PANAMA — "Covid-19, One-off GDP Decline but Still Strong Fundamentals & Robust Recovery Projected"

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GLOBAL ECONOMIC CHALLENGES

Panama felt the brunt of covid-19 as GDP declined by 17.9% in 2020 on the back of domestic mobility restrictions, international travel restrictions, reduced trading activity and reduced revenue inflows. The shock to GDP led to a sharp increase in the fiscal deficit, a deterioration of the primary balance, an increase in interest expense and a **deterioration of the Debt/GDP** ratio (from 40.8% in 2019 to **61.7%** in 2020).

The shock to GDP led to a one-notch **downgrade by S&P** from "BBB+ to BBB" in Nov-2020 and was closely followed by a **revised outlook from Stable to Negative** in August-2021.

Despite the marked contraction in growth in 2020, the Panamanian economy saw a sharp recovery in 2021. **GDP growth came in at 15.3%** driven by the operations of a large copper mine, a reduction in restrictions on movement, increased operations at the Panama Canal compared to 2020 and the general reopening of the domestic and global economy.

Panama - Selected Economic Indicators

	2016	2017	2018	2019	2020	2021	2022E	2023f	2024f	2025f
Real GDP growth	5	5.6	3.7	3	-17.9	15.3	5.5	4.5	4.5	4.5
Real investment growth	2.1	7.6	0.7	-0.6	-49.3	87.2	10.5	9.2	4.5	4.5
Investment/GDP	40.5	41.7	41.4	39.1	25.5	35.8	37.8	39.8	39.8	39.8
Exports/GDP	42	48.7	48.9	47.2	41.4	47.5	48.8	50.4	51.6	53.2
Real exports growth	-4.3	26.3	5.1	0.1	-29.4	31.5	8.4	8	7.1	7.6
Unemployment rate	5.5	6.1	6	7.1	18.5	11.3	10	9	9	9

Source: S&P Estimates as @ Aug-10-2022
E-estimates; f-Forecasts

The recovery in GDP however does not automatically lead to a recovery in all economic variables in the same magnitude and within a short time-frame; in particular, the fiscal and debt dynamics can be stubborn especially where the global economic environment is challenging. Panama's revised outlook by S&P in August-2021 was driven by concerns regarding increased financing costs as higher global benchmark interest rates continue to rise. The US Federal authorities, in an attempt to control inflation have continued increasing interest rates, though the forecast for 2023 is a possible levelling off of rates or at least a reduction in the size / pace of rate increases.

US FED rate movements are particularly important for Panama given that **the Panamanian economy is dollarized** and have adopted the US-dollar as their official legal tender. This means that effectively, **there is no power to conduct monetary policy** and fiscal policy is the only medium to long term tool of economic adjustment. That said, dollarization has kept inflation historically low (*0.4% average- 2015-19*) however the forecast is for Panama's CPI increases to average about 2.2% as US inflation rises.

The absence of a central bank for Panama has also meant the absence of a formal lender of last resort. There is also **no effective deposit insurance system to aid financial institutions during periods of distress**. To offset this challenge, the government has used the state-owned Banco Nacional de Panama to provide liquidity support to maintain capital adequacy ratios during periods of distress. The local Superintendency of Banks has indicated that despite the global challenges, the local banking system remains sound and well capitalized

