INVESTMENT AND SOVEREIGN RESEARCH

***SOVEREIGN*: The Bahamas** **October-19-2021**

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Summary

After contracting by over 16% in 2020, the Bahamas economy is slowly recovering. We expect the economy to expand by 3.5% in 2021 and will likely reach the 2019 output level by 2024. Due to years of poor fiscal management and external shocks, the deficit is elevated and so too is the debt. Debt servicing cost has risen to over 25%, putting the Bahamas at risk of facing liquidity pressures in the near to medium term if spending increases and the economy fails to grow in line with expectations. The incumbent political administration has made an election promise to reduce the value-added tax. However, if this policy is executed without countervailing measures, it could have negative consequences. It will further weaken the Bahamas' fiscal situation and put the sovereign at an even greater risk of defaulting on the debt further down the road. **External risk factors are rising, and the Bahamas must consolidate its fiscal accounts and improve buffers to help mitigate liquidity risk. We maintain our UNDERWEIGHT recommendation for the government of Bahamas' sovereign global bonds.**

Table 1: SWOT of the Bahamas

Strengths
- ✓ The Bahamas has a strong governance framework and institutional strengths rooted in English common law.
- ✓ Favourable tax regime and enabling business environment make the sovereign a preferred destination for offshore financial activities. There exists a strong regulatory framework for banks, trusts, and pooled investments.

Weakness
- ✓ The sovereign is highly vulnerable to external shocks because of its narrow economic base and small size.
- ✓ High fiscal deficit and low economic growth pushing debt to GDP towards unsustainable levels
- ✓ Erosion of competitive advantage as an offshore financial centre because of more stringent and continually changing regulatory environment in G-20 countries, particularly the US and Europe.

Opportunities
- ✓ The political administration has signalled its willingness to deregulate the economy and reduce capital restrictions.
- ✓ Over a prolonged period, improvements in global and US real GDP and job market conditions could usher in a cycle of higher real GDP growth and improvements in the external and fiscal accounts. The net impact would be a reduction in the debt servicing ratios and debt to GDP.

Threats
- ✓ Acceleration in the unemployment rate because of the coronavirus could cause social unrest and increase violent crimes.
- ✓ Prolonged global economic recession because of the coronavirus may exacerbate the Bahamas' fiscal problems and lead to challenges in servicing the debt. It could also push the debt dynamics on an unsustainable path.

Ratings: S&P, BB-/negative; and Moody's, Ba3/negative

Macroeconomic Outlook

The Bahamas continue to face headwinds from the Covid-19 pandemic, resulting in fiscal slippages and rising debt service cost and debt levels. Having contracted by 16% in 2020, we expect the economy to expand by 3.5% in 2021 due to increased visitor arrivals and overall improvements in tourism-related activities. Tourism accounts for well over 20% of direct economic activity and 40% when its impact on transportation and restaurants are taken into consideration. Up to July, total stopover arrivals of 525,244 were 27.7% higher than the number of visitors for the same period in 2020. Notwithstanding the positive development, stopover arrivals remain 58.6% below 2019 levels. Still, the data shows a rise in visitor numbers over the last four months (4). This coincides with the easing of travel restrictions in the Bahamas and robust US GDP growth. Over the next two years, we expect that tourism throughput will return to 2019 levels, putting the economy on a path to match output recorded that same year by 2024. Despite the positive outlook, underlying structural weaknesses and elevated daily cases of coronavirus infections will act as a drag on overall growth.

With government finances strained because of underlying weak economic conditions and a wide deficit, we do not expect increased spending to help boost growth. The tightening of tax loopholes continues to affect offshore financial centres across the Caribbean. The sector continues to undergo structural changes within the new paradigm. It does not feature prominently in our growth outlook for the sovereign. Although the short to medium-term growth path for the Bahamas looks positive, external shocks could derail it and exacerbate the sovereign's risk profile.

