SOVEREIGN: The Bahamas

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Summary

The Bahamas will find it challenging to service the debt because of high debt servicing costs and elevated debt levels. An economic shock would exacerbate the sovereign's liquidity and solvency risks. With over US$150 million per year in maturity in the coming years and a high cost of funding, The Bahamas will have to leverage its relationship with multilateral institutions such as the Inter-American Development Bank and the World Bank to provide budgetary support over the medium term. Headwinds from the global economy and a projected slowdown in US growth could adversely affect tourism income and government revenues: the net impact would be a material deterioration in the fiscal accounts that limit fiscal consolidation over the short to medium term. **Because of the high volatility in the external market and the poor state of the Bahamas' macro-fiscal metrics, we are changing our recommendation for the sovereign's global bonds to Strongly Underweight.**

Table 1: SWOT of the Bahamas

Strengths

- ✓ The Bahamas possess a robust governance framework and institutional strengths rooted in English common law.
- ✓ A favourable tax regime and an enabling business environment make the sovereign a preferred destination for offshore financial activities. It has a robust 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.
- ✓ Poor fiscal management, high fiscal deficits and low growth have resulted in high debt servicing costs and elevated debt levels.
- ✓ More stringent regulation in G-20 countries, particularly the US and Europe, will curtail future growth in the offshore sector.

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. If this were to happen, fiscal and debt sustainability metrics would improve.

Threats

- ✓ High unemployment occasioned by the Covid-19 pandemic, Hurricane Dorian, and increased volatility in the global markets could lead to social unrest.
- ✓ A steep reduction in global growth and a recession in the US could further erode the Bahamas' fiscal deficit, exacerbate debt service challenges, and push the debt dynamics on an unsustainable path.
- ✓ External weather-related shocks, especially hurricanes and flooding, increase the vulnerability of the fiscal accounts.

Ratings: S&P, B+/Stable and Moody's, Ba3/negative

Growth and Fiscal Outlook

After the steep 27.5% decline in growth in 2020 as a result of the Covid-19 pandemic, the Bahamas economy rebounded in 2021 and 2022 with growth of 13.7% and 11.0%, respectively. Expansion in tourism, which accounts for about half of the country's output, was the main factor responsible for the growth outturn. With the economy's output nearing the pre-pandemic level, we expect growth to slow to 4.3% in 2022 and fall further in the medium term. With visitors from the US accounting for well over 80% of arrivals, pent-up demand for leisure and job market conditions will buoy arrival numbers in 2023, despite high inflation weighing on household spending. However, we expect some of these factors to wane in subsequent periods. With the economy operating from a higher base, their contribution to growth will fade.

We expect debt to GDP to remain elevated over the medium term despite the reduction in the fiscal deficit. The sharp decline in revenues and increased spending to mitigate the health and the economic risk of Covid-19 pushed the fiscal deficit to 7.4% in 2020 and 13.6% in 2021. As a result, debt to GDP rose from 59.7% in 2019 to 75.0% in 2020 and 103.3% in 2021. However, strong growth and a reduction in the fiscal deficit helped to lower the debt to 89.4% in 2022. Over the medium term, as growth normalises, it will immunise the impact of the fiscal deficit and cause debt to GDP to stabilise at around 83% over the medium term.

Fiscal consolidation will characterise central government operations over the medium term. Within this context, the authority plans to increase revenues to 25% of GDP and balance the budget by FY 2025/26. On the revenue side, measures are being implemented to increase the use of technology to improve operational efficiency at customs and inland revenue and curtail revenue leakages. In addition, enhanced collection measures and expansion in the property tax roll are expected to boost revenue inflows.

On the expenditure side, a sharp reduction in hurricane and Covid-related spending will lower the spending profile. There are also plans to reduce the subsidies to state-owned corporations, which are a drag on the budget. Although the government has articulated plans to take action, doing so will be politically challenging. Despite expenditure cuts, the government wants to maintain relatively high public investments. Towards this end, the government plans to increase public-private partnerships (PPPs). Plans are well advanced, and at least one project has been executed under said terms. However, there are no guarantees regarding the sustainability of PPPs over the long run, as investors will assess the merit of each project based on its private return rather than the social return ascribed by the government.

