SOVEREIGN: The Bahamas

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Executive Summary

The domestic economy is slowly improving driven by growth in tourism and related construction activities. For the period 2018 – 2019, real output is expected to expand above 2% but thereafter is expected to level off at around 1.6%. In mid-2017, the controversial Baha-Mar hotel started accepting guests. This has contributed to our improved growth outlook in the tourism industry and the broader economy.

The fiscal deficit is expected to contract over the medium-term driven by higher revenue flows and lower government spending. Revenue intake has increased significantly since the implementation of the value-added tax (VAT) in 2015 resulting in revenue to GDP rising from 15.1% of GDP in 2015 to 18.7% in 2018. The new political administration has an overwhelming majority in parliament and has commenced the process of implementing measures to curtail the fiscal deficit and reduce the debt and has signalled its intention to minimise capital controls. Our baseline forecast is indicating stabilisation in some of the sovereign's leading macroeconomic indicators.

The last time we assessed the Bahamas we expressed concerns regarding the sovereign's macro-fiscal dynamics as well as the willingness of the authorities to prioritise servicing the debt relative to other spending in the face of mounting debt and debt servicing costs. These concerns have subsided due in part to fiscal measures adopted by the new government and the expectation of further measures to be implemented to help improve the sovereign's macro-fiscal dynamics. Given our outlook on Bahamas' macro-fiscal profile and our view in relation to its capacity to meet its debt serving cost, we are changing our recommendation on the sovereign global bonds to **MARKET WEIGHT**

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Summary of the Sovereign

Strengths	**Weakness**
✓ Positive economic developments in the US economy pose upside risk to tourism and domestic job growth. ✓ Strong governance framework and institutions strengths rooted in English common law. ✓ Favourable tax regime and enabling business environment make the sovereign a preferred destination for offshore financial activities. ✓ Strong regulatory framework for banks, trusts, and pooled investments	✓ The sovereign is highly vulnerable to external shocks due to its narrow economic base and small size. ✓ High fiscal deficit and low economic growth pushing debt to GDP towards unsustainable levels ✓ Erosion of competitive advantage as an off-shore financial centre due to more stringent and continued evolving regulatory environment in G-20 countries, particular the US and Europe.
Opportunities	**Threats**
✓ The political administration has signalled its willingness to deregulate the economy and reduce capital restrictions. ✓ Real growth and strong job market conditions are likely to persist in the US, which augur well for dependent services given the sovereign's strong ties to the US economy.	✓ High energy cost and unemployment are likely to mitigate higher GDP growth over the medium- to long-run. ✓ Competition from cheaper destinations poses downside risk to the tourism sector, which accounts for the lion share of employment

Ratings: S&P, BB+/Stable; and Moody's, Baa3/stable

Economic Overview

The domestic economy is slowly improving driven by growth in tourism and related construction activities. For the period 2018 – 2019, real output is expected to expand above 2% but thereafter is expected to level off at around 1.6%. In mid-2017, the controversial Baha-Mar hotel started accepting guests and this has contributed to our growth outlook in the tourism industry. Despite the general positive view on the industry, further growth is being curtailed by increased competition from low cost destinations and the closure of 1,000 rooms due to the passage of Hurricane Irma in 2016.

On the fiscal side, we are expecting the deficit to contract over the medium-term driven by higher revenue flows and lower government spending. Revenue intake has increased significantly since the implementation of the value-added tax (VAT) in 2015 resulting in revenue to GDP rising from 15.1% of GDP in 2015 to 18.7% in 2018. We are expecting revenues to rise over the forecast period due to increase in the VAT rate to 10%, up from 7% on July 1, 2018, as well as other revenue measures implemented during the FY 2019 budget. Revenue inflows are also expected to get a boost from economic growth induced by tourism and investments.

Efforts to curtail the deficit is being given further traction on the spending side as well. The government in the FY 2019 budget mandated a 10% reduction in discretionary expenditure across all government ministries, which is expected to cut spending by $120 million. Requests have also been made for state owned entities to submit plans to reduce their expenditure. The expected savings to be generated is not yet known. However, the combination of this and measures that were already announced, which can be measured, are likely to slow the growth in expenditure expansion relative to previous years.

The combination of fiscal consolidation and real economic growth are likely to push the debt on a lower path. Gross Government debt ballooned to 70% of GDP in 2017 compared to 26% in 2008 due to a combination of poor fiscal management, including off balance sheet expenditure; low economic growth; and the government bail-out of at least one domestic bank.