RECOVERY

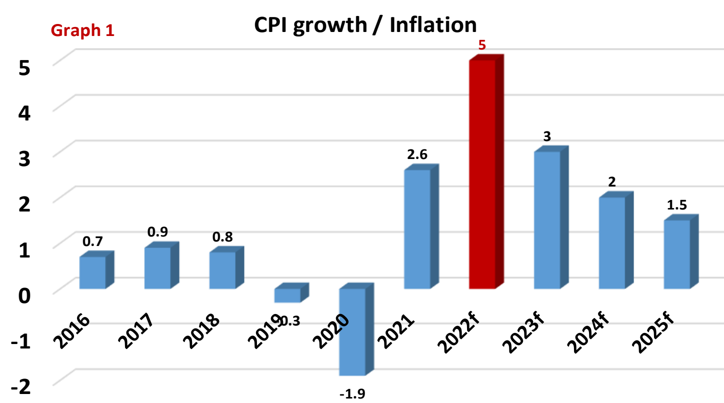
Panama is a high growth economy. For the immediate 4-year period pre-covid-19, Panama had average GDP growth of approximately 4.3% which is marginally below the sovereign's long term historical trend growth rate of 4.5% per annum. For 2022 the estimate is for GDP to grow by 5.5% following the 15.3% GDP recovery experienced in 2021. Major infrastructure projects such as a tunnel below the Panama Canal, a third metro line (railway which allows mass movement of people) and the extension of metro lines 1 & 2, a new hospital and road improvements are expected to boost GDP and employment over the medium term. **Consequently, the forecast is for a return to trend GDP growth of 4.5% per annum.**

Despite the projected recovery, the global economic environment is challenging. High global interest rates, declining bond prices and higher yields, high inflation due to the Russia / Ukraine war and reduced global trade activity all represent risks to the forecast. The US, Panama's major trading partner, is forecasted to experience a deceleration in growth to 2.4% in 2023 following recovery in 2021 of 5.5% and growth of 3.4% in 2020.

Panama also faces the risk of **reduced capital inflows** over the medium-term due to **external regulatory challenges** related to the **non-implementation of effective (by international standards) anti-money laundering & tax evasion laws**. Panama remains on the Financial Action Task Force's (FATF) and the EU's black list of non-cooperative jurisdictions.

PUBLIC PROTESTS & THE FISCAL

High global commodity prices, due primarily to the Russia / Ukraine war, pushed inflation from recent historical levels of below 1% to 5.0% in 2022 (**Graph 1**). This led to protests among the populous which forced the government to agree to the introduction of a gasoline price subsidy and to put price caps on 72 food products. Since July-2022 when protests were at their peak, the discontent has eased. However, there is a view that continued political pressure **could lead to further spending** which might deteriorate fiscal and economic performance.



To close the fiscal gap, the government has **negotiated an annual US$375 million royalty payment** from the Minera Panama copper mine. This along with projected annual inflows from the Panama Canal Authority, which represents approximately 18% of govt. revenues, and a reduction in capital expenditure, should help to keep the **4% deficit target** within reach.

Over the medium term however, there are risks to maintaining a low and manageable fiscal deficit. Panama's Social Security Fund has been running small cash deficits since 2020. The government has propped up the fund by making transfers from their coffers but this is not ideal; the fund needs to be self-financing.

DEBT DYNAMICS

PANAMA - Fiscal Indicators (General Government; %)

	2016	2017	2018	2019	2020	2021	2022E	2023f	2024f	2025f
Balance/GDP	-1.9	-1.9	-2.8	-3	-10.1	-6.7	-4.1	-3.1	-2.8	-2.4
Primary balance/GDP	-0.2	-0.1	-1	-1.1	-7.3	-4.3	-1.2	-0.4	0.1	0.2
Revenue/GDP	20	20	19.7	18.3	18.4	18.1	20.7	21.8	22.5	23.3
Expenditures/GDP	21.9	21.9	22.5	21.3	28.6	24.8	24.8	24.9	25.2	25.7
Interest/revenues	8.7	8.7	9	10.3	15.6	13.4	13.7	12.6	12.7	11
Debt/GDP	32.8	32.7	34.9	40.8	61.7	57.9	56.6	55.3	54.3	53.3

Source: S&P Estimates as @ Aug-10-2022

E-estimates; f-Forecasts

Panama's debt/GDP climbed sharply from 34.9% in 2018 to 61.7% in 2020 due to a sharp deceleration in growth (↓17.9%) and accompanying 10% fiscal deficit. However, the economy sharply recovered (↑15.3%) in 2020. The debt/GDP however is going to be a bit slower in its recovery. While the debt came in at 57.9% of GDP in 2021, the ratio is projected to remain in the low 50's over the medium term and is only forecasted to come in below 50% after 2025.