Although possible, the capacity to boost revenue will be challenging as the economic base is relatively weak. Lowering the VAT rate from 12% to 10%, an election promise fulfilled, may also have undermined revenue growth. We do not contemplate a reversal, as to do so would compromise the credibility of the ruling People's Liberation Movement (PLM) government. The government is likely to make progress on the expenditure side, where a reduction in subsidies to the state-operated entities (SOEs) is credible, although it will be unpopular. The gradual weaning of these entities from the budget will lower spending by at least two percentage points of GDP over the medium term. The public will have to absorb the increase in cost, and the government will take the political hit for its action. However, the PLM's sizeable parliamentary majority will ensure policy continuity over the rest of the election cycle.

Concerns

Despite fiscal consolidation, the Bahamas faces elevated liquidity and solvency risk over the medium term. With interest payments accounting for over 20% of revenues, fiscal slippages, especially from weather-related shocks, could put intense pressure on the authority to service the debt over multiple budget cycles. In addition, the authority may need to do more than fiscal consolidati**on to reduce the debt to more manageable levels within a reasonable timeframe. Toward this end, the sovereign may require an enhanced liability management programme. Such a programme would allow the authority** to increase the maturity buckets of the existing debt and gradually lower the interest cost.

The arrival of the Atlantic hurricane season amplifies the weather-related risk. Given the archipelago's location, the increased frequency and intensity of hurricanes enhance the weather-related risk and its attendant impact on the budget. **With limited fiscal buffers, the Bahamas would need support from multilateral agencies to meet budget obligations during a significant weather event.**

External Account

After spiking during the Covid-19 pandemic, a trend which continued into 2022, we expect the current account deficit (CAD) to taper. Over the period 2017-2019, the CAD averaged 8.5% of GDP. However, it increased to 23.6% in 2020 and remained elevated in 2020 -2022, averaging 20.1%. The sharp rise in the CAD was occasioned by a steep decline in tourism receipts and increased imports, especially oil. With visitor arrival above pre-pandemic levels and moderation in commodity prices, we envisage the CAD to decline to 8.8% in 2023 and to fall to 6.8% in 2026. We expect capital inflows to cover the deficit over the medium term. Given this view, reserves would remain relatively stable, and the fixed-exchange rate will remain anchored.

Despite these developments, the current account is highly vulnerable to shocks, as evidenced by the Covid-19 pandemic. With the high dependency on tourism and arrivals from the US accounting for over 80% of the total arrivals, shocks to the US economy would have an oversized negative effect on the Bahamas' CAD. Under a scenario where high deficits persist for an extended period, we do not foresee an increase in capital inflows to cover them. In this regard, there would be a material adverse effect on foreign reserves and the stability of the exchange rate.

Rating Action

On October 6, 2022 Moody's Investors Service (Moody's) downgraded the Bahamas' credit ratings to B1 from Baa3 and changed the outlook from negative to stable. The rating agency advised that it downgraded the credit because of elevated liquidity risk. Despite robust economic growth, the sovereign faced funding constraints from high external borrowing costs, Moody's noted. Over the long run, the sovereign could face serious challenges servicing international bond payments, the rating agency stated. Moody's expects the fiscal deficit to shift to a surplus in 2025 and that the government will rely primarily on domestic borrowings to meet its financing needs. However, the rating agency believes the local market was not deep enough to allow the government to raise sufficient financing to roll international amortisations. With over US$250 million in external maturities due each year over ten years starting in 2027, the sovereign needs to maintain a diverse source of funding, including multilaterals and banks, to meet its external funding needs.

Table 2: Selected Macroeconomic Indicators

	2017	2018	2019	2020	2021	2022	2023 (e)	2024	2025	2026
Population, '000	0.372	0.377	0.381	0.385	0.389	0.394	0.398	0.402	0.407	0.4
GDP per capita, USD	33,186	33,877	34,650	25,194	28,792	33,121	35,459	36,687	37,668	38,606
GDP, %	3.1	1.8	1.9	-23.8	13.7	11.90	4.3	1.8	1.6	1.6
Inflation, % of GDP	1.6	2.0	1.4	1.2	4.1	5.5	3.7	2.8	2.5	2.3
Unemployment rate	10.1	10.4	10.1	25.6	18.1	12.3	12.0	11.7	11.6	11.4
Revenue, % of GDP	15.4	16.3	18.4	18.4	19.4	21.2	20.6	21.0	21.3	21.4
Expenditure, % of GDP	23.4	19.6	20.1	25.8	33.0	27.1	25.4	24.5	24.0	23.9
Fiscal balance, % of GDP	-8.1	-3.3	-1.7	-7.4	-13.6	-5.8	-4.8	-3.5	-2.7	-2.4
interest to revenue, %	22.5	17.9	34.0	22.8	29.7	25.1	27.5	27.2	26.5	25.1
Gross debt, % of GDP	54.5	61.9	59.7	75.0	103.3	89.4	83.9	83.5	83.1	82.9
Current account balance, % of GDP	-13.4	-9.4	-2.6	-23.6	-22.6	-14.2	-8.8	-8.1	-7.5	-6.8
Reserve, million USD	369.9	694.8	477.7	566.9	654.1	744.4	866.0	890.5	982.5	1,085.3
Import Cover, months	3.46	3.46	3.46	3.46	3.46	3.46	3.46	3.46	3.46	3.46

