# "Panama after the Papers"

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## EXECUTIVE SUMMARY

***In 2017 the Panamanian economy was hit by the negative sentiments associated with the "Panama Papers" and the "Waked Money Laundering" scandals***. The scandals negatively affected the sovereign's ease of doing business as well as the country's attractiveness as an investment destination. Since the scandals however investors may be wondering how Panama has been doing and whether they have shaken off the adverse effects.

The simple response is yes! ***Even before the money laundering scandals broke, Panama had taken steps to diversify its economic base in an attempt to smooth the impact of possible shocks***. Traditionally economic growth is Panama was driven by the Panama Canal and associated investments in banking and logistics. Since then, the sovereign has diversified into mining, real estate, transportation, tourism, and construction in addition to the mainstays of the economy.

***Growth has not been as robust as the double digits experienced in the early 2000's but solid growth averaging about 6.3% between 2012 and 2018 remains impressive***. Growth fell off to an estimated 4.5% in 2018 however the forecast is for a recovery in the medium term (between 2019 and 2021) to 5.5% on average.

This comparatively robust level of growth combined with modest fiscal deficits of approximately 2% and a primary balance of less than -1% on average, has contributed to an impressive debt/GDP ratio holding steadily below 36%. ***This has resulted in a revision of Panama's outlook upwards from stable to positive as at July-2-2018 and the maintenance of its "BBB" rating.***

Despite the positive growth numbers and prudent management of fiscal resources, Panama needs to improve the way that the sovereign distributes its wealth. The indigenous people have not benefitted as much as the rest of the populous from the growth and development. Important issues such as poverty, extreme poverty, basic education, healthcare and sanitation in rural areas and among the indigenous people is a concern echoed by the World Bank.

That said, we are of the view that Panama is an attractive sovereign from a fundamental perspective and maintain our ***BUY recommendation*** at this time.

## THE POLITICS

***General elections in Panama are scheduled for May-5-2019***. Approximately 2.7 million voters will elect a new president, new law makers and mayors to lead the Central American sovereign for the next five years. More importantly, bond holders have come to expect policy continuity from the multi-party system where coalition governments are the norm.

***To Panama's credit, successive governments have pursued consistently pragmatic pro-growth policies despite regular changes in leadership***. Successive governments have also respected the autonomous management position of the canal which is a key asset for the country. An ambitious project to more than double the capacity of the canal by expanding transit and allowing it to accommodate larger ships took place between 2007 and 2016.

***The current President, Juan Carlos Varela, encouraged both private and public investment to enlarge economic activity connected to the canal***. Growth has been more balanced in recent years as more investment has come to the relatively poorer Caribbean coast. This has helped to raise living standards and enlarge the middle class. The President has also responded well to external pressure to enhance the supervision of the sovereign's large financial sector by passing new laws.

## THE ECONOMICS

Panama's economic growth numbers have historically been impressive. ***Between 2001 and 2013, economic growth averaged 7.2%, more than double the average growth in Latin America and by far the fastest growing economy in Central America***. The economy is robust with services representing more than 75% of GDP. The Panama Canal is essential to trade and accounts for approximately 10% of GDP.

Other key components include the ***Colon Free Trade Zone***, which is the second largest in the word and the ***Trans-Panama Pipeline***. The pipeline allows the efficient transportation of crude oil between the Pacific and Atlantic coasts. ***Ship license and registry*** of the Panama flag to merchants, ***a large logistics and storage hub*** combined with a ***modern banking and insurance services*** sector continue to drive revenue and boost growth. While a dollarized economy abandons monetary policy, it does help to strengthen doing business and the ease of trade by the use of a global currency.

***Agriculture*** has lost its historical importance, accounting for less than 10% of GDP; fruits and nuts however remain a major export while bananas, corn, coffee and sugar are still important crops.

Economic activity in 2018 is estimated to have declined to 4.5% which is below the historically robust 7.3% recorded on average between 2011 and 2017. The fall-off in economic activity is largely attributed to a major strike in the construction sector which effectively halted large public and private sector projects. Growth is projected to rebound (***Table 1***) in the medium term (2019 to 2021) to on average 5.5% on the back of increased activities in mining, the continued expansion of the Tocumen Airport and other large scale infrastructure projects.

