

**PLEASE REFER TO EXPLANATIONS ON RECOMMENDATIONS  
CONTAINED IN APPENDIX BELOW**

Table 1: Cuba's SWOT Analysis

<p><b>Strength</b></p> <ul style="list-style-type: none"> <li>▪ Large well educated workforce relative to other countries in Latin America and the Caribbean</li> <li>▪ Close proximity to the US and an emerging competitive tourist destination in the Caribbean</li> <li>▪ A well-developed healthcare and bio-medical system and highly trained professional technicians in the health sector</li> </ul>	<p><b>Weakness</b></p> <ul style="list-style-type: none"> <li>▪ Heavily dependent on tourism from the US, and dependency on Venezuela and Russia for oil imports</li> <li>▪ Heavy concentration of primary exports – nickel and agriculture- exposes the country to international price volatility.</li> <li>▪ Lock out of the international capital market and is reliant on monetising government deficit</li> <li>▪ US embargo hinders foreign direct investment</li> </ul>
<p><b>Opportunities</b></p> <ul style="list-style-type: none"> <li>▪ Easing of relationship and ultimately an end to the embargo could open doors for a greater level of external private investment</li> <li>▪ Reduction in bureaucratic red tapes and economic reform could potentially shift the investment landscape and unlock greater private sector participation in the economy</li> </ul>	<p><b>Threats</b></p> <ul style="list-style-type: none"> <li>▪ A more aggressive political stance by the Trump administration could effectively, among other things, lead to a massive reduction in tourist flows and amplifies Cuba's economic problems.</li> <li>▪ Exposure to hurricanes pose serious threat to the sovereign's infrastructure and is disruptive to economic activities</li> </ul>

**Introduction to Cuba and its Politics**

Following the Spanish arrival in Cuba in 1492 and subsequent development of the island as a colony, the indigenous Indian population was decimated resulting in Spaniards importing African slaves to work on sugar and coffee plantations. Cuba became the launching spot for the annual treasure fleet bound to Spain from Mexico and Peru. The Spaniards dominated all aspects of Cuban lifestyle and oppressed the local population. This led to many slave rebellions, which were put down by the military force. With the help of the United States (US) during the Spanish-American war of 1898 the Spaniards were defeated. Under the terms of the Treaty of Paris that same year Spain relinquished its claim on Cuba and the US became a protectorate for the territory until 1902 when Cuba officially declared its independence from Spain. For the next 60 years US business and financial interests dominated the domestic economy. A succession of corrupt puppet-political administrations, military dictators, backed by the US government, ruled over Cuba during that period. This incited a nationalist movement for change, and in 1959 a rebel force led by Fidel Castro overthrew the government of Fulgencio Batista. The victory of the rebels and their actions thereafter set the stage for Cuba's social, political and economic relationship with the US and rest of the world for the remainder of the 20<sup>th</sup> century.

Fidel Castro cemented power and aligned his administration with the Soviet bloc, which was not to the liking of the US and other western powers. Having ruled for nearly five decades, Fidel Castro ceded power to his younger brother Raul Castro in 2018. The younger Castro demitted office on the 19<sup>th</sup> of April 2018 and Miguel Diaz-Canel Bermudez took over after being unanimously elected president by the National Assembly of the People.

## Political System

Cuba is a democratic-centralist state organized along a socialist model rooted in Marxist-Leninist ideology. There is only one official party, The Partido Comunista de Cuba (Communist Party of Cuba). Like most other countries the government is divided into three tiers – the executive, the legislative and the judicial branch. The executive branch is comprised of the Council of State and Council of Ministers, and the president of the Council of State serves as president of Cuba. The national legislative branch is a group of elected officials known as the National Assembly of the Peoples Power. The Supreme Court is the highest judicial branch and is the court of last resort for all appeals from convictions in the provincial courts. Cuba is divided into 14 provinces and numerous municipalities. Each province and municipality has an elected assembly and a system of courts. Provincial courts deal with criminal and civil matters, as well as act as an appellate court for legal matters dealt with by the municipal courts.

## Legal System

Cuba's legal system reflects and incorporates three distinct stages of its history. As a former Spanish colony there is system of civil law with written codes rather than precedence that guide matters before the court. There is an inquisitorial system for criminal matters which is similar to the process used in France and Spain. The legal system is also infused with aspect of Anglo-American law such as habeas corpus. There is a greater separation of the courts and prosecutors, unlike most communist states. The courts are also shaped by a half century of Marxist-Leninist legal theory, which have added an element of socialist characteristic to its operation. For example, the law is used as a tool for social development and there are informal courts that resolve conflicts such as labour and housing disputes.

