INVESTMENT AND SOVEREIGN RESEARCH

SOVEREIGN: Cayman Islands

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPEDIX

Strength	**Weakness**
✓ Strong institutional strengths backed by solid governance framework and adherence to the rule of law ✓ Legal framework based on British common law and the Judicial Committee of the Privy Council acts as the final court of appeal ✓ Viable off shore financial sector grounded in low tax rate and proficient labour force ✓ Relatively stable economy with low inflation, high per capita GDP and low debt-to-GDP	✓ Small island with a very narrow economic base which leaves the sovereign exposed and susceptible to external shocks ✓ Coalition government lacks a reasonable majority to push through legislation without opposition ✓ Reliance on the financial sector as the engine of growth could have an adverse effect on economic outturn in the long-run in light of the current uncertainty in relation to ongoing changes in the tax code in developed countries.
Opportunity	**Threat**
✓ Strong push by the government to buildout the infrastructure to make the destination more attractive to tourism. ✓ The Cayman Islands remain one of the more favourable tax destination in the western hemisphere, which makes the destination relatively ideal for tax planning purposes.	✓ Further tightening in financial regulation by the OECD could put downside pressure on the offshore financial sector resulting in additional job losses in the sector and economic contraction ✓ Lower than anticipated growth in the US and/or weather related shocks could negatively affect earnings from tourism

Ratings: Moody's Aa3/Stable; Fitch, N/A; and S&P, N/A

Economic Outlook

The Cayman Island's macroeconomic outlook remains relatively positive, but there are headwinds that could negatively affect growth and undermine future economic development. Real GDP is expected to expand by 2% per annum over the medium term driven by activities in tourism and to a lesser extent financial services. Strong job market conditions in the US buoyed by positive economic fundamentals will provide a tailwind for tourist arrivals over the forecast horizon. However, the financial sector contribution to real growth is expected to remain subdued and could potentially become a drag in the future owing to the evolution in financial and taxation laws in developed countries.

Offshore financial jurisdictions, such as the Cayman Islands, are becoming less appealing to corporates and individuals who value secrecy and low taxation due to changing reporting standards by developed states. For this reason, legislation passed by the UK government which mandates its overseas territories to provide a public registry of all individuals and corporates that use the offshore financial sector does not sit well with the government of the Cayman Islands. The political directorate has lobbied the British parliament seeking an exemption, but the House of Commons has not acquiesce to this demand. It is our view that that the erosion of the sovereign's competitive advantage in the offshore financial sector will result in its contribution relative to GDP falling in the long run. Additionally, it could have far reaching negative implications for the socio-economic development of the Cayman Islands whose economy benefits substantially from the sector and the large pool of highly skilled and well-paid expatriates who work therein. The decline in the sector will force these workers to repatriate to their homeland. Looking down the road, if some other sector does not pick up the slack, which we find unlikely at least over the next decade, the demand for goods and services and property is likely to fall, and this could have a negative effect on tax receipts and social spending.

Macro-fiscal Outlook

Despite the positive outlook on growth, tax intake as a proportion of revenue is expected to fall from 23.2% of GDP in 2017 to 20.9% in 2023. With a marginal increase in expenditure it is envisaged that the sovereign will move from a fiscal surplus to a small deficit. Debt to GDP is expected to decline due in part to positive real growth and a stable domestic currency.

Having built fiscal buffers from the fiscal surpluses generated over the past 5 years, the Cayman Island is in a position to fund the fiscal deficits for the next two to three years, at a minimum. As it relates to the Cayman 2019 global bond which becomes due in in August, the authority can either pay it out or role a portion of it in order to maintain a presence in the international capital market. We are of the opinion that they will choose to pay it off in full.

