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Colombia Multi-Asset Strategy

Impact of rating downgrades on external and local assets

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CITI'S TAKE

Colombia appears to be getting closer to a possible rating downgrade from more than one rating agencies, an outcome that could trigger a degree of forced selling from passive benchmarked investors. We examine the historical experience of other 'fallen angels' to determine the impact on sovereign and corporate credit, as well as local assets.

- Colombia is at risk of losing Investment grade status from two ratings agencies, which would imply exclusion from cross-over credit indices.
- Based on current credit spreads, the sovereign is already pricing downgrade to sub-IG levels. However we are concerned with forced-selling from passive investors that benchmark to crossover indexes that could push spread wider and overshoot.
- According to our analysis given the relative small weights of Colombia sovereign in the Bloomberg Barclays Global and US Agg, the amount of forced selling is around USD1 to USD1.5, hence not excessive. But there won't be any buyers before the potential downgrade and the best buying opportunity comes right after the second downgrade.
- In corporates, state owned companies will likely follow suit with downgrades of their own. We would expect a total spread widening of 70bps in this scenario.
- We do not see local currency bond index exclusion as an imminent threat, but a spillover from the hard currency downgrade is likely.
- We find that local rates and FX both tend to underperform into the first foreign currency debt downgrade (even if local ratings do not lose IG). The second downgrade tends to have less of an impact for both FX and rates.

See Appendix A-1 for Analyst Certification, Important Disclosures and Research Analyst Affiliations.

Impact of rating downgrade on assets

Colombia's USD bonds are at risk of losing investment grade status. Colombia's USD bonds (LT Foreign Bonds) are rated BBB- with a negative outlook from both S&P and Fitch. A potential downgrade has important pricing implications, given that they are only one notch above high yield status. This includes the potential exclusion from global credit indexes, if Colombia loses IG ratings from two agencies – which creates some technical headwinds. Timing of the downgrade depends on the outcome of the government's tax reform, which is just beginning its discussions in congress, with an expected approval of a watered-down version of the bill by June 20 (see this note). Fitch typically communicates decisions around May and November, but is likely to wait for the tax reform outcome in June and may communicate its decision then. Or they could follow S&P's lead and postpone a decision on their negative outlook for a meeting later in the year. Furthermore, agencies have noted they will avoid actions around the 2022 presidential elections, so we should see a resolution still in 2021.

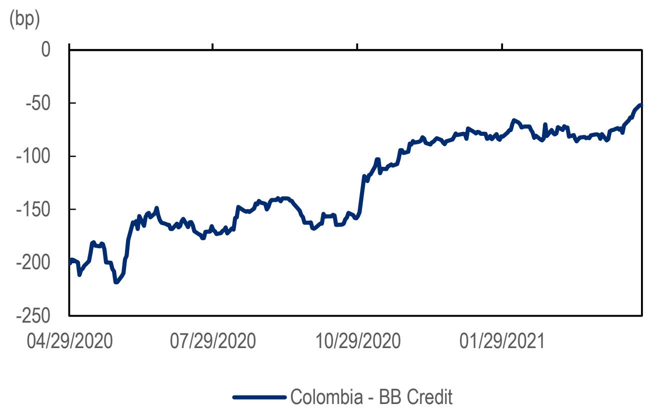
Recent developments related to the approval of the tax reform do not look encouraging. The government originally proposed a reform seeking 1.4% of GDP in net revenues on average over 10 years, with 2.0% of GDP in gross revenues for the Central Government and 0.6% in new social expenditures. The fact that most revenues come from a wider personal income tax base and VAT changes has been met with resistance from most political parties, with several (Liberal and Cambio Radical) saying they would not vote in favor even before debating in congress, and even Duque's own CD party has been proposing changes (see this note). Their argument for this stance can be roughly summarized as the tax mix being hurtful for the middle class, despite the overall reform focusing mainly on the top 10% of wage earners and actually including new transfers for the lower 50%. We believe the backlash responds to political calculations in light of next year's elections. The latter implies that approval of the current bill is unlikely as is, though there is room for a watered down version to pass. The government should present a modified version soon and then more modifications will take place. The size and medium term adjustment that the final bill promises will be key deciding factors for rating decisions.

