Colombia (GXG) - Introduction 9/2/16

Colombia is a country with baggage.

The mention of this South American destination often conjures up frightening images of narco-terrorism, Pablo Escobar, mounds of white lightening and the birthplace of that singer who wrote that horrendous official World Cup song… tragic.

To be fair, Colombia long deserved the bad rap. It suffered tremendously during the cocaine cowboy decades of the 60s-90s. Here's some stats to paint the picture of just how grim things were (via HBR):

- Over the past 50 years some 220,000 people, 80% of whom were civilians, have been killed.
- More than 6 million people have been internally displaced, a population on par with that of the Syrian refugees.
- Nearly 500,000 women have suffered sexual violence
- 27,000 people have disappeared.
- Land mines have killed or injured more than 11,000 people since 1990, the second-highest number of landmine injuries in the world, after only Afghanistan.
- At their peak in the late 90's, the FARC rebels had roughly 20,000 fighters who carried out kidnappings, bombings, and other atrocious acts against the Colombian government and its people.

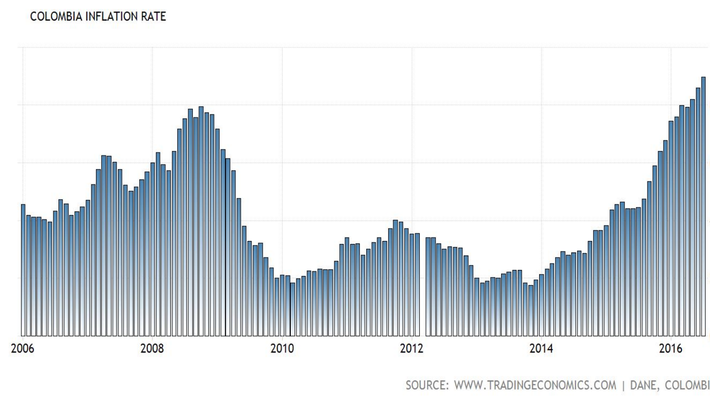
Colombia was essentially a real life Dolph Lundgren movie and not of the *Kindergarden Cop 2* variety. The economic impact of this bloody history is incalculable, but it's safe to say it was costly on many levels.

For these reasons, the country has long been one you wouldn't want to invest in with a 10ft pole, not even with your buddy holding.

In addition, the country's economy has been hit hard over the last two years due to the ongoing collapse in commodities. Colombia is the 53rd largest exporter in the world; dealing mostly in crude, petroleum, coal, coffee, and gold. And though exports only account for 16% of GDP; oil provides over half of all export revenue. For every dollar drop in the price of oil, the government loses roughly $200 million in state revenues.

This has put the squeeze on government spending, forcing President Santos to announce a 3% cut to the federal budget as part of his "intelligent austerity" program.

Low oil prices and rising food costs caused by an El Nino-related drought and a multi-month nationwide trucker strike have pushed inflation up to 8.9% in July — the country's highest annual inflation rate since 2000. In response, the central bank has been forced to raise interest rates and tighten money. Its benchmark rate is now at 7.75%.



Under this poor economic backdrop, the credit rating agency Fitch and Moody's lowered the country's outlook, from stable to negative.

Okay, so now that I've told you all of these depressing details I can finally say that Colombia is a raging **buy**.

Famed billionaire investor Jim Rogers once said *"I just wait until there is money lying in the corner, and all I have to do is go over there and pick it up."*

Colombia is that pile of money and it's in a corner that nobody has looked at in decades… and that's why it's just sitting there waiting for you and me to go pick it up. Let me tell you why.

So everything I described above is bad, negative, horrendous and not what you want to see in an investment prospect. But here's the catch: all of that information is of the past.

Colombia's past is horrible but its future couldn't be brighter. In our opinion it's setting up to be one of biggest growth stories over the coming decade and none of that growth is priced in at the moment.

Remember that 52-year-old narco fueled civil war? A formal cease fire was just declared last week and a final agreement will be signed next month. FARC leader Rodrigo Londono said this to journalists:

> *Never again will parents be burying their sons and daughters killed in the war… All rivalries and grudges will remain in the past.*

The significance of this peace deal cannot be overstated. It's huge…

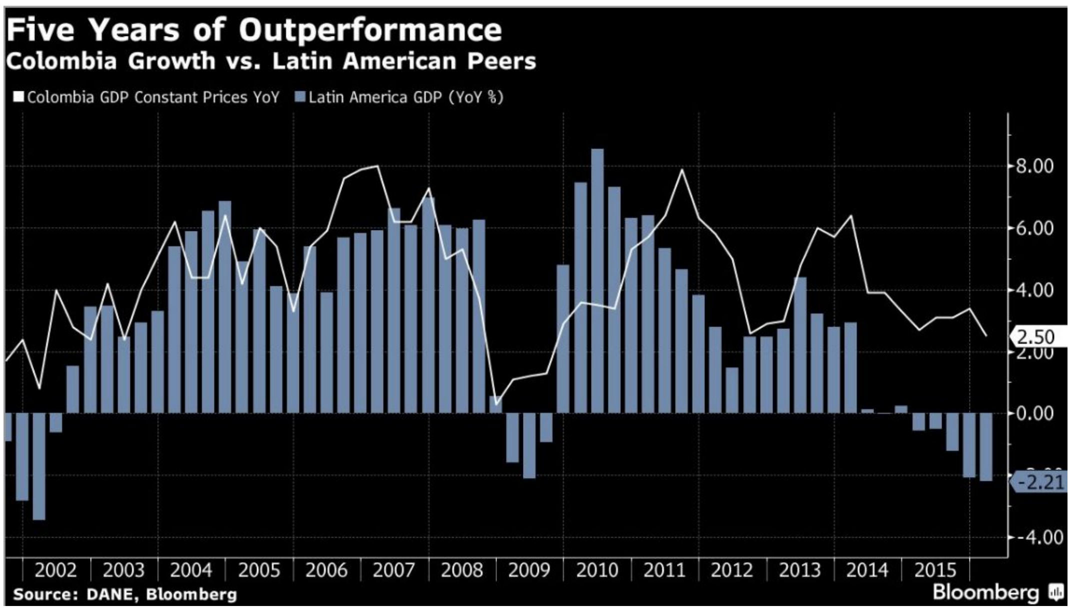
The civil war affected everything from consumer habits to infrastructure development.