***A threat to the global growth forecast is the current trade impasse between the US and China***. Other external challenges could come from risk aversion after Brexit as well as anti-money laundering legislation passed by major economies seeking tax revenue from their citizens. To Panama's credit they have responded to the tax threat by having ***automatic exchange of tax information with thirty three (33) countries including the members of the EU***. To complement the exchange of information, Panama has also made several legal changes to improve the sovereign's transparency.

These important moves will help to maintain Panama's ease of business and help the country to retain its position as a global logistic hub for the Americas.

***Table 1***

| Panama-Selected Economic Indicators | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018Est. | 2019f | 2020f | 2021f |
|---|---|---|---|---|---|---|---|---|---|---|---|
| ***ECONOMIC INDICATORS (%)*** | | | | | | | | | | | |
| GDP per capita ($000s) | 9.2 | 10.5 | 11.8 | 12.8 | 13.7 | 14.3 | 15.1 | 15.8 | 16.8 | 17.8 | 18.9 |
| Real GDP growth | 11.8 | 9.2 | 9.6 | 5.1 | 5.6 | 5 | 5.4 | 4.5 | 5.5 | 5.5 | 5.5 |
| Investment/GDP | 43.5 | 44.4 | 44 | 44.3 | 42.6 | 43.8 | 42.2 | 41.1 | 39.5 | 37.9 | 36.4 |
| Exports/GDP | 72.9 | 70.7 | 65.2 | 55.4 | 47.5 | 41.4 | 41.2 | 41.5 | 41.4 | 41.5 | 41.7 |
| Real exports growth | 18.1 | 9.8 | 9.5 | -7.1 | 0.9 | -2.2 | 5.4 | 5.3 | 5.3 | 5.8 | 5.8 |
| Unemployment rate | 4.5 | 4.1 | 4.1 | 4.8 | 4.6 | 4.4 | 4.8 | 4.6 | 4.6 | 4.6 | 4.6 |
| ***EXTERNAL INDICATORS (%)*** | | | | | | | | | | | |
| Current account balance/GDP | -14.5 | -9.6 | -9.1 | -13.4 | -7.9 | -5.5 | -4.9 | -4.4 | -3.5 | -3.4 | -3 |
| Trade balance/GDP | -21 | -16.4 | -20.7 | -21.7 | -12.1 | -10.1 | -10.4 | -10 | -9.2 | -9.1 | -8.8 |
| Net FDI/GDP | 8.6 | 7.9 | 7.1 | 8.3 | 7.3 | 8.7 | 8.8 | 7.7 | 6.4 | 5.3 | 4.4 |
| Gross external financing needs/CARs plus usable reserves | 159.9 | 163.3 | 165.2 | 181.1 | 177.5 | 191 | 184.6 | 168.6 | 162.9 | 161.7 | 156.7 |
| Short-term external debt by remaining maturity/CARs | 57.5 | 63.1 | 65 | 76.1 | 87 | 102.1 | 97.4 | 83.2 | 80.5 | 81.1 | 76.9 |
| Usable reserves/CAPs (months) | 1 | 0.8 | 0.8 | 0.9 | 1.4 | 1.2 | 1.3 | 1.5 | 1.7 | 1.8 | 1.9 |
| Usable reserves (mil. $) | 2,304 | 2,466 | 2,848 | 4,032 | 3,378 | 3,847 | 4,643 | 5,488 | 6,346 | 7,057 | 7,698 |
| ***FISCAL INDICATORS (%, Gen. Govt.)*** | | | | | | | | | | | |
| Balance/GDP | -2.5 | -1.7 | -2.5 | -3.4 | -2.5 | -1.9 | -1.8 | -2.4 | -2.1 | -2 | -2 |
| Primary balance/GDP | -0.3 | 0.1 | -0.7 | -1.7 | -0.8 | -0.2 | 0 | -0.5 | -0.2 | -0.1 | -0.2 |
| Revenue/GDP | 22.2 | 22.2 | 21.5 | 20.2 | 19.4 | 20 | 20 | 21.4 | 21.6 | 21.6 | 21.6 |
| Expenditures/GDP | 24.6 | 23.9 | 24.1 | 23.6 | 21.9 | 22 | 21.7 | 23.8 | 23.7 | 23.6 | 23.6 |
| Interest /revenues | 9.7 | 8.4 | 8.4 | 8.3 | 8.9 | 8.7 | 8.7 | 8.8 | 8.6 | 8.6 | 8.5 |
| Debt/GDP | 31.1 | 29.4 | 29.2 | 31.4 | 32.9 | 32.9 | 33.6 | 34.8 | 35.2 | 35.3 | 35.5 |
| ***MONETARY INDICATORS (%)*** | | | | | | | | | | | |
| CPI growth | 5.9 | 5.7 | 4 | 2.6 | 0.1 | 0.7 | 0.9 | 1.5 | 2 | 2 | 2 |

