INVESTMENT AND SOVEREIGN RESEARCH

SOVEREIGN: **ARUBA – September-26-2017**

PLEASE REFER TO EXPLANATIONS ON RECOMMENDATIONS CONTAINED IN APPENDIX BELOW

Summary

Aruba is an upper-middle income Caribbean country with strong political and legal institutional ties with the Netherlands. The legal system is heavily rooted in Dutch law with The Hague acting as the final Court of Appeal.

The domestic economy is heavily dependent on tourism and over 50% of visitor arrivals are from the US. Robust economic growth in the US and growing household income bode well for continued growth in the industry over the medium term. The island's sole oil refinery, which was shuttered is undergoing modernization and is set to re-open in 2019. The risk factor associated with the cash-constraint of Petróleos de Venezuela, S.A, the parent company and operator of the refinery, is the main headwind that could derail investment flows to the project and push the timeline for the re-opening further into the future. Barring this outcome, annualized real economic growth of 3% is expected over the forecast horizon.

Fiscal consolidation measures being undertaken by the government is expected to result in a reduction in the fiscal deficit and the stabilization of the debt. Moderate erosion is expected in the current account due to capital imports associated with work at the refinery. Notwithstanding, net foreign direct investment flows from tourism is likely to lead to improvements in the balance of payments account, resulting in an increase in foreign reserves.

The currency peg is expected to hold while it is envisaged that the central bank will gradually increase the policy rate over time to minimize capital flight risk.

Given the sovereign's impeccable payment record, strong ties to the Netherlands and macro-fiscal profile, we are recommending Aruba at MARKETWEIGHT at this time.

Overview of Aruba's Economy and Bond Recommendation

Synopsis of the Sovereign

Strengths

- Moderately strong growth outlook supported by expansion in tourism and recommencement of operations at the sole oil refinery.
- Solid political and legal institutions with strong policy influence by the Dutch government.
- High per capita GDP and growing employment opportunities.
- Currency peg with the US dollar limits currency risk of the external debt and minimises inflation risk.

Weaknesses

- Narrow industrial base - heavily dependent on imports of industrial goods and consumables.
- An undiversified economy and heavy reliance on tourism render the sovereign vulnerable to external shocks, in particular economic downturn in the US.
- The sovereign lacks complete autonomy over its affairs and therefore certain political decisions have to be given the accent of the government in the Netherlands.

Ratings: S&P, BBB+/Positive; and Fitch, BBB-/Stable

Default: Never

Introduction

Aruba is a small island located north of Venezuela with a population of 105,000 persons and per capita GDP of around US$26,000. The sovereign is a constituent country of the Kingdom of the Netherlands and has full autonomy over internal affairs. However, the Dutch Government maintains responsibility for defence and foreign affairs. Governance of the country is regulated by its Constitution, which is subordinate to the Charter for the Kingdom of the Netherlands.

The sovereign is a multi-party parliamentary democracy. The Chief of State is the monarch of the Netherlands who is represented by a Governor General appointed for a six-year term. Executive power is exercised by the government, while Federal legislative power is vested in both the government and the Parliament. The government is headed by a Prime Minister and eight Cabinet Members. The parliament has one legislative chamber from which 21 members are directly elected by popular vote for a four-year term.

The legal system is modelled on civil law based on the Dutch civil code. Persons can seek legal redress first through the Court of First Instance in Aruba. Appeals are heard by the Joint Court of Justice and the Supreme Court in The Hague Netherland acts as the final court of appeal.

Economic Base and Outlook

Like a number of other Caribbean territories, Aruba's economy is dependent on tourism which accounts for well over 50% of gross domestic product (GDP). Of the over 1.5 million visitors which visited the island in 2016, a little over 60% were from the United Stated (US). In 2014 tourist arrivals from Venezuela accounted for over 20% of total visitor arrivals, but have since fallen to below 10%. The narrow economic base and dependence on the US and Venezuela to a lesser extent makes the sovereign very vulnerable to shocks in both economies. At this moment, the balance of risk is tilted towards the upside in respect to the tourism industry over the medium-term. On the one hand, robust economic growth, positive labour market developments and growing household income in the US have led to continued strong demand for leisure activities. Consequently, year-on-year growth in tourism of at least 3% from that market is expected over the forecast horizon. While overall growth is expected, on the other hand, it is likely to be tempered by decreased visitors' arrival from Venezuela resulting from the economic challenges that the sovereign has been grappling with over the last 3 years with no end in sight.

Plans are well advanced regarding the re-opening of Aruba's sole refinery by Citgo Petroleum, a unit of Petroleos de Venezuela (PDVSA). The plant is used to process heavy crude from Venezuela with a focus on exports. Investment totalling more than US$700 million is expected to be used to help retrofit the plant. Of this amount, Citgo is expected to provide US$100 million and the remaining portion is likely to flow from commercial sources as PDVSA is facing liquidity challenges, which is the main headwind to the project that is programmed to come on stream in 2018. Commencement of operations at the refinery is likely to drive exports, employment and real output, all of which are factored in our forecast.

