INVESTMENT AND SOVEREIGN RESEARCH

SOVEREIGN: The Bahamas

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Summary

The Bahamas faces significant challenges in servicing its debt due to high interest rates and elevated debt levels. An economic shock would further worsen the sovereign's liquidity and solvency risks. With annual maturities exceeding US$1,200 million in the coming years and the high cost of funding, the Bahamas will need to rely on its connections with multilateral institutions like the Inter-American Development Bank and the World Bank to secure budgetary support over the medium term.

Headwinds from the global economy and a slowdown in US growth could have adverse effects on tourism income and government revenues. The overall result would be a substantial deterioration in the fiscal accounts, limiting the potential for fiscal consolidation in the short to medium term. **Due to the challenging state of the Bahamas' macro-fiscal metrics, we are maintaining our recommendation for the sovereign's global bonds at "Strongly Underweight**."

Table 1: SWOT of the Bahamas

Strengths

- ✓ The Bahamas boasts a robust governance framework and institutional strengths firmly grounded in English common law.
- ✓ A favourable tax regime and a conducive business environment make the nation a preferred destination for offshore financial activities. Moreover, it maintains a robust regulatory framework for banks, trusts, and pooled investments.

Weakness

- ✓ The nation is highly susceptible to external shocks due to its narrow economic base and small size.
- ✓ Ineffective fiscal management, coupled with high fiscal deficits and low growth, has led to elevated debt levels and increased debt servicing costs.
- ✓ Anticipated more stringent regulations in G-20 countries, particularly in the US and Europe, are expected to restrict future growth in the offshore sector.

Opportunities

- ✓ The political administration has signalled its willingness to deregulate the economy and reduce capital restrictions.
- ✓ Sustained high growth and strong job market conditions in the US could contribute to increasing the Bahamas' growth rate higher, attracting increased FDI flows, and facilitating enhancement in the external and fiscal accounts. In this scenario, the sovereign would experience material improvements in fiscal and debt sustainability.

Threats

- ✓ A substantial decrease in global growth and a recession in the US could exacerbate the Bahamas' fiscal deficit, worsen debt service challenges, and increase the debt.
- ✓ External weather-related shocks, particularly hurricanes and flooding, heighten the vulnerability of the fiscal accounts.

Ratings: S&P, B+/Stable and Moody's, B1/Stable

Growth and Fiscal Outlook

The Bahamas' economy is expected to experience low growth over the medium term, which will limit fiscal consolidation. We anticipate a 4.3% expansion in 2023, following a robust 14.4% growth in 2022. However, the growth momentum is slowing down as the economy operates at a higher base compared to 2019, and conditions normalize following the aftermath of the COVID-19 pandemic. The average annual growth rate is projected to decrease to 1.6% over the medium term.

Our baseline forecast foresees sustained positive growth in tourism, supported by financial services, as household and business consumption improves and the central bank adopts a less hawkish monetary policy. With the economy in expansion mode and conditions improving, the government will try to accelerate much-needed fiscal reforms. However, the authorities may not obtain the desired effect from the policy shift due to structural impediments in the economy, such as the small size, the impact of higher taxes on corporate competitiveness, and reliance on state-owned entities (SOEs) on government support to function.

Upside risks to growth are limited while downside risks are elevated. Robust growth in the key tourism source markets (US and Canada) and above-average growth in financial services could cause the Bahamas' growth rate to exceed our base forecast. Conversely, a slowdown in the source markets for tourism or weather-related shocks could lower the trend growth rate.

The Bahamas Government aims to reduce the fiscal deficit, as outlined in the Fiscal Strategy Report (FSR) 2022. However, structural challenges are likely to impede the speed of the adjustment. The plan targets a balanced budget by FY 2024/25, a fiscal surplus thereafter, and a reduction of the debt-to-GDP ratio to 67.1% by the end of FY 2026/27. We view these plans as overly optimistic.

Although we anticipate a decrease in the fiscal deficit and debt, the pace of decline is expected to be slower than proposed by the government. For 2023, we project a fiscal deficit of 3.6%, down from 5.8% in 2022, facilitated by marginal revenue increases and expenditure cuts. Falling unemployment and revenue tightening measures will positively impact revenue growth, edging revenues to GDP slightly higher to 21.2% in 2023 from 21.1% in 2022. Looking forward, we expect stable unemployment and diminishing revenue enhancement impact, resulting in no substantial change in revenues.