External Position

With the partial completion of the Baha Mar mega resort and no imminent major infrastructural work on the horizon, the current account deficit (CAD) is expected to contract steadily to 9.2% of GDP over the medium term. This is expected to be offset by capital inflows resulting in incremental gains in external reserves. Despite the relatively upbeat baseline forecast, the sovereign's external account remains highly vulnerable to external shocks. The resilience of the external accounts has been tested in the recent past with the passage of Hurricane Irma in 2013. In the year following the hurricane, the CAD widened from 17% of GDP to 23% of GDP. While the sharp decline did not persist over multiple periods, the shift however highlighted that adverse shocks, that are sustained, could have a prolonged negative effect on the external accounts.

Ratings Action

Table 1: Summary of Ratings Action

Agency	Rating	Outlook	Date
Moody's	Baa3	negative	17-Aug-2018
S&P	BB+	stable	14-Dec-2017
Moody's	Baa3	negative	25-Aug-2017
Moody's	Baa3	negative watch	6-Jul-2017
S&P	BB+	stable	20-Dec-2016
Moody's	Baa3	stable	22-Aug-2016
Moody's	Baa2	negative watch	01-Jul-2016
S&P	BBB-	negative	25-Aug-2015
S&P	BBB	negative watch	2-Jul-2015
Moody's	Baa2	stable	2-Sep-2014

Source: tradingeconomics.com and JMMBIR

In December 2017 Standard and Poor's (S&P) Ratings agency affirmed the Bahamas BB+/stable ratings. The rationale underlying the ratings is the country's high external liquidity needs; rising debt levels; and slowing economic growth in an economy which has lost competiveness. On the positive side, the country's strong institutional foundation mitigate a further credit downgrade.

The Free National Movement (FNM) overwhelmingly swept the general elections held in May 2017 where the party captured 35 of the 39 seats. S&P believes that the strong institutional mandate of the new government will result in a reduction of the fiscal deficit and the debt. The ratings agency advised that strong political capital will likely facilitate early reforms, but it will take time for this to translate into sustainable public finances and higher real GDP growth.

S&P expects room capacity and ongoing tourism projects to lead to an uptick in real growth over the next three years. However, the ratings agency noted the higher growth is being constrained by increased competition from other destinations, exposure of the Bahamas to weather-related and other shock as well as high non-performing loans in the banking sector. The gradual opening of the Baha Mar since mid-2017 is expected to add another 2,700 rooms by the end of 2018 however over 1,000 rooms were taken out of commission due to the hurricane in 2017 and there is no defined timeframe when they will re-open.

A slowdown in the offshore financial sector is expected to subside due to the multilateral approach taken by the sovereign to implement the Organisation of Economic Cooperation & Development's Common Reporting Standards for Automatic Exchange of Information. The wider economy is likely to remain insulated from the evolution of the sector due to the limited linkages. The sector directly contributes 3% to the economy and employs less than 1% of the labour force, which has remained relatively static despite a shift in assets jurisdiction over the last several years.

Table 2: Selected macroeconomic data for the Bahamas

Indicator Name	2013	2014	2015	2016	2017	2018 (e)	2019 (f)	2020 (f)	2021 (f)
Population, million	0.38	0.38	0.39	0.39	0.40	0.40	0.40	0.41	0.41
GDP per capita, US$	28,303	28,374	29,056	28,785	28,150	29,155	30,098	30,930	31,740
Real GDP, % y-o-y	-0.6	-1.2	-3.1	0.2	1.3	2.3	2.1	1.6	1.6
Unemployment, % of labour force, ave	16.2	13.8	12.0	12.7	12.6	12.2	12.0	11.5	11.5
Inflation, % y-o-y, eop	1.4	0.2	2.0	0.8	0.9	2.0	2.0	2.0	2.0
Total revenue, % of GDP	12.7	13.4	15.1	17.1	18.5	19.5	20.5	21.0	21.0
Total expenditure, % of GDP	16.8	17.8	19.0	19.9	24.5	21.5	22.0	22.2	22.0
Fiscal balance, % of GDP	-4.1	-4.4	-3.8	-2.8	-6.0	-2.0	-1.5	-1.2	-1.0
Current account balance, % of GDP	-16.9	-23.5	-14.9	-11.5	-11.2	-10.0	-9.2	-9.1	-9.2
Foreign reserves ex gold, USDbn	0.7	0.8	0.8	0.9	1.4	1.3	1.4	1.4	1.5
Import cover, months	1.8	1.7	2.2	2.5	3.9	3.4	3.3	3.3	3.2
Total external debt stock, % of GDP	16.9	21.2	21.0	22.6	24.1	23.4	22.1	21.0	19.8
Total external debt stock % of XGS	42.5	55.5	57.2	64.2	77.7	71.4	65.4	61.2	57.0
Government domestic debt, % of GDP	35.5	37.0	37.6	40.6	39.2	39.0	38.0	38.0	38.0
Total government debt, % of GDP	52.4	58.0	58.9	62.6	70.4	68.0	66.5	66.0	66.0