Local currency debt is still two notches above HY for two agencies Moody's currently has a Baa2 rating on local currency debt, while S&P is at BBB. This means that Colombia's local debt is still two notches away from an investment grade loss for these two agencies. The fact that S&P has local currency debt one notch higher than external debt is not entirely surprising, since governments can inflate away this debt instead of defaulting. Meanwhile, Fitch has local currency debt at BBB-, but given where the other two agencies sit, a downgrade from them is not enough to result in index exclusion.

Impact of a potential credit downgrade

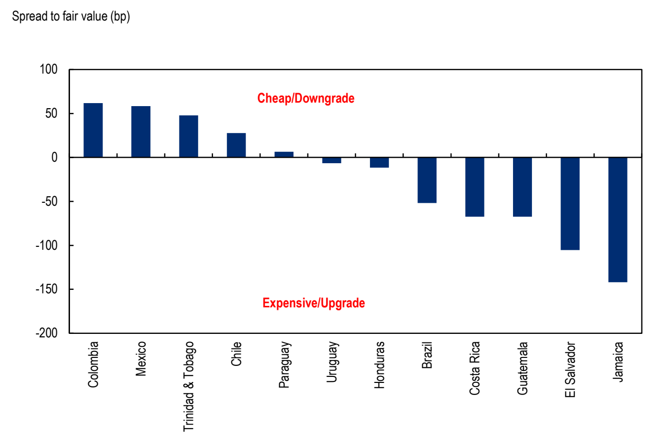
Colombia external bond spreads are already pricing a downgrade. Colombia bond spreads have been underperforming other EM sovereign BB credits over the last 12 months (see Figure 1). At an index level, Colombia trades only 50bp tighter than the BB complex, versus 200bp tighter back in April 2020. This suggests that the market is front running the downgrade and pricing in this possibility.

Figure 1. Colombia credit has been underperforming the BB sector, downgrade probability in rating



Source: Citi Research

Figure 2. The credit is one of the cheapest to its rating in LatAm



Source: Citi Research

The market implied probability of losing IG is practically 100%. According to our fair value model, a BB+ credit stable outlook trades at 186 bp, and currently Colombia 3.125% 2032 trades at 186. This suggests that the market is fully pricing a downgrade below investment grade.

Front-running forced selling leads to an overshooting in sovereign credit spreads. But we are concerned with a potential overshooting in valuation even though Colombian spreads already price a downgrade. For a 'fallen angel', the downgrade is significant for the market, as the credit is excluded from the Bloomberg Barclays Global Aggregate and US IG Fixed Income Indexes (Global Aggregate and US Aggregate), which are key benchmarks. We are particularly concerned with passive investors that are not valuation-sensitive. In addition, we stress that the delay for a credit's inclusion in a relevant HY index is usually 1-2 months. During this pre-inclusion period, the bond becomes orphaned, creating an imbalance between forced sellers due to immediate index exclusion and "forced buyers" due to future index inclusion.

As a sovereign credit, Colombia's bonds would not be included in many global HY benchmarks that are not specifically EM oriented. Colombia has to be downgraded by at least two rating agencies for this to occur, yet we suspect both rating agencies will act within a narrow period of time. Finally, the timing of the exclusion, which typically happens the month following the second downgrade, depends on when the credit was downgraded within the month itself. We have done extensive work on this topic analyzing previous experiences in this note.

Forced selling is unlikely to be large based on Colombia's small weight, but will be relevant. To estimate the size of the bonds that investors are forced to sell after the downgrade is not an easy task. Any estimate should be taken with a grain of salt and, more importantly, investors should know that these technical factors tend to be short-lived.

Best buying opportunity after second downgrade. Credit crossover investors (i.e. non-EM dedicated) will potentially be forced to sell Colombian bonds on exclusion. As we mention above, most of them track the Global Aggregate and US Aggregate indices. Anecdotal evidence suggests that an estimated USD2tn and

USD2.5tn worldwide is benchmarked against the Global Agg and US Agg, in which Colombia's sovereign bonds have small weights (approximately 0.05% and 0.13% respectively). A back of the envelope calculation suggests this would translate into forced selling of USD1bn-1.5bn (approximately 4% of the total sovereign bond market value that is around USD35bn), assuming that passive investors are approximately 25%-30%. While we do not think this is a large number, investors should weigh the caveats mentioned above regarding timing of the downgrade within the month that will give more opportunities to sell. In addition, other technical factors could help performance: for instance, anecdotal evidence shows that EM investors are underweight Colombia credit and could absorb some of the extra supply. Still, we expect an overshoot, and Colombian bonds may continue to trade poorly until the first downgrade is out of the way. After some relief, the credit then is likely to sell off again into the second downgrade, which results in the best buying opportunity.

