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INVESTOR UPDATE

OCTOBER, 2021

VENEZUELA UPDATE

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SOVEREIGN FOREIGN CURRENCY CREDIT RATING: DEFAULT ("D")

***As at Sep-20, 2021, S&P has withdrawn its ratings due to lack of information.**

SUMMARY

Venezuela remains in default. The sovereign/country has officially been in default since November 3, 2017 when President Nicholas Maduro announced the establishment of a national commission to pursue the restructuring of all of Venezuela's debt, including the debt of the state run oil company, Petroleos De Venezuela S.A., more popularly known as PDVSA.

US sanctions which severely impede market access for the sale of oil, the country's lack of capacity to invest in the oil sector, mass migration, political and economic instability and general leadership uncertainty (Maduro vs Juan Guaido) all undermine governance in Venezuela.

THE ECONOMIC SITUATION

The US implemented heavy sanctions on Venezuela from as early as 2016 due to issues regarding democracy and the legitimacy of President Maduro. As the sanctions came into effect, Venezuela was deprived of the ability to export oil and other hydrocarbon products which represent in excess of 90% of export earnings. The country was frozen out of the international financial system and, consequently, hard currency/US-dollars could neither enter nor leave via the SWIFT code system. As a result of this, global bond payments could not be facilitated.

On the domestic side, debt and fiscal deficits continued to be financed using the Bolivar/local currency. However, the payments were made via monetary financing; i.e. unstructured credit transfers from the central bank / the printing of money. This created unprecedented levels of liquidity in the system which led to, and continues to drive, hyper-inflation. Further, the government and the monetary authorities continued to publish multiple exchange rate guidance to the public. This led to inconsistencies and an absence of confidence in the monetary and exchange rate system.

Since 2015, Venezuela's oil production has continued to decline. The nationalization of the oil industry, from as early as the presidency of Hugo Chavez, combined with asset seizures, legal action for compensation by oil companies due to these seizures and the absence of access to new technology have been the major factors contributing to the decline in output. Venezuela has what is referred to as heavy sour crude which means that their oil is heavily sand based, difficult to extract and has a high sulphur content. Experts have also noted that to continue to extract the oil, the country needs ongoing access to new and ever evolving technology. The nationalization of the oil sector deprived Venezuela of these expertise.

Oil aside, the other productive sectors of the economy have been stymied by price controls, asset seizures, erratic policy making and a general lack of consistency on both the monetary and fiscal fronts. These policy actions have led to an estimated 75% contraction in GDP between 2013 and 2020.

Based on the most reliable data available, economic activity in Venezuela has been contracting since 2014 (-3.9%). Since the country was forced out of the global capital markets in 2017, economic activity has contracted by an average of 23.8% including an estimated 35% contraction in 2019. Investment as a percentage of GDP has contracted by an average of 4.5% per annum since 2017 while unemployment climbed to as high as 9.3% in 2018 shortly after which, most of the data became unmeasurable.

On the external trade side, the current account became unmeasurable shortly after the sanctions while the country's external vulnerability continued to deteriorate. Gross external financing needs compared to current account receipts plus usable reserves deteriorated by an estimated 70% between 2017 and 2021. Narrow net external debt/ current account receipts, another measure of external vulnerability, deteriorated by an estimated 259% between 2017 and 2021. Usable net international reserves (NIR) declined from US$9.8 billion to US$7.2 billion (27%) between 2017 and 2020.

The fiscal numbers make for dire reading as well. The fiscal deficit as a percentage of GDP has averaged 23% between 2017 and 2020. The debt/GDP has also ballooned from 23.7% in 2017 to an estimated 8,179.6% in 2020. On the monetary side, hyperinflation has been the norm as food shortages, multiple exchange rates, inconsistent monetary and fiscal policy and now dollarization have all contributed to uncertainty and price instability. CPI growth has averaged 36,752% between 2017 and 2020.

THE POLITICAL SITUATION

Venezuela's opposition continues to weaken and lose relevance. Most of the opposition parties refused to participate in 2020 national elections for Congress citing a lack of democratic guarantees. As a result, Nicholas Maduro, his party's high ranking officials, and the military combine to hold all of Venezuela's executive, judiciary and legislative powers. The opposition lost its legislative power in an election widely deemed unfair. President Maduro has also continued to consolidate power via a constitutional assembly controlled by the government which continues to extend executive power.