Expenditure is expected to decrease to 24.8% of GDP in 2023 from 26.9% in 2022, driven by COVID-19-related and other spending cuts. However, over the medium term, structural constraints and policy fatigue may hinder further expenditure cuts. We project the debt to GDP ratio to decrease to 84.2% in 2023 from 88.9% in 2022. In our baseline forecast for 2026, revenues are anticipated to be 22.2% of GDP, expenditure at 24.4% of GDP, resulting in a fiscal deficit of 2.1% of GDP and debt to GDP of 82.3%.

Interest costs and refinancing risks rare high and are projected to remain elevated over the medium term. Despite global inflation's decline, interest rates are expected to decrease gradually. Given the Bahamas' high debt burden and borrowing needs, the marginal cost of borrowing is anticipated to fall incrementally, leading to a marginal decline in interest cost to revenue. However, interest to revenue will rise at the end of the forecast period because of the high borrowing needs and debt (See table 1).

Our baseline estimate indicates that approximately $3.5 billion, or about 31% of the debt, will become due over the next three years, with an average annual gross borrowing need of $1.2 billion (10.4% of GDP) to meet maturing debt obligations. A positive for the Bahamas is that the lion share of the debt is owed to locals through bank loans and other securities. However, the concentration of debt becoming due within a narrow period raises concerns, as a shock to the domestic financial markets could severely impede the government's ability to secure sufficient financing to cover these obligations.

External Account

We anticipate a gradual decline in the current account deficit (CAD) as tourism revenue increases and commodity prices, particularly fuel, decrease. Our baseline forecast indicates the current CAD to decrease to 9.5% in 2023, following a recording of 13.6% in 2022. The reduction in CAD is significantly influenced by a combination of higher tourism inflows and a decline in commodity prices. We expect these dynamics to persist over the medium term, leading to a further decrease in CAD to 7.0% by the end of 2026. Barring periods of external shocks, inflows into the Bahamas' capital account remain relatively consistent. We envision that external loans and foreign direct investment flows will be adequate to cover the CAD. In this context, we project net international reserves to remain relatively stable at around US$3.0 billion (26.7% of GDP). The sustained stability in the external account is favourable for the Bahamian dollar, as it is expected to remain anchored to the US dollar over the medium term.

Rating Action

Figure 1: Bahamas' Sovereign Credit Rating 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

The latest rating update, conducted on October 6, 2022, by Moody's Investor Services (Moody's), resulted in a downgrade of the Bahamas' sovereign credit rating from Ba3 to B1, accompanied by a shift in outlook from negative to stable. The key factors influencing this rating action were elevated liquidity risk and concerns regarding fiscal sustainability. Moody's indicated that, despite robust economic growth, the sovereign faces challenges in funding due to high external borrowing costs, raising apprehensions about servicing international bond payments in the long term.

Moody's projected a fiscal deficit of 4.4% in 2023, with the primary balance turning into a small surplus. The agency suggested that improvements in tourism would contribute to a stable outlook by driving economic activities and positively impacting the fiscal account, ultimately leading to debt reduction. However, Moody's emphasized the importance for the sovereign to diversify its funding sources to meet external funding needs, especially considering annual external maturities exceeding US$250 million starting in 2027.

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Table 2: Selected Macroeconomic Indicators

	2018	2019	2020	2021	2022	2023 (e)	2024 (f)	2025 (f)	2026 (f)
Population, million	0.381	0.385	0.389	0.394	0.399	0.404	0.408	0.413	0.417
Real GDP growth, %	2.9	-0.7	-23.5	17.0	14.4	4.3	1.8	1.6	1.6
Inflation, eop, %	2.0	1.4	1.2	4.1	5.5	3.4	2.6	2.2	2.0
Unemployment rate, %	10.4	10.1	26.2	17.6	10.8	8.8	8.8	8.9	9.0
Policy Rate, %	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
Lending rate, %, ave	11.34	10.46	11.00	11.00	11.00	11.00	11.00	11.00	11.00
Interest to Revenue	18.6	9.4	12.1	11.0	16.5	17.4	15.8	16.4	17.9
Revenue, % of GDP	16.4	18.6	18.5	18.8	21.1	21.2	22.0	22.2	22.2
Expenditure, % of GDP	19.7	20.3	25.9	31.9	26.9	24.8	24.8	24.4	24.3
Fiscal balance. % of GDP	-3.3	-1.7	-7.4	-13.1	-5.8	-3.6	-2.8	-2.2	-2.1
Government debt, % of GDP	62.4	60.3	75.3	100.0	88.9	84.2	83.7	82.9	82.3
Domestic debt, % of GDP	41.2	38.0	40.8	52.7	47.1	46.3	46.9	44.8	43.6
Reserves, USD billion	1.2	1.8	2.4	2.4	2.9	3.0	3.2	3.3	3.5
Total reserves ex gold, % of GDP	5.2	7.8	14.5	11.9	22.5	22.1	22.3	22.3	22.3
Import cover months	2.8	4.4	8.4	6.5	7.1	7.0	7.0	7.0	6.9
Current account balance, % of GDP	-9.5	-2.2	-23.4	-21.1	-13.6	-9.5	-8.8	-7.7	-7.0