Impact on local currency bonds

Foreign currency bond exclusion could spill over to local rates and FX. We look at previous foreign currency debt downgrades, which resulted an investment grade loss, but where local assets did NOT lose investment grade, to understand the impact on local assets. We focus on the countries that had liquid bonds and FX at the time of the downgrade: Brazil, South Africa, Russia, and Hungary (see details in historical discussion below, dates in Figure 3). Figure 4 shows that rates tend to sell-off versus UST into the first downgrade and then broadly stabilize after. The second downgrade in our sample, which results in fallen angel status, comes soon after the first downgrade (Figure 3). We find that for local assets, this event tends to matter less. This is likely because there is no direct index exclusion, and in turn no forced selling, and thus the IG loss is already in the price.

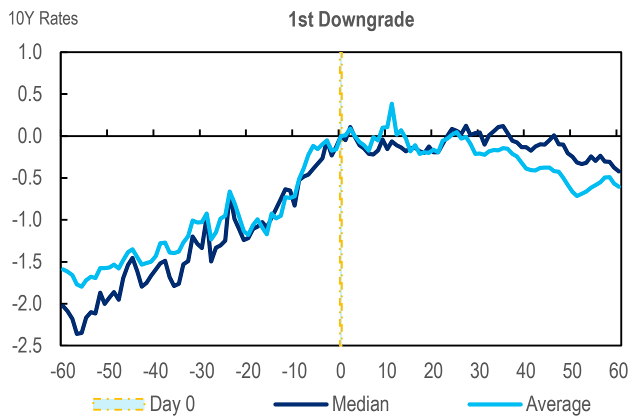
Figure 3. First and second downgrade dates

	First Downgrade	Fallen Angels Downgrade
Brazil	September 9, 2015	December 16, 2015
Hungary	November 25, 2011	December 21, 2011
Russia	January 26, 2015	February 20, 2015
South Africa	April 3, 2017	April 7, 2017

Source: Citi Research

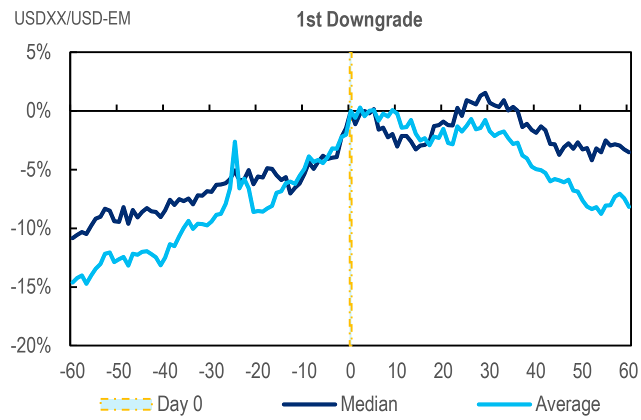
We find a similar pattern in FX. Currencies tend to underperform their EM peers into the first downgrade as well, and typically stabilize after (Figure 5). The average appears to outperform after the event, mainly driven by the Russian experience. For Colombia, we would expect a similar pattern, where the first downgrade to HY matters more for local assets. In fact, like external bonds, we have seen local assets underperform their EM peers so far this year.

Figure 4. Rates tend to underperform ahead of credit downgrades…



Source: Citi Research, Bloomberg; Note: 10Y rates are adjusted for UST

Figure 5. …as does FX



Source: Citi Research, Bloomberg

Index exclusion would be worse if local bonds lose IG. We are currently not concerned about local currency debt losing its investment grade status in the near term, given that two agencies are still two notches above high yield. However, if this were to happen, Colombian bonds would be excluded from the Bloomberg Barclays Global Aggregate Index. The index currently includes USD61bn in TES bonds, equivalent to about 0.09% of the total index (Figure 6). While this may seem small, the sheer size of assets tracking the index (our estimate is around USD2tn) means that a removal from the index would represent outflows of up to ~USD1.8bn.

UVRs and COP would also be affected. The same is true for the UVR bonds that are part of the Bloomberg Barclays Universal Inflation Index. This index includes roughly USD28.5bn in UVR bonds, or 0.72% of the index. We estimate a tamer impact there due to the smaller AUM linking to the inflation-linked index (note that the impact when these bonds were included on February 1, 2021 was quite muted). Regarding COP, bond outflows would lead investors to buy USDCOP as they unwind their positions and thus the FX should underperform under this scenario.

