



Peru Accelerates, While Colombia Seeks to Gain Footing

Growing middle class supports banking and retail in
Peru and Colombia

February 2019

A group of us visited Peru and Colombia in January to obtain a deeper perspective on these Andean markets. Our visit fortified our view that these countries—despite their different dynamics—are growing at steady rates and under good economic management. In Peru, an expanding middle class and underpenetrated banking systems make for some attractive investment opportunities, especially within financials and consumer-oriented sectors.

Peru's Economy Is Growing, and Finances Are Well Managed

Peru is a small but prudently managed economy. The country has a disciplined fiscal policy, a high level of reserves, and a low current account deficit. Peru offers one of the best macroeconomic backdrops in the region, with growth expected to be on an upward trend of about 4% over the forthcoming years. The trip reinforced my conviction in the attractive investment opportunities in Peru, which represents the second-largest country overweight in our Latin America Equity Strategy.

National Anticorruption Referendum Should Rebuild Confidence

This was my first trip to Peru since the country's December referendum



NOTES FROM THE ROAD

Traveling the Emerging Markets

Verena Wachnitz

Portfolio Manager, Latin America Equity Strategy

in which Peruvians overwhelmingly voted to support government political and judicial reforms aimed at cracking down on corruption. Some of Peru's previous leaders have been tainted by the far-reaching corruption scandal of Brazilian construction giant Odebrecht, and as a result, the strength and independence of Peru's institutions have been tested.

The recent referendum was organized by market-friendly President Martin Vizcarra, who took over from former President Pedro Pablo Kuczynski. The vote was the latest move in Vizcarra's antigraft campaign and was a significant step in the right direction. Vizcarra's continued success should rebuild confidence after a period of political uncertainty and help prevent opposing leftist parties from gaining ground ahead of the next presidential election in 2021.

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Key Holdings Represent Long-Term Growth Potential

We had a series of very positive company meetings, including one with the chief executive officer of Credicorp, Peru’s dominant banking franchise. Credicorp is one of the most attractive and more liquid opportunities in Peru and has a long runway for growth. It is our largest investment in the country as we like the exposure it gives us to one of the most underpenetrated banking markets in Latin America. While we don’t expect the bank to achieve the +20% loan growth of the past, we were impressed with the bank’s plans to digitize and optimize its branch network.

We also met with InRetail, a consumer holding company that is well positioned to make inroads into the underpenetrated Andean consumer market, with its exposure to real estate, supermarkets, and pharmacies. InRetail was one of the best-performing consumer staples stocks in the world last year. Its acquisition of a fellow, leading pharmacy retail business in early 2018 led to a structural change in the profitability of InRetail’s pharmaceutical arm, and we see significant room for operational synergies and earnings expansion.

Bouts of Volatility Expected Leading to 2021 Presidential Election

While opportunities exist, it’s worth noting that the leadup to the 2021 presidential election could create bouts of volatility, and we will keep a watchful eye on political developments. Nonetheless, our conversations in the country suggested that some risks have been tempered by the solid economy and the fragmentation of the left-wing opposition parties. It also helps that Vizcarra’s popularity is relatively high, largely because of the growing acknowledgment of locals that macroeconomic improvements will ultimately be vital to their own well-being.

Colombia’s Security Issues Still Impeding Investment Potential

Colombia is a more complicated investment story than Peru, especially from a top-down perspective. It is a less liquid market, is still heavily dependent on oil revenue, and continues to deal with security challenges stemming from its decades-long conflict with left-wing rebel groups. While the government has signed a peace treaty with the Revolutionary Armed Forces of Colombia, the National Liberation Army is gaining strength. Unfortunately, the current situation does not have an easy answer and will likely remain a risk for the foreseeable future.

Fiscal Reform Efforts Have Been Disappointing

While Colombia has made some progress on fiscal reform, more reforms are needed to meet the country’s future fiscal targets—especially as 2018 savings missed the mark. However, after passing an unpopular and watered-down tax bill, President Ivan Duque Marquez’s approval rating has dropped considerably, and he may struggle to pass the necessary reform through Congress. The final tax bill almost halved the original revenue target and placed much of the tax increases on banks.

Nonetheless, with the help of solid oil revenues in 2018, I expect Colombia’s economy to grow about 3.4%, up from 2.7% in 2018. By 2020, it could achieve a 4% growth rate. While the tax reform was not good for banks, I am positive on the broader impact it has had on investors’ confidence. That showed up in increased construction activity. We expect consumer confidence to recover as the value-added tax was held steady and minimum wages were increased 6%.

Stronger Growth and Confidence Should Help Banking Sector

Stronger growth and a solid consumer environment should help Grupo Aval

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Acciones, which is Colombia’s largest banking group and currently our only holding in the country. We met with Aval’s chief financial officer, who expects loan growth to pick up next year with the support of a strong consumer and a lower cost of risk as the company

transitions to Basel III regulation. Meanwhile, its merchant banking arm performed well as new infrastructure projects move ahead, a trend expected to continue through 2019. The new bank tax looks largely priced in, and Aval remains our top banking pick.

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