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THE IMPACT OF EXCHANGE RATES

ON U.S INVESTMENTS

IN COLOMBIAN REAL ESTATE

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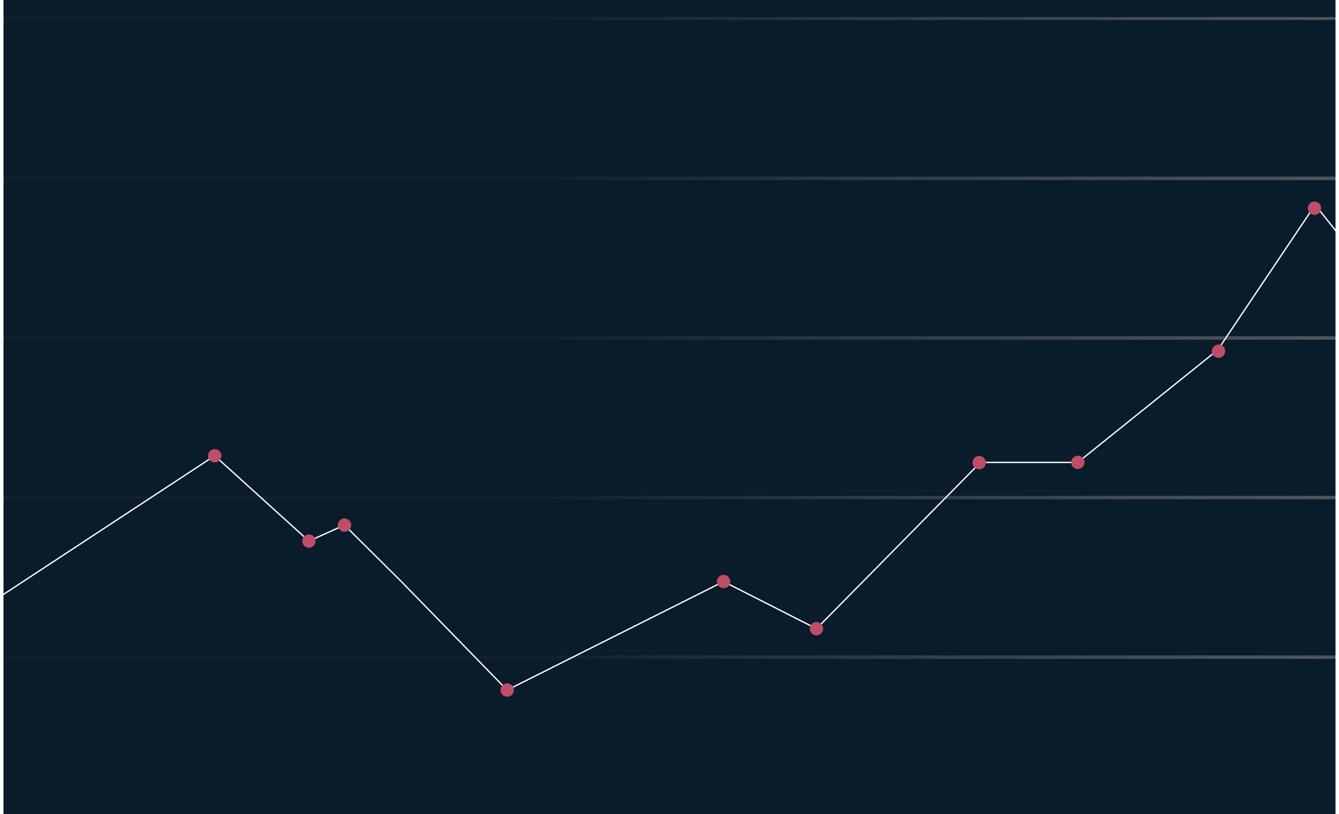

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ABSTRACT

The purpose of this paper is to identify trends in the COP/USD exchange rate and discuss whether or not these trends are likely to benefit U.S. investors.

We accomplish this by examining the dynamics of five major factors that influence exchange rates. The factors are: inflation rates, interest rates, current account deficits, sovereign debt ratings, and terms of trade. We use these observations both to establish a general outlook for the future of COP/USD exchange rates and to provide insight into the current foreign investment climate in Colombia.

Overall, we find that these factors support the long term strengthening of the COP against the USD, which adds further incentive for U.S. investors to enter an already promising Colombian real estate market.

INTRODUCTION

FAR International deals predominantly with investors that hold U.S. Dollars. It is thus important to us that our clients understand the dynamics of the financial and legal environments in which foreign investors operate. Fortunately, both foreign and Colombian investors enjoy equal protection under Colombian law and the Colombian government has recently made a concerted effort to streamline foreign investment processes.

