

PLEASE REFER TO EXPLANATIONS ON RECOMMENDATIONS CONTAINED IN APPENDIX BELOW

Assessment of Aruba’s Economy and Bond Recommendation

Executive Summary

Aruba is in a precarious economic position. On the one hand fiscal consolidation has led to reduction in the fiscal deficit while on the other hand the debt overhang severely constrains government spending. We are forecasting growth of 2% per annum over the medium term, but the outlook hinges on the re-opening of the petroleum refinery in 2019. Citgo, the majority owner in the partnership, is facing financial challenges arising from issues with its parent company. Delays in the start time of the refinery will negatively affect GDP growth and government revenues. With the sovereign finances already constrained by austerity measures, the government will find it exceeding difficult to generate additional revenues and/or cut expenditure further to meet the fiscal targets. Under the scenario of lower than envisaged growth, debt servicing will become increasingly challenging. Economic problems facing Venezuela have spilled over into Aruba via lower tourism and domestic exports. The external accounts are vulnerable, as the economy is not sufficiently diversified to weather external shocks and reserves are relatively low. **Given our outlook on Aruba’s macro-fiscal profile and political environment as well as the risks facing the country, we are changing our recommendation on the sovereign bonds to UNDERWEIGHT**

Table 1: SWOT Analysis of Aruba

<p>Strengths</p> <ul style="list-style-type: none"> Improved growth outlook over the medium term buoyed by tourism and crude oil refinery. Strong political and legal institutions highly influenced by the Dutch government. High per capita GDP and growing employment opportunities Currency peg with the US dollar limits currency risk on the external debt and minimises the pass through effect of external price increases. 	<p>Weaknesses</p> <ul style="list-style-type: none"> Narrow industrial base - heavily dependent on imports of industrial goods and consumables. Undiversified economy that is reliant on tourism which leaves sovereign susceptible to external shocks, in particular economic downturn in the US. The sovereign lacks complete autonomy over its affairs and therefore certain political decisions have to be given the accent of the government in the Netherlands.
<p>Opportunity</p> <ul style="list-style-type: none"> Refurbishing of the oil refinery by Citgo will help to diversify the economic output. Lower debt burden over the long term will help to free up fiscal space and allow the government to improve the country’s infrastructure. 	<p>Threat</p> <ul style="list-style-type: none"> The economic challenges in Venezuela poses downside risk to tourism and higher economic growth. Fiscal austerity has the potential to cause social unrest as the government cut public sector jobs and reign in entitlement benefits.

Ratings: *S&P, BBB+/negative; and Fitch, BBB-/negative*

Default: Never

Macroeconomic Outlook

The growth outlook for Aruba over the medium term is positive with growth expected from two main areas: tourism and refined petroleum products. Over the medium term it is envisaged that real output will expand upward by 2% per annum. However, downside risks to growth is increasing due to long standing and emerging challenges. Like most other tourist-dependent destinations across the Caribbean the domestic tourism product has benefited and is expected to continue to benefit from strong economic growth and robust job market conditions in the United States (US) from which 60% of the more than 1.1 million visitors are from. On the downside, Aruba's economy is susceptible to Venezuela's ongoing economic problems which are transmitted through three means: tourism, exports and the refurbishing of the oil refinery by Citgo. Tourism flows from Venezuela continue to fall and indications are that in 2017 total visitor arrival from Venezuela declined by more than 100,000 or 53% when compared to 2016. This had a negative impact on overall arrivals despite growth in other markets.

Central to Aruba's growth outlook is the restart of the sole oil refinery which is slated to recommence operation in 2019. Re commencement of operation was originally scheduled to start in mid-2018 but has been pushed back due to a number of issues, including financial challenges with majority owner, Citgo. Citgo is owned by Petroleos de Venezuela (PDVSA), the Venezuelan state-owned and operated oil company. Arising from sanctions imposed by the US and poor economic management, foreign direct investment flows to Venezuela have dried up. The sanctions and low oil prices have negatively affected PDVSA revenue flows while the decline in investments severely constrain the corporate's ability to explore new oil acreage, or to undertake needed capital expenditure and at a minimum maintain stable oil output. In a nutshell PDVSA is beset with serious financial challenges which is a major risk to Citgo completing the Aruba refinery project within the stipulated time frame. Later than expected completion and/or abandonment of the project would adversely affect Aruba's near- to medium-term economic growth and put pressure on the fiscal trajectory.