Current Account, Reserves and Inflation

Aruba's current account deficit surplus (CAS) declined marginally to 3.6% of GDP in 2016 compared to 4.1% of GDP in 2015. Looking ahead, the current account balance is expected to move towards a small deficit predicated on capital works on the oil refinery. The currency account is however expected to return to a surplus by the end of the forecast period where it is envisaged that full operation will resume at the refinery. Production at the facility is likely to drive exports and help to improve the sovereign's external accounts. This coupled with continued robust investment flows should result in the sovereign building reserves. Over the forecast horizon, reserves are likely to move from US$600 million (3.5 months of imports) in 2016 to US$800 million (3.5 months of imports) in 2020.

Against the backdrop of a favourable development in the balance of payments account the currency peg is likely to continue to hold. The US Federal Reserve commenced the cycle of rate increase in 2016 and this is likely to continue incrementally over multiple quarters in the future, in keeping with higher inflation expectation and labour market conditions. Many central banks in the Caribbean have reacted by increasing policy rates to maintain interest rate differentials between assets denominated in the domestic and US currency in order to restrict capital outflows. Aruba's central bank increased its policy rate from 1% to 2% in 2016 and rates are expected to inch up to 3% by end-2017 and 4.25% at end-2020. This should also support the maintenance of order in the currency market.

The pass-through effect of projected increases in commodity prices should have minimal impact on the sovereign's headline inflation given the currency peg. Given this outlook, Inflation and inflation expectations are likely to remain subdued in keeping with the policy direction of both the fiscal authority and the central bank.

Table 1: Some Key Statistical Indicators for Aruba

Indicator Name	2010	2011	2012	2013	2014	2015	2016	2017 (e)	2018 (f)	2019 (f)	2020 (f)
Population	101,669	102,053	102,577	103,187	103,795	104,341	104,822	105,264	105,670	106,053	106,438
GDP per capita, USD	23,413	24,898	24,740	25,128	25,752	26,005	25,800	26,700	27,887	29,371	30,518
Real GDP, AWGbn 2010 prices, % y-o-y	-3.6	3.8	-1.4	4.7	1.2	-0.7	1.8	3.1	3.3	4.0	2.3
Total revenue, % of GDP	27.7	21.4	22.5	24.7	23.4	25.0	25.4	25.1	24.6	24.6	24.7
Fiscal balance % of GDP	-7.1	-9.8	-7.2	-7.8	-3.5	-3.1	-2.7	-2.5	-1.9	-1.6	-1.4
Unemployment, ave	10.6	8.9	9.6	7.6	7.4	7.4	7.2	7.0	6.8	6.8	6.5
Inflation, % y-o-y, eop	-0.7	6.1	-3.7	0.1	2.2	-0.9	-0.3	1.5	1.5	2.0	2.0
AWG/USD, eop	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79
Current account balance, % of GDP	-19.2	-10.2	3.5	-12.8	-5.1	4.1	3.6	0.8	-0.9	-0.1	0.2
Foreign reserves ex gold, USDbn	0.6	0.5	0.6	0.5	0.6	0.5	0.6	0.7	0.7	0.7	0.8
Import cover, months	3.3	1.0	2.5	2.8	3.0	3.0	3.5	3.5	3.5	3.5	3.5
Government domestic debt, % of GDP	29.9	36.0	35.7	38.5	42.0	39.4	40.7	40.4	40.0	39.5	39.4
Total government debt, % of GDP	56.1	61.4	67.7	73.9	81.5	82.2	84.8	84.1	83.3	82.3	82.2
Central bank policy rate, % eop	1.00	1.00	1.00	1.00	1.00	1.00	2.00	3.00	3.00	3.00	4.25

Source: BMI/JMMBIR
(e) estimated and (f) forecast

Fiscal Operation and Debt Trajectory

Improvements in real GDP growth and the government policy actions to increase revenue and reduce expenditure have led to reductions in the fiscal deficit from 7.8% in 2013 to 2.7% in 2016. Further reduction is expected in the fiscal deficit in outer years. In keeping with developments in the fiscal accounts and the sovereign's growth story, debt to GDP is expected to stabilize at around 82% over the forecast horizon.

Agency	Rating	Outlook	Date
S&P	BBB+	positive	Jun-16
Fitch	BBB-	stable	Jul-14
Fitch	BBB	negative	Aug-13
S&P	BBB+	stable	Jun-13
S&P	A-	negative	Aug-12
Fitch	BBB	stable	Nov-11
S&P	A-	stable	Nov-11
S&P	A-	negative	Nov-10
Fitch	BBB	stable	Jun-06
Fitch	BBB	negative	Jun-03
Fitch	BBB	stable	Apr-00

Table 2: Ratings History

Ratings Action

Aruba is rated at the lower end of investment grade by Standard and Poor's (S&P) and Fitch. S&P assigns the credit BBB+/positive while Fitch rates the credit at BBB-/stable.