Figure 1 Stopover Visitor Arrivals, January-July: 2019-2021

Sources: Tourism Analytics and JMMBIR

<u>Fiscal Operation</u>

The Bahamas economy suffers from structural weaknesses, including a very narrow economic base and is facing headwinds from the coronavirus pandemic. In the aftermath of the damage caused by the hurricane in late 2019, the Bahamas was recovering when the Covid-19 pandemic hit. The pandemic hurts tourism, which is the primary source of revenue and employment. Revenue flows declined significantly in 2020 while expenditure remained elevated. For the calendar year 2021, we expect the sovereign to generate a fiscal deficit of around 12%. In 2020, the deficit was 6.6%. The slow pace of economic growth and high deficits have resulted in debt levels climbing. At the end of 2019, the total government debt to GDP was 58.8%, and it grew to 68.8% by 2020. We expect the debt to reach 88.6% of GDP in 2021 and stabilize at around 86% over the medium term.

Interest cost has risen substantially over the past five years. We expect it to reach 31.9% of revenue in 2021 and move closer to 34% in 2024 without fiscal intervention. Rising debt service cost is of great concern to us, especially with the election promises made. If the government was to reduce the VAT by 2% with no offsetting tax measures, interest to GDP would increase at a much faster pace. Under this scenario, the risk of default would rise at a more rapid rate than currently envisaged. Therefore, the Bahamas must seek to build fiscal buffers by increasing its primary balance surplus through a combination of revenue and tax measures. **If these measures are not implemented, then in the absence of strong GDP growth, the sovereign credit risk will further erode, putting it on a path of one inevitable outcome—debt default.**

Table 2: Selected Macroeconomic Indicators

Indicator	2016	2017	2018	2019	2020	2021	2022	2023
Population	377,930	381,755	385,637	389,482	393,244	396,913	400,516	404,058
Population, % chg y-o-y	1.0	1.0	1.0	1.0	1.0	0.9	0.9	0.9
GDP per capita, USD	29,110	29,685	30,246	30,276	25,067	25,285	27,132	27,907
Real GDP growth, % y-o-y	1.4	3.1	3.0	1.2	-16.3	3.5	6.0	4.0
Unemployment, % , ave	12.7	12.6	11.0	10.7	25.6	23.0	15.0	12.0
Inflation, eop, % chg y-o-y	0.8	1.8	2.0	1.4	1.2	2.0	2.0	2.0
LCU/USD, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Revenue, % of GDP	16.3	16.7	16.0	18.1	16.9	14.1	16.2	18.0
Expenditure, % of GDP	18.9	21.9	19.2	19.8	23.4	26.6	25.0	21.9
Fiscal Balance, % of GDP	-2.6	-5.2	-3.3	-1.6	-6.6	-12.5	-8.8	-4.0
Interest Payment, % of Revenue	22.5	17.9	34.1	19.7	25.0	31.9	33.6	34.9
Government gross debt, % of GDP	50.6	53.0	61.0	58.8	68.6	88.6	88.2	86.3
Current account balance	-8.9	-12.6	-8.6	3.9	-17.6	-22.5	-16.8	-12.7
Foreign reserves ex gold, USD	904	1,417	1,196	1,758	2,381	2,476	2,575	2,678
Foreign reserves ex gold, pct of GDP	7.5	11.5	9.3	13.4	24.0	27.4	26.7	26.5
Import cover months	2.4	3.5	2.8	4.4	8.5	8.5	8.6	8.6

Sources: IMF, Fitch Connect and JMMBIR

Election Result

General elections were held in the Bahamas on September 16. The Opposition, Progressive Liberal Party (PLP), captured an overwhelming majority of the House of Assembly, 39 seats to 7 for the Free National Movement. Therefore, it means that Phillip Davis will become the next prime minister, taking over from Hubert Minnis. The Bahamas has a history of policy continuity, still, there are reasons for us to be concerned about the sovereign's policy direction. The PLP made a campaign promise to reduce the value-added tax (VAT) by 2% if it forms the government. Given the fiscal challenges that beset the Bahamas, a reduction in taxes will not aid fiscal consolidation, which is necessary to help reduce the debt and the cost of servicing it.