Sources: IMF, Fitch Connect and JMMB

General View and Relative Value

Table 3 presents a summary of the Bahamas' global bonds, with a total face value amounting to US$3.9 billion, equivalent to 34% of GDP, and an average time to maturity of seven years and eight months. Beyond the external market issues, the debt stock also comprises domestic market securities and non-market debt, primarily bank loans. Following the sovereign refinance of the Bahamas 2024 global bond ($300 million), the next external market maturity is due in 2029 (the Bahamas 2029 with a face value of US$800 million). Despite the fragmentation in external maturities, a consistent series of domestic maturities is anticipated over the medium term, requiring gross borrowing needs to exceed US$1,200 million per annum for the next five years. We anticipate that the bulk of the financing will come from the local capital market and banks, potentially crowding out domestic investments and constraining growth. The government is expected to maintain close relationships with multilateral institutions – including the International Monetary Fund, World Bank, Inter-American Development Bank, and the Caribbean Development Bank – to secure fiscal support.

Given the absence of a sharp reduction in US/global interest rates over the forecast period, the Bahamas is likely to face elevated interest rates on new issuances, influencing the debt dynamics. Due to the sovereign's fixed exchange rate regime, the Central Bank of the Bahamas defers its monetary policy to the US Federal Reserve. Without aggressive fiscal consolidation, the timeline to bring the debt under control is expected to be prolonged due to relatively wide fiscal deficits, high borrowing costs, and low growth.

In the context of relative value analysis, we consider only the Bahamas 2028, 2029, and 2033 bonds, as these have sufficient peer issuances. Based on the data, the yields for these bonds are notably above the average for bonds with similar risk profiles. In essence, the relative value graph suggests that the bonds are relatively underpriced. We believe that the market is factoring in higher liquidity and credit risk compared to the assessments of rating agencies.

Investors with a very high risk appetite and portfolios capable of accommodating these bonds may exploit the relatively low prices. In the event of a positive fiscal correction, we anticipate prices to rise. However, it is essential to note that the associated risk is very high, considering our assessment of the Bahamas' liquidity and solvency risks

We hold the view that economic shocks could potentially lead the Bahamas to default on its debt, especially in the absence of sustained support from multilateral institutions over extended periods. We are of the view that that the fiscal measures proposed by the government are inadequate to bring the debt to a more sustainable level. Without a more assertive approach to fiscal consolidation, encompassing broad-based revenue enhancement and significant cost cuts, the Bahamas might find it necessary to undergo a debt restructuring process to attain a level of debt 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	9.27	0.102
Bahamas 2028	21-Nov-28	750.0	Callable	200/1	6.000	10.27	3.302
Bahamas 2029	20-Nov-29	300.0	Bullet	1/1	6.950	10.52	3.995
Bahamas 2029	16-Jun-29	250.0	Callable	200/1	9.000	10.74	4.584
Bahamas 2032	15-Oct-32	1,000.0	Callable	200/1	8.950	10.82	5.280
Bahamas 2033	15-May-33	200.0	Bullet	1/1	6.625	9.56	6.473
Bahamas 2036	16-Jun-36	135.0	Sinkable	200/1	3.850	9.56	8.505
Bahamas 2038	2-Feb-38	1,000.0	Bullet	1/1	7.125	10.21	8.096

Sources: Bloomberg, JMMBIR and Oppenheimer

Recommendation

Years of fiscal excesses and slippages, exacerbated by weather-related and other shocks, have significantly eroded the Bahamas' macro-fiscal metrics. High liquidity and solvency risks are evident, reflected in elevated interest-to-revenue and debt-to-GDP ratios. Despite the sovereign's efforts to consolidate fiscal accounts, our forecast suggests that the timeline to achieve the stated objectives is more prolonged than outlined in the Fiscal Strategy Report.