Table 1: Selected macroeconomic indicators

Indicator Name	2013	2014	2015	2016	2017	2018	2019 (e)	2020 (f)	2021 (f)	2022 (f)	2023 (f)
Population	58,371	59,172	59,963	60,765	61,559	62,348	63,129	63,890	64,643	65,393	66,135
GDP per capita, USD	55,345	56,814	58,177	59,468	61,192	63,412	66,018	68,466	70,643	72,868	75,182
Real GDP, % y-o-y	1.5	2.3	3.0	3.1	2.2	1.9	1.8	1.9	2.0	2.1	2.1
KYD/USD, eop	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Inflation rate, eop	2.2	0.6	-2.5	0.6	2.4	3.6	3.5	2.5	2.2	2.2	2.2
Unemployment, % of labour force, ave	6.3	4.6	4.2	4.0	4.0	4.0	4.0	3.8	3.5	3.5	3.5
Lending rate, %, ave	5.0	5.0	5.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Total revenue, % of GDP	24.0	24.1	23.5	23.8	23.2	22.4	21.9	21.2	20.8	20.6	20.3
Total expenditure, % of GDP	22.3	21.7	20.6	21.6	21.2	20.8	21.9	21.5	21.2	21.0	20.9
Budget balance, % of GDP	1.7	2.4	2.9	2.3	2.0	1.6	0.0	-0.3	-0.4	-0.5	-0.5
Total government debt, % of GDP	21.1	19.4	17.9	16.3	17.9	17.8	17.5	17.2	16.9	16.6	16.3