## Economic System

Cuba is a heavily state controlled economy with limited private sector participation. Government spending accounted for 68% of GDP in 2018 compared to 32% of GDP for Latin America and the Caribbean. Following the collapse of the Soviet Union in 1991 the Cuban economy underwent a period of economic stagnation known as the Special Period. Cuba's high dependence on sugar output and limited economic diversification were partly to be blamed for the fallout in the economy. Immediately following the revolution, Cuba's economy became heavily intertwined with the Soviet Union. Cuba exported sugar, coffee and other primary products to its benefactors. The sovereign benefitted from the relationship in two ways: Cuba received premium prices for primary exports while the Soviet Union provided subsidized imported goods, including oil; low cost loans; and technical assistance. The disintegration of the Soviet Union severely derailed this relationship and resulted in deep cuts in Cuba's foreign exchange inflows.

It is estimated that the economy contracted north of 33% between 1991-1993, reflecting a massive decline in Soviet support and precipitous fall in the price of sugar on the world market. The ensuing foreign currency shortage curtailed the importation of basic food items, which severely affected the general population. Having defaulted on loans from external creditors in 1986, the authorities found it challenging to obtain external funding to ease the supply shortage. However owing to the socialist government control of the distribution channels, prices were slow to adjust upwards and inflation was curtailed. The shortage of foreign exchange persisted for much of the period testing the resolve of the socialist government to maintain order despite the economic hardship. Public discontent was tempered not only through price controls, but also as a result of the state providing the wider society with continued free access to healthcare and education. The state subsidizes and provides utilities, which is ubiquitous in Cuban household unlike a number of its peers in LAC.

Given the level of state involvement in the economy, the resultant fallout in sugar prices and support from the Soviet Union resulted in a sharp rise in the fiscal deficit and debt levels.

Table 2: Selected Economic Data

	2014	2015	2016	2017	2018	2019 (e)	2020 (f)	2021 (f)	2022 (f)	2023 (f)	2024 (f)
Population, million	11.34	11.34	11.34	11.33	11.33	11.33	11.33	11.32	11.31	11.29	11.28
Nominal GDP per Capita, USD	7,133	7,694	8,061	8,541	8,822	8,606	8,982	9,475	10,000	10,575	11,203
Real GDP growth, % y/y	1	4.4	0.5	1.8	2.2	-2.2	0.3	1.6	1.6	1.9	2.1
Revenue, % GDP	58.6	57.6	56.3	57.6	57.2	61.5	55.9	56.4	56.6	56.5	56.6
Expenditure, % of GDP	60.8	63.4	63.3	66.0	68.6	67.6	64.3	62.8	62.7	62.4	61.9
Fiscal Surplus/(Deficit), % of GDP	(2.2)	(5.8)	(6.7)	(8.6)	(11.7)	(6.3)	(8.7)	(6.7)	(6.4)	(6.1)	(5.6)
Capital expenditure, % of GDP	3.50	3.90	3.70	4.20	5.00	5.90	6.30	6.70	7.10	7.40	7.70
Inflation, ave, % of GDP	2.10	2.98	(2.90)	0.60	0.64	3.00	3.00	3.00	3.00	3.00	3.00
Current account balance, % of GDO	3.01	3.69	4.70	5.51	5.42	4.83	4.81	4.88	4.96	5.04	5.16
LCU/USD, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Tourism receipt, % of GDP	3.16	3.24	3.36	3.41	3.34	3.20	3.20	3.20	3.40	3.41	3.41

Sources: Fitch Connect and JMMBIR

*e-expected and f-forecast*

Present day Cuba is heavily dependent on tourism, which is the main source of foreign exchange inflows, and exportation of nickel. The government also benefits from sending healthcare workers to various countries, including Venezuela. Under the Chavez administration Venezuela became one of Cuba's largest trading partners. Venezuelans supplied subsidized crude oil to Cuba and received part payment in cash and the remaining portion of the sums owed was given as a soft loan. It is estimated that Venezuela accounted for 44.0% of all imports to Cuba and 44.5% of exports in 2012. The arrangement between the two states continued through to the Nicholas Madura administration, but Venezuela has since cut subsidised fuel exports to Cuba because of its own economic issues despite the increase in oil prices. Cuba's trade deficit is likely to increase in coming years as a result of the sovereign being forced to purchase higher priced oil on the open market.