Figure 6. Colombia local bonds included in Bloomberg Barclays Indices

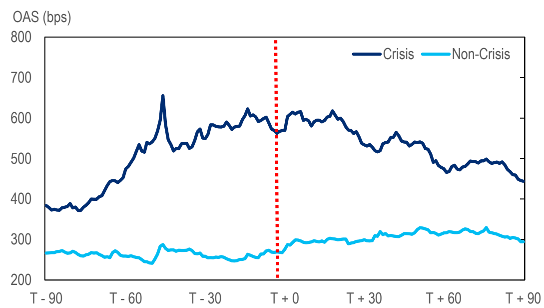
TES		UVR	
Maturity	Amount	Maturity	Amount
COLTES 10 07/24/24	25.8	UVR 2 ¼ 04/18/29	2.4
COLTES 5 ¾ 11/03/27	15.1	UVR 3 03/25/33	11.8
COLTES 6 04/28/28	31.1	UVR 3 ½ 05/07/25	11.0
COLTES 6 ¼ 07/09/36	1.1	UVR 3 ¾ 02/25/37	10.1
COLTES 6 ¼ 11/26/25	20.0	UVR 3 ¾ 06/16/49	6.1
COLTES 7 05/04/22	27.9	UVR 3.3 03/17/27	18.6
COLTES 7 06/30/32	24.3	UVR 4 ¾ 02/23/23	29.2
COLTES 7 ¼ 10/18/34	26.6	UVR 4 ¾ 04/04/35	16.3
COLTES 7 ¼ 10/26/50	6.9		
COLTES 7 ½ 08/26/26	28.8		
COLTES 7 ¾ 09/18/30	20.3		
Total TES (COP tn)	228	Total UVR (COP tn)	105
Total TES (USD bn)	61	Total UVR (USD bn)	28

Source: Citi Research, Bloomberg

Impact on the corporate sector of sovereign downgrade

In corporates, we expect 70bp of widening. An examination of past incidents shows that in non-crisis periods, a total spread widening of approximately 70bps should be anticipated, implying Colombia has more to widen. This is essentially the "overshoot" premium. If the market is experiencing a crisis, then it can be significantly larger, over 200bps. Figure 7 and Figure 8 show periods of historical spread widening for EM fallen angels in the period 2014-2019. We deliberately leave out 2020 downgrades as the COVID crisis exacerbated any EM fallen angel overshoot to the tune of 500bps or more vs BB peers, and 1000bps or more in total spread movement. We see this (hopefully) as an isolated event.

Figure 7. Spread widening during crisis and non-crisis scenarios



Source: Citi Research

Figure 8. EM Fallen Angels average spread widening

	Country/Corporate downgrade					Avg. Spread Widening (bp)
Crisis	Brazil 189	Brazil Quasis 508	Russia 160	Russian quasi 164	Mining 163	237
Amt. Outstanding in the global agg. (USD, bn)	34	37	37	19	2	
Non Crisis	South Africa 49	Turkey 54	Turkey Banks 68	Pharma 110	Petrochem 62	Avg. Spread Widening (bp) 69
Amt. Outstanding in the global agg. (USD, bn)	14	40	12	4	1	

Source: Citi Research

Colombian corporates likely to follow in downgrades, but exclusion may be quicker. State owned credits like Ecopetrol or senior debt of banks would immediately be downgraded upon a sovereign downgrade of Colombia. However, the exclusion rules matter for credits that are rated by only two agencies. If Fitch downgrades the sovereign, and the other two agencies maintain the IG rating, then Colombia and these 2 IG, 1 HY corporates can remain in the benchmark. However, for corporates that are rated IG by either S&P or Moody's, and HY by Fitch, these would be excluded from the benchmark prior to Colombia's exclusion. Corporates that stand out as at risk are Promigas (PROMIG) and Empresas Publicas de Medellin (EEPME). We maintain our UW in Colombia corporates.