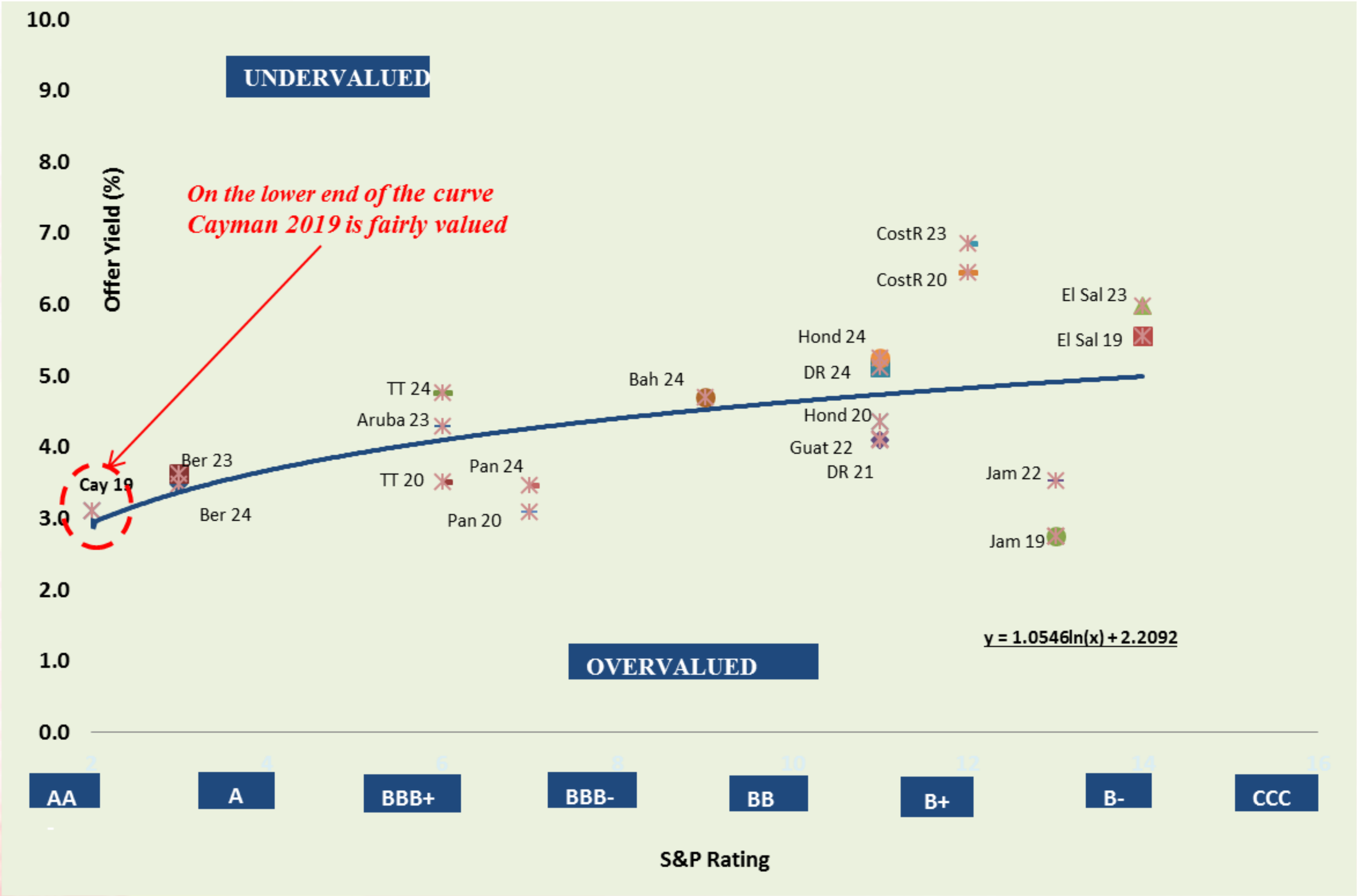
Sources: BMI and JMMBIR

Risks

Being a relatively small open economy, the Cayman Islands are exposed to shifting conditions in the international economy, including sharp movements in commodity prices; geo-political turbulence and falling real economic output in the source countries for tourism, particularly the United States. The sovereign lies in the hurricane belt and with the changing weather patterns the frequency of hurricanes have increased over the last decade. In fact, in 2004 the Cayman Islands were ravaged by Hurricane Ivan, which left a trail of death and destruction in its path. It took the sovereign a few years to recover from the damages that were done. In a nutshell external shocks, especially hurricanes, could stymie real GDP growth and government finances, and impair the sovereign's ability to service the debt.

On the political front, the Alden McLaughlin led government has had to play its card very carefully in the 19-member Legislative Assembly where the administration controls the reign of power only because of the support of three independent members. The coalition holds a razor thin majority and as such finds it very challenging to pass legislation without compromise. On the positive side, there is no significant ideological differences between the various political factions that vie for control of the government. The transition of the government has often been smooth and there is a sound record of policy continuity. Notwithstanding, in the event of an external shock to the economy, given the thin majority, the government may find it difficult to prioritise debt servicing to other expenditure because of political pressures, including the fear of defection by the independent members of the coalition.

Table 2: Relative Value



Sources: Oppenheimer and JMMBIR

From a relative value perspective the Cayman 2019 is trading close to the curve in the universe of Latin America and Caribbean sovereigns with comparable tenor. With a little over 6 months to go until the bond reaches maturity, it is trading with a yield to maturity of 3.12% which is 66 basis points than the yield on the 6-months US Treasury.

Conclusion

Near term risk to the Cayman Islands economy is relatively low however the risk over the long term is increasing due to greater scrutiny of the global offshore financial sector by developed countries. The sovereign is losing its competitive advantage in this space owing in no small part to greater reporting standards and the creation of a public registry for clients using the services, which is mandated under British law. It is our opinion that the sector's contribution to GDP, fiscal flows and employment will continue to fall. At this point there are no clear indications as to what the end result will look like. However, what is clear is that the sector is likely to be much smaller than it was leading up to the 2008-2009 global financial crises.

In spite of the changes taking place in the offshore financial sector, the sovereign's fiscal position is relatively strong and as noted overleaf the government is in a position to repay the Cayman 2019 from accumulated internal resources. **Given this view, the current yield, and the short time to maturity we are recommending the Cayman 2019 at market weight.**

Source:

Bloomberg
Business Monitor International

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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