Fiscal operation and debt trajectory

The government of Aruba reached a deal with the Dutch government to monitor the sovereign's fiscal operation. In 2015 a decision was reached by the Aruban authorities to reduce the fiscal deficit and debt so as to improve the sovereign's fiscal profile. Arising from the global recession in 2008 which devastated Aruba's tourism-dependent economy, the government engaged in counter-cyclical fiscal policy to stabilize growth. For the period 2008-2014, the economy grew marginally while the debt level doubled and the fiscal balance moved from a surplus of 1% of GDP to a deficit of 8% of GDP. The coalition government led by Evelyn Wever-Croese's People's Electoral Movement (MEP) who won 9 of the 21 seats in the uni-cameral legislative house in September 2017 is expected to allow continuity of the economic monitoring agreement reached with the Dutch.

In keeping with measures adopted to improve fiscal operations, revenues are expected to increase on average by 5% per annum. The revenue forecast includes anticipated flows from the refinery, the crises-levy implemented in mid-2018, and self-assessed corporate income tax. Tax receipt from income and profits grew by 10% in 2015 and this trend is expected to continue over the medium-term contingent on positive real GDP growth.

On the spending side, the government is expected to implement expenditure cuts to help achieve the overarching objective of a sustainable fiscal path for Aruba. It however is going to be difficult to overhaul certain entitlement benefits, as there is staunch opposition from powerful forces in the population. Notwithstanding, the fiscal deficit is expected to narrow over the medium term. Given the combination of revenue increase, expenditure cuts and economic expansion, overall debt to GDP is expected to stabilize at around 86% of GDP, of which the domestic component is expected at 41% of GDP.

External Accounts

Aruba currently runs a small current account deficit (CAD), but this is expected to shift to a surplus over the medium term. We are projecting a current account surplus of 0.9% of GDP over the forecast horizon. Under the baseline scenario of relatively modest capital inflows, it is envisaged that reserves will grow marginally to US\$1.1 billion, or 4.4 months of import cover. Despite our baseline forecast of relative improvements, Aruba’s external account remains highly vulnerable to external shocks. The economy is dependent on tourism, of which the majority is from the US. Given the limited diversification of the economic base and heavy dependence on imports, instability in the US economy and/or volatility in international prices is quickly transmitted to the external accounts.

Ratings Action

Figure 1: Summary of Ratings Action

Agency	Rating	Outlook	Date
S&P	BBB+	negative	25-Jun-18
Fitch	BBB-	negative	18-Apr-18
S&P	BBB+	stable	14-Jun-17
S&P	BBB+	positive	6-Jun-16
Fitch	BBB-	stable	23-Jul-14
Fitch	BBB	negative	22-Aug-13
S&P	BBB+	stable	14-Jun-13
S&P	A-	negative	24-Aug-12

Tradingeconomics.com/JMMBIR

Aruba is rated BBB+/negative and BBB-/negative by Standard and Poor’s (S&P) and Fitch, respectively. On June 25, 2018 S&P revised the outlook on Aruba from stable to negative, but maintained the sovereign’s BBB+ credit rating. Prior to S&P’s credit action, on April 18, 2018 Fitch revised the outlook on the sovereign from positive to negative but maintained the BBB-ratings.

