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Global Macro Strategy

COLOMBIA STRATEGY – A Junk Sovereign Whose Growth is Set to Surprise

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1. S&P stripped Colombia of its investment grade rating with a downgrade to BB+ with stable outlook. S&P's decision to downgrade Colombia to BB+ with stable outlook was not surprising at all, but the timing was. In fact, in our year-ahead outlook back in December we argued that we saw "a strong chance of Colombia losing its investment-grade rating by at least one of the three main rating agencies by the end of 2021" (see LATAM STRATEGY REPORT—2021, A Decent-Enough Comeback Year – December 17, 2020). However, we were expecting rating agencies to wait before taking any actions until a fiscal reform was approved at some point this year, most likely by the end of June (with a 60% probability), although we are seeing a significant chance (roughly 40%) of it being delayed until 4Q21 (see COLOMBIA STRATEGY—The Bill that it Deserves, But Not the One that it Needs Right Now – May 3, 2021).

2. Colombia still keeps its investment-grade rating by Fitch and Moody's and we do not expect any new actions until a tax reform is approved. We reckon that yesterday's move by S&P raises the likelihood of Fitch taking a similar rating action this year, since, up to recently, it had been the most skeptical and critical about the country's ability to reverse the deterioration of its fiscal accounts. Nevertheless, according to our recent conversations with Fitch, they seemed to be more welcoming of a smaller, less structural, less long-lasting and less business-friendly fiscal adjustment. Thus, barring a much deeper worsening of local conditions due to the ongoing strikes and episodes of social unrest, we would expect Fitch to remain in a wait-and-see mode until a fiscal reform is approved later this year. Regarding Moody's, even though a rating action is possible, we see almost no chances of more than a one-notch downgrade this year. Keep in mind that Moody's rates Colombia at Baa2, two notches above "junk" status.

3. We expect a negative price action in Colombian financial markets today, but we think it should be short-lived as we have long argued that markets have been pricing in, with a very high probability, a downgrade to high-yield for quite some time. Expect a sell-off in CDS spreads and long global bond yields of around 5-10 bps, in long local TES rates of 10-15 bps, and in the currency of some 1%-2% on Thursday.

4. On a more positive note, we are materially raising our 2021 GDP growth forecast from 5.5% to 7.5%. Real GDP increased 1.1% y/y in 1Q21, much higher than our forecast of a 0.5% y/y decline. On a sequential basis, GDP increased 2.9% q/q seasonally adjusted. On the back of this data, we are upgrading our

2021 GDP forecast to 7.5% from our previous long-standing out-of-consensus 5.5%. The carry-over effect of the 1Q21 figures on this year's GDP growth is a whopping 8%, so our new forecast is actually penciling in a very significant hit from the ongoing strikes and protests that began in late April and from the renewed set of lockdowns and restrictions due to the third virus wave that is currently hitting the country. At this stage, it is extremely unclear how long it will take for the government to find a solution to recent political and social political unrest. However, assuming that the current crisis does not extend beyond this quarter, we think the local and global backdrop will be very favorable for a strong pick-up in economic activity during the second half of the year and we may even have to revise our 2021 GDP growth forecast to the upside once again.

5. We are also upping our 2021 inflation forecast from 2.8% y/y to 3.1% y/y, but BanRep will be in no rush to start its tightening cycle this year. The nationwide strikes since late April will exert upward pressure on inflation this month, while some of the well-known factors that are driving global inflation temporarily higher this year will also add more pressure to the CPI in Colombia. Yet, with still very wide output and employment gaps throughout this year and with inflation running comfortably within the target range, along with very little underlying demand-driven price pressures, we continue to expect BanRep to keep its policy rate unchanged this year at 1.75%.

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