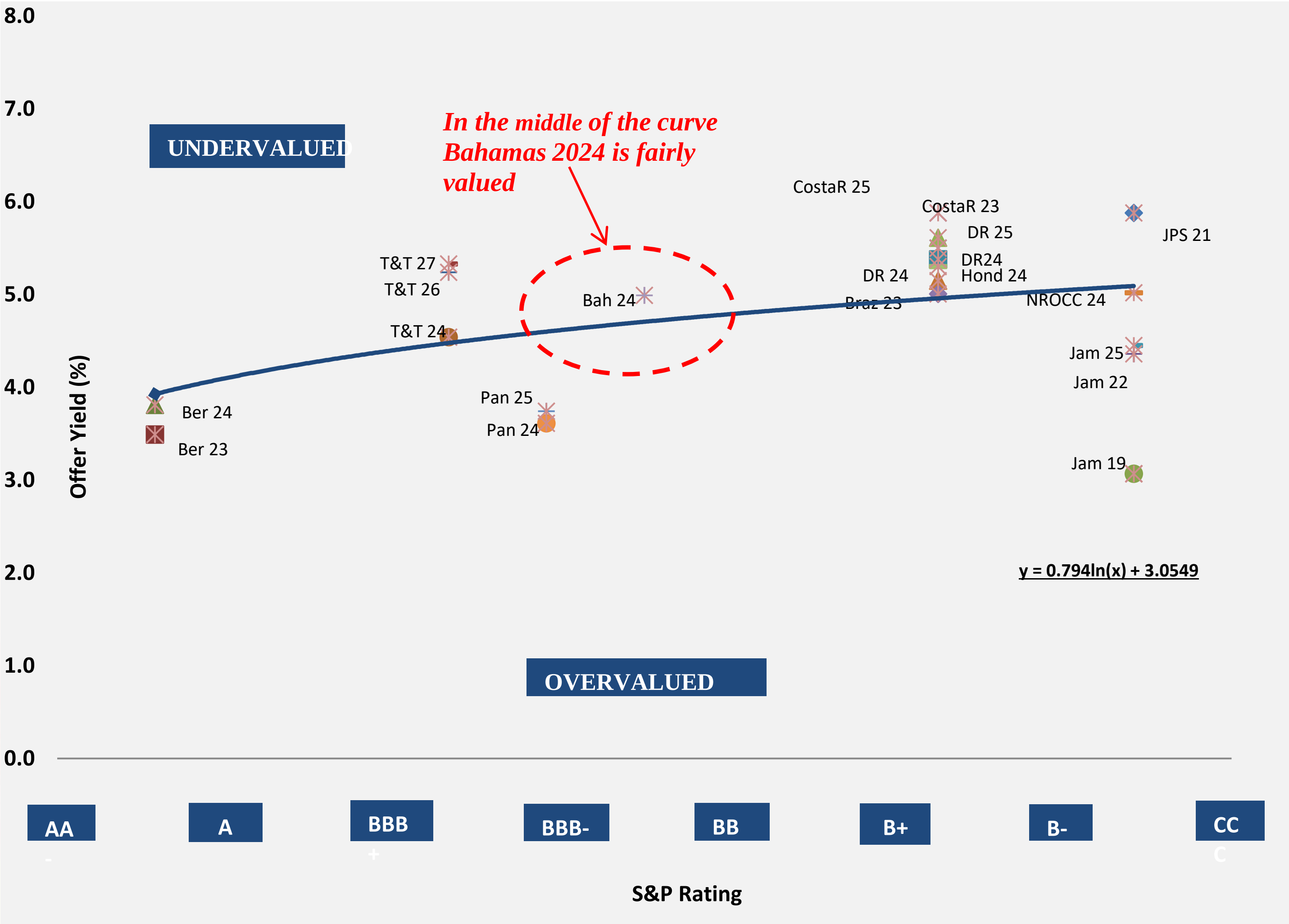
Source: Business Monitor International, IMF and JMMBIR