Figure 9. Colombian corporates at risk of downgrades

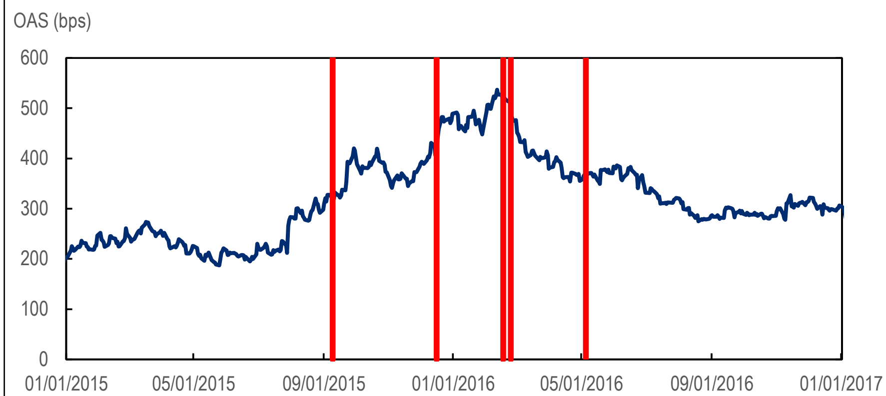
		Ratings			
Tickers	**Mkt Val (USD)**	**S&P**	**Fitch**	**Moody's**	**Industry**
ECOPET	10,769,083	BBB-	BBB-	Baa3	Energy
EEPPME	1,610,175	NA	BBB- *-	Baa3	Utilities
BCOLO	982,607	BB+	NA	Baa2	Banking
SUAMSA	927,930	NA	BBB	Baa1	Financials
TRAGSA	865,352	NA	BBB	Baa3	Energy
BANBOG	646,697	BB+	NA	Baa2	Banking
GRUPOS	629,675	BBB-	BBB-	NA	Financials
PROMIG	531,500	NA	BBB-	Baa3	Energy
GEBCB	451,527	NA	BBB	Baa2	Energy

Source: Citi Research, Bloomberg

Historical experience of Fallen Angels

Lessons from Brazil downgrade. The most recent LatAm loss of IG happened in Brazil, which serves as a useful benchmark for assessing the potential impact of a move to HY in Colombia. If a downgrade event were to happen, spreads could obviously widen significantly for the sovereign: in 2015/16, credit spreads for Brazil widened to 600bps as the downgrade triggered forced selling in the manner mentioned above.

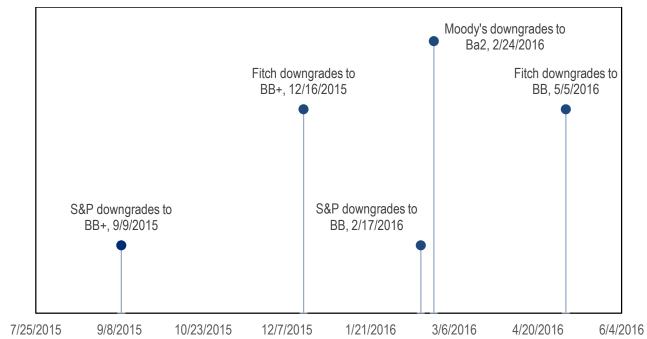
Figure 10. Brazil sovereign spreads widened significantly as the credit lost IG



Source: Citi Research

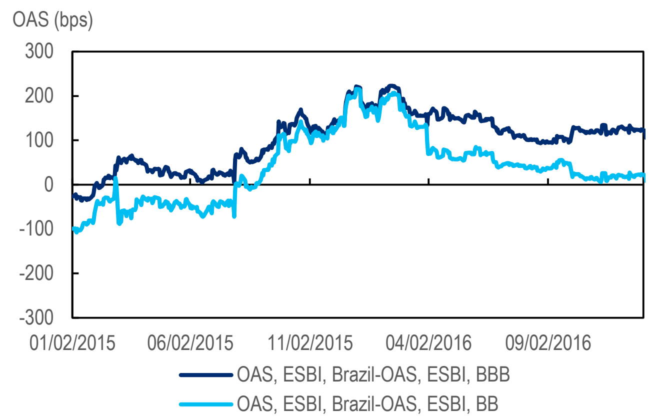
In Figure 10, the five red bars denote the major ratings actions regarding Brazil during this time period as listed in the timeline in Figure 11. Spreads began to widen in fall 2015 even before the first downgrade from S&P to BB+ on September 9th. Between this downgrade and the first downgrade from Fitch, spreads widened 85bps overall, 100bps vs the BB sector, and 61bps vs the BBB sector. The spread performance was notably worse as S&P further downgraded the sovereign to BB on February 7th, 2016, widening 110bps vs levels from the first Fitch downgrade. The relative performance during this time period was slightly better, with a 70bps widening vs BB and an 81bp increase vs BBBs. At this point, Brazil had become a fallen angel as it had more than one downgrade below IG. Typically fallen angels mostly recover after the forced selling pressure eases, and the bonds find a home. This was the case in Brazil, with the credit rallying 141bps from the local high to May 5th, 2016 when Fitch downgraded the sovereign again to BB. In relative terms, it tightened 145bps vs BBs and 72bps vs BBBs.

