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INVESTOR UPDATE

NOVEMBER, 2020

COSTA RICA UPDATE

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EXECUTIVE SUMMARY

Costa Rica's economic fallout from Covid-19 has been less significant than its peers. For 2020, it is estimated that a decrease in GDP of 4.2% will be experienced, compared to a LATAM average of 8.8%.

Significant fiscal challenges ensue as the pandemic has highlighted significant longstanding vulnerabilities. *Persistent wide fiscal deficits*, combined with extensive domestic debt issuances has deteriorated Debt/GDP and has hiked the interest burden. A fragmented Congress is the main obstacle to any fiscal reform as the two-thirds majority needed to pass any reform has been difficult to achieve. Recently, Congress has even allowed local governments to break prescribed fiscal rules of the 2018 reform.

Rating Agency	Rating	Outlook	Date
S&P	B	Negative	Jun-20
Fitch	B	Negative	May-20
Moody's	B2	Negative	Jun-20

The 2020/21 budget gives the clearest indication that there will be no improvement in the fiscal stance. The deficit is expected to be larger than in 2020, with over half the budget being financed by debt issuances. The government is however seeking the IMF's assistance with fiscal adjustment efforts via a US $1.75 billion Extended Fund Facility.

There are looming maturities which total approximately 25% of GDP which the government will have difficulties handling. We expect that these difficulties may lead to a preemptive debt restructuring, and if this is not completed in due time, the sovereign is at risk of defaulting.

MONETARY & FISCAL STIMULI

In response to the Covid-19 crisis, the Costa Rican government rolled out a comprehensive package which was aimed at protecting citizens as well as the firms in the country. The response consisted of both fiscal and monetary stimuli, aimed at protecting the vulnerable, alleviating any liquidity crunch while trying to fuel economic output. On the fiscal side, there was a sweeping number of 'tax-break' measures. Coupled with these measures, the government directly distributed cash transfers to households affected by the virus containment measures. The monetary half of the stimulus package was aimed at creating an accommodative environment for growth as government tried to set a platform for businesses, while trying to provide liquidity for the private sector.

An interest free 4-month moratorium on VAT, business income tax as well as customs duties gave firms some breathing space. Since the end of this moratorium in July, Congress has approved a bill which frees registered members of the tourism sector from VAT for 1 year. This move was done to assist with the rebound of tourism, as the sector is a main foreign exchange earner and is critical to Costa Rica's external position. Further to the VAT moratorium, Congress made amendments to social security contributions payable by firms. The contributions were now proportional to total time worked for 6 months, given that the economy was now operating on reduced hours. Firms were granted a deferral on these payments until the end of 2020.

In protecting those households affected due to loss of jobs or self-employed or informal workers made worse off, a cash transfer program was created. This program, called Protegar Bono (Bonus Protect), involved a cash transfer of a monthly subsidy of a maximum of C $200,000 (US $327). This subsidy was paid to a total of 700,000 persons, the final of these payments being made on the 4th of November. The strain which these fiscal measures have put on the accounts of the government has led them to pass a decree in Congress to suspend all salary increases for public employees except police officers.

On the monetary side, the Central Bank of Costa Rica (BCCR), has used accommodative monetary policy tools to provide liquidity and a foundation for firms to grow amidst the pandemic. The BCCR has cut its policy rate by 1% down to a historic low of 0.75%. The BCCR also embarked on the purchasing of government securities in the secondary market. These securities had to be issued in Colones prior to 2020 with a maximum maturity of 10 years. This move was done to provide liquidity support in times of market distress. State owned banks have also offered loans at preferential interest rates in an attempt to reduce the cost of credit. All banks have offered moratoriums on all forms of debt, with the National Bank of Costa Rica extending moratoria to December of 2020.

ECONOMIC STANDING

Similarly to the rest of the world, both Covid-19 and the measures undertaken to contain its spread, have had an untoward effect on the Costa Rican economy. The strict and extensive containment measures, in addition to the global downturn, have stressed both the fiscal and external accounts and has highlighted existing economic vulnerabilities. These containment measures have led to a significant decrease in economic output as well as a partial depletion of the government's revenue base. Additionally, fallouts from the tourism sector and a dip in export levels due to the contraction of its main trading partners has preceded Balance of Payment difficulties. The government has however successfully approached the IMF for a Rapid Financing Instrument (RFI) to assist in meeting both the increased expenditure demands as well as to cover the BOP shortfalls.