Before Mr Davis took over as prime minister, Moody's downgraded the sovereign's credit rating. In the absence of correcting the fiscal challenges, the Bahamas' risks further credit downgrade and, at worst, could default on servicing the debt. It is therefore imperative that government, under the guidance of Mr. Davis, sends a powerful signal to the market regarding the fiscal path that he will take. Any sign of fiscal excess or the government's unwillingness to embark on fiscal consolidation could cause a funding crisis.

External Accounts

At the start of the pandemic, the government implemented measures to help curtail capital migration. The efforts have been successful, but we expect them to ease gradually. These measures, coupled with inflows from insurance companies concerning payments for damages caused by Hurricane Dorian and US$250 million drawn from the International Monetary Fund Rapid Finance Instrument, led to an increase in international reserves. At the end of 2020, reserves were US$623 million (35%) higher than the previous year (See Table 2). We expect reserves to grow to US$2.5 billion, 4% higher than 2020. We envisage that the growth rate will remain on par with that level over the next two years with reserve cover (reserves to imports) of just over eight months.

Despite the economic challenges that the Bahamas is facing, we expect official financing and foreign direct investment to remain buoyant, which helps explain our belief about reserves. We do not have any reason to believe that the sovereign will adjust the currency peg over the forecast horizon.

Rating Action

Table 3: Bahamas Sovereign Credit Ratings Change

Moody's	Ba3	negative	17-Sep-21
S&P	BB-	negative	12-Nov-20
Moody's	Ba2	negative	25-Jun-20
S&P	BB	negative	1-Apr-20
Moody's	Baa3	under review	9-Apr-20
S&P	BB+	negative	12-Mar-20
Moody's	Baa3	stable	21-Feb-19
Moody's	Baa3	negative	25-Aug-17
Moody's	Baa3	negative watch	6-Jul-17

Sources: Trading Economics and JMMBIR

Following the Downgrade by Standard and Poor's in November 2021, Moody's Investors Service (Moody's) downgraded the Bahamas' long-term issuer ratings to Ba3 from Ba2 and maintained a negative outlook on the sovereign. Moody's advised that the downgrade reflected a deterioration in the Bahamas' economic and fiscal strength occasioned by the coronavirus pandemic. The rating agency believes that the gradual recovery in tourism will lead to higher debt levels and interest burden. Moody's stated that the unwinding of Covid-related spending and improved revenue would support fiscal consolidation, which will lead to a gradual reduction in the debt. However, the Bahamas debt level is expected to remain above 80% of GDP by the end of FY 2022/23. Debt to revenue for the Bahamas stood well over 509% at the end of FY 2021/22. The median debt to GDP and debt to revenue for the Ba3 peer group was 60% and 266%, respectively.

Moody’s advised that the negative outlook highlights the risk to the credit profile, which is mainly influenced by the strength of the recovery in the tourism sector. A slower pace of fiscal consolidation, Moody's stated, would cause borrowing costs to rise and exacerbate funding risks

As it relates to a rating change, Moody's noted that an upgrade in the near future is not likely, given the negative outlook for the Bahamas. Fiscal and economic reforms that support fiscal consolidation and assist in debt reduction could stabilize the sovereign's outlook. An increase in debt affordability, including lower-cost domestic and external financing instead of high-cost external market-based debt, could also facilitate a return to a stable outlook.

A further downgrade could result from a slow pace of fiscal consolidation, which could undermine the government's ability to finance the deficit and rollover maturing debt.