In April 2016, Fitch reaffirmed the sovereign's credit ratings. The key ratings drivers Fitch noted are fiscal consolidation and increased real GDP growth rate that have resulted in reduction in the fiscal deficit and stabilization of the debt. The ratings agency views as positive, improvements in the current account balance and reserves.

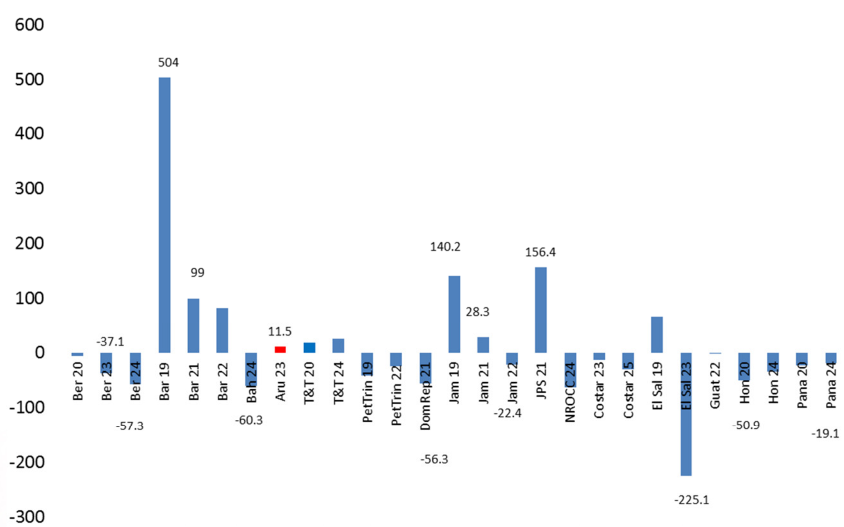
In June 2016 S&P reaffirmed the sovereign's BBB+ credit ratings but revised its outlook to positive. The ratings agency noted that the revision reflects the agreement between Aruba and Citgo to reopen the refinery. S&P however opined that uncertainty regarding Citgo following through on its investment plans within the designated time frame proposed weighed on the ratings. The ratings agency however stated that if the investment is realized, it would lead to stronger FDI inflows which would boost GDP growth and improve the sovereign's external position. S&P stated further that faster growth, coupled with the sovereign's fiscal agreement with the Netherlands, could result in fiscal consolidation and debt decreasing faster than expected.

Bond Performance

The yield curve for some Caribbean sovereigns have experienced a marginal shift to the right over the last 6 months which in part reflects increased appetite for emerging market debt. Excluding Barbados, the average yield for selected Latin America Sovereign and Corporate bonds fell by 13 basis points (bps) over the said time horizon.

Aruba has two global bonds, the Aruba 2018 and Aruba 2023 with issue sizes of $51.0 million and US$253 million respectively and coupon payments of 6.550% and 4.625%, respectively. Given the relatively small issue size of the Aruba 2018, we give exclusive coverage to the Aruba 2023's which is trades in a minimum block $200,000 and currently yields 2.9%.

Figure 1: Selected LATAM and Caribbean, change in bond yields Feb-July, 2017 (basis points)



The yield on the Aruba 2023 ranks favourably with other Latin America and Caribbean sovereign bonds with relatively similar ratings and tenor. When compared to these bonds, the sensitivity of the price of Aruba's 2023 to interest rate changes, given by duration, is lower.

Relative Value Analysis

Figure 2: Relative Value of Asset in the Mid-range of the LATAM yield Curve

The last time we covered the asset in late 2016, Aruba's 2023 was trading close to the relative value yield curve for Latam and Caribbean assets with comparable tenor. With the compression in emerging market bond yields, the situation has remained the same as the quantum of yield change is almost similar across all credits. Aruba 2023 is trading close to the relative value yield curve, which indicates, in a nutshell, that the credit is fairly priced when compared to other Latam credits of similar tenor.

Analyst's Recommendation

The macro-fiscal outlook for Aruba is positive over the short- to medium-term. Real economic growth upward of 3% is expected over the forecast period predicated on robust growth in tourism and recommencement of operations at the oil refinery. Continued strong economic growth and improvement in household disposable incomes in the US are likely to remain the key drivers of visitor arrivals to Aruba. It is our view that the decline in tourism arrival from Venezuela has bottomed out and the industry is most likely to face a tailwind from activities in the US. There are risks to the economy which if they materialize could negatively impact GDP growth, government revenues, employment and debt servicing. The most recognized of these risks are i) the failure of the operators of the oil refinery to secure sufficient funding to complete the project on time, and ii) economic slowdown in the US. While we note these risks, they do not form part of the metrics which informed our overall positive view of the sovereign and debt servicing ability. It is our view that given the sovereign's macro-fiscal profile, impeccable debt service record, and support from the Netherlands that the sovereign will continue to honour future debt obligations. Given this outlook and the risk associated with the sovereign, we **are recommending Aruba at MARKETWEIGHT.**

Source:

Bloomberg,
Business Monitor International (BMI)
https://www.cia.gov/library/publications/the-world-factbook/geos/aa.html

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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