Cuba successfully negotiated and restructured outstanding debt, including Soviet-era debt, with Paris Club members. This resulted in a reduction in principal and arrears owed to the Club by about 81% of what was accumulated during the period 2010 – 2017. The Cuban authorities have since resumed servicing the debt including the payment of interest and principal. Data from the Bank of International Settlement indicates an uptick in bi-lateral lending, perhaps for export payments, however Cuba still remains blacklisted from the international capital market.

Real GDP growth is estimated to have expanded by 2.2% in 2018, but is expected to contract by 2.2% in 2019. The fallout is likely to result from lower tourist arrivals occasioned by the travel restriction imposed by the Trump administration and long standing structural issues in the economy. Modest recovery in growth is however expected over the medium term due to an increase in tourist arrivals and spending. On the fiscal side, a deficit of more than 6% is envisaged in 2019, and the deficit is likely to remain elevated over the forecast horizon.

### Economic reform, dual currency and government finances

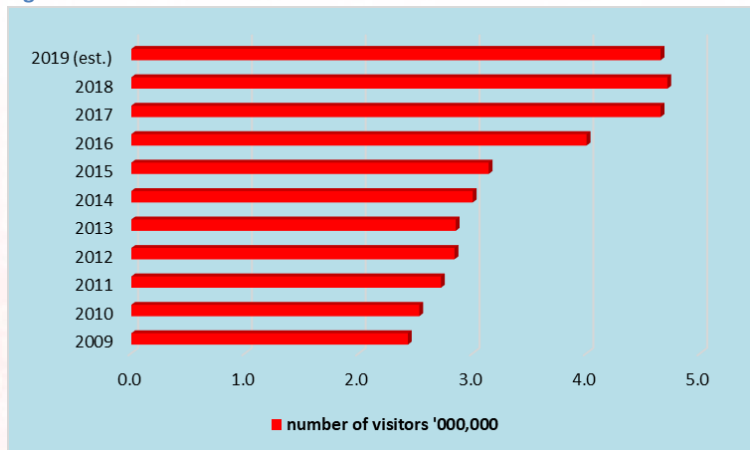
In recognition of the shift in the global environment and its impact on Cuba, the economy and the socialist regime, the government unveiled plans to reform the economy and improve government finances. The plans among other things were geared to weaken the black market, stabilize the economy and stimulate domestic production. Some of the actions taken by the authorities included legalizing the possession of US dollars, allowing ordinary Cubans to sell goods and services to tourists, giving bonuses to certain groups of workers, and reforms in the agriculture and banking sectors. There were plans to set established special export zones, however the planned funding has not been realized, as international investors are wary of US sanctions and possible lawsuits.

During the last quarter of 1994 the government introduced a convertible pesos priced at par with then US dollar (1 convertible pesos = US \$1). The convertible peso was used alongside the old pesos and the US dollar and could be used to purchase goods in dollar stores that were established to sequester foreign currency. This coupled with legalization of possession of US dollars helped to attenuate depreciation pressure on the peso.

## Tourism

During the period between the Spanish-American war and the Cuban Revolution, Cuba experienced an influx of visitors from the US due in part to its close proximity and US influence on the economy. The island became a very popular tourist destination for Americans in search of adventures and those seeking to escape restrictions on alcoholic beverage consumption during the prohibition era in the 1930s. From that period until the end of prohibition, tourism in Cuba, in particular Havana, became synonymous with the US mafia, as the crime syndicate used the island to move alcohol and narcotics to the US. Funds were channelled back to Cuba to purchase properties and construct hotels and casinos, which earned Havana the moniker the Latin Las Vegas.

Figure 1: Visitor Arrivals to Cuba



Sources: Fitch Solution and JMMBIR

government to find other avenues to generate revenues and earn foreign exchange. As a result the government drafted and actioned a policy to solicit visitors from Canada and Europe in 1994. The plan included the upgrade of hotels, roads and airports and the state invested heavily in the sector. The number of hotel rooms increased more than threefold to over 35,000 in 1996.

The earnings generated from tourism quickly surpassed the earnings from sugar and other exports in the mid-1990s. It is estimated that earnings from the sector amounted to US\$3.3billion in 2016 or 3.3% of GDP. Four million tourist arrivals was recorded that year, 80% higher than a decade earlier.

