Peso power

Driven by yield fever, foreign investors are snapping up Latin American bonds denominated in local currencies. It's a great deal — while it lasts. By Mary D'Ambrosio

When Colombia tapped the international capital markets last November, its lead manager for the sovereign bond offering, Citgroup, had no difficulty attracting $250 million from more than 80 U.S. and European portfolio managers. In fact, institutional investors so clamored for the five-year, 11.75 percent notes that Citi arranged for Bogotá to issue an additional $125 million. Those were also snapped up. Less than two months later, Colombia was back again, tapping the global bond market for a further $150 million this time.

The market reception was impressive, as was the $525 million in total proceeds for a developing country whose foreign debt load stood at $37 billion. But what made the flurry of deals all the more noteworthy was that the notes were denominated not in dollars or even euros but in Colombian pesos.

The conspicuous success of the offering — one of the first significant Latin American local-currency deals packaged specifically for international portfolio managers — underscored a growing confidence in Colombia, whose 4 percent GDP growth last year was the highest in the country since 1995. It also evinced the triumph of hope over experience on investors' part, given the region's recurring debt crises and spotty repayment record. And it pointed up the fervor of investors' quest for yield at a time when ten-year U.S. Treasury bills yielded only about 4 percent.

"This is an unusual period, with global yields being so low and liquidity being so high," points out James Barrineau, an emerging-markets economist at Alliance Capital Management in New York, who has a relatively favorable outlook on much of the region. "Latin markets are rocking and rolling."

Until very recently, international financings by Latin American countries in their native currencies were rare. And for good reason. Few investors wanted to risk the refixings, unpeggings and outright defaults that have blighted so many Latin American currencies over the years. The sorry record includes Argentina's abandonment of its dollar peg (not to mention bond default) in 2001, which left the peso only a third of its former self; Mexico's 1994 surprise slashing of its peso's value by half; and Brazil's and Peru's hyperinflation in the 1970s and '80s, when workers spent their paychecks at lunchtime to beat afternoon price hikes. So hazardous and hopeless did reais, bolivares, pesos and other Latin currencies seem in the 1990s that it was fashionable to talk about doing away with them altogether and simply dollarizing the whole region.

But to many investors, that is ancient history. "All is forgiven" seems to be their refrain. With the dollar languishing, U.S. Treasury yields meager, the future of the euro up in the air and most Latin economies flourishing, foreign investors have been avid in their support of Latin local-currency borrowers, government and corporate alike. With sovereign bonds yielding up to 20 percent, their enthusiasm is understandable.

Still, as investors from La Paz to Pittsburgh to Paris learn sooner or later, there is no free lunch. The bonds pay extravagant yields because they are risky. Like some of its governments, the region's currencies can be subject to sudden ups and downs, and the interest premium may not wholly offset the damage.

"Current conditions are too good to be true," cautions Arturo Porzecanski, former chief of emerging-markets sovereign research at ABN Amro in New York, who in September will join American University in Washington, D.C., as a professor of international economics. In his estimation the biggest threat to Latin America's current good times is rising U.S. interest rates, which historically have drawn capital away from all emerging markets. Yet much to the surprise of even central bankers, the much-anticipated increase in long-term U.S. rates has yet to materialize, despite the Federal Reserve Bank's relentless hiking of short-term rates. Nevertheless, warns Charles Calomiris, a Columbia Business School economist specializing in emerging markets, "It's going to hit eventually."

"Latin markets are rocking and rolling," says Alliance Capital Management economist James Barrineau.

That note of caution sounded, local-currency Latin American bonds have lots to recommend them. Start with the macro picture: It couldn't be more inviting. The region grew by 5.8 percent in 2004, its best performance in a generation, according to the United Nations' Economic Commission for Latin America and the Caribbean. The commission projects a still-solid 4.5 percent gain this year.