Political Outlook

It is our view that political stability will be maintained over the medium- to long-run and that the incumbent party which forms the government, the FNM, will follow through on its campaign promises to reduce the fiscal deficit and the debt, as well as to minimise capital control. The sovereign has a long history of political continuity and we are not expecting any shift from this path in the coming decade. Having expressed this view, there are concerns regarding rising unemployment and crime and their potential impact on the sovereign's social stability. The Bahamas however remains one of the Caribbean's most stable political territories. The Constitution which was adopted since independence in 1973 has not had any major changes while power transitions have been smooth. There has been minimal deviation from the overarching policy direction over the last two decades despite changes in political administration.

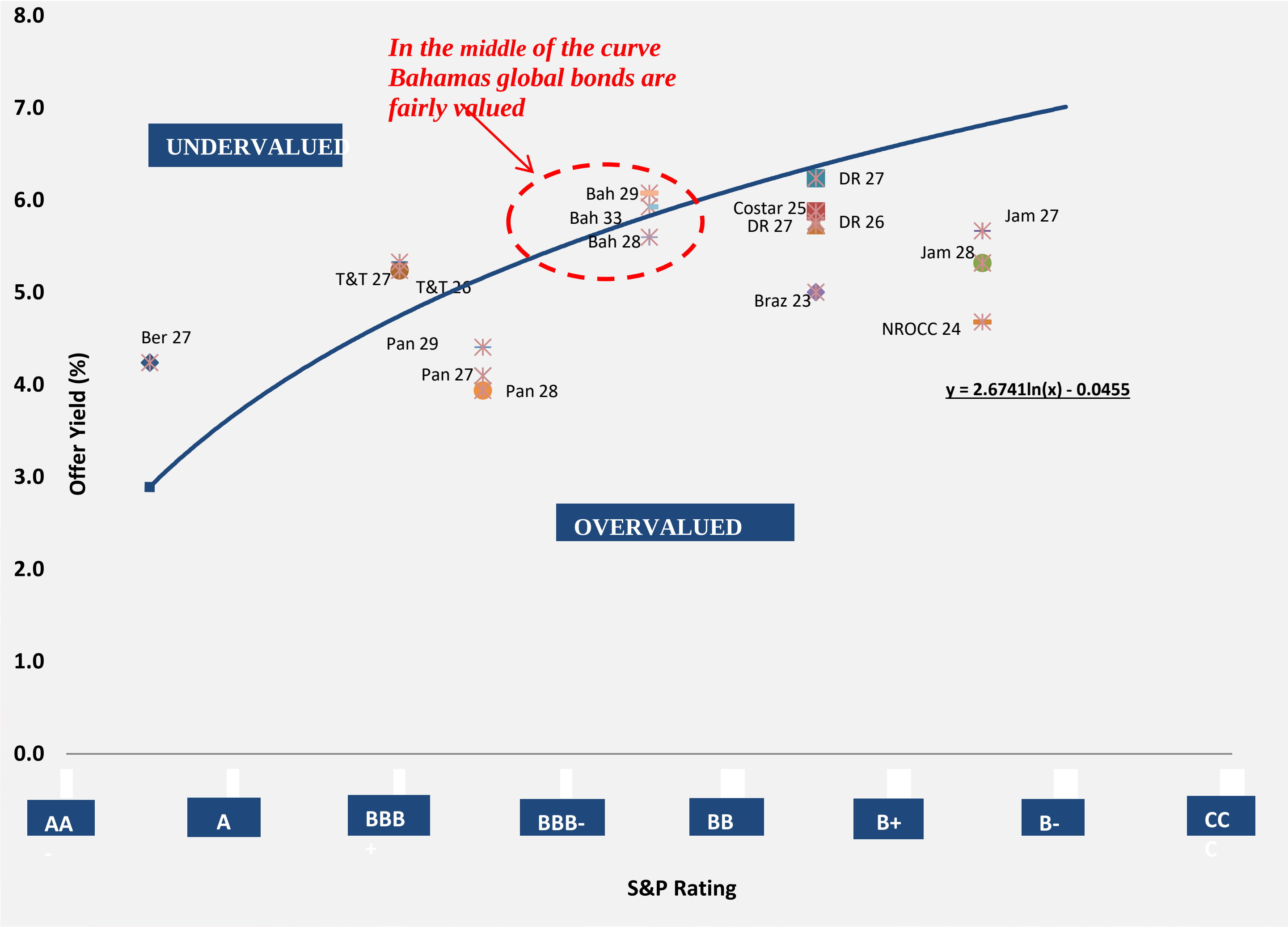
Bond Analysis: Price Comparatives, Relative Value