***Source: CapitalIQ.com***

An endogenous challenge for Panama however is the inadequate education levels of its workforce. We note that major improvements have been made in poverty reduction and the growth of the middle class. Panama's per capita GDP is estimated to climb to about US$18,301.70 by 2018 (***Table 2***), just marginally out ranking Trinidad due to years of weak hydrocarbon prices. Despite the growth in per-capita GDP, the inadequately educated labour force is one if the major concerns of investors according to the ***Global Competitiveness Index***.

***Table 2***

| GDP Per Capita 'US$" | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|
| Costa Rica | 11,728.61 | 12,095.04 | 12,566.80 | 13,133.94 | 13,731.29 |
| Dominican Republic | 7,477.62 | 7,891.29 | 8,267.18 | 8,673.14 | 9,080.59 |
| Jamaica | 5,193.36 | 5,393.38 | 5,475.67 | 5,685.74 | 5,919.23 |
| **Panama** | **15,089.35** | **15,877.48** | **17,117.38** | **18,301.70** | **19,331.78** |
| Trinidad and Tobago | 16,637.65 | 16,930.88 | 17,491.34 | 18,210.20 | 19,182.14 |

***Source: IMF WEO Database, October-2018.***

***Panama's prudent fiscal management has underpinned its strong rating***. Fiscal deficits averaging a modest 2.3% between 2011 and 2018 combined with a modest average primary deficit of 0.5% over the same time period, suggests prudent fiscal management. Prudent debt management combined with robust growth has kept the debt/GDP ratio firmly below 35% over the last decade.

For 2018 and 2019 higher government spending on the expansion of the Tocumen Airport, a second Metro Line and national elections (presidential, congressional & mayoral) plus the visit of the Pope, could see the deficit widen. The fiscal deficit came in at 1.8% in 2017 but is estimated to widen to 2.4% in 2018 and possibly 2.0% in 2019. That said, GDP growth and consequently government revenues should pick up in the medium term which will contain the debt/GDP ratio ***and likely keep the interest burden below 9% of GDP.***

The structure of Panama's debt also shows a well planned and executed debt management strategy. Only 1.5% of the sovereign's total debt is short term. The debt overall has an average maturity of ten years and 83% of the debt is fixed rate debt; this means low refinancing risk.

***Panama has a history or prudent policy making.*** The country has ***a Canal Stabilization Fund*** or sovereign wealth fund which acts as both a savings fund and a stabilization fund. The Fund was incorporated into law on June 5, 2012 and is funded by revenue from an expanded Canal. The Fondo de Ahorro de Panama or FAP (Spanish acronym) is a long term savings for the Panamanian state. FAP offers a stabilization mechanism where funds can be disbursed in emergency cases as declared by the government and can be used to enhance growth via fiscal expenditure if there is an economic recession.

Panama has gone a step further by creating a ***Fiscal Council*** that is tasked with assessing and monitoring fiscal plans. The Council was passed into law on December 26, 2018 with the authority to pass a non-binding opinion publicly. If the government fails to adhere or comply with the Council's recommendation they must explain to the populous why they have not chosen the recommended path. This move goes a far way in improving transparency.

***On the external side, Panama's current account deficit has declined*** from 14.5% of GDP in 2011 to an estimated 4.4% as at the end of 2018. Ongoing growth in the services surplus, including financial, banking and insurance services associated with the Canal, has been the main driver of the reduction in the current account deficit. The medium term forecast is for the current account deficit to narrow even further to 3% by 2021. The narrowing of the current account is projected to be driven by (I) exports of copper and gold projected to begin in 2019; (II) increased domestic energy production and (III) lower investment related imports.

