

PLEASE SEE **IMPORTANT DISCLOSURES** IN THE **APPENDIX**

## Executive Summary

The sovereign is facing headwinds in the off-shore financial sector due to legislative changes in G-20 countries to clamp down on tax evasion. The competitiveness of the Bahamas as an off shore jurisdiction is waning and therefore the government is relying on the tourism sector as the main conduit to fuel real sector growth. The high dependency of the economy on one sector makes it extremely vulnerable to external shocks.

Fiscal austerity will weigh heavily on household disposable income over the medium-term and will contribute to increased unemployment. The economy is expected to grow marginally over the said time horizon. However, it is envisaged that the fiscal deficit will contract at a slow pace as revenue inflows from the VAT will be subdued. Debt to GDP is therefore likely to stay elevated, but should stabilize at around 70% of GDP. The sovereign will face increased pressures to meet interest and principal payments. The fiscal pressure faced by the sovereign is unprecedented, therefore the government may be forced to develop an appetite for prioritising debt payments, possibly to the detriment of other government expenditure in the future.

The institutional framework in the Bahamas remains strong and political risk appears relatively low at this time. However, in assessing the macro-fiscal framework of the sovereign –low growth rate, high debt levels and overall risk in the fiscal and external accounts – **the balance of risk appears high and on the downside. Consequently, we are recommending the sovereign bonds as UNDERWEIGHT at this time.**

## Summary of the Sovereign

### Strengths

- Continued strong growth in the US enhances the prospect of growth in tourism, which accounts for the bulk of economic activity.
- Strong institutional strength and governance framework grounded in a solid democratic framework and respect for the rule of law.
- The sovereign is well positioned as an offshore financial centre complemented by its favourable tax regime, adherence to international best practise, strong supervisory and regulatory framework for banks, trusts, and pooled investments.

### Weakness

- Narrow economic base and small size make the sovereign highly susceptible to exogenous shocks, including hurricanes.
- High fiscal deficit and low economic growth pushing debt to GDP towards unsustainable levels.
- Erosion of competitive advantage as an off shore financial centre due to more stringent and continued evolving regulatory environment in G-20 countries, particular the US and Europe.
- High energy cost and unemployment weigh heavily on GDP growth over the medium- to long-term.
- Competition from cheaper destinations poses downside risk to the tourism sector, which accounts for the lion share of employment.

Ratings: **S&P, BB+/Stable; and Moody's, Baa3/stable**

### Overview

The Bahamas is an archipelago of islands located in the Atlantic Ocean southeast of Florida and north east of Cuba. The present day population is estimated at around 393,400 and is made up primarily of persons of from African descent.

The sovereign obtained independence from Britain in 1973, but retains the queen as head of state. The political system is a constitutional monarchy and mirrors the British Westminster system. The queen appoints a governor general who acts as the titular head of state however the day-to-day function of government resides with the executive arm comprising a 18 member cabinet, including the prime minister. Legislative power is vested in a two-tiered Parliament, comprising a lower and an upper house. There are 39 members in the lower house and 16 members in the upper house or Senate. Members of the lower house are elected by popular vote to serve for five-years while senators are appointed by the governor general on the advice of the prime minister or the leader of the opposition

Two main political parties dominate in the Bahamas– the centre-left Progressive Liberal Party (PLP) and the centre-right Free National Movement (FNM). Following general elections, the party with the largest majority in the House of Assembly is invited by the Governor General to form the government and to select a Prime Minister. In the recently concluded general elections in May 2017 the FNM under the leadership of Hubert Minnis defeated the Perry Christie led PLP in a 34-5 parliamentary split. The FNM forms the government and the party's commanding victory at the poll is likely to allow Prime Minister Minnis and his cabinet to push through its legislative agenda with relative ease.

Bahamian law reflects the English Common Law System. Civil and criminal matters are heard by the lower or upper courts and appeals are heard by the Appellate court, or