S&P advised that its ratings reflect the benefit of Aruba’s strong link with the Netherland, its prosperous economy and moderate

debt level. However, the ratings agency stated that the risk of worsening government debt burden in the next two years is high due to fiscal slippage. The ratings agency advised further that there is a one-in-three chance of Aruba being downgraded within the next two years due to the risk of rising government debt. S&P noted that the steady rise in the debt burden and interest costs pose a threat to Aruba's public finances. Despite the change in the political administration in September 2017, the ratings agency believes that there is consensus on key economic and fiscal policies across the political parties to foster sustained policy continuity.

S&P stated that the new political administration faces a daunting task of fiscal consolidation to stabilize and contain the debt. It also faces the task of promoting sustainable economic growth, complicated by the problem riddled oil refinery, which has exacted a high economic cost on Aruba. The ratings agency noted further that financial challenges facing Citgo have hindered progress to upgrade the refinery.

S&P is expecting the low current account deficit to be offset by capital inflows resulting in a relative increase in international reserve. The ratings agency advised that Aruba's long standing currency peg with the US dollar anchors inflation, but constrains monetary flexibility.

Table 1: Some Key Statistical Indicators for Aruba

Indicator Name	2013	2014	2015	2016	2017	2018 (e)	2019 (f)	2020 (f)	2021 (f)	2022 (f)
Population	103,187	103,795	104,341	104,822	105,264	105,670	106,053	106,438	106,797	107,147
GDP per capita, USD	25,018	25,523	25,796	25,256	25,655	26,127	27,414	28,451	29,575	30,747
Real GDP, % y-o-y	4.2	0.8	-0.5	-0.2	1.3	0.7	3.7	2.3	2.4	2.5
Unemployment, % of labour force, ave	7.6	7.4	7.4	7.2	7.0	6.8	6.8	6.5	6.5	6.5
Inflation, % y-o-y, ave	-2.4	0.4	0.5	-0.9	-0.5	0.6	1.8	2.0	2.0	2.0
Central bank policy rate, % eop	1.00	1.00	1.00	2.00	3.00	3.00	3.00	4.25	4.25	4.25
AWG/USD, eop	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79
Total revenue, % of GDP	24.7	23.6	25.1	25.8	25.9	26.1	26.2	26.3	26.3	26.4
Total expenditure, % of GDP	31.1	31.4	28.7	28.9	28.7	28.8	28.2	27.9	27.8	27.7
Budget balance, % of GDP	-7.2	-7.9	-3.5	-3.1	-2.8	-2.7	-2.0	-1.7	-1.5	-1.4
Current account balance, % of GDP	-12.8	-5.2	4.1	3.7	0.9	-0.9	-0.2	0.2	0.6	0.9
Capital account, % of GDP	0.1	-	-	-	-	-	-	-	-	-
Foreign reserves ex gold, USDbn	0.5	0.6	0.7	0.8	0.8	0.9	0.9	1.0	1.0	1.1
Import cover, months	2.8	3.0	4.0	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Total government debt, % of GDP	74.0	81.9	82.5	86.2	87.0	88.3	87.5	87.4	87.0	86.6
Government domestic debt, % of GDP	38.6	42.2	39.5	41.4	41.8	42.4	42.0	41.9	41.8	41.6

Source: BMI/JMMBIR

(e) estimated and (f) forecast

Political Risk

The MEP-led coalition government has continued with the fiscal consolidation measures adopted by the previous administration, which demonstrates the strength of policy continuity across political administration. The new administration has taken the austerity policy a bit further by implementation a 'crisis levy'; which took effect on July 1 and include: increase in the sales tax from 2% to 6%; a salary cap for executives of state owned entities;

and a tax on gasoline. These measures are welcoming in light of the depth of Aruba’s debt burden, but they could have negative repercussions, as coupled with spending cuts households are being impacted negatively and there is a risk that people could take to the streets to voice their opposition if austerity continues over multiple periods.

The instability in Venezuela poses downside risks to the sovereign’s economic stability. Earlier in the year the Madura administration banned all travel with the ABC Islands, accusing them of illegal smuggling activities. The ban was lifted in April, but tension between the two nations persists.