***Export destination diversity*** due to the emergence of China has reduced Panama's vulnerability to external shocks. Asia consumes 27% of Panamanian exports, up from 19% in 2012 while North America now absorbs 18% of Panama exports, down from 35% in 2012. ***Panama's external vulnerability indicator*** (*gross external financing needs / current account receipts plus usable reserves*) is also projected to decline significantly from 191 in 2016 to a forecasted 156.7 in 2021. Growth in usable reserves, as the current account and trade balance improves, are identified as the stimulus for the improvement in the vulnerability indicator.

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### *The Absence of Monetary Policy Flexibility*

Panama has adopted the US dollar as its official legal tender, i.e. the sovereign has a dollarized economy. Being a dollarized economy means that Panama takes monetary policy dictates from the US Federal Reserve. The sovereign also cannot act as lender of last resort, in the traditional sense, to the banking or wider financial sector in times of crisis because it cannot print US-dollars. There is also no effective deposit insurance system or mechanism to provide temporary liquidity to distressed financial institutions.

That said, despite this weakness, Banco Nacional De Panama (BNP), one of two government-owned banks, came to the rescue of Balboa Bank and other banks during a relatively recent money laundering case. BNP was able to facilitate the creation of two trusts to administer and sell the assets of the companies involved. ***BNP's action mitigated the risk and alleviated the pressure faced by the financial system at the time. BNP also created a US$500 million facility to provide temporary liquidity support where needed.***

As noted before***, Panama also has a sovereign wealth fund*** which is financed by surplus canal earnings. Though by law the surplus is not for bailing out the financial sector, its presence does mean that funding is available which could be accessed in a crisis situation.

Dollarization for Panama has also had the spill-off benefits which have accrued to the US economy. Historically low inflation, complemented in recent times by a strong US dollar and low oil prices.

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### *CONCLUSION*

Panama's growth, prudent fiscal management, low debt, strong external indicators and sovereign wealth fund make it an attractive and stable investment option. This is offset somewhat by the absence of monetary flexibility, income inequality, poverty and extreme poverty especially in rural areas and recent scandals regarding money laundering. The positives however, by far outweigh the negatives and consequently we maintain our ***BUY Recommendation*** on Panama based on the fundamentals.

***Therefore, "Panama after the papers" is still a robust sovereign***. It is even arguable that since the "papers" scandal the country is more attractive. The strengthening of its institutions, its adherence to international law and the sharing of information with a number of countries has removed a lot of suspicion regarding both its on and off-shore financial dealings. This would have also likely strengthened its ranking in terms of doing business.

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# Panama —"S&P Rating BBB/Positive"



## THE TECHNICALS

| Panama Global Bond Yields | | | | | |
|---|---|---|---|---|---|
| *Figure 1* | | Rating | | | |
| *Maturity* | *Coupon* | *S&P* | *Moody's* | *Offer Price* | *Offer Yield* |
| 1/30/2020 | 5.200% | BBB | Baa2 | 102.150 | 2.920 |
| 9/22/2024 | 4.000% | BBB | Baa2 | 102.900 | 3.403 |
| 3/16/2025 | 3.750% | BBB | Baa2 | 101.500 | 3.464 |
| 1/29/2026 | 7.125% | BBB | Baa2 | 120.550 | 3.744 |
| 9/30/2027 | 8.875% | BBB | Baa2 | 136.100 | 3.906 |
| 3/17/2028 | 3.875% | BBB | Baa2 | 101.650 | 3.655 |
| 4/1/2029 | 9.375% | BBB | Baa2 | 143.750 | 4.064 |
| 1/26/2036 | 6.700% | BBB | Baa2 | 127.350 | 4.310 |
| 5/15/2047 | 4.500% | BBB | Baa2 | 101.900 | 4.380 |
| 4/16/2050 | 4.500% | BBB | Baa2 | 100.200 | 4.487 |
| 4/29/2053 | 4.300% | BBB | Baa2 | 98.150 | 4.406 |

*Source: Jefferies LLC as @ 11/2/2019*

A cursory look at the yields and rating suggest that Panama may be a bit expensive and rightly so given the strength of its fundamentals and outlook. (***Figure 1***). Offer yields range from 2.92% on the short end (2020's) to a modest 4. 406% on the long end (2053's).