As a result, the only major factor that separates foreign investors from Colombian investors is currency. Because of this, exchange rates play an important role in determining the viability of U.S. foreign investments in Colombian real estate. Exchange rates provide an excellent lens through which to examine a country's investment-worthiness because they take into account a variety of macro-economic factors and condense them into one simple ratio that directly impacts even small-scale investment decisions. Unfortunately, this complexity also makes exchange rates difficult to forecast. Thus, the goal of this paper is to analyze current trends for each relevant macro-economic factor, to use these observations to build a long-term outlook for COP/USD exchange rates, and to discuss the implications of this outlook for U.S. or U.S. based investors. The factors are as follows:

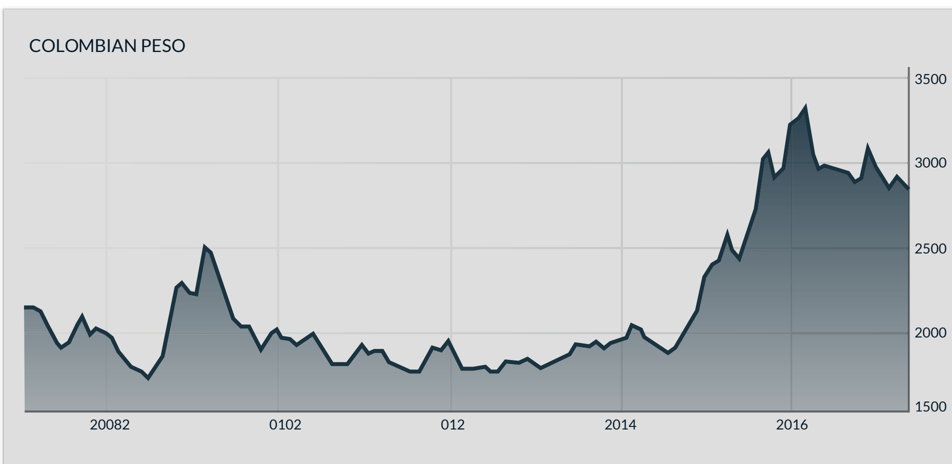
1. Differentials in Inflation Rates
2. Differentials in Interest Rates
3. The Current Account Deficit
4. Sovereign Debt Ratings
5. Terms of Trade

Note: When addressing inflation and interest rate differentials it is important to take into account both Colombian and U.S. dynamics. However, in addressing points three to five I choose to hold U.S. trends effectively constant for several reasons. First, the USD is one of the world's most trusted and stable currencies. The U.S. consistently maintains AA+ sovereign debt ratings and fluctuations in the current account deficit have little effect on the value of the USD. Second, the U.S. engages in trade with a wide variety of countries and boasts a diversified portfolio of exports, contributing further stability. In comparison, the U.S. is Colombia's primary trading partner by a wide margin, indicating a less diversified portfolio of not only exports but also trading partners. Because of this, the COP contributes a large percentage of the volatility in the relationship between the two currencies. Thus, when I refer to changes in the value of the COP "relative to the USD", it is a USD that is, for all intents and purposes, being held constant.

THE CURRENT STATE OF COP/USD EXCHANGE RATES

From 2008 to 2013, COP/USD exchange rates hovered steadily between 1800 and 2000 COP/USD.[1] When oil prices plummeted in late 2014 the value of many Latin American currencies, including the Colombian peso, took a huge hit. Exchange rates skyrocketed to around 3000 COP/USD, peaking at 3300 COP/USD in early 2016. Since then the COP has strengthened slightly, with exchange rates declining to around 2900 COP/USD at present day, which is well above the pre-2014 average of 1956 COP/USD. Figure 1, below, illustrates this trend.

FIGURE 1



SOURCE: WWW.TRADINGECONOMICS.COM | OTC INTERBANK

As Figure 1 indicates, the purchasing power of the USD is currently near an all-time high in Colombia. U.S. investors can buy Colombian property at a 30-40% discount compared to prices they would have paid in early 2014. This is a unique opportunity given the strength of the Colombian real estate market, which is expected to continue to grow steadily as the middle class expands. If we conservatively estimate that exchange rates will fall to 2500 COP/USD by 2022, any U.S. investor that bought property between October of 2015 and the present will enjoy average yearly currency appreciation of 3.2% before property appreciation and rental dividends are factored in.[2] In conclusion, COP/USD exchange rates currently offer U.S. investors a unique opportunity. However, to take full advantage of this opportunity it is important to determine whether or not the value of the COP is likely to appreciate in the future.