Figure 1: Bond Comparatives: Bahamas versus selected Latin American and Caribbean Sovereigns



Source: Bloomberg, Jefferies and JMMBIR

Figure 2: Bond Comparatives: Bahamas versus other Latin American Sovereigns



Source: Bloomberg, Jefferies, and JMMBIR

The Bahamas debt has been growing in recent years owing to poor GDP growth dynamics and high fiscal deficits. However, looking over the medium-term the debt is expected to stabilize at around 66% of GDP due to a reduction in the fiscal deficit and improvements in real growth. More than 60% of the debt (around 38% relative to GDP) of the issuances are domestic and a large portion of the external debt is held by domestic institutions. This is in part due to the rigorous capital control imposed by the monetary authority, which limits the universe of assets that domestic institutions can invest their funds. Of the total sovereign debt outstanding, there are four (4) global bonds with face value amounting to over US$1,500 million and remaining time to maturity of up to nine (9) years (See Table 2).

In assessing the Bahamas global bonds with comparative instruments issued by Latin America and Caribbean sovereigns of varying credits, the bonds appear to be fairly valued as their yields fit tightly with the relative value curve. Over the last 6 months or so yields on emerging market bonds have increased due to rising interest rates in the United States (US). The outlook is that the US Federal Reserve will continue along the rate hike path for the rest of 2018 through to 2019. The pace of rate adjustments however is among other things dependent on the inflation outlook. It is therefore envisage that EM global bond prices will fall due to rising yields. Thus, the downside risk for EM bond prices is slightly elevated, which indicates a relatively high probability of capital lost for bonds which are not held to maturity.

Table 3: Bahamas Global Bonds

Bond	Ratings (S&P)	Maturity date	Face $MN	Minimum/ Increment ($)	Coupon (%)	Offer yield (%)	Duration
Bahamas 2024	BB+	16-Jan-2024	300.0	200/1	5.750	4.99	4.52
Bahamas 2028	BB+	21-Nov-2028	750.0	200/1	6.000	6.89	8.9
Bahamas 2029	BB+	20-Nov-2029	300.0	1/1	6.950	5.93	7.68
Bahamas 2033	BB+	15-May-2033	200.0	1/1	6.625	6.06	9.27

Sources: Jeffries and JMMBIR

Recommendation:

A few months ago there were genuine concerns about the policy direction of the fiscal authority. However, with the conclusion of the general elections and the new government clearly articulating its policies and taking steps through the budget process to address the fiscal challenges, these concerns have subsided. The proactive measures are geared towards cauterizing the fiscal deficit and stabilizing the debt through a combination of revenue measures and expenditure cuts. These actions have not gone unnoticed by the investor public and ratings agencies. There are clear signs that the Bahamas is serious about fiscal and debt sustainability and meeting future debt obligations.

Low economic growth is programmed over the medium term with the balance of risk tilted towards the downside as the economy is not very resilient to shocks and the main growth driver, tourism, faces growing competition from other destination. The tourism product is vulnerable to shocks, economic and weather-related. Additionally the austerity measures being pursued by the government will limit growth and it will take time, if implemented, for reduction in capital control to have any meaning or positive impact on the economy.

The last time we assessed the Bahamas we expressed concerns regarding the sovereign's macro-fiscal dynamics as well as the willingness of the authority to prioritise servicing the debt relative to other spending in the face of mounting debt and debt servicing costs. These concerns have subsided due in part to fiscal measures adopted by the new government and expectation of further measures to be implemented to help improve the sovereign's macro-fiscal profile. Although the debt is relatively high by historical norms, we believe that the sovereign will be able to comfortable meet debt servicing costs over the medium-term. Given our outlook on Bahamas' macro-fiscal profile and our view in relation to its capacity to meet its debt obligations we are changing our recommendation on the sovereign global bonds to **MARKET WEIGHT**

Source:

Bloomberg
Business Monitor International
Jefferies
https://www.cia.gov/library/publications/the-world-factbook/geos/cj.html
Oppenheimer

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.
HOLD/MARKETWEIGHT—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.
OVERWEIGHT/BUY—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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