Consider too Latin America's greatly improved ratio of debt outstanding to cash flow from exports. The cost of servicing foreign debt today represents about 21 percent of total exports, down from 32 percent in 2001, according to the Institute of International Finance, the Washington-based association of global financial institutions. That's owing largely to currency appreciation and higher exports. In 2004 private capital flows into Latin America rose to nearly $30 billion, or by more than 25 percent. The IIF estimates that those flows will rise by almost 44 percent this year, to nearly $43 billion.

Latin American stock markets have also enjoyed a boom, with equity prices rising 27 percent in local currency terms and 46 percent in dollar terms for the 12 months ended in early June, according to Morgan Stanley Capital International. Buoyant conditions last year ignited a string of IPOs, especially in Brazil, where seven companies went public, the greatest burst of action seen on the São Paulo Stock Exchange in a decade. So far this calendar year, though, Latin equity markets have been mostly flat.

Amid all this encouraging news, betting on local currency Latin American debt hasn't seemed such a gamble. Claudia Calich, a portfolio manager at Invesco in New York, considers Colombia's initial peso deal a clear winner. The bonds garnered investment-grade ratings, a notch above the nation's dollar-denominated, junk-rated debt ("local" debt is typically rated higher, on the theory that countries can always choose to print more money rather than default). A strengthening peso plus the notes' high yield — a tantalizing 475 basis points above that of Colombia's 2010 U.S. dollar bond — returned Calich an annualized 15 percent in less than two months.

"I bought this deal with the view that the peso still had room to appreciate," she says. Her foresight paid off. The Colombian currency rose 10 percent against the dollar between the end of October and the end of January, before flattening out this year. Also appealing to Calich: The issue was structured to settle in dollars in the U.S. with no Colombian tax on the interest earned.

Investor interest in Latin America's local currency instruments has been building since 2002, when the World Bank's capital markets arm, the International Finance Corp., became the first multilateral institution to raise money in a Latin American currency. The IFC's $100 million Colombian peso issue was whimsically dubbed an "El Dorado" bond, after the mythical golden kingdom that 16th-century conquistadores sought but never found. Argentina, Brazil and Mexico have all seen heightened foreign interest in their local currency instruments, typically versions of treasury securities, occasionally in inflation-linked or securitized form.

Mexico's Treasury bills, or *bonos*, have been a runaway hit. One institutional investor marvels at the "unheard of" yield of 10 percent for an investment-grade country's ten-year bonds and interest-rate swaps. Some 60 percent of Mexico's debt is denominated in pesos.

For months Brazil has been expected to issue a real-denominated bond aimed at the global marketplace but thus far has held out for lower rates. In the meantime, foreign investors are snapping up São Paulo's real-denominated sovereign bonds, which yield as much as 20 percent. By one estimate, foreign buyers now constitute one tenth of the market for these *selics*.

The IFC takes credit for jump-starting the local currency bond trend in Latin America. "Once we came into that market, it snowballed," says John Borthwick, head of funding. The Washington, D.C.–based IFC has now done three Colombian peso issues of its own and floated ten more on behalf of Colombian corporate borrowers. The Word Bank private sector unit is pursuing the same strategy for Peru.

Now a few top-tier Latin American banks and corporations have joined the local-currency borrowing party. Brazil's Banco Votorantim was first, issuing a $75 million, 18-month real bond with an 18.5 percent coupon last November. Two other large Brazilian banks, Bradesco and Unibanco, along with the Brazilian subsidiary of ABN Amro, followed, together raising more than $300 million. The issues were oversubscribed, largely as a result of hedge funds' seeking alternatives to dollar assets.

The local-currency debt phenomenon is potentially much more than just a good deal for Latin American borrowers and foreign investors. The ability of Latin American governments and companies to borrow from foreigners in local currencies may well constitute a seismic shift in emerging-markets finance, enabling issuers to match their borrowing to their needs, rather than having to raise funds in foreign currencies over which they have no control. "Latin currencies are now re-