1. http://www.xe.com/currencyconverter/convert/?From=USD&To=COP
2. https://www.oanda.com/currency/average

1. Differentials in Inflation Rates

High rates of inflation negatively affect currency value. Therefore, the current differential in inflation rates between two countries plays a significant role in determining the equilibrium exchange rate. Figures 1 (above), 2 (below), and 3 (below) illustrate this relationship. In 2016, the COP bottomed out when the differential between COP and USD inflation rates reached 8.2%, the highest in 10 years. Accordingly, the COP topped out in mid-2011 when inflation rates in both countries met at 4%. Worth noting is that the COP also topped out in 2008 when the U.S. mortgage market crashed and investors fled American markets in droves. This, however, was not "business as usual". Thus I find the example from 2011 to be more useful in demonstrating normal market dynamics.

As of April 2017, the Colombian inflation rate sits at 4.7% while U.S. inflation sits at 2.4%, making the differential 2.3%. Looking to the future, this differential is likely to decrease. U.S. inflation rates are expected to remain stable, hovering in the 2-3% range through 2019.[3] Additionally, The World Bank projects that Colombian inflation rates will fall to the Central Bank's target rate of 3% over that time period.[4] If these projections hold true, the differential should shrink to <1%, which will lead to the strengthening of the Colombian peso.

FIGURE 2

SOURCE: WWW.TRADINGECONOMICS.COM | DANE COLOMBIA

3. https://knoema.com/kyaewad/us-inflation-forecast-2015-2020-and-up-to-2060-data-and-charts2. https://www.oanda.com/currency/average

4. http://www.worldbank.org/en/country/colombia/overview#1

FIGURE 3

SOURCE: WWW.TRADINGECONOMICS.COM | U.S. BUREAU OF LABOR STATISTICS

2. Differentials in Interest Rates

Like inflation, there is a strong correlation between interest rates and exchange rates. Higher interest rates generally favor stronger exchange rates. Generally, the larger the interest rate differential between two countries, the more often investors will choose the market that offers higher interest rates (and thus higher returns). Exchange rates respond to this increase in demand, driving up the relative value of the currency in the country that offers higher rates.

Worth noting is that inflation rates must be manageable in both countries for the interest rate differential to have a significant impact on exchange rates. Generally, high inflation scares off more foreign investors than high interest rates attract. Colombia is currently recovering from a period of high inflation as a result of oil price shocks in late 2014, and thus high interest rates (which central banks use to battle inflation) have had little effect on exchange rates. However, if World Bank projections hold true and inflation rates fall to 3% in the medium term, this is may change.

Colombian interest rates are currently set at 6.5%, and the Latin Focus Consensus Forecast predicts rates will finish 2017 at 4.7% and 2018 at 3.4%.[5] In comparison, the U.S. Federal Funds Rate is currently set at 1%, and is expected to finish 2018 at 1.9%.[6] If Colombia maintains higher interest rates as inflation falls, it is likely that we'll observe an influx of U.S. investors looking to take advantage of higher returns. This will ultimately have a positive impact on the value of the COP.

5. https://www.focus-economics.com/country-indicator/colombia/interest-rate
6. https://www.focus-economics.com/country-indicator/united-states/interest-rate

3. The Current Account Deficit

The International Monetary Fund (IMF) defines the current account deficit as “the difference between the value of exports of goods and services and the value of imports of goods and services”. Running a current account deficit is not, as the IMF makes clear, necessarily detrimental to overall growth, but it does tend to hurt a country’s exchange rates. If a country imports more than it exports, it creates higher demand for foreign currency while increasing supply of domestic currency, which is detrimental to exchange rates. Fortunately, the Colombian current account deficit has been making its way back towards equilibrium since 2015. Figure 4, below, illustrates this trend. If, as BBVA Research projects, this trend continues, it should lead to the appreciation of the COP relative to the USD.[7]