A look at the primary balance indicates that government operations, minus the impact of debt via interest payments, is well contained as the ratio is forecasted to move from a deficit to a surplus by 2024. The interest burden (interest / revenues) increased from 9% in 2018 to 15.6% in 2020 but is forecasted to decline to a more manageable 12.6% in 2023. This comes amid a higher global interest rate environment characterized by US FED rate hikes and higher global inflation.

➔**Panama's debt profile is impressive; the average maturity on government debt is 13 years and 81% of debt is at fixed interest rates. This is especially important when taken within the context of a rising global interest rate environment. The weighted average cost of government debt is a manageable 4% as at June 2022.**

In terms of revenue buffers, Panama has a Savings /Canal Stabilization Fund of US$1.5 billion or approx. 2.5% of GDP. Further, the sovereign has access to the IMF's Precautionary and Liquidity Line (PLL-signed in Feb-2021) of US$2.7 billion. While the government does not intend to tap the PLL, the funding acts as an important buffer to maintaining market confidence.

On the political side, there is broad consensus on key economic issues which continues to maintain investor confidence. The sovereign has a stable democracy, policy making is predictable and macroeconomic management is cautious. In recent times there have been tensions between the executive and legislative branches of government which could pose potential challenges when passing legislation. Nonetheless the ruling Democratic Revolutionary Party (the PRD) in coalition with the Molirena Party, has the majority in the National Congress while the opposition is fragmented.

CONCLUSION

A review of the economic fundamentals indicates that Panama is a strong sovereign with good prospects; the investment grade rating is therefore justified. We acknowledge the negative impact of covid-19, the ongoing Russia / Ukraine conflict, high global inflation and the negative outlook from S&P. However, we also note how quickly the sovereign has experienced a rebound in GDP growth combined with a turnaround towards a lower fiscal deficit, declining debt and a primary surplus. The outlook is also favourable with revenue from the expanded canal, recent annual royalty payments from the copper mine, the Panama Savings Fund and access to the IMF's Precautionary & Liquidity Line (PLL) all boosting investor confidence.

Despite a challenging global climate, the government has continued to roll out major projects. These include a tunnel below the Panama Canal, a third metro line (railway which allows mass movement of people) and the extension of metro lines 1 & 2, a new hospital and road improvements. These are all expected to boost GDP and employment over the medium term.

