MARKET FLASH

PINEBRIDGE INVESTMENTS

Peruvian Elections In The Rearview Mirror: An Investor's View

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Overview

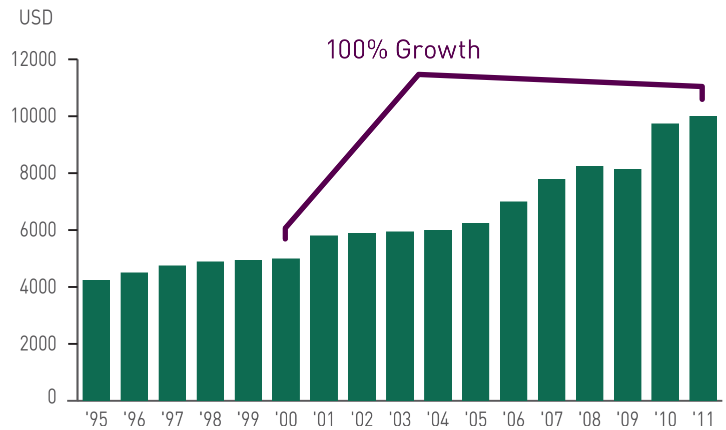
Ollanta Humala's victory in Peru's presidential elections is without doubt a defining moment for the country. Not only does it underscore an important disconnect between urban and rural realities, but it also proves that the overall level of growth seen in Peru has not yet trickled through to more localized areas of the country's economy, in spite of the 100% growth in per capita income over the past decade (Figure 1).

Peru's recent political history is dominated by outsiders entering the presidency during the most critical moments. Such was the case of Alberto Fujimori in 1990 (economic crisis), Alejandro Toledo in 2001 (political crisis), and again in 2011 with Ollanta Humala (social crisis). In each of these cases, although very different from one other, the empowered and disenfranchised have joined forces to speak with a rare clarity in a country renowned for the excessive power of its elite and where extreme centralization continues to exist.

This was especially true when the rich and poor joined forces against Alberto Fujimori and his increasingly authoritarian and corrupt regime. Interestingly, this was the scenario in which both Alejandro Toledo and Ollanta Humala entered the political arena, although each took slightly differing paths. For Humala in particular, his role as an army rebel who helped mobilize the indigenous population of the south against "fujimorismo" became crucial in his ability to build on that base of support in subsequent elections (even though he lacked support from the top during the 2006 elections).

It is especially interesting to note that the indigenous population of Peru to date is not yet organized at a level comparable to neighboring Bolivia and Ecuador, where the voice of the indigenous population is highly representative.

FIGURE 1 GDP Per Capita (PPP)



Source: IMF, WEO Database, April 2011.

Toledo also recognized the potential to mobilize the indigenous population (hence his nickname "el Cholo" – gente del campo), which arguably took him to the presidency in 2001, with the help of a few members of the elite who were convinced by his education credentials. During Toledo's regime, Humala returned to the military and became Peru's army attaché in France and later in South Korea, slowly creating a partnership between them.

With these facts in perspective, the second round of presidential elections this year has actually been closely consistent with Peru's recent history. Toledo and Humala, both supported by the indigenous population and aligned with the intellectual leadership under Alvaro Vargas Llosa, focused on a social agenda. While Keiko Fujimori, using a more populist strategy, only achieved the support of the establishment and newly created middle class, which collectively remain a minority in the population. The adage that politics creates strange bedfellows was never truer than in Peru in 2011.

How Do We Interpret This As Investors?

First, we can be assured that Toledo is the strongman and mastermind behind Humala's victory and, depending on the cabinet appointments, the economic program could continue in an orthodox vein. Second, Peruvians have become more susceptible to the idea of social change and justice rather than economic prosperity, a worldwide trend in 2011 highlighted by the changes taking place in the Middle East. Many of the new governments' initial measures are expected to address those pressing issues, such as an increase in the minimum wage and provisions for retirement and youth employment, all of which are likely to increase consumption. Finally, the tremendous success of the Lula model in Brazil, which embraces orthodox economics and serious poverty reduction, has proved that this unusual approach can be successful. If this is followed - and only time will tell - we can expect both a leap in consumption as well as improved housing conditions.

In this context, Humala will have to govern tied to a list of priorities that may differ from his own more radical agenda, but which will determine his success or failure in governing the country. It is important to note that Humala's party has only 47 of 130 seats in Congress (31%) and Toledo's party has 21 seats (16%), making it virtually impossible for Humala to pass any legislation without Toledo's explicit approval. Moreover, many of Humala's advisors and probable cabinet members were originally supporters of Toledo, highlighting the importance of this partnership. Toledo understands that the current economic model that he helped to build is working and that this cannot be jeopardized. But there are some changes that could be made within the existing regime that will have a large impact on investors. The mining sector is key. Keeping in mind that the current corporate tax rate for miners in Peru is 30% + 3% royalties/duties + 4.1% on dividends, which is below international benchmarks, changes should be expected. Such moves, however, are in line with other mining countries like Australia, but in contrast to neighboring Colombia where investment through low taxes is incentivized. Royalties in Colombia on different minerals varies between 1% and 12%, some of the most attractive in the world, and the government offers other tax incentives, such as waiving VAT for temporary imports of capital machinery required for mineral extraction.

Another crucial question for investors is what will happen to pension fund savings. At currently around 15% of GDP, pension funds have been a key factor in the development of Peru's capital markets. Humala has mentioned their potential nationalization, similar to that championed by Argentina's Cristina Fernandez de Kirchner in 2008, and that could cause another sharp decline in local capital markets. One wonders how the Andean market integration (known under its Spanish acronym MILA) will advance with these questions outstanding. Certainly, new issuance activity will be restrained. However, Humala's lead economic advisor, Kurt Burneo, is talking about reform rather than nationalization of the pension scheme.

The unwinding of existing trade pacts - another key factor in Peru's economic development - is an additional area of concern. The extension of free trade agreements for the smaller, open economies in Latin America has been an important developmental tool, as evidenced by the success of Chile in this area. It is important to note that Peru's trade pacts are currently defended by the constitution and thus any change will require strong congressional support.

The best case scenario going forward is that Humala begins his presidency with a strong centrist cabinet, which at this point seems likely, and delivers on economic changes that address the disenfranchised (minimum wage, elderly and unemployed youths) in the overall context of an orthodox macroeconomic scheme. The worst case scenario, however, would involve a breakdown between Humala and Toledo and other centrist supporters, thereby compromising governability and prompting a more radical approach from the President. In this case, it is conceivable that Humala would consider dissolving congress and attempt to call a referendum that allows him to establish a constitutional assembly to rewrite the constitution. Although extreme, there are precedents to this: Peru under Fujimori in 1994, and also in neighboring countries like in Colombia in 1991, Venezuela in 1999, Ecuador in 1998 and 2008, and Bolivia in 2008. Therefore, it cannot be disregarded.

Both scenarios resemble three comparable cases in the recent history of Latin America: those of Lucio Gutierrez in Ecuador, Hugo Chavez in Venezuela, and Lula da Silva in Brazil. Gutierrez was an army officer who led the ousting of Jamil Mahuad in 2000 and then became president in 2003 with the support of the indigenous population on leftist promises. He quickly became pro-market to gain support from the rest of the country, but failed when he tried to make structural changes to the judicial system to gain more power and bring Abdala Bucaram back from exile. Such moves from Humala will likely have a similar outcome. The case of Hugo Chavez was extremely similar, except that he did not start with a leftist agenda but became more radical as he gained control of congress after the constitutional assembly of 1999. His most radical change was in 2002, almost four years after he was elected. Finally, in the case of Lula, very little actually happened and focus went mostly on social programs under an orthodox economic policy. From these three cases, although Humala's personality is more similar to that of Chavez and Gutierrez, a Lula-like scenario seems more probable at this point, primarily due to external factors and the democratic maturity of the country. It is important to keep in mind that Humala has real admiration for the Brazilian model and chose Brazil for his first international visit.

Investment Outlook

Peru's growth pattern is still fairly positive and momentum is expected to continue. Under Humala, we see risks for the mining industry in the form of taxes and possibly some contributions to the community, but we expect this to be heavily debated in congress and there is still room to increase the level of tax whilst maintaining it at or below the international average. We see a very good environment for domestic sectors, such as banks (particularly those exposed to microfinance and Small and Medium Enterprise financing), retail, consumer staples, and construction, based on increases in the minimum wage, directed lending programs, and decentralization efforts (both in political terms and physical infrastructure). Going forward, it will be vital to understand the role of Peru's development institutions, such as COFIDE (Corporación Financiera de Desarrollo), which we expect will take a front seat in terms of social spending. Clarity on the usage of this institution will be an important driver of the banking sector.

The bottom line is that investors should tread carefully, first focusing on broad consumption with an eye to the participants in the Humala administration. The mining sector, while attractive on a fundamental basis, is probably best avoided until the debate on taxation begins. Finally, particular attention needs to be paid to pension funds and further progress on MILA, as that will affect the price and value of all listed companies in Peru.