General View and Relative Value

Table 4 shows a summary of the Bahamas' global bonds. Since our last review of the bonds there have been some changes in the global environment. Inflation has risen significantly in international markets, occasioned by challenges in the global supply chain. The United States Federal Reserve signaled that it would begin unwinding quantitative easing in November to curb inflation expectation. In Latin America, at least three central banks, including Brazil's, increased their policy rates to help curtail inflation expectation. As a result, we have seen a slight decline in emerging market bond prices and a marginal rise in yields. For the Bahamas, the yield curve flattened. The yields on Bahamas 2024 and 2028 increased over 100 basis points, while there was a slight reduction in yields on Bahamas 2033 and 2038.

Table 4: Bahamas Global Bonds

Bonds	Date Issued	Coupon (%)	Face Value (US$millions)	Minimum Increment ($'k)	Yield (%)	Duration
Bahamas 2024	16-Jan-24	5.750	300	200/1	7.330	2.040
Bahamas 2028	21-Nov-28	6.000	750	200/1	7.450	4.823
Bahamas 2029	20-Nov-29	6.950	300	1/1	7.480	5.859
Bahamas 2032	15-Oct-32	8.950	825	200/1	9.100	6.426
Bahamas 2033	15-May-33	6.625	200	1/1	7.750	7.414
Bahamas 2038	2-Feb-38	7.125	100	1/1	7.340	7.410

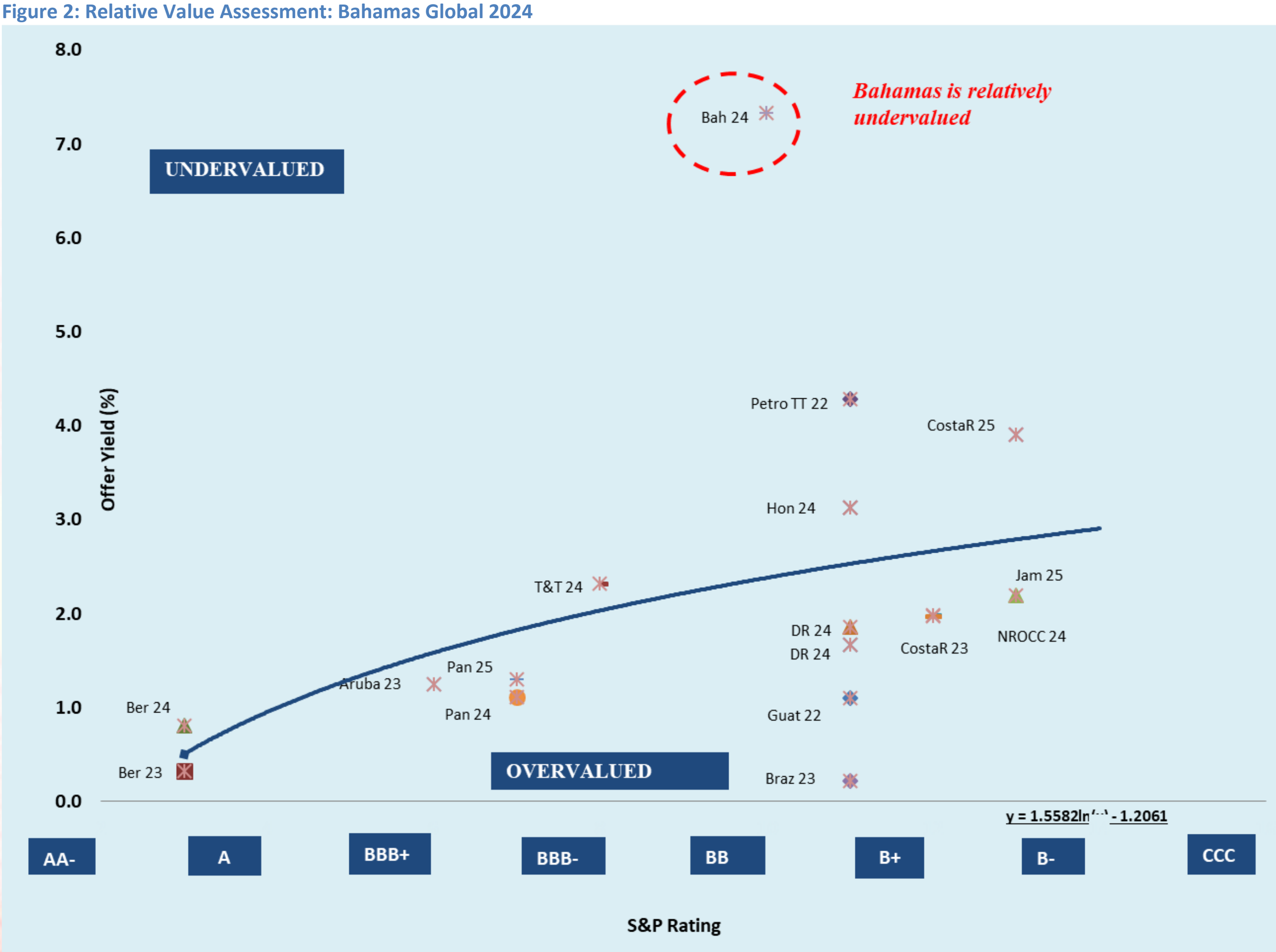
Sources: Bloomberg, JMMBIR and Oppenheimer

