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INVESTOR UPDATE

NOVEMBER, 2019

VENEZUELA UPDATE

THE CHALLENGES CONTINUE!

The difficult Venezuelan situation continues with no clear sign of a near-term resolution. Persistent fiscal deficits, high debt, hyperinflation, heightened political risk and ineffective monetary policy have become the norm for the once affluent South American oil giant. **Sanctions imposed by the US have prevented the sale of oil, crippling the economy and government resources.** Weak revenue inflows from oil combined with limited access to new technology has reduced hydrocarbon production levels which has further exacerbated the problem. Oil production generally tends to be capital intensive; Venezuelan oil, which is described as heavy sour crude, has a high sulphur content, is sand based, relatively harder to refine and requires ongoing improvements in production techniques to access.

The official recognition of Juan Guaidò by the US, the EU and several Latin American & Caribbean countries as President, has created a parallel political authority which has generated further instability. Guaidò's emergence as a legitimate alternative increases the level of instability. Further instability is also ongoing; an assassination attempt on Maduro in August 2018, a failed uprising in April 2019 and a failed coup in May 2018 are just some key examples.

Venezuela's economy has been in recession since 2014. After defaulting on its external debt in November-2017, the sovereign has accumulated approximately US$10.0 billion in arrears. While it is possible that majority ownership of Venezuela's external debt is by hedge funds that can play the long game, the possibility of legal action by bondholders to seize external assets, including oil tankers and overseas refineries, exists.

Economic sanctions have continued to have a crippling effect on the sovereign. In August, the US increased the pressure by freezing the property and assets of the Venezuelan government globally. This prompted Ziraat Bankasi, Turkey's largest bank and state owned, to announce on August 15th, that it would cut services to the central bank of Venezuela. China National Petroleum Corporation (CNPC), another state owned entity, also announced, on August 16th, that it would cut direct purchases of Venezuelan oil. It is reported that CNPC cancelled an order for approximately 5 million barrels of oil in August- 2019.

The CNPC cancellation, at least on the face of it, is a crippling blow. China, Russia, India and Turkey represent a shrinking list of countries who are still willing to do business with Venezuela, at least above board. Ziraat's halting of banking services is also likely to be a significant blow as Venezuela relied on them heavily for **correspondent banking services**. On the positive side, the Maduro administration has stated publicly that it could change to the Russian-operated international payment system as an alternative to the US-system.

What is more troubling for Venezuela is that China and Turkey have, in the past, come out in support of the Maduro regime. **If the latest actions by both**

state owned enterprises is an indication that they are no longer willing to do business with Venezuela because of US sanctions, this would likely be crippling to Maduro. This would leave only Russia as a major political power in support of Maduro. It is vital that oil finds its way out of Venezuela and hard currency finds its way in. Only with the consistent supply of hard currency will Maduro be able to maintain the support of the army and the political elite.

A POSSIBLE "EXIT CLAUSE" FOR MADURO

On August 27th, the US announced that it would not prosecute or otherwise punish Venezuelan President, Nicholas Maduro if he demitted office. This was announced by US special envoy to Venezuela, Elliot Abrahams, after talks held by both parties in mid-August. This announcement by the US authorities signals a softening of the otherwise rigid stance against Maduro. The US also announced that it would be setting up a Venezuelan affairs unit in Colombia to pursue a more diplomatic resolution to the Crisis. It is likely that the US led Trump administration is surprised by the strength, durability and consequent longevity of the Maduro administration which was expected to capitulate in short order after sanctions were introduced.

Despite the US' softened stance, Juan Guaidò, who the US recognizes as the legitimate president, does not seem to support the US approach. The opposition, to date, has not offered amnesty to any member of President Maduro's cabinet or other party officials. In fact, actions taken by Washington to increase sanctions and hold private talks with Maduro served to undermine the Venezuelan Opposition's own negotiations. This led Guaidò to send a delegation to Washington to seek clarity and likely express his own frustrations.

OIL PRICE VOLATILITY: A POSITIVE!

The current global geopolitical risk emanating from the Middle East due to the bombing of Saudi Arabia's oil fields has led to oil price volatility. Houthi rebels in Yemen claim responsibility, however Saudi Arabia suspects Iran and have made their opinion known. Iran has responded by pointing out that they are not responsible for the attack and any reprisal attack by the Saudis would mean all-out war. The Saudis are in a very precarious position. They cannot allow this action to go unpunished, neither can they appear to be weak and allow others to believe that they can be attacked at will. Saudi Arabia however, is likely also concerned at how easily their defenses were breached and the likely implications of a war with Iran. Consequently the chess game will continue with oil price volatility a clear consequence.

The attacks reportedly knocked out approximately half of the country's oil production. This equates to about 5.7 million barrels of oil per day or 5% of global oil supply. While the attacks led to a spike in oil prices, the Saudis have noted that production will return to 11 million barrels per day by the end of the month. This has seen a reversal of the recent price hike.

Regardless of when production levels return, it is likely that more volatility in oil prices is on the horizon. This should have some spill-off benefits for Venezuela assuming that they are able to actually get oil into the market and hard currency back to government coffers.

ANALYST'S OPINION

In the past, upward movements in oil prices would have been enough for us to be bullish or at least adjust our sentiments on Venezuela. However, there has been a paradigm shift. US sanctions now restrict trade in Venezuelan oil and even more crippling, the movement of money via the US-international payment system which affects correspondent banking services. Venezuela also has challenges with oil and natural gas output, which has been steadily declining over the last few decades.

Key allies like China and Turkey seem to have prioritized, at least publicly, ongoing access to the US international payment system over maintaining ties with the Maduro administration. That said, one positive is that a Russian based payment system exists, however limited its reach and capabilities may be.

The US has also changed its approach to negotiating with Maduro; the Trump administration has noted that it will not prosecute or otherwise punish Maduro if he vacates office. There has also been the establishment of a Venezuelan affairs unit in Colombia to pursue a more diplomatic resolution. These actions suggest that some middle ground may be reached but there is still uncertainty. Will Maduro simply view any diplomatic approach as a "victory" for him and an indication that he can withstand the US pressure long term? Or will he see the US' offer as a way to opt out of an increasingly difficult situation; and what of his lieutenants? Will he abandon them as the US has made no mention of how they will be treated?

There are definitely more questions than answers and the level of uncertainty remains. Consequently, at this time we maintain our **SELL** recommendation on Venezuela.

Source: Fitch-Connect, Bloomberg, S&P Global/RatingsDirect®, Moodys.com.

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/MARKET WEIGHT -
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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