

6 Financial markets remain positive, but correction expected

Low risk premiums and continuing appetite for domestic assets, although we expect some correction going forward

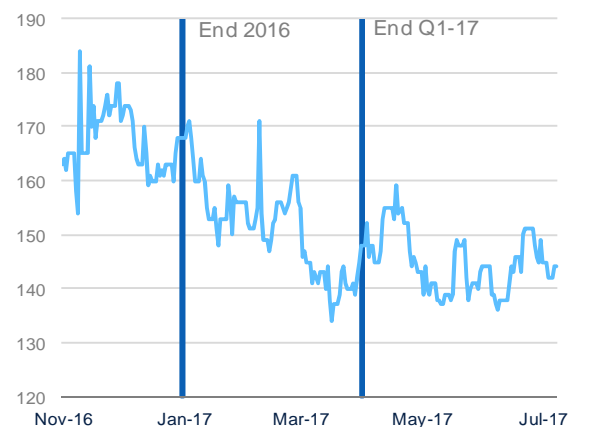
Local financial markets performed positively in the first half of the year. Risk indicators remain contained and on a positive trend, despite local political tensions in the initial months of the year and a degree of deterioration in the robustness of Peru's fiscal position. Country risk indicators for Peru, such as the 5 year CDS and the EMBIG-Peru, are stronger than at the end of the first quarter, with the former having fallen by 14% and the latter by 3% since the end of March (see Figures 6.1 and 6.2).

Figure 6.1. Peru: Peru 5 year CDS (basis points)



Source: Bloomberg and BBVA Research

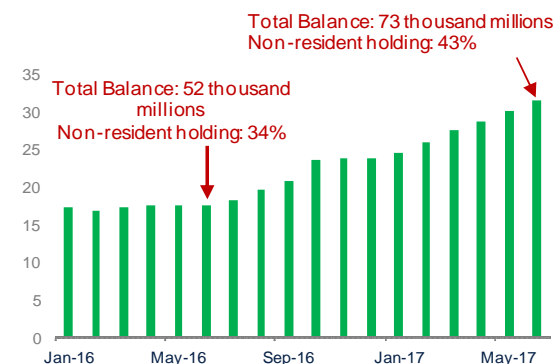
Figure 6.2. EMBIG-Peru (basis points)



Source: Bloomberg and BBVA Research

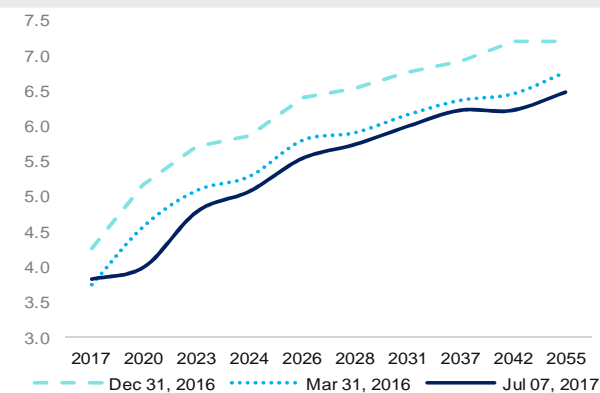
In this regard, the Peruvian currency has remained relatively stable, with local financial assets revaluing. This is supported by the prices of the metals Peru exports - such as gold and copper - which have remained high, and the strong appetite of foreign investors for local financial assets. The latter is reflected in holdings of sovereign bonds by non-resident investors, which have increased by around 80% (14 billion soles) in the last year, to 42% (34% one year ago, see Figure 6.3). The yield curve has also shifted downwards this year (see Figure 6.4). As a result, yields on the most heavily traded sovereign bonds are below their average for the last few years (see Figure 6.5).

Figure 6.3. Holdings of sovereign bonds by non residents (billion soles)



Source: Bloomberg and BBVA Research

Figure 6.4. Peru: Sovereign bond yield curve (%)



Source: Bloomberg and BBVA Research

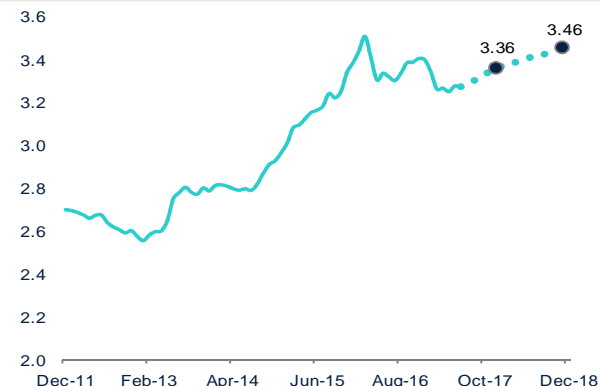
The local currency has remained relatively stable, despite domestic political noise and a degree of deterioration in the fundamentals of the Peruvian economy (such as reduced fiscal robustness and a slowdown in productivity). We therefore consider the Peruvian currency to be somewhat overvalued. We expect a reversal over the coming quarters. This is apparent from the decrease we are discounting in the terms of trade in 2018, the increase in the interest rate spread between soles and dollars (Peru will cut its monetary policy rate, whilst the FED will increase its), and the reduction in the size of the FED's balance sheet. However, these will be counterbalanced to an extent by Peru's continuing balance of trade surplus. On balance, we expect a slight correction in the prices of local financial assets, such as sovereign bonds, and a gradual depreciation of the local currency over the coming quarters. Consequently, our baseline scenario provides for an exchange rate slightly in excess of 3.35 at year-end 2017, and around 3.45 in 2018, see Figure 6.6.

Figure 6.5. Peru: Sovereign bond yield 2023 (%)



Source: Bloomberg and BBVA Research

Figure 6.6. Projection of the USDPEN (soles per dollar exchange rate)



Source: Central Reserve Bank of Peru and BBVA Research

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