In the short term, the sovereign will likely need to borrow at relatively high-interest rates in both domestic and international capital markets. With over $1,500 million in near-term maturities, any fiscal slippages or economic shocks could have a substantial impact on the government's ability to rollover the debt. This risk persists over the medium term, given the high proportion of annual maturities. Despite improvements in the sovereign's growth metrics, elevated liquidity and solvency risks persist, exacerbated by global and local economic headwinds and the potential for climatic events. The default risk aligns with the relatively high yields on the global bonds
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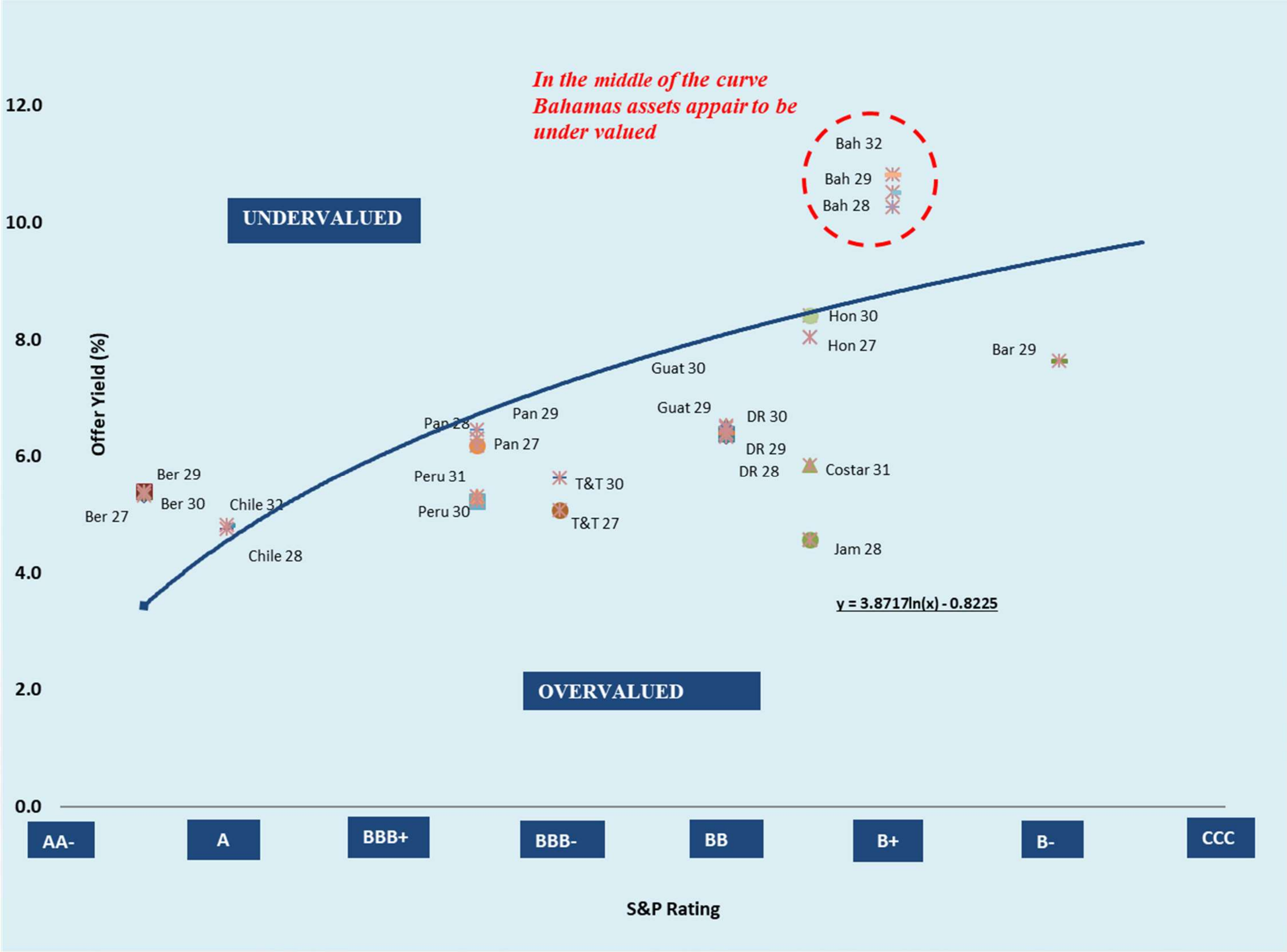
In light of these considerations, we strongly recommend that bondholders <u>Strongly Underweight</u> the Bahamas' sovereign bonds.

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.

UNDERWEIGHT—REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.
HOLD / MARKETWEIGHT—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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