Figure 11. Brazil downgrade timeline



Source: Citi Research

Figure 12. Relative performance vs BBBs, BBs

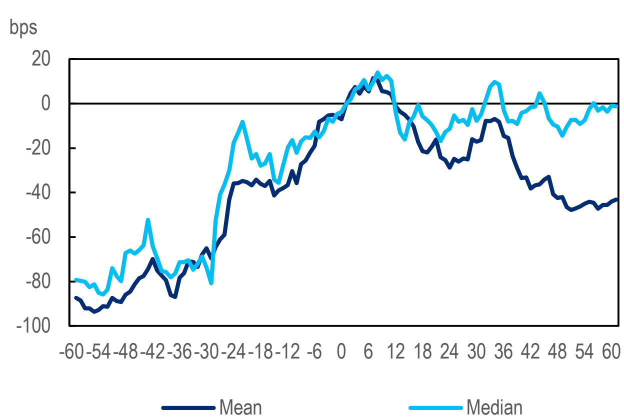


Source: Citi Research

Loss of IG in Turkey and South Africa tells a similar story. Both of these fallen angel sovereign credits exhibited similar price action to Brazil as downgrades began. In South Africa, sovereign spreads widened 13bps vs BBBs and 31bps vs BBs in the three months leading up to S&P's rating change on 4/3/2017. The underperformance was amplified in the four days between S&P's action and the follow-up from Fitch, with the credit widening another 13bps vs BBBs and 20bps vs the BB sector. S&P would lower the rating again to BB on November 24th, 2017, however this time spreads ended up 10bps tighter vs BBs, and 14bps wider against BBBs.

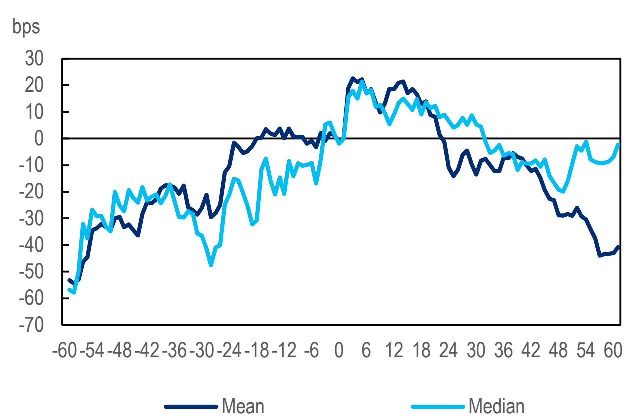
Turkey did not have as clear cut of a ratings progression as these other sovereigns, but we use Fitch's rating change from BBB- to BB+ on January 27th, 2017 to compare performance before and after losing IG status. In the three months preceding the downgrade, credit investors correctly called the future ratings action as spreads widened 32bps vs BBBs and 43bps vs BBs. As we noticed in South Africa and Brazil, a rally swiftly followed after forced selling had been exhausted, with a 59bps rally vs BBBs and a 36bps rally vs BBs occurring over the following three months.

Figure 13. Mean and median spread change into first downgrade



Source: Citi Research

Figure 14. Mean and median spread change into second downgrade



Source: Citi Research

In total, we examined eleven instances of IG sovereigns moving to HY and found that the price action generally matched the specific cases in Brazil, South Africa, and Turkey. In Figure 13 and Figure 14, we plot the mean and median spread changes 60 days before and after the first (Figure 13) and second (Figure 14) downgrades to HY using the date of downgrade as the base spread level. We see that spreads typically widen 80-100bps going into the first downgrade event, and while the median spread change out to 60 days afterward is near zero, the mean represents an approximately 40bps tightening. For the second downgrade, the mean and median spread change is about a 50 to 60bps widening heading into the event followed by similar spread moves to the first downgrade afterwards. It is worth noting that the second downgrade may have taken place within 60 days of the first, and therefore the data overlaps somewhat.

Appendix A-1

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