Compared with Latin America and Caribbean sovereigns and quasi-sovereign bonds, the Bahamas 2024 appears way undervalued with a yield of 7.3%. We believe that the market is pricing the bonds with a much higher risk than embedded in the ratings, hence the relatively high yield. We therefore apply little weight to the results provided by the relative value curve for the Bahamas 2028, 2029, and 2033.

Recommendation

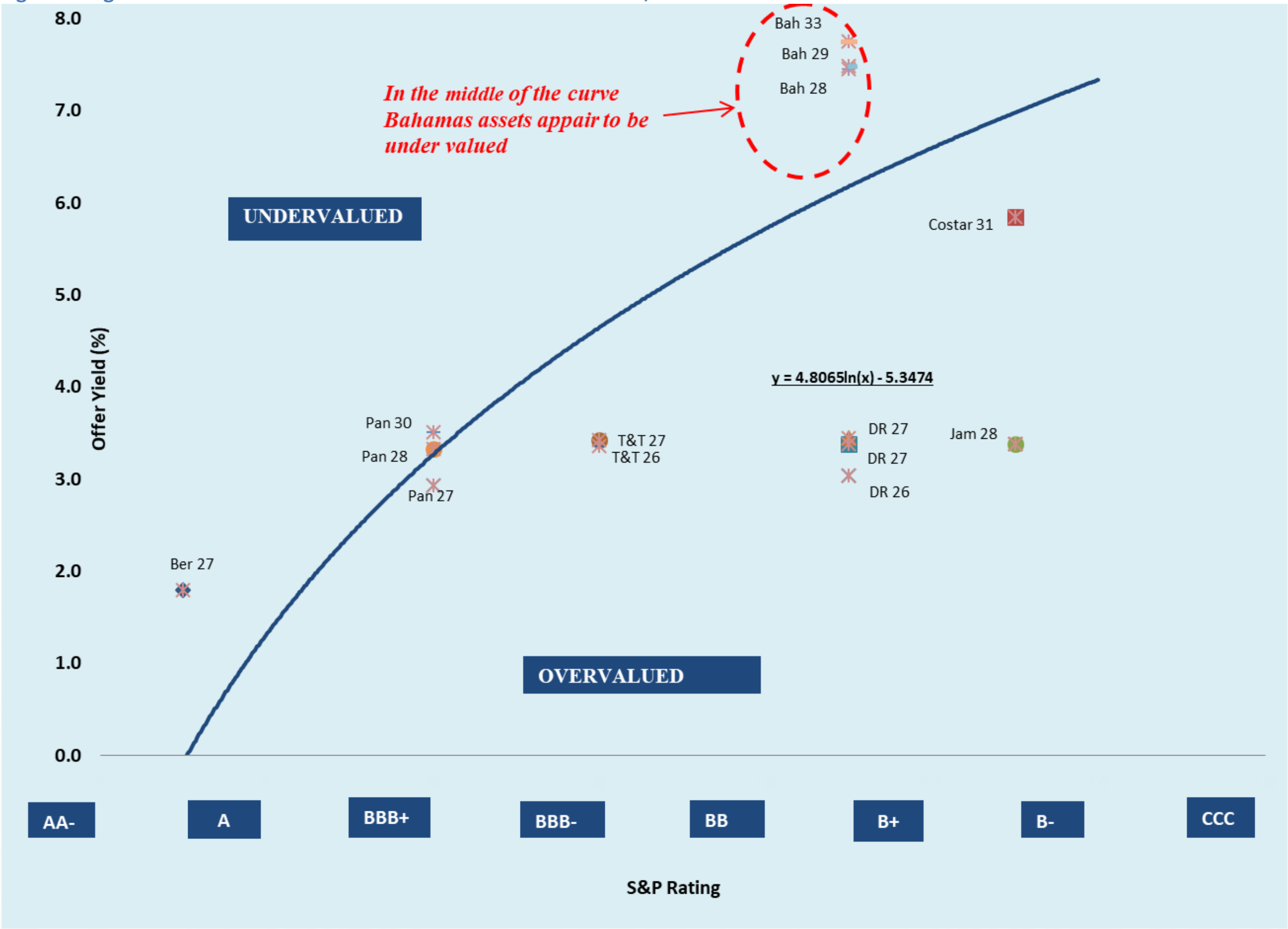
The Bahamas faces severe fiscal challenges that will take time and a strong political will to correct. With a new political administration in charge, the government needs to signal to the market that it has the appetite to consolidate the fiscal accounts- lower the deficit and the debt. The prime minister made an election promise to reduce the VAT. We believe that a reduction in the VAT without offsetting measures would amplify the sovereign's credit risk. The situation would be made even worse if spending rises. If the government lowers the VAT without offsetting revenue measures, we would have no other option but to recommend a sell on the instruments. We believe the sovereign will take steps to temper spending in the near term and embark on further fiscal consolidation. The overall risk to the domestic economy is high but for now the sovereign can still service the debt despite the relatively high cost. **After weighing the macroeconomic, governance and risk factors, we maintain our <u>UNDERWEIGHT recommendation</u> for all the Bahamas sovereign bonds**.

Figure 2: Relative Value Assessment: Bahamas Global 2024



Sources: JMMBIR and Oppenheimer

