tortured or executed by the regime. There were 2,000 confirmed executions during the 16 years of the Pinochet regime and at least 29,000 imprisoned and tortured. An estimated 30,000 left the country (including, as noted above, the likely next president). Civil liberties were abolished, the legislature was banned and labor activities were outlawed.

Second, the Pinochet regime, under the guidance of a group of University of Chicago economists (known as the "Chicago boys"), began a program of privatization and deregulation. Inflation, which rose 800% during the Allende regime, fell to 9.5% by 1981. Although the economy suffered greatly during the onset of the Latin American debt crisis in 1982, the introduction of pragmatic reforms, including a floating exchange rate and capital controls, fostered strong growth. In fact, Chile grew 5.9% per year from 1984-90, by far, the fastest growth in the region.

The Chilean constitution under Pinochet made him president in 1980 with an eight-year term. The constitution offered a plebiscite at the end of his term in 1988. Chilean voters rejected another term for Pinochet; surprisingly, Fernando Matthei, a member of the junta (and the father of Evelyn Matthei), admitted the regime had lost the plebiscite, forcing the junta to accept the results.

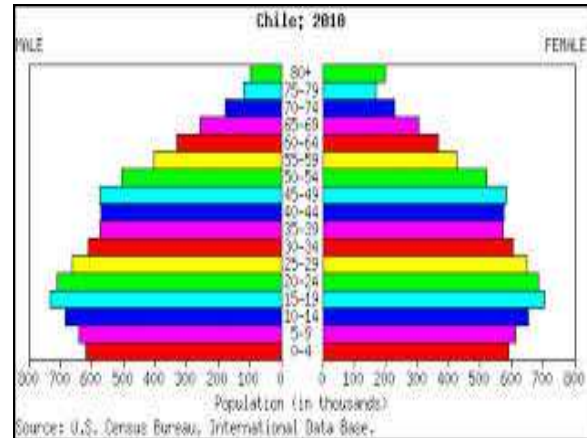
In late 1989, democracy was restored with a center-left coalition called the *Concertacion* winning the presidency. This coalition has since dominated Chilean politics, winning all the presidential elections except in 2009, when the current president, Sebastian Pinera, led a center-right coalition to power. Barring a major surprise, the *Concertacion* will return to power in December, led by Bachelet.

A Generational Change

Since the early 1980s, Chile has been considered the best economy in the region. Other nations have enjoyed stronger equity rallies and occasionally better growth but, over time, Chile has been the most consistent performer. The country has a reputation for stable governments in a region where leftist demagoguery is a persistent risk (e.g., Argentina, Bolivia, El Salvador, Nicaragua and Venezuela).

Since 2011, there has been a steady increase in unrest. Students protesting the high cost of college and wide income inequalities have been a nearly constant feature of the Pinera years. There are two reasons for this rising unrest.

First, there is a large demographic cohort that is too young to remember the Pinochet years. This group represents a mini “baby boom” that occurred with the return of democracy in Chile.



This chart shows the population pyramid for Chile. Note the bulge in the 15-24 year group. This is the largest demographic grouping in Chile. The oldest of this cohort were infants at the time the country was transitioning toward democracy; they have virtually no memory of the Pinochet years. For this group, the compromises and decisions made to foster the return to democracy seem irrelevant and they are clamoring for change.

Some of the compromises include high education costs and the protection of the wealthy. As we have noted above, in Chile’s history, there has been a steady shift between left and right-wing policies. Pinochet’s economy included many right-wing policies that have worked quite well. However, one of the downsides of this policy leads us to the second factor.

Chile is one of the most unequal societies in the world. The CIA Factbook ranks Chile as the 15th most unequal. Interestingly enough, it is bracketed by Bolivia at 14 and Panama at 16. The former is being run by an avowed left-wing government. In comparison, the CIA ranks the U.S. at 41.

The young protestors in Chile want policies to lower the cost of education and reduce income inequalities. Bachelet ran on a

platform promising to address these issues. Her opponent will argue that Chile has prospered under the current policies and reversing them runs the risk of undermining that prosperity. If Bachelet wins and follows through on her promise to make significant changes, the macroeconomic and political risks rise significantly.

Ramifications

Essentially, the issue for Chile comes down to this factor—since Bachelet will almost certainly win a second term next month, how much change can she engineer? The left in Chile has tempered its demands over the past two decades, wanting to ensure that a right-wing reaction doesn't develop. And, the right has generally agreed to democracy within the constraints of the current constitution. To make major changes in Chile, Bachelet will be required to manage a rather large coalition as her party only has direct control of six seats in the 38-seat Senate. Her coalition includes centrist parties who will not be inclined to do anything radical. In addition, the political system has a method of proportional representation that balances the left and right unless one side wins by a factor of two. To enact reforms to this system, she would need to convince right-wing parties to forgo this

method, which would be political suicide for the right.

This doesn't mean she can't make changes. We would expect a change in tax laws to equalize corporate and individual tax rates, closing a major loophole (rich households tend to incorporate to get a lower corporate rate).

Chile has been the weakest performing equity market in Latin America this year. Although fears of political change are not the only reason for the weakness (the market's valuation metrics are not wildly attractive), we do believe they have played a major role in market weakness. If Bachelet proves to be less radical than the market seems to expect, we could see a recovery in Chilean assets. However, it should be recognized that the demographic changes in Chile could trigger a more radical, extra-constitutional outcome, and until investors are more confident that this won't occur, Chilean financial assets will likely remain weak.

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November 25, 2013

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