Global Asset Management

BlueBay Asset Management

Colombia
Government Plans Collide with Popular Will

This year we have seen a number of what we view as positive political developments in Latin America.

We have already witnessed notable events in Argentina and the impact a change of government is having on the country's economic climate as well as its investor base.

We have also seen significant political developments within Peru, where a newly-elected government led by former World Bank economist Pedro Pablo Kuczynski, is looking to implement reform and turn the country's economic dependence away from natural resources.

Meanwhile in Brazil the impeachment of President Dilma Rousseff on corruption charges has heightened hopes interim president Michel Temer will enact economic reform.

Elsewhere in the region, we are seeing significant political developments in Colombia with Juan Manuel Santos working hard to end the country's 50-year civil war with the rebels of the Revolutionary Armed Forces of Colombia (FARC).

In the following, our Head of EM Sovereign Research Graham Stock examines the current situation in Colombia and outlines the positives and negatives that can be drawn from the plebiscite's rejection of the government's proposed peace deal.

Colombia – the vote

While Colombia's political stability is uncertain, we have observed that its economy has always (in stark contrast) performed relatively well. This situation highlights the complexities of investing in emerging markets and therefore the need for investors to carry out in-depth, fundamental research to ensure investment decisions are both informed and considered.

At the beginning of October Colombia joined a growing list of countries that have put important strategic decisions to a popular vote, and found that the people stubbornly refuse to follow the government's script. In this case, President Juan Manuel Santos had spent four years eking out a painstaking peace deal with leaders of FARC, in a bid to end more than five decades of violent conflict. Having already held a formal signing ceremony attended by visiting heads of state, the plebiscite held on 2 October was intended to secure popular approval for the government's peace negotiations. Instead, and confounding polls suggesting a 20-point margin for the 'Yes' camp, opposition spearheaded by former President Alvaro Uribe won 50.2% of the vote. Just 50,000 votes out of 13 million tipped the balance into defeat for the government. Adding to the frustration, it seems likely that Hurricane Matthew depressed turnout on the Caribbean Coast, where support for the Santos administration and peace deal is strong, and may have been a deciding factor. Nevertheless it is also clear that opposition to the peace deal centred on a perception that FARC leaders stood to escape punishment for their role in driving the conflict, and were being rewarded with congressional representation.

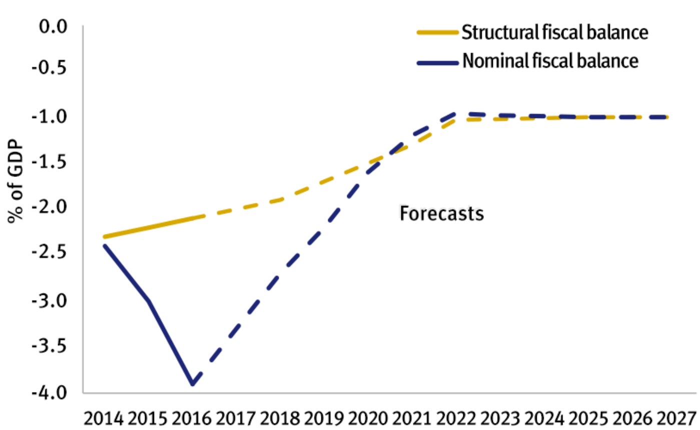
The peace process will be kept alive

It may surprise some to learn that we do not see the plebiscite defeat as a make-or-break episode for the peace process in Colombia. We did not expect the government to lose, but equally we do not expect a resumption of widespread violence. The conflict had been gradually winding down for some time, and the broad outlines of a peace deal have been agreed between the combatants. Indeed, the government, the FARC and the opposition all quickly promised to work together to forge a new agreement. It is possible that moves to further restrict impunity for FARC leaders prompt splits between the different factions, but it is a sad fact that Colombia's formal economy has long performed well even against a backdrop of conflict in more remote rural areas. One interesting new development is that President Santos has been awarded the Nobel Peace Prize for his efforts; we will be watching to see if this has any impact on the negotiations.

The main casualty of the plebiscite could be economic policy

Defeat in the vote is a major blow for President Santos, who had staked his administration on the peace process. We expect him to stay in office, but he has used up valuable political capital and will need to deploy more to successfully revive the negotiations with the FARC in Havana. The government's game plan was to bounce from euphoria over endorsement of the peace deal straight to submission of an unpopular tax reform to Congress, arguing that higher taxes were necessary to shore up funding to finally extend the state's presence to all corners of the country. In practice a tax reform was necessary anyway to compensate for the impact of falling oil prices and falling oil production on the budget. The proposed adjustment is evident in the government's long-term fiscal forecasts below.

Exhibit 1
Colombia Plans Fiscal Adjustment



Soucre: BlueBay, Bloomberg as at September 2016

The rating agencies had already warned that tax reform is necessary

Colombia is an investment-grade sovereign, rated BBB or equivalent by all three major rating agencies. However two of them (Standard & Poor's and Fitch) put their ratings on negative outlook earlier this year, warning that a downgrade was likely if the government's tax reform proposals fell short of expectations. Moody's has highlighted similar concerns following the plebiscite. Given our fears that the government is now in a weak position to approve an effective fiscal adjustment, we expect the rating agencies to follow through with downgrades in the coming months, albeit by just one notch and therefore narrowly preserving the country's investment-grade status.

We expect further near-term underperformance and remain underweight across all strategies

Given risks around the plebiscite, the tax reform, soft oil prices and rating agency outlooks, we have been running underweight positions in Colombian local currency bonds, and have had zero exposure to hard currency sovereign credit across our strategies. Since the vote, the currency, local rates and sovereign credit have all sold off somewhat, despite support from firmer oil prices. We expect further weakness as the market's attention turns from the peace process to the broader policy agenda, and specifically to the prospects for tax reform and rating downgrades. We therefore maintain our near-term underweight bias.

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