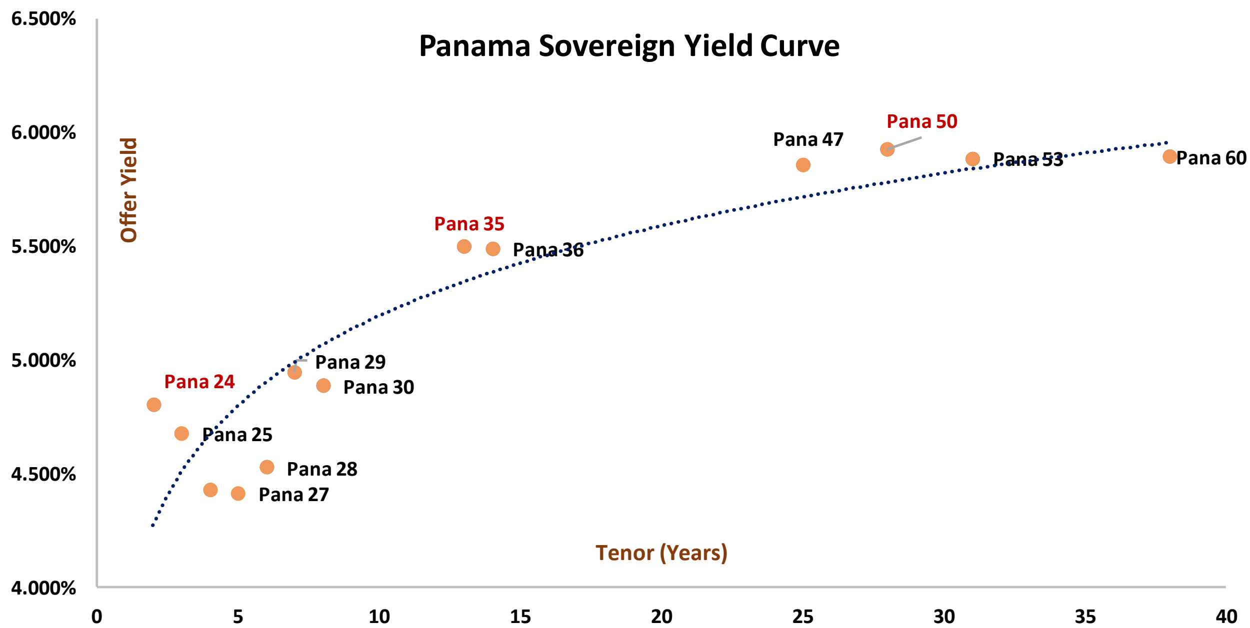
With that said, we would recommend Panama as a **HOLD** / **MARKETWEIGHT** in your portfolio based on the economic fundamentals alone. Essentially, if you are looking to do business in the country or if you wish to provide lending facilities to different sectors, we would advise exposure up to 5% of your portfolio. **We acknowledge the negative outlook due to fiscal issues and high global interest rate environment but we are also of the view that the strong economic growth should offset the debt/GDP and interest expense / revenue ratios.**

BOND YIELDS / SOVEREIGN DEBT EXPOSURE

Country	Maturity	Coupon	S&P	Moody's	Fitch	Bid Price	Offer Price	Bid Yield	Offer Yield
Panama	9/22/2024	4.00%	BBB	Baa2	BBB-	98.250	98.750	5.131%	4.805%
	3/16/2025	3.75%	BBB	Baa2	BBB-	97.650	98.150	4.934%	4.679%
	1/29/2026	7.13%	BBB	Baa2	BBB-	106.450	107.450	4.777%	4.429%
	9/30/2027	8.88%	BBB	Baa2	BBB-	117.300	118.550	4.688%	4.416%
	3/17/2028	3.88%	BBB	Baa2	BBB-	96.450	97.050	4.662%	4.527%
	4/1/2029	9.38%	BBB	Baa2	BBB-	122.000	123.250	5.155%	4.944%
	1/23/2030	3.16%	BBB	Baa2	BBB-	89.300	89.900	4.998%	4.888%
	2/14/2035	6.40%	BBB	Baa2	BBB-	107.250	107.750	5.554%	5.498%
	1/26/2036	6.70%	BBB	Baa2	BBB-	109.500	110.500	5.599%	5.490%
	5/15/2047	4.50%	BBB	Baa2	BBB-	81.850	82.850	5.950%	5.859%
	4/16/2050	4.50%	BBB	Baa2	BBB-	80.150	81.150	6.015%	5.926%
	4/29/2053	4.30%	BBB	Baa2	BBB-	77.000	78.000	5.973%	5.886%
	7/23/2060	3.87%	BBB	Baa2	BBB-	68.800	69.800	5.983%	5.893%

Source: Jeffries LLC as@ Feb-2-2023

A look at Panama's bonds across the curve indicates that offer yields range from 4.8% for the 2024's on the short end to 5.89% on the 2060's at the long end. The most actively traded bonds are the **benchmark** USD denominated, 6.4%-2035's with an issue size of US$1.5 billion followed by the USD-denom. 4.5% - 2050's with an issue size of US$2.5 billion. A cursory look at the sovereign debt curve below indicates that the 24's, the benchmark 35's, 47's and the 2050's trade widest from the extrapolated yield curve and consequently offer the most value.



