PERU

Executive Briefing

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Capital Market Dynamics

Foreign Exchange ► The Peruvian sol (PEN) maintains its appreciation bias against the US dollar, gaining 3.9% over the last 12 months and reaching its strongest level in 15 years in mid-October. The currency has not been immune to global financial market distress, European sovereign debt problems and, more recently, US fiscal concerns; however, the effects have been temporary. Monetary authorities have encouraged the use of the domestic currency in local transactions and have accelerated the process of structural de-dollarization of the economy. Additionally, the authorities, aiming to decrease predictability of FX interventions, have established a new USD purchase mechanism, which is activated irrespective of the currency's direction (previously authorities only purchased USD when the local currency was appreciating). We expect the USDPEN rate to close 2012 and 2013 at 2.57 and 2.49, respectively.

Sovereign Debt & Credit Ratings ► Peru enjoys a favourable sovereign credit profile and it is a candidate to receive a rating upgrade. Moody's has recently raised the country's long-term foreign-currency rating to "Baa2" from "Baa3", maintaining a "positive" outlook. The move was the result of strong economic performance, solid public finances and less exposure to political risks. Standard & Poor's rates Peru at "BBB" with a "positive" outlook, and has stated that the rating could be upgraded if investment projects, mainly in the mining sector, are advanced in the foreseeable future, triggering higher export volumes and offsetting any metal price shock. Fitch maintains a sovereign debt rating of "BBB" with a "stable" outlook. The cost of insurance against sovereign default measured by the five-year credit default swaps (CDS) remains in line with other Latin American countries such as Mexico, Colombia and Panama, at a low level of 100 basis points (bps).

Economic Outlook

Growth ► The Peruvian economy remains as the best output growth performer among its Latin American peers, expected to expand at an average rate of 6% y/y in the 2012-13 period, despite the mild global growth scenario. Local demand, particularly household consumption (due to improved labour market conditions, higher wages and credit expansion), and private investment (strong foreign direct investment and higher global liquidity) continue to drive economic activity forward. Both mining and construction have been - and will continue to be - major sectors benefiting from investment flows. Repatriation risk of short-term inflows has raised the central bank's concerns, mostly if the European distress, and the US fiscal situation elevate tension in the coming quarters.

Inflation & Monetary Context ► Inflation is expected to slowly return to the 3% y/y mark in 2013, after more than a year above the central bank's tolerance range (1-3% y/y). Headline inflation has been treated as temporary by authorities, due to supply shocks; however, there are some signs of price pressures on the demand side. The central bank has been tolerant, leaving the reference rate unchanged at 4.25% for the last 17 months. With a 400 bps spread versus the US Fed funds rate, a solid economic profile, the excess of global liquidity triggered by major central banks and the high degree of dollarization - albeit decreasing - in the local economy, a significant amount of foreign capital flowed in. Accordingly, the central bank has raised the reserve requirements on many occasions, particularly in US dollars deposits. We anticipate the authorities to use these unconventional measures in the foreseeable future, without adjusting its monetary policy rate.

Fiscal & Current Account Balance ► We anticipate that the trade balance will remain in surplus over the next two years but will gradually narrow. Exports have decelerated as commodity prices moderate, while imports remain sound as local demand improves. Massive foreign direct investment flows will continue to increase, while growing profits by foreign firms will continue to be registered as a strong outflow, preserving the deficit in the income account. The overall current account deficit will widen to a range between 2.9 and 3.4% of GDP over the 2012-2013 period. The fiscal situation offers a stable outlook over the medium term, with a budgetary surplus averaging 1.3% of GDP in 2012-13, slightly below the 1.8% in 2011. Peruvian public finances remain vulnerable to aggressive shifts in commodity prices; however, so far this year, income coming from the mining sector (taxes and royalties) has decreased, while non-mining sources of income are slowly gaining ground.

Institutional Framework & Political Environment

Governance ► The administration of President Ollanta Humala remains committed to maintaining a business-enabling environment as highlighted by improving investment and consumer confidence trends. However, social problems surrounding the mining sector have increased in line with rising mining investment. In addition, the Humala administration is facing sometimes violent resistance in confronting informal mining and illegal activities, such as drug trade and contraband. Relations with key neighbouring countries such as Colombia, Brazil, Mexico, and to some extent Chile, will favour regional integration. Additionally, Peru looks to improve trade ties with the Asia-Pacific countries.

Financial Sector ► The Peruvian financial sector is well equipped to face adverse external events. Local banks are adequately capitalized with low non-performing asset ratios. Credit to the private sector is increasing once again, with consumption loans, which accounts for almost 60% of total lending, expanding by 16% y/y in September.

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