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Featuring: COLOMBIA | Peru | COVID-19 IMPACT

This week we comment on Colombia's decision to suspend its fiscal rule and Peru's record breaking economic contraction as Latin America becomes the new epicenter of the COVID-19 pandemic. We also highlight the tug-of-war markets are experiencing amid profound economic uncertainty and massive policy support.

Colombia has suspended its fiscal rule for 2020 and 2021

Market Relevance: Colombia's Fiscal Rule Committee has granted the government's request to suspend the country's fiscal rule for 2020 and 2021. The decision comes after two previous revisions of the fiscal limit proved to be insufficient to address the COVID-19 challenges.

Gramercy View: The suspension of the fiscal rule will allow the authorities to use more forceful stimulus measures to support the economy that is projected to contract by 5 to 8% this year. However, like in many other emerging markets in similar situations, this will come at a cost; the sovereign debt burden will increase to at least 60% of GDP in 2020, from 52% in 2019. Colombia's economy and sovereign credit metrics have been hit hard due to the imposition of very strict lockdowns that have managed to keep the country's COVID-19 cases and fatalities to a fraction of those seen in its regional peers. Fiscal consolidation has been a major challenge for Colombia and President Duque unsuccessfully attempted tax reforms that proved to be very difficult to implement politically. Now, the new administration that will take office in the summer of 2022 will

have an even more challenging task in terms of walking back spending to comply with the fiscal rule when it gets restored. These dynamics also increase rating risks for the government that is now at the cusp of losing its investment grade rating after Fitch downgraded to BBB- with a negative outlook in April primarily due to concerns over the trajectory of debt. Colombia is far from unique in this position. As nearly every country opens its purse strings during the COVID-19 pandemic, what we see as a differentiator is governments ability to convince the market that extra loose fiscal policy is temporary and can be reversed without material social fallout after the emergency is over. Sovereigns with larger fiscal space and credible fiscal frameworks are the ones that will outperform in the post COVID-19 world.

Peru experiences severe economic contraction as coronavirus cases continue to rise

Market Relevance: Peru’s economy contracted by more than 40% year-over-year (YoY) in April due to lockdown measures, marking the worst monthly decline on record. Year to date activity is down 13% compared to the same period in 2019 as coronavirus cases in the country continue to increase rapidly, with nearly 250,000 reported and over 6,000 deaths (Latin America’s second most impacted country; only Brazil has reported higher figures).

Gramercy View: The magnitude of April’s economic contraction came as a negative surprise for the market, which had predicted a 30% decline. Additionally, labor reports for May show that 2.4 million people have been laid off. Peru was one of the first countries in Latin America to impose a lockdown to stop the spread of the coronavirus, having enforced quarantining since mid-March, less than two weeks after the first reported case. Yet, despite swift action, Peru has nearly 250,000 cases and the most deaths of any Latin American country other than Brazil. In Gramercy’s view, Peru is an example of the unfortunate reality of COVID-19 management in many emerging economies. Even when governments act swiftly and decisively, dense urban populations, large informal economies and underequipped healthcare systems create a devastating combination. As the epicenter of the pandemic has moved to Latin America and perhaps Africa, the risk of deeper social and economic costs in the emerging world is increasing.

As economies reopen, the global outlook hinges on avoiding a significant second COVID-19 wave

Market Relevance: As economies around the world begin to reopen, easing restrictions on businesses, travel, and social activity, authorities are challenged to find the optimal balance between the health of their economies and the health of their citizens. While reopening has triggered recovery optimism in the markets, sustaining the momentum into the second half of 2020 and beginning of 2021 depends on avoiding a significant second wave.

Gramercy View: For markets, this means a constant tug-of-war. On the one hand, we are experiencing profound uncertainty about COVID-19’s trajectory and the global economic recovery. The pandemic’s full impact on labor markets, consumption, corporate bankruptcies, and sovereign balance sheets is far from clear. On the other hand, authorities around the world have responded

with massive and timely policy support, as exemplified by the Fed's announcement this week of its intent to buy $250bn in U.S. corporate bonds through the Secondary Market Corporate Credit Facility (in addition to the roughly $5.5bn in ETF purchases the Fed has made so far). While we acknowledge the strong near-term market momentum supported by "whatever it takes" commitments by governments and central banks, we remain cautious until we see compelling signs that the ongoing tug-of-war shift firmly in markets' favor.

When you're left wanting more

Market Commentary: Markets grappled with the idea of rising infection rates in Beijing and various U.S. states, which was set against Oxford University's dexamethasone development. After last Thursday's slump, the market found itself wanting more. The U.S. Infrastructure Bill ($1tn) and the equivalent of $1tn in monetary stimulus from the Bank of Japan went some way to offset such concerns. Meanwhile, Powell was able to maneuverer through the Capitol Hill testimony reiterating his previous FOMC remarks, which came after the Fed announced the addition of corporate bonds within the SMCCF package. The bid for U.S. IG and U.S. HY was particularly strong, with U.S. HY some 33bps tighter on the week. Within equities, the rotation from "value" to "tech" continued to play-out with the Nasdaq outperforming, while the VIX continued to trade down. With some USD strength returning, EMFX was mostly in the red, although central banks were more in focus given MPC meetings. Brazil, Russia, and Indonesia cut while Chile, Poland and Taiwan kept policy rates unchanged but committed to more stimulus. While sentiment remains positive, conviction is still low. That said, the primary market is still open as Indonesia, Belarus and Honduras issued bonds, along with 24 corporates that raised $16.5bn in aggregate.

Please contact our Co-Heads of Sovereign Research with any questions:

Kathryn Exum, Senior Vice President, Sovereign Research Analyst
kexum@gramercy.com

Petar Atanasov, Senior Vice President, Sovereign Research Analyst
patanasov@gramercy.com

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