MARKET YIELD RECAP

Our last look at the relative value curve at the beginning of the 4th quarter (Oct-Dec) suggested that yields on average widened by 178.7 basis points (bsp) compared to the previous quarter for the sovereigns and quasi-sovereigns in the Caribbean and Latam space that we cover on the short end of the curve. It was a similar story on the long end as yields widened by an average of 121.65 bsp for the said sovereigns and quasi-sovereigns. This general widening of yields is expected as the US FED continued to raise interest rates in the last quarter of 2022.

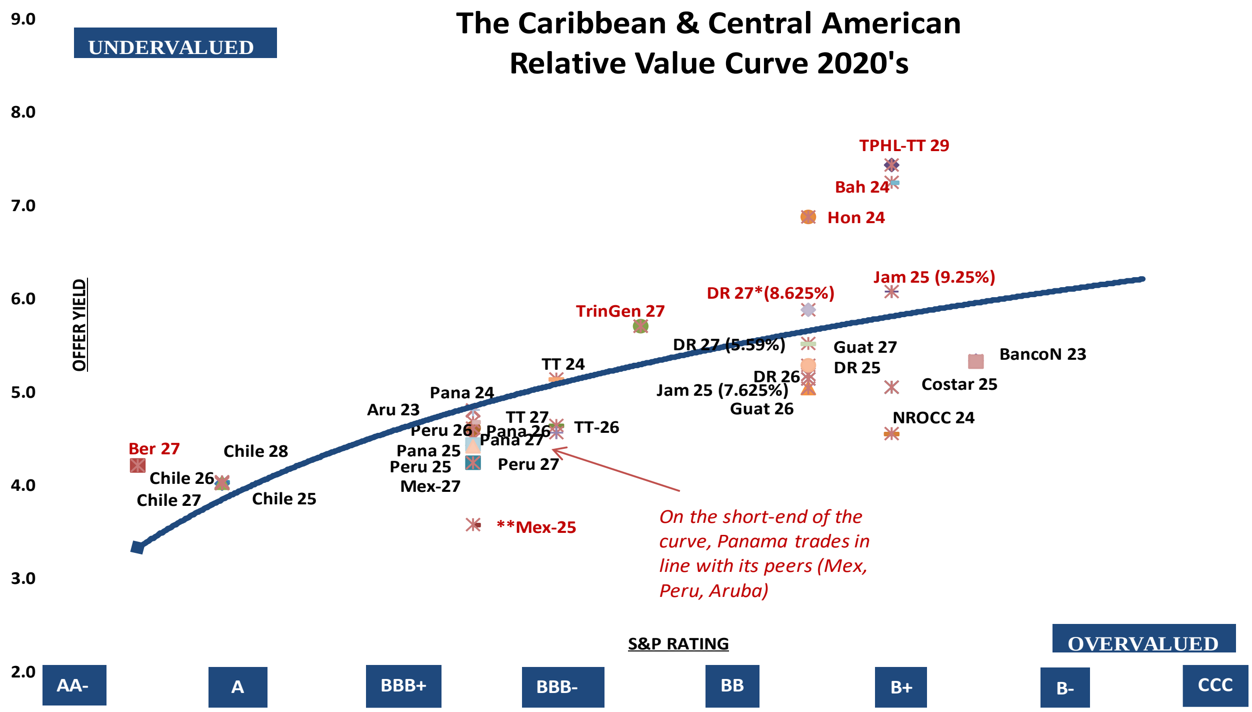
For the **current period** (Feb-2-2023), **yields have contracted on average by 34 bsp** on the short-end of the curve compared to the beginning of the December quarter. The long end saw a **75 bsp contraction** on average compared to the similar period.

This contraction is also in line with market expectations as the general view is that the FED would ease the pace of its rate increases or possibly halt rate increases by the 4th quarter of 2023.