We are of the view that the US will not support former National Assembly leader, and Presidential claimant, Juan Guido, in a military offensive. The US' withdrawal from Afghanistan indicates that there is little stomach in Washington for any such move. Hence, as long as the military supports President Maduro, a peaceful and democratic transition of power is unlikely.

Given both the political and economic instability facing Venezuela, it is extremely difficult to get reliable information out of the country. **Consequently, Standard and Poor's (S&P), as at September 20, 2021, withdrew its ratings due to lack of sufficient information.**

POSITIVE POLICY ACTIONS BY THE GOVERNMENT

Venezuela's numbers suggest a high debt burden, ever widening fiscal deficits and hyperinflation. To combat the instability, the government has acted to allow the devaluation of the currency to parallel market levels in an attempt to push money to the formal economy and reduce hyperinflation. The government has also taken a more pragmatic approach, allowing transactions to be priced in USD (dollarization) although hard currency remains very elusive for the majority of the population. There has also been the issuance of a new currency called the "Bolivar soberano" which is hoped to garner more confidence from the populous.

Oil is the lifeblood of the Venezuelan economy as it represents approximately 90% of total exports. The recent increase in hydrocarbon prices from a low of below US$0 per barrel when oil futures contracts were being dumped, to almost US$80/barrel is unprecedented. This increase has meant that Venezuela has received an injection despite the difficulties accessing hard currency globally due to US-led embargoes.

Despite the uptick in oil, it is estimated that Venezuela's total public sector debt is in excess of US$140 billion. **Note also that from a bondholder perspective, even if Venezuela wanted to service its debt, US sanctions do not allow the movement of cash in or out of the sovereign nor do they allow US banks and financial institutions to engage in any dealings with Venezuelan assets, leaving investors in a state of uncertainty for the foreseeable future.**

US MAINTAINS HARDLINE STANCE!

We maintain our view that a timeline for a possible resolution of the Venezuela situation is difficult to predict. We were hopeful that Joe Biden's election as US president would lead to less of a hardline stance. However, according to Anthony Blinken, US Secretary of State, Joe Biden's administration will continue to recognize Venezuelan opposition leader Juan Guaido as the South American country's president. In June-2021, President Maduro, in an exclusive Bloomberg interview, reached out to Joe Biden, calling on him to lift sanctions, normalize relations and end the "demonization of Venezuela".

The US State Department however noted that a US policy shift would require major changes by the Venezuelan president. This included engaging with opposition leader Juan Guaido to resolve the country's political crisis and the paving of the way for free, fair and democratic elections likely overseen by international observers as well as the restoration of economic and political freedoms.

President Maduro has argued that the Trump Administration's sanctions, from 2017, have barred the country from accessing the financial markets and consequently banned trading in Venezuelan debt and doing business with the state-owned oil company, PDVSA. This is preventing Venezuela from paying down and restructuring its foreign debt, Maduro argued. Maduro said that he had a plan to repay bondholders. However, a US State Department spokesperson, who spoke on condition of anonymity, said that the repayment plan was not credible and instead blamed Maduro's economic mismanagement for Venezuela's ongoing woes.

Venezuela has the world's largest proven oil reserves, coming in at 304 billion barrels or approximately 17.5% of the entire global share of reserves. That said, very little of the oil exports actually generate US-dollar cash because of US sanctions. Some of the oil is sold at a loss locally while the rest is exported as loan repayments to China, Russia and European Oil companies Repsol and ENI. It has been reported that Venezuela has accessed Russia's SPFS-(System for Transfer of Financial Messages) and China's CIPS-(China International Payments System) due to US restrictions on access to the SWIFT system of money transfer.

Unsubstantiated reports suggest that CIPS and SPFS, combined, represent about 10% of the global money transfer system. Venezuela's access to these payment systems could explain hard currency/USD access and consequently how President Maduro has kept the army and other arms of government and some of his supporters happy despite the US-sanctions.

RECOMMENDATION

Due to the sanctions imposed on Venezuela by the US, financial institutions and clients are unable to trade (buy/sell) Venezuelan debt. This means that while we would normally put a SELL recommendation based on the above analysis, technically we are unable to do so as clients cannot take any action at this time.

Source: Capitaliq.com, Moodys.com, Reuters, US-Department of Treasury, Bloomberg, eia-US Energy Information Administration

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.

STRONGLY UNDERPERFORM - Reduce exposure in your portfolio to less than 2.5% for this particular asset.
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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