Containment measures which have included, but not been limited to, temporary curfews and decreased work hours for the private sector has damped economic output severely. An 8.6% year-on-year decline in GDP was recorded in Q2 of 2020. This contraction is attributable to a fall in private consumption, doubling of unemployment and a decrease in private investments. A 4.2% fall in real GDP for the full year 2020 is being forecasted as gradual scaling back of the containment measures has been accompanied by an uptick in economic output.

Tourism, which accounts for 9% of GDP and is a major foreign exchange earner, came to a grinding halt for close to two full quarters. Combined with the cessations of tourism receipts, a fall in export levels by 11% has caused the current account balance to worsen. This worsening of the current account, has pushed Congress to approve the government's decision to engage the IMF for an RFI. The RFI, valued at US $504 million will be used to help finance the current account gap which is forecasted to be 5.3% of GDP for 2020. It will also be used to fund the critical expenditure needs in the health sector, and relief packages for the most affected and vulnerable sectors and citizens. The current account

balance is however expected to narrow in 2021, as with the gradual restart of tourism and a return of some of the FDI flows, the country's external position will slightly improve.

The fiscal position of Costa Rica has long been an area of vulnerability. The major ratings agencies have continued to cite that the persistent fiscal deficits in excess of the growth rate of real GDP is a major point of weakness. This, in combination with the inability of a fragmented Congress to implement the needed fiscal reforms, has worsened public finances. Costa Rica has received a second rating downgrade in six months from both S&P and Fitch. This downgrade has come about due to the already weak fiscal stance, being further stressed due to the pandemic.

A fiscal deficit of 9% has been forecasted by S&P, as there continues to be little evidence to indicate that there will be any fiscal consolidation efforts. We expect that the hit to the revenue base and the increased expenditure on health care and fiscal relief packages will keep the fiscal deficit wide, leading into 2021. Government revenue has contracted by 10% while expenditure has only contracted by 0.3%. This 0.3% contraction in expenditure is attributable to a 33% cut in capital expenditure.

The government has presented its budget for the 2020/2021 fiscal year which began October 1st. The government's budget highlighted that they are making an effort to contain public spending, with a decrease in primary spending by 5.3%. The high cost of servicing debt recently incurred however remains a challenge. The new budget includes an increase in resources for tourism oriented activities, health and education. Worryingly, the recently presented budget has zero new revenue generating initiatives for the government and shows an estimated shortfall of -9.9%. This has led to concerns about the government's commitment to fiscal adjustment and consolidation. Elections being due in February 2022 also further these concerns.

The new budget also indicates that over half of the country's financing needs will be financed by raising debt. This will place further pressure on the deteriorating debt dynamics. Interest/Revenues has constantly trended upwards and will seemingly continue as the government fails to implement policies to ensure debt sustainability. Debt/GDP will end the year slightly below 80% while interest as a percentage of revenues will climb to 19%. The raising of the debt needed to finance the budget will most likely be done in the domestic markets due to the current global financial conditions and the difficulty in getting congressional approval for international issuances. This domestic raising of debt will further the crowding out effect which has been a constant phenomenon over the past 5 years.

DEBT DYNAMICS

Costa Rica's debt is becoming unsustainable. The persistent fiscal deficits and continuous debt financing has worsened the debt numbers and interest costs. Policy uncertainty and the lack of fiscal corrective actions has led to the deterioration of the debt numbers and contributed to the sobering outlook for the country's debt. In October, President Carlos Alvarado withdrew his initial proposal to engage the IMF, citing legislative pushback to proposed tax increases. The government is however still in negotiation with the IMF for a US $1.75 billion Extended Fund Facility (EFF) arrangement. The government also plans to tap the domestic market for the equivalent of 2.4% of GDP for the rest of the year. Plans to raise financing in 2021 include external financing worth up to 3.8% of GDP and reliance on the domestic markets for over 10% of GDP. This level of financing is still inadequate as the wide fiscal deficits, coupled with a steep amortization schedule over the next 3 years requires significant funding. Over the next 3 years, Costa Rica faces maturities equivalent to 25% of GDP.