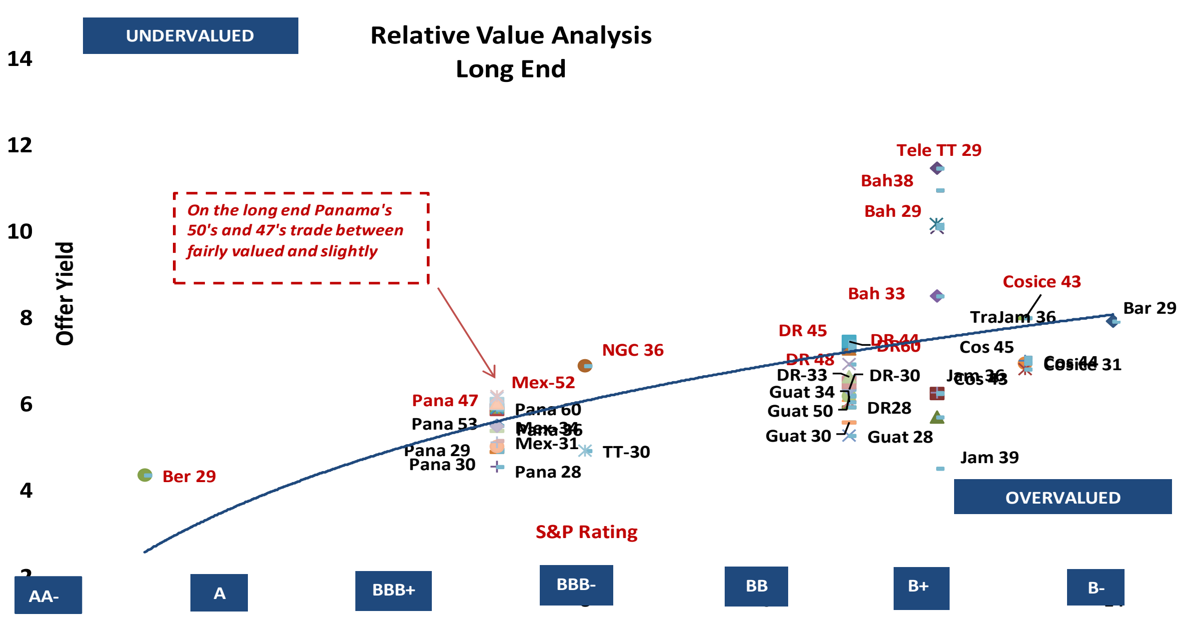
RELATIVE VALUE

On the short end of the curve, Panama trades fairly valued to marginally overvalued and in line with similarly rated sovereigns (Peru, Mexico, Aruba). Despite the negative outlook, the market trades the sovereign in line with its "triple B" peers because of its strong growth outlook, the Canal and Panama's strong trade relationship with the US.

Your Best Interest At Heart. Full Stop.



On the long end of the curve, Panama's 2047's are undervalued while most of the other long dated Panama bonds are fairly valued to slightly overvalued. The 47's are therefore attractive on the yield curve as well as the relative value curve.



CONCLUSION

Panama's most attractive bonds are the benchmark 2035's, the actively traded 2050's along with the 47's and 24's. On the short end of the curve, the relative value indicates that most of the bonds are overvalued however on **the long end the 47's are undervalued**. Consequently, we would recommend the 47's as the most attractive of Panama's bonds along with the benchmark 35's. **We wish to highlight however, the possibility of bond yields rising / prices declining** as the latest report from the US FED indicates that non-farm payrolls increased by 517K in January (above estimates/forecasts) and unemployment hit a 53-year low. A strong and robust US economy would suggest that the FED may raise rates again to cool down the economy and lower inflation expectations.

Source: Standard & Poor's / www.capitaliq.com, FITCH Solutions / www.businessmonitor.com, www.imf.org, US department of State, Moody's Investor Services, CIA Factbook.

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

UNDERPERFORM—REDUCE EXPOSURE IN YOUR PORTFOLIO TO 2.5% - 4.9% FOR THIS PARTICULAR ASSET

SELL—REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

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

OUTPERFORM/BUY—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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