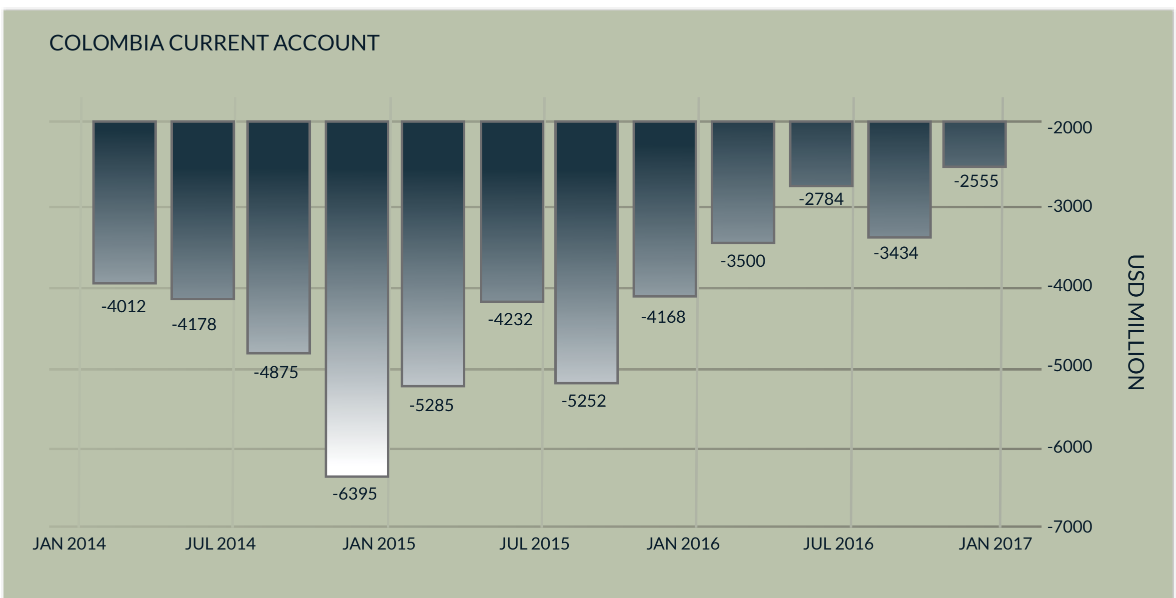


FIGURE 4

SOURCE: WWW.TRADINGECONOMICS.COM | BANCO DE LA REPÚBLICA DE COLOMBIA

7. https://www.bbvaresearch.com/wp-content/uploads/2016/05/Colombia_Economic_Outlook_2T16.pdf

4. Sovereign Debt Ratings

Sovereign debt ratings give investors insight into the risk associated with investing in a particular country. Naturally, a country with a stronger credit rating will attract more foreign investment and thus will have stronger exchange rate. In March of 2017 Fitch upgraded Colombia's credit rating to BBB, which is investment grade and "Relatively Low Risk". This is in keeping with a 17 year positive trend in credit ratings. Since 2000, Colombian credit has steadily climbed from BB (2000) to BB+ (2007) to BBB- (2011) to BBB (2017) where it is now. Conversely, during this same period the United States' credit rating was reduced from AAA to AA+.

In addition, multiple credit agencies cite the lack of a definitive peace deal between the Colombian government and the FARC as reason for not further upgrading Colombian credit. However, both the FARC and the Colombian government are currently taking significant steps to towards reaching a lasting peace agreement in the near future. Thus, given past rating trends and the imminence of a FARC peace deal, Colombian sovereign debt ratings are likely to continue to improve, which will result in the strengthening of the COP.

5. Terms Of Trade

Terms of trade consist of a ratio comparing the price of exports to the price of imports. Increased terms of trade imply increased demand for Colombian exports, leading to the appreciation of the COP. Given that crude petroleum constitutes 34% of total exports, global oil prices have significant impact on Colombian terms of trade.[8] Fortunately, BMI Research predicts that global oil prices will recover steadily through 2020 and will thus cause the COP to strengthen.[9] Furthermore, BMI states that the primary risks to their forecasts are to the upside, meaning that any deviation from their predictions will likely trend towards a stronger COP than was expected.

8. http://atlas.media.mit.edu/en/profile/country/col/#Exports

9. http://www.latinamericamonitor.com/currency-forecast-cop-modest-upside-amid-easing-oil-headwinds-june-2016

CONCLUSION

There is strong evidence that, after bottoming out in 2016, the value of the COP will appreciate relative to the USD over the long term*. All five of the factors that most heavily influence exchange rates are projected to strengthen the COP in the coming years. Colombian terms of trade are steadily improving, and major ratings agencies such as Moody's and Fitch continue to upgrade Colombian credit. The Colombian account deficit is shrinking. Inflation rates are falling while interest rates are likely to remain attractive to foreign investors. Because of these trends, U.S. investors can be confident that a strengthening COP will serve to both augment returns and mitigate any unforeseen losses, making Colombian real estate a competitive option for investors interested in expanding their international holdings.

*Occasionally, political and economic events occur that fall outside the scope of standard market analysis. It is thus worth addressing a few circumstances under which the accuracy of our projections may fluctuate:

1. Unforeseen disruption of global oil markets

As Colombia is primarily an oil exporter, the value of the COP tends to track global oil prices. While oil markets are expected to remain stable or increase, a market disruption (increased major usage of green energy, expanded shale production, OPEC production accords violated, etc.) could negatively impact the value of the COP.

2. Regional or global financial crises

In the face of financial uncertainty, investors tend to flee towards "safe" currencies, such as the USD. This most recently occurred during the global recession of 2008. It is thus possible that a similar crisis could provoke another flight to the USD, negatively impacting the strength of the COP

3. The FARC peace plan fails

Many international investors look to the relationship between the Colombian government and the FARC rebel group as an indicator of the country's investment safety. While unlikely, failure by the two parties to reach a peace deal could have adverse effects on the strength of the COP in relation to the USD.

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