Figure 3: Figure 4: Relative Value Assessment: Bahamas Global 2028, 2029 and 2033



Sources: JMMBIR and Oppenheimer

Sources: Bloomberg, Fitch Connect, Oppenheimer, and Standard and Poor's

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

COPYRIGHT INFRINGEMENT

The investments referred to in this report may not be suitable for you should consult your licensed investment advisor. Nothing in this report constitutes investment, legal, accounting or tax advice or a representation that *any investment or strategy is suitable to your individual circumstances or otherwise constitutes a personal recommendation to you.*

Disclosure Under The Securities Act

This disclosure is being provided pursuant to section 39 of the Securities Act. This research report is prepared by Jamaica Money Market Brokers Limited (JMMB) and the information and views expressed are those of JMMB. JMMB is a subsidiary of the JMMB Group Limited (JMMBGL). Associated persons of JMMB include JMMBGL and its subsidiaries and affiliated companies, including JMMB Fund Managers Limited, a licensed securities dealer and manager of collective investment schemes.

As at the date of this report, JMMB and its affiliates, directors, officers, employees and other associated persons may from time to time buy or sell, or act as principal or agent in, the securities mentioned in this research report. JMMB or its affiliates, directors, officers and employees have no interest in or interest in the acquisition or disposal of the securities other than expressed above. No part of their compensation is or will be related to the recommendations or opinions in this report.