Markets

Colombia Risks More Downgrades and Forced Selling of Its Bonds

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- Others are likely to follow after S&P cut the country to junk
- Second downgrade would trigger forced selling of bonds

Investors are bracing for more credit downgrades for Colombia, which would cement the country's junk rating and force some fund managers to ditch billions of dollars of its bonds.

In recent years, nations that lost investment-grade with one ratings agency lost it with others soon after. That was the case with Brazil, Hungary, Russia and South Africa, where a second downgrade to junk followed within three months of the first, according to Citi Research.

Quick to Cut
A second downgrade to junk came quickly for these `fallen angels'

	First Downgrade	Second Downgrade
Hungary	Nov. 25, 2011	Dec. 21, 2011
Russia	Jan. 26, 2015	Feb. 20, 2015
Brazil	Sept. 9, 2015	Dec. 16, 2015
South Africa	April 3, 2017	April 7, 2017

Source: Citi Research

S&P Global Ratings cut Colombia to junk this week, while Fitch Ratings and Moody's Investors Service still rate the nation investment grade. With junk ratings from two agencies, Colombia would be dropped from indexes that investors use to balance their portfolios, causing automatic selling.

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Mandates that prohibit some institutional bondholders from holding speculative-grade debt would force them to sell as much as $1.5 billion of government dollar bonds, according to an estimate by Citi.

Another $1.4 billion to $2.6 billion of peso-denominated debt, known as TES, could also be dumped, according to Credicorp Capital Research. Foreign funds hold about a quarter of the nation's local peso bonds.

"The downgrade of Colombia to junk status on its foreign currency credit rating reflects the deterioration in its fiscal dynamics and could be a prelude to further downgrades," said William Jackson, chief emerging markets economist for Capital Economics Ltd. in London. "That, to us, seems quite likely given the political difficulty of passing tax reform."

Finance Minister Jose Manuel Restrepo plans to meet with Fitch and Moody's in the coming weeks to try and convince them to keep Colombia as investment grade. S&P's downgrade came after the government ditched a plan to raise taxes after opposition in congress and mass unrest.

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Fallen Angels

For now, Colombia remains in investment-grade indexes, even though investors are already pricing them as so-called fallen angels, a term for countries that have been downgraded to junk. Colombia's dollar bonds are the worst performers in Latin America after El Salvador since the tax legislation was introduced in mid-April, according to data compiled by Bloomberg.

The selloff reflects the expectation that its only a matter of time before Colombia is downgraded again, said Guido Chamorro, co-head of emerging-market hard-currency debt at Pictet Asset Management Ltd in London.

"Colombia is still technically investment grade, but this is just semantics," Chamorro said. "Downgrades are typically get priced by the time they happen."