Sources: IMF, Fitch Connect and JMMB

Figure 1: Bahamas Sovereign Credit Ratings Change

Agency	Rating	Outlook	Date
Moody's	B1	stable	6-Oct-22
S&P	B+	stable	12-Nov-21
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	16-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
S&P	BB+	stable	20-Dec-16

Sources: Trading Economics and JMMBIR

Regarding the stable outlook, Moody's stated that improvements in tourism supported it and that those improvements drive economic activities and positively impact the fiscal account, resulting in debt reduction over the forecast horizon. Moody's also noted that the sovereign's robust political and institutional frameworks, which support response to shocks, and high per capita GDP, which improve the debt repayment profile, supported the stable rating.

Moody's envisages the fiscal deficit contacting 5.4% in 2022 and 4.4% in 2023 on the heels of solid revenue performance buoyed by tourism growth. The rating agency expects the primary balance to turn into a small surplus in 2023 and advised that a gradual increase in the tax base and the unwinding of pandemic-related expenditures support fiscal consolidation.

General View and Relative Value

Table 3 Summarizes the full suite of global bonds that the Bahamas have issued with face value amounting to US$3.5 billion or 31% of GDP. The average time to maturity of the bonds is approximately eight (8) years. However, domestic market securities and other non-market debt become due every year. Based on our calculation, the Bahamas will have to roll debt valued at $US150-US$200 million yearly over the next decade. With rising interest rates and a volatile global environment, raising external market financing will be very challenging for the Bahamas. Therefore, we expect the sovereign to use domestic loans/securities, bilateral loans and loans from multilateral sources to help fund the budget in the near term.

We needed more data on sovereign and quasi-sovereign bonds maturing in 2024 for an in-depth relative value analysis. However, this differed for the longer-dated bonds - 2028, 2029 and 2032. Based on our assessment, all these bonds are trading with yields significantly beyond the average price point for bonds with a similar rating. The market is pricing in a higher default risk than the rating suggests. Consequently, the yields are much higher than the rating assigned.

As we have noted in a previous publication, bondholders with a very high-risk appetite and whose portfolios can accommodate these bonds can take advantage of what appears to be mispricing by the market. **However, this is risky given the Bahamas' high liquidity and solvency risks. Shocks to the economy could cause The Bahamas to default on its debt without support from the multilaterals over multiple periods. Additionally, the Bahamas may have to restructure the debt to achieve sustainability.**

Table 3: Bahamas Global Bonds

Bond	Maturity date	Face $MN	Principal Term	Minimum/ Increment ($)	Coupon (%)	Offer yield (%)	Modified Duration
Bahamas 2024	16-Jan-24	300.0	Bullet	200/1	5.750	7.11	0.532
Bahamas 2028	21-Nov-28	750.0	Callable	200/1	6.000	11.83	3.599
Bahamas 2029	20-Nov-29	300.0	Bullet	1/1	6.950	11.5	4.790
Bahamas 2030	16_June-29	250.0	Callable	200/1	9.000	11.68	4.404
Bahamas 2032	15-Oct-32	1,000.0	Callable	200/1	8.950	11.57	5.406
Bahamas 2033	15-May-33	200.0	Bullet	1/1	6.625	10.11	6.577
Bahamas 2036	16-Jun-36	135.0	Sinkable	200/1	3.850	5.12	8.978
Bahamas 2038	2-Feb-38	1,000.0	Bullet	1/1	7.125	11.00	8.030

