Colombia Illustrates Emerging Market Hazards

When you get to my age, you have seen a thing or two emerge and not all of them are pretty. National stock markets are not well-represented on that list. It seems they can live in a permanent state of emergence, which is sort of like the 37 year-old PhD student in sociology who has managed a permanent state of adolescence.

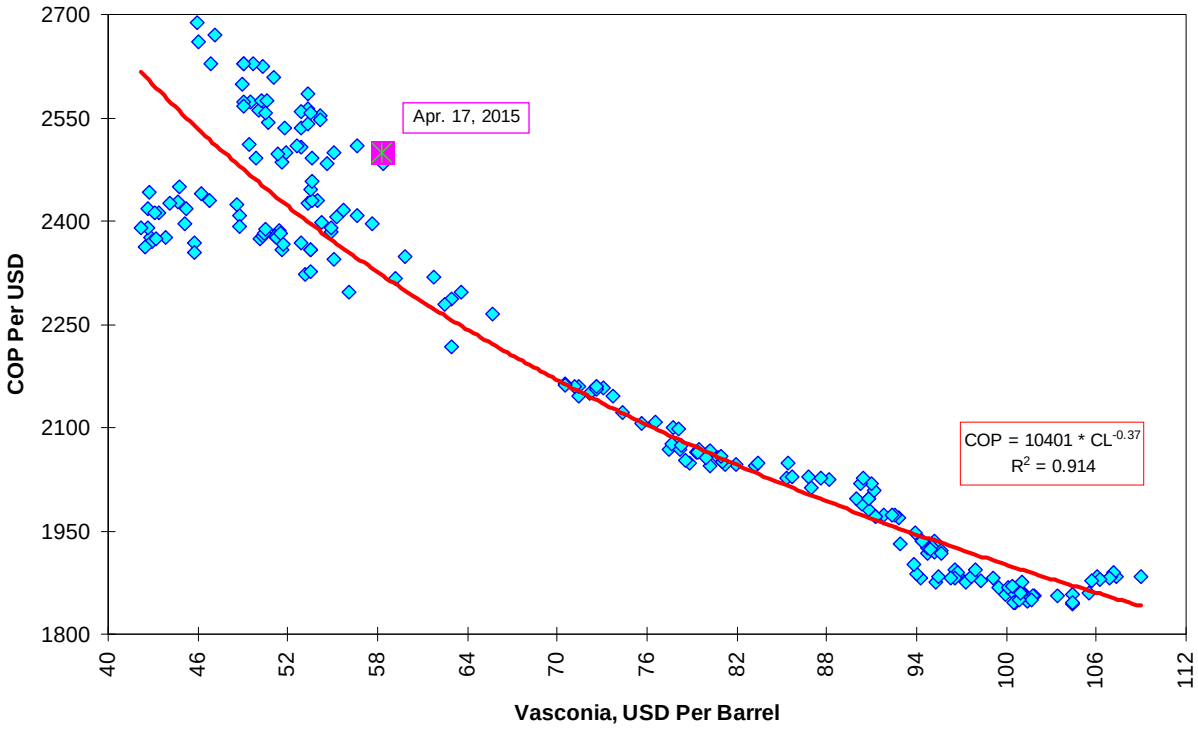
Many emerging markets have a distressingly high reliance on commodity exports, often those of a single commodity, and many are characterized by high interest rates and levels of inflation. There was a time when I might have included a reliance on competitive currency devaluation, but that seems to be as much of a part of nationhood these days as a flag, a money-losing state airline and a meaningless vote in the U.N. General Assembly.

Hail Colombia

Colombia has been underperforming the U.S. since the start of QE2 back in November 2010. This followed a long period starting with Alan Greenspan's (remember him?) first emergency rate cut back in January 2001 where Colombian equities outperformed the U.S. strongly. As money chases performance, the excess carry return for borrowing the dollar and lending into the Colombian peso (COP) rose as well. By the end of July 2014, the Bogota government decided it was high time to drive the COP lower and make imports more expensive at a time when crude oil prices were starting to fall.

The COP has been very much a commodity-linked currency. If we map it against Colombia's Vasconia crude oil price since the crude oil downturn began in late June 2014, we see it weakened as an exponential function of crude oil prices. It has worked to the upside since crude oil's January low.