Costa Rica's Debt/GDP has worsened to 78% as at 2020. This represents a doubling of the nation's debt in less than a decade. Over this same period, the government has programed an average fiscal deficit of 7%. With fiscal deficits expected to remain wide for the next 2 years and the government indicating that 53.4% the 2020/21 budget will be covered by debt financing, the Debt/GDP figure will only worsen. Another area of major concern is the rising interest burden. A major contributor to this interest burden rise is the

frequency at which the government has to raise debt in the local markets. Congressional approval for external debts is a lengthy process which has previously kept government from raising debt externally for 3 years.

The proposed EFF agreement with the IMF could see a postponement of some debts owed to the IMF until the pandemic's effect begin to subside while the sovereign receives much needed disbursements. Successfully negotiating an EFF could also see the government unlocking low cost funding from agencies such as the World Bank, which would be at better interest rates than debt raised locally. The possibility of getting congressional approval within the next 2 quarters is very unlikely. Congress took 4 months to approve the non-conditional RFI from the IMF and the fiscal adjustment conditions which will accompany the EFF will not be easily passed in congress. Evidence of this lies in Congress exempting local governments from complying with fiscal reform laws of 2018.

With upcoming maturities being 25% of GDP over the next 3 years, Costa Rica faces significant financing needs in the near term to honor these maturities. Obtaining the financing to honor these maturities will be a difficult task as the current debt dynamics and market conditions are unfavorable to the raising of additional debt and congress could stand to be a significant obstacle in getting the desired financing. According to La Nacion (Costa Rican Newspaper), the government has already started a round of meetings with domestic bondholders in an effort to prevent a default. The finance minister has begun the process of engaging what he calls 'heavyweight' participants in the local-currency bond market in order to source the much needed financing. In 2019 Costa Rica reopened the bonds maturing 2045 to address liquidity concerns. They are now faced with an immediate solvency issue. The country may have issues in rolling their debt and may move towards a restructuring process in order to prevent a default.

BOND PROFILES

Costa Rica Bond Profiles

Sovereign	Maturity	Coupon	S&P	Moody's	Offer Price	Yield	Issue Size (USD Millions)	Min Piece/Increment	Tenor
Costa Rica	1/26/2023	4.250%	B+	B1	92.25	8.139	1000	200k/1000	3
	4/30/2025	4.375%	B+	B1	86.38	8.060	500	200k/1000	5
	2/19/2031	6.125%	B+	B1	84.5	8.400	1200	200k/1000	11
	4/30/2043	5.625%	B+	B1	74.98	8.050	500	200k/1000	13
	4/4/2044	7.000%	B+	B1	80.35	9.030	1000	200k/1000	14
	3/12/2045	7.158%	B+	B1	81.44	9.058	1300	200k/1000	15

Source: Capital-IQ, Fitch Connect, Moody's, Bloomberg

While there are looming maturities over the next 3 years, the first international maturity is set to become due in 2023. The 2023 bonds are the third most liquid of all outstanding international bonds and carry a coupon rate of 4.25%. The issue size of this bond is US $1 billion. The second most liquid of the Costa Rican international bonds is the 2031s, with an issue size of US $1.2 billion and a coupon rate of 4.375%, while the 2045s are most liquid with a total issue size of US $1.3 billion.

On the short end of the Caribbean & Central American Relative Value Curve, the Costa Rican bonds trade widest to the curve. The 2023s and 2025s have yield to maturities of 8.139% and 8.06% respectively. These yields are very elevated and in our view, reflect the perceived risks associated currently with these bonds, given the fiscal problems being faced.

The graph depicts how the bond prices for the 2023 bonds have moved over the past 12 months. It can be immidiately observed where the prices fell as investors reacted to the onset of the Covid-19 pandemic. The subsequent, albiet, muted recovery of the bond prices can also be identified. This muted recovery is one of the primary reasons why the bonds have an elevated yield to maturity. The prices of these bonds have however begun to decrease further after the presentation of the 2020/21 budget highlighted that Costa Rica will continue to run a sizeable fiscal deficit. The deficit will further worsen debt dynamics and decrease the attractiveness of Costa Rica's debt.