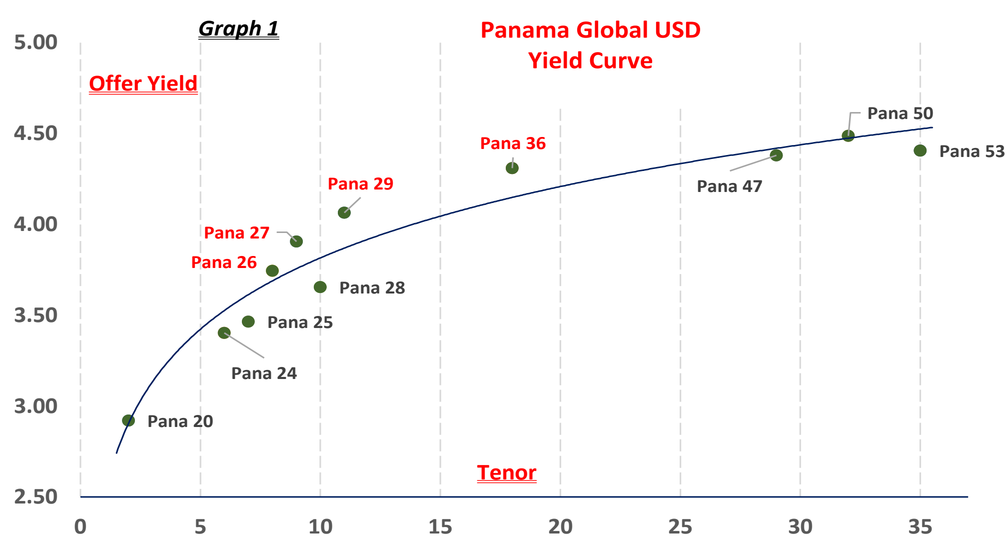
We went further by comparing another investment grade sovereign with a slightly higher rating, Trinidad (BBB+), to Panama (***Figure 2***). In our comparison we included not only Trinidad's sovereign debt but also the debt of Trinidad Generation Unlimited (rated BBB-/2027's), the country's largest power plant, supplying approximately 50% of Trinidad's electrical energy needs and owned by the government. We also included the National Gas Company of Trinidad & Tobago (NGC-2036/rated BBB) which is wholly owned by the government of Trinidad & Tobago.

| Trinidad Global Bond Yields | | | | | | |
|---|---|---|---|---|---|---|
| *Figure 2* | | | Rating | | | |
| | *Maturity* | *Coupon* | *S&P* | *Moody's* | *Offer Price* | *Offer Yield* |
| **Sovereign** | 7/1/2020 | 9.750% | BBB+ | Ba1 | 108.500 | 3.400 |
| | 1/16/2024 | 4.375% | BBB+ | Ba1 | 99.700 | 4.440 |
| | 8/4/2026 | 4.500% | BBB+ | Ba1 | 95.950 | 5.160 |
| | 5/17/2027 | 5.875% | BBB+ | Ba1 | 104.450 | 5.200 |
| ***Trinidad Generation*** | 11/4/2027 | 5.250% | BBB- | N/A | 96.500 | 5.830 |
| ***National Gas Co.*** | 1/15/2036 | 6.050% | BBB | Ba1 | 98.500 | 6.190 |

*Source: Jefferies LLC as @ 11/2/2019*

Trinidad provides additional yields ranging from 48 basis points on the short end (2020's) to a maximum of 141 basis points for the 2026"s. The Tringen-2027's also trade at a healthy 192 basis points wide of the Panama's 2027's.

***It is important to note however, that while Trinidad has a slightly higher rating, the outlook is negative***. The fiscal and debt dynamics are a concern. The contingent liabilities of state enterprises (Petrotrin) and volatility in hydrocarbon prices, Trinidad's major export, additionally suggest that investors should be cautious. This is likely the reason for the additional yield across the curve compared to Panama.




A look at the Panamanian yield curve suggests that its most attractive bonds are in the middle of the curve (***Graph 1***); the 26's, 27's 29's and 36's seem to be the pick of the lot.