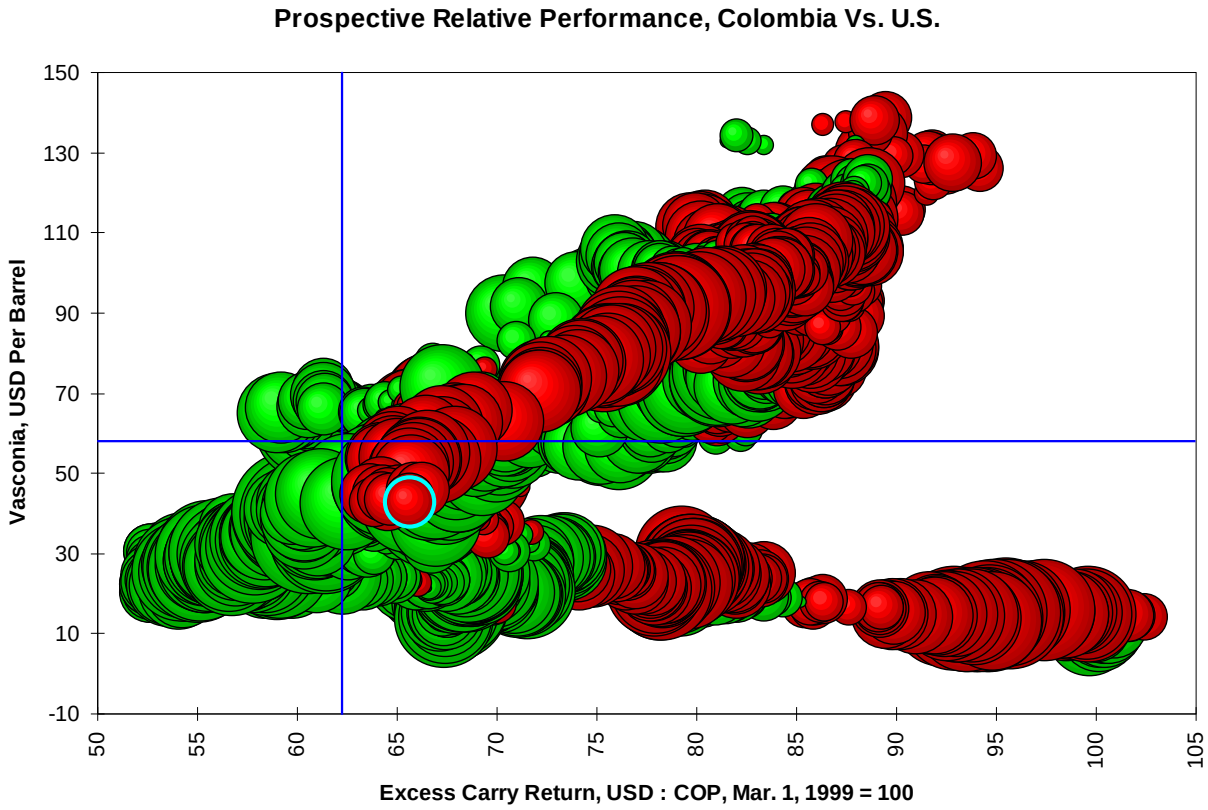
COP As A Function Of Crude Oil Since June 19, 2014



You might think a stronger COP would be somewhat welcome in Colombia, but when much of the country's export revenue is priced in dollars and most of its operating expenses are priced in pesos, the country's business leaders and political class wants a weaker peso as a matter of policy.

What does this combination of crude oil prices and the carry return from the dollar into the peso do for the prospective relative returns on Colombian equities vis-à-vis U.S. equities? Let's map the three month-ahead relative return for Colombia vs. the U.S. as a function of the carry return and Vasconia prices. Colombian outperformance is depicted with green bubbles, U.S. outperformance is depicted with red bubbles and the diameter of the bubbles

corresponds to the absolute magnitude of the relative return. The last datum used, from January 21, 2015 is highlighted and the environment on April 17, 2015 is marked with a bombsight.



We have been shifting to the northwest over the past three months, a combination of higher crude oil prices and a deliberately weaker peso. The current environment nominally favors Colombian outperformance, but when a nation's policy is to devalue its currency regardless of positive economic factors, it raises the risk your investment gains will be offset and then some by currency losses. This has happened to American investors in European equities over the past year. Until this policy changes, I would recommend avoiding Colombia.