On the longer end of the curve, the 31s, 43s, 44s and 45s all still trade substantially wide to the curve.

CONCLUSION

For the past decade, Costa Rica's Debt/GDP has almost doubled, owing to the wide and persistent fiscal deficits. These deficits have been financed by debt issuances. A majority of these debts have been issued in the domestic markets which has led to an increase in the interest rate burdens as well as a perpetuation of the crowding out effect. This has led to a decrease in private investments and is an obstacle to growth in the economy. With the economy expected to contract by 4% for the full year 2020 and only recover slightly over the next 2 years, turbulent times are ahead. The 2020/2021 budget recently presented by the government painted a negative picture as to the future of the fiscal accounts for Costa Rica as the deficit will remain wide and will continue to be financed by the raising of debt.

The new budget has also outlined that the deficit will widen to 9.9%. This underscores our concerns that the current administration is not committed to any fiscal adjustments or consolidation. Of additional concern is the assertion by the government that more than half of this new budget will be financed by debt. The government will continue to program wide deficits and finance these by raising debt internally, which worsens the debt numbers and hikes the interest burden.

There has been an initial dialogue with the IMF to secure a US $1.75 billion EFF. Reaching an agreement with the IMF for this EFF will go a long way to correct the fiscal imbalances being faced. Along with a new disbursements of funds to meet expenditure, the government could also unlock sources of financing cheaper than their domestic markets (From multilaterals such as the World Bank). The possibility also exists that there could be a moratorium granted for already outstanding debt to the IMF, upon the signing of the EFF agreement. Additionally, conditionalities associated with the EFF will see the implementation of fiscal reforms to narrow the fiscal deficits and decrease the need to constantly seek debt. There are however, several obstacles to this agreement.

The agreement is needed within the next few quarters but it is unlikely that congressional approval for such will be granted in short order. It took congress 4 months to approve a no conditional RFI, so it is expected that an agreement which imposes strict fiscal adjustment policies will take a longer time to be approved. Our expectations of this is underscored by the initial proposal by the finance minister to increase taxes to secure the EFF being rebuffed and subsequently withdrawn. Restrictive fiscal measures, even if they are approved by congress will lead to social conflict and unrest.

With maturities looming over the next 3 years, the country will have difficulty rolling its debt and honoring maturities. A majority of the looming maturities however, are domestic maturities. The government has already begun the process of sitting down with the major debt holders in the country to have discussions as to the best action to handle these maturities. The closest looming international maturity is the bonds maturing in January 2023. These bonds would mature within the first budget cycle of the new government to be selected by February 2022.

We expect at best, a preemptive restructuring of local debt, where the government tries to swap close dated bonds for longer dated bonds. This would have to be done with caution however, as history has shown that market based swaps during tight financial and economic times, has been shown to provide immediate

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liquidity relief but creates long term solvency issues. Any restructuring could also see the major rating agencies downgrade the risk rating of Costa Rica, which would adversely affect bond prices.

There also exists the possibility of a default in the scenarios where: a) the government is unable to get the financing needed to honor the maturities or rollover the debt; and: b) the domestic maturities are honored by the raising of additional debt which would add to the interest burden which has almost doubled in 4 years.

The sovereign debt at this time is **NOT** attractive even though it trades wide to the yield curve.

The credit fundamentals of this sovereign has deteriorated significantly as we expect them to have difficulties rolling their debt and honoring maturities. If they are able to get the financing to meet maturities, it would have to be raised locally which would worsen their interest burden and their debt numbers. We therefore attach a SELL weighting to Costa Rica.

Source: Capitaliq.com, Moodys.com, Reuters, US-Department of Treasury, Bloomberg, UBS Securities-LLC, Oppenheimer, La Nacion, Focus Economics, Stista, Fitch Connect

APPENDIX

IMPORTANT DISCLOSURES

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

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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.

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EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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