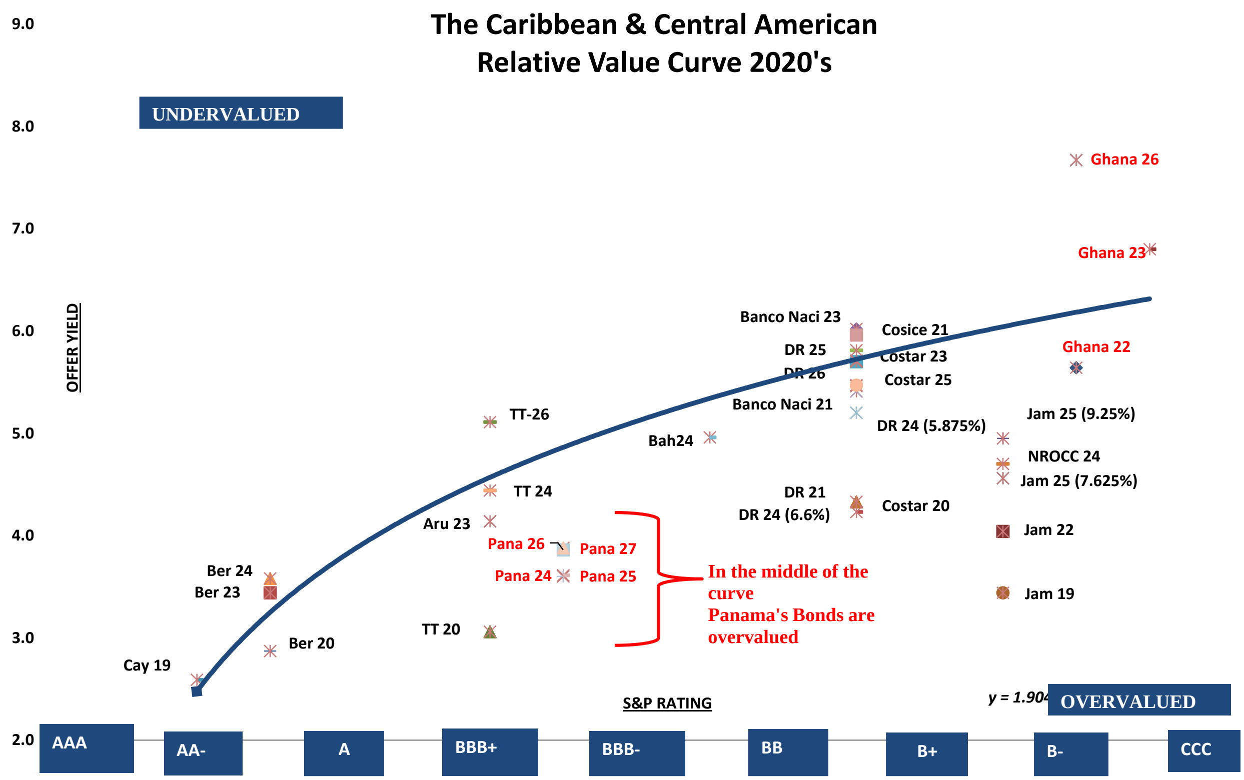
# Panama —“S&P Rating BBB/Positive”

Our base case assumption is that the Fed has at least another two rates hikes left for 2019. Consequently we are still in a rate hiking environment and therefore ***low duration assets*** are the preferred option. Combining the yield curve with our investment strategy suggests that the 26’s, 27’s and 29’s are the pick of the global bonds at this time.

## CONCLUSION ON THE TECHNICALS

Our ***relative value analysis indicates*** that overall, Panama, at the short to middle segment of the curve, is overvalued. Both Aruba and T&T offer higher yields but with slightly higher rating levels. The market has effectively priced in about a four notch upgrade of Panama as the sovereign trades in line with Bermuda which is rated at “A+”. ***Panama however does have its place in a portfolio if the investment manager is seeking an investment grade, high growth sovereign with strong exposure to global trade***. Capital gains is also a distinct possibility.

We have neglected to look at the relative value analysis from the long end given that we project an increasing interest rate environment. Consequently we are seeking exposure only to low duration assets.




***Source: Capitaliq.com, Moody’s, www.imf.org, Bloomberg, Reuters, Cia-factbook.WTO.org, The Panama Papers: The International Consortium of Investigative Journalists***

# 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.

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