Aruba Global 2023: Description and Relative Value

Aruba has two global bonds – Aruba 2023 and Aruba 2029, which is a variable rate bond that was issued in August 2018. The issue size of Aruba 2023 is US\$253 million, it pays coupon of 4.625% and can be purchased in a minimum block of \$200,000. The current yield to maturity on the instrument is 3.55%. The issue size on the Aruba 2029 is US\$150 million and the instrument pays coupon of 3.55% over the 10-year US Treasury. The bond currently yields 6.39% and can be purchased in a minimum block of US\$500,000.

From a relative value perspective the Aruba 2023 appears fairly priced when compared to Latin America and Caribbean (LAC) sovereign and quasi-sovereign bonds with relatively similar ratings and tenor. On the other hand, the Aruba 2029 appears to be undervalued. The bond is currently trading more than 150 basis points higher than where it is expected to be trading given the sovereign’s credit risk. .

Table 2: Selected macroeconomic data from investment grade LAC sovereigns

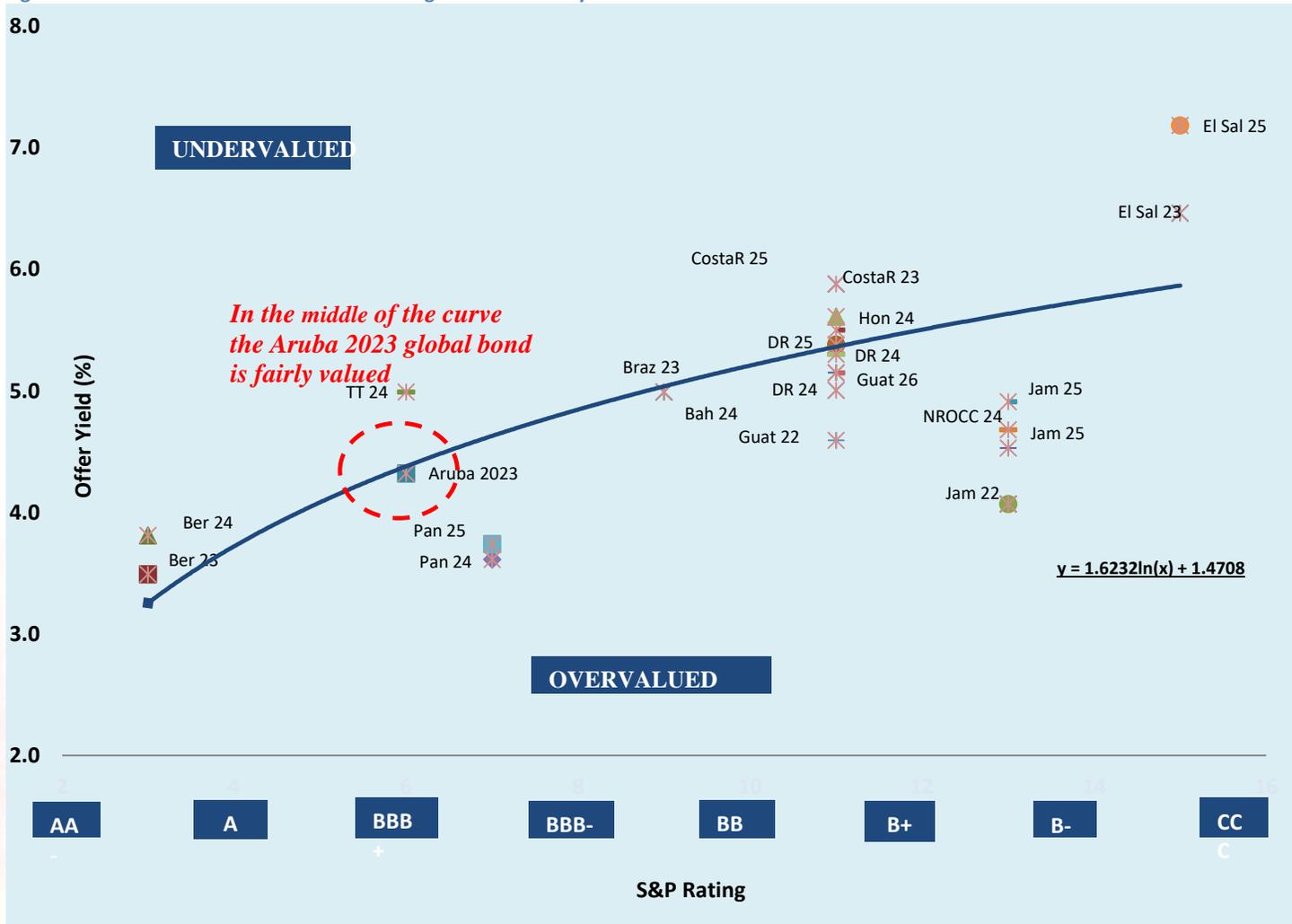
Country	Ratings	Per capita GDP (US\$)	Real GDP (%)	Inflation (%)	Current account (% of GDP)	Fiscal balance (% of GDP)	Debt to GDP (%)
Aruba	BBB+	25,655	1.3	-0.3	-0.9	-2.8	87.0
Bermuda	A+	97,667	-2.7	2.0	11.2	-3.3	43.3
Cayman Island	A	61,192	2.2	2.4	-25.6	2.0	17.9
Colombia	BBB-	6,273	1.8	4.1	-3.4	-3.1	49.4
Panama	BBB	15,089	5.4	0.5	-6.1	-1.6	38.1
Trinidad and Tobago	BBB+	15,727	-0.3	1.3	-8.7	-3.8	62.8
Average	BBB+	36,934	1.3	1.7	-5.6	-2.1	49.8