## US Sanctions

In 1996 two US senators – Jesse Helms and Dan Burton - sponsored the Cuban Liberty and Democratic Solidarity Act commonly referred to as the Helms-Burton Act. The act among other things extended the territorial application of the initial

The relationship between the US and Cuba declined further after the 1960s due in part to the socialist government nationalising banks and other industries and declaring private property illegal. A number of the properties that were seized by the Cuban government were owned by US citizens and corporates. The situation was not helped by the alliance between Cuba and the Soviet Union. In 1961 the US government declared US citizens travel to Cuba for vacation contrary to US national policy and strategic interest. Visitor arrivals from the US to Cuba fell precipitously and remained subdued to date.

Pressure on the fiscal and balance of payment accounts occasioned by the withdrawal of Soviet era subsidies and deterioration in the terms of trade forced the Cuban

embargo to apply to foreign companies trading in Cuba. It penalizes foreign companies that are deemed to be “trafficking” in property formerly owned by US citizens but was confiscated by the Cuban government after the revolution. The Act covered Cubans who formerly owned properties and are now citizens of the US. In a nutshell the Act allows US citizens covered thereunder to sue foreign corporates operating in Cuba and dealing in their properties in a US court. It also denies travel access to the US to foreign nationals associated with corporates acting in contravention thereof.

During the Obama administration there was a thawing of the relationship between the US and Cuba, which led to the re-establishment of diplomatic ties between the two states in 2015. The US however still maintained the economic embargo which makes it illegal for US corporates to do business in Cuba. In 2014 the Obama and Cuban administrations announced normalization of the relationship following months of behind the scene negotiations in Canada and the Vatican, with the assistance of Pope Francis. The agreement reached between the parties led to the US easing restrictions on travel and remittance, and access of Cuban financial system by US banks.

Not all Americans were enamoured with a shift in US-Cuba relationships, so with the election of new President Donald Trump on the Republican ticket in November 2016 there were concerns of a possible roll-back in Obama-era policy advancements. It did not take long for President Trump to roll-back some of these policies. In June 2017 he announced the suspension of unconditional relief for Cuba. However he left the door open for the US to get a better deal, if the relationship were to revert to where it was before the end of the previous administration.

## Opinion

Cuba has made significant strides in its socio-economic development despite the imposition of economic sanctions by the US, which severely undermines the sovereign maximizing its socio-economic development potential. Cuba ranked 73 out of 189 countries in the World Bank’s Human Development Index published in 2018. Having expended a large share of its budget on education and healthcare Cuba is a very literate society with a highly functional and skilled workforce. The incidence of communicable diseases is relatively low when compared to regional and global levels. Notwithstanding the gains made by Cuba in advancing the education and healthcare of the populace there are concerns about the suppression of civil liberties and personal freedoms. These concerns are further fermented by allegations of state influence on the judiciary and limitation of private property ownership.

The thawing of relationships between the US and Cuban offered a glimmer of hope that it may persist, and help to usher a socio-political shift in the Cuba-US relationship over the long-run. This easing of restrictions under the Obama administration was short lived as Donald Trump reversed many of the gains that were made.

Notwithstanding, Cuba’s level of human development, the infrastructure, including housing, is dilapidated and the use of technology is not widespread in household and businesses. Cuba’s lack of opportunity to integrate into the world economy has curtailed foreign investment flows, economic growth and development. There are some opportunities for external investors in the areas of mining, bio-technology and hotel accommodations, but the spectre of a lawsuit by US persons under the Helms-Burton Act and restrictions on property rights act as a deterrence.

Assuming a change in administration in the upcoming US presidential election and reversion of US-Cuba relations to where it was in 2016, there is no guarantee that another Republican President will not derail this relationship. There is uncertainty among potential investors because of the political situation in Cuba and the relationship between the sovereign and the US. This is not good for long-term planning and in the absence of a monumental shift in the relationship with the US, exploration of business pursuits in Cuba is deemed at best very uncertain and at worst very risky. In our humble opinion, we would advise against any investment in Cuba that is not commensurate with an investors’ appetite to stomach the potential losses due to the high level of political and economic risk that exists.

# MARKETCALL

JMMB INVESTMENT RESEARCH

**Sources:**

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## 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.

**UNDERPERFORM/UNDERWEIGHT**— ADJUST EXPOSURE IN YOUR PORTFOLIO HELD AT JMMB TO BETWEEN 2.5% AND 4.9% FOR THIS PARTICULAR ASSET

**SELL**—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO (0%).

**MARKETPERFORM/HOLD/MARKETWEIGHT**—EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

**OUTPERFORM/OVERWEIGHT/BUY**—EXPOSURE TO THIS ASSET SHOULD BE UP TO 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

**STRONGLY UNDERPERFORM**—REDUCE EXPOSURE TO THIS ASSET TO BELOW 2.5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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