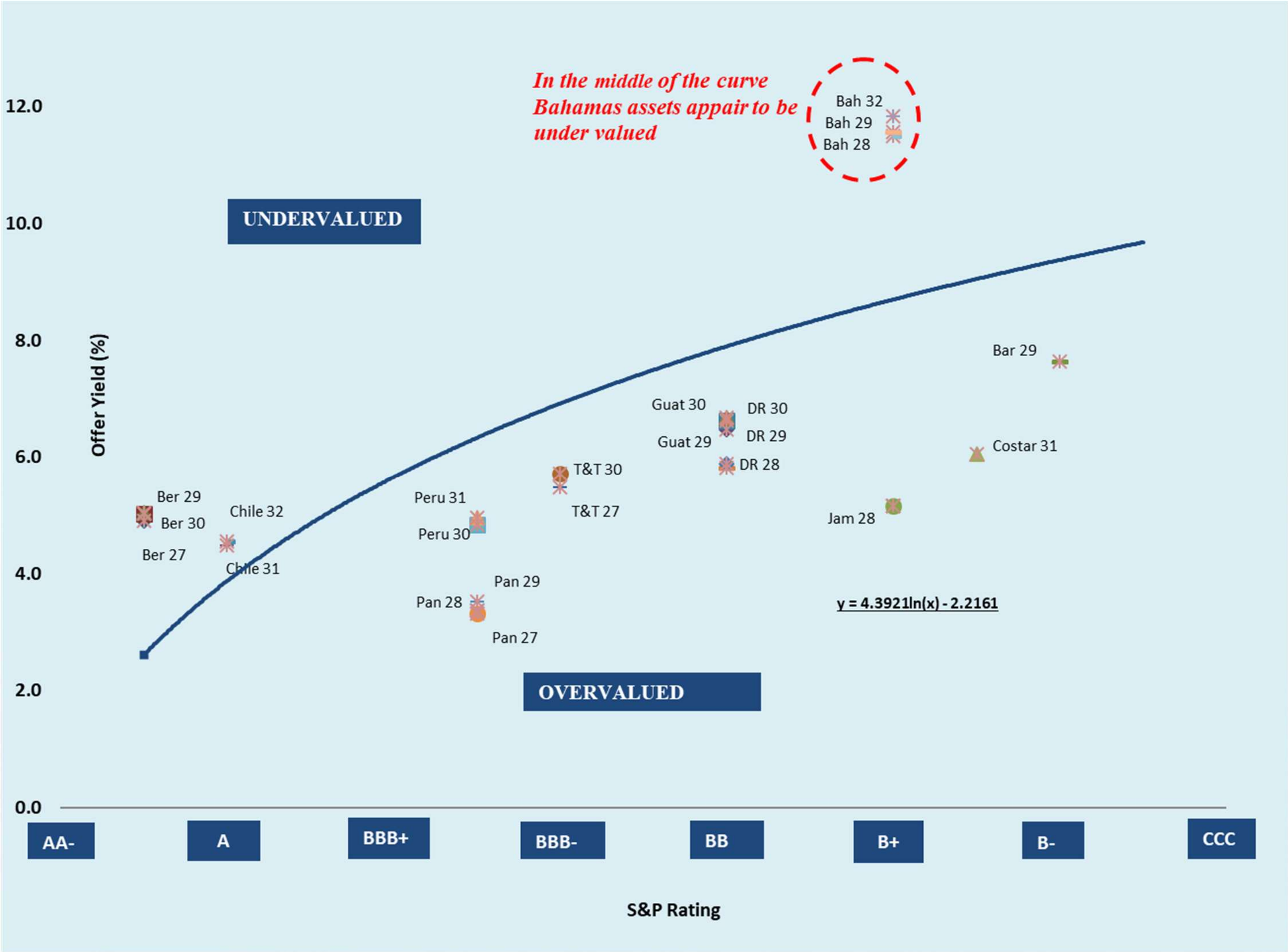
Sources: Bloomberg, JMMBIR and Oppenheimer

Recommendation

The Bahamas faces severe fiscal challenges that will take time and decisive political action to correct. It will be very challenging for the sovereign to consolidate the fiscal accounts in a volatile international environment with elevated inflation and interest rate risks. We expect the slowdown in growth in source countries for tourism, particularly the US, to weigh on the leisure market in the short to medium term and negatively affect GDP growth and fiscal accounts. With high debt servicing costs, a revenue slowdown could amplify the sovereign's already high liquidity risk. Fiscal slippages and lower growth would push debt above the current levels and magnify the sovereign's solvency risk.

The overall economic risk is very high: Liquidity and solvency risk outweigh other positive debt servicing metrics, such as the high per capita GDP and the government's willingness to service the debt. We are very concerned about how a shock could affect the interest burden and solvency metrics, which weighs on our recommendation. **Bondholders should STRONGLY UNDERWEIGHT the Bahamas' sovereign bonds.**

Figure 2: Figure 3: Relative Value Assessment: Bahamas Global 2028, 2029 and 2033



Sources: JMMBIR and Oppenheimer

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 UNDERWEIGHT—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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