Source: BMI, IMF, and JMMBIR

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Figure 2: Relative Value of Asset in the Mid-range of the LATAM yield Curve

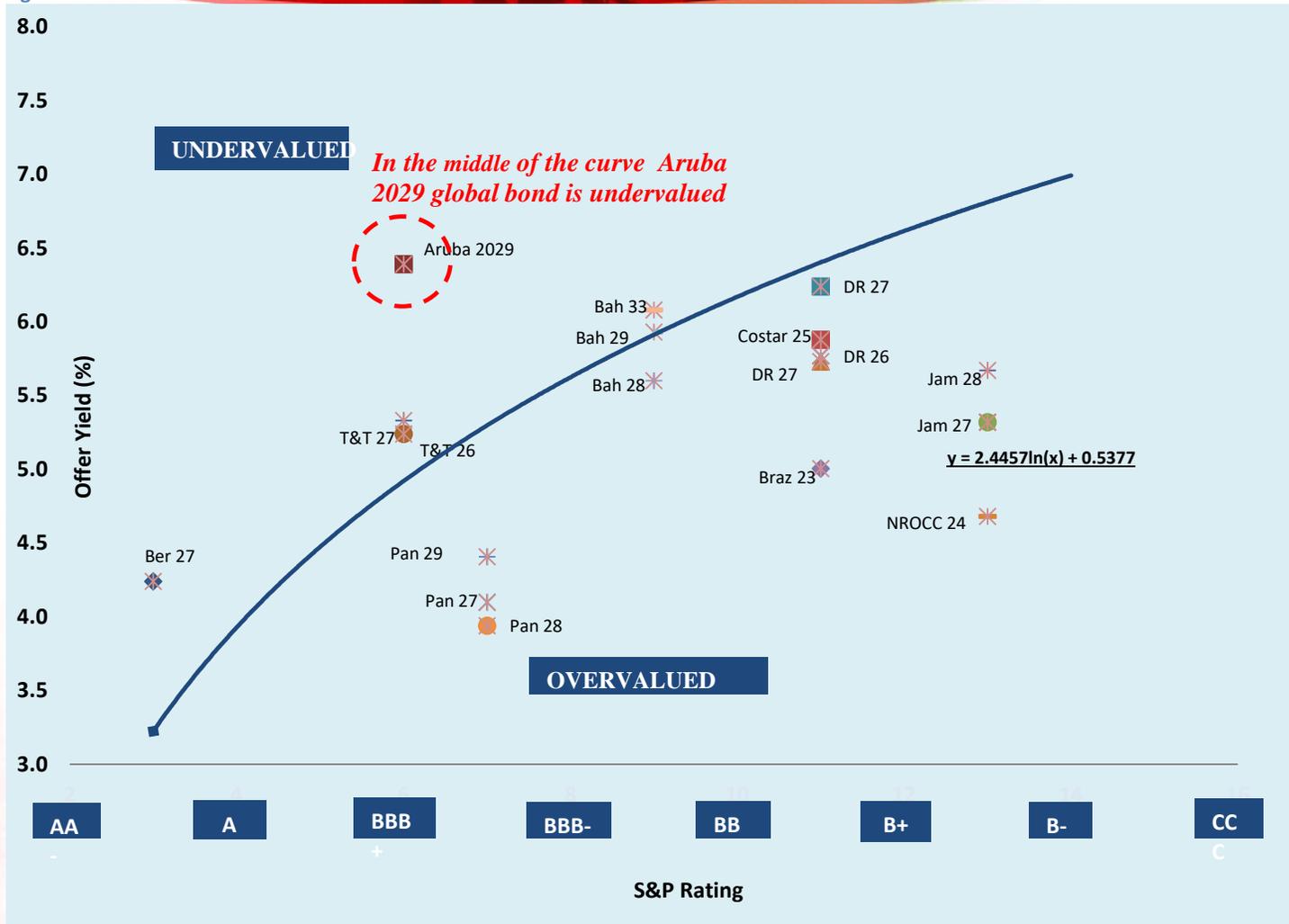


Source: Jeffries and JMMBIR

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Figure 3:



Analyst's Recommendation

The macroeconomic fundamentals in Aruba are slowly evolving. There are some improvements, particular on the fiscal side, but the debt burden is elevated and debt servicing cost is rising. While our forecast for growth is relatively upbeat, it is contingent on the re-opening of the oil refinery in 2019. The completion of work to upgrade the refinery is tilted towards the downside given financial and operational challenges with PDVSA, the parent company of the majority owner of the refinery Citgo. If the plant does not come on stream in 2019, it will cut the growth forecast by at least one-half. This has implications for fiscal operations on the revenue side, which means that in the absence of deeper expenditure cuts the fiscal deficit could widen and debt levels increase. If this persist over multiple periods it could put further pressure on the sovereign's ability to service the debt, as servicing cost which is at 10% of GDP keeps rising.

Notwithstanding this narrative, the fiscal consolidation effort and policy continuity of the new government are noteworthy and will help to steer the country towards fiscal sustainability if it is not derailed. However there are limits within which additional fiscal efforts can yield the desired result to correct the deviation from the intended fiscal path in the event of shocks, especially against the background of low GDP growth and high external vulnerability.

Having assessed Aruba's macro-fiscal and political environment as well as the risks that could affect the country, we are changing our recommendation on the sovereign bonds to UNDERWEIGHT.

Source:

Bloomberg,
Business Monitor International (BMI)
<https://www.cia.gov/library/publications/the-world-factbook/geos/aa.html>
International Monetary Fund (IMF)
Jefferies

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

PLEASE NOTE THAT NO INDIVIDUAL ASSET IN YOUR PORTFOLIO SHOULD HAVE A WEIGHTING GREATER THAN 5% UNLESS OTHERWISE RECOMMENDED BY YOUR PORTFOLIO MANAGER OR A SPECIFIC JMMB RESEARCH REPORT. CONSEQUENTLY THE FOLLOWING **DEFINITIONS** ARE PROVIDED FOR CLARITY.

UNDERWEIGHT—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

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HOLD/MARKETWEIGHT—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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