Living under the constant threat of violence shaped Colombian culture, the following being a perfect example of this (via HBR):

> *"It's a culture thing," María Lacouture, the head of government economic development agency ProColombia, told me. "In the social arena, we would go to our friends' [house] to go out, or we'd stay in the house. We'd focus on, how can I develop in my area, in my business?"*

And the war separated large swaths of the country, making it nearly impossibly to carry out modern infrastructure projects. As a result, Colombia is ranked 103 out of 140 in the Business Environment and Infrastructure index and 130th out of 140 for transportation infrastructure.

Many point to these things as negatives going forward, but we see it as the exact opposite. Look at the following chart showing Colombia's impressive growth relative to its LatAm peers *despite* these difficulties.

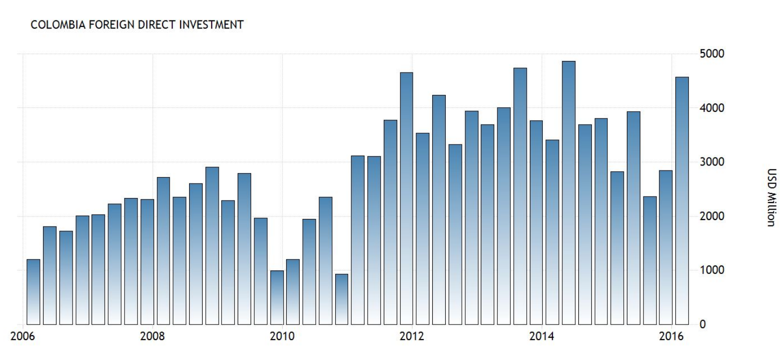


While its commodity exporting neighbors have been experiencing contracting GDPs due to falling oil, Colombia has been able to maintain growth under tough external conditions.

In the past decade alone the country has seen per capita incomes more than double and foreign direct investment 10x over the same period.

Now imagine the social and consumer changes that will take place over the next five years with the newly developed peace and growing sense of security. Maybe Colombians stop spending Saturday nights at their friends' houses and instead hit the town to tear up some rugs salsaing while throwing back some Aguardiente.

The renewed peace will drive up tourism — it's my favorite place to visit in South America and I know the US Secret Service loves it there too — and foreign direct investment will also continue to increase.



Now let's circle back to the poor infrastructure. The government has recently embarked on a bold decade long infrastructure build with the aim of creating a nationwide toll road network that connects vast areas of the country long separated by jungle and conflict. They also have an additional $70 billion spending program focused on modernizing other parts of the economy.

This all means increased government spending, which equals more jobs, rising incomes and increased consumer spending. The toll road program alone is expected to reduce transport costs by 28% and raise GDP by 1.5% per annum. And with low public and private debt, the country can afford to open its purse strings a bit and pursue an expansionary fiscal policy.

The country has been blessed with a long established and functioning democracy — especially by South American standards — and has the highest ranking business climate amongst Latin American and Caribbean countries in the World Bank's "Doing Business Report" (wow, great title!).

As Dylan said "the times they are a-changin'" and that couldn't be more true for Colombia. After decades spent in the dark corners of the dangerous frontier markets, it's about to break out onto the world stage as a major player in LatAm politics and global economics.

It's time to walk on over to the corner and scoop up as much Colombia as you can before the others wake up and see what's happening.

Here are our picks for playing the Colombian bull theme:

Pictured below is the Global X MSCI Colombia ETF. The chart has nearly completed a textbook head and shoulder bottoming pattern. The target at 12.57 (a 30% price increase) is just a first target. Once this pattern completes GXG could run all the way to its 200 day moving average and beyond.

Another available play is Grupo Aval (AVAL). AVAL is Colombia's largest financial services company with a controlling stake in four of the country's largest banks; as well as its largest fund manager.

Colombia has one of South America's healthiest financial sectors and its banking is largely oligopolistic; meaning the five largest banks hold over 75% of all banking assets, enjoy close ties to the government, and thus have large moats to protect them from competition.

AVAL enjoys healthy margins and a low NPL (non-performing loan) ratio. So if there's a continued shift in the macro outlook — and I think there will be — the bank's stock should recover to levels last seen in mid-2015.

And then finally there's Ecopetrol S.A., Colombia's largest energy producer and refiner.

This stock is a pure energy play. If oil doesn't rise in the near-term, then I don't care to be in it. But if it does, then I think this advance will likely outpace crude oil's.

EC recently completed an expensive modernization project on its largest refinery (Reficar). The project was plagued by cost overruns and typical Lat-Am corruption and scandal; which led to a 100% cost increase to the tune of $8B. But now all of that's behind it and the company possesses the largest and most efficient refinery in Latin America — making it competitive with the major refineries in the US (where it exports a lot of its product).

With the major one time capital expenditures out of the way, the company should see improving margins moving forward, bolstered by the better throughput efficiency of the modern refinery.

Investors entering into any of these stocks will be getting in near a secular bottom for Colombia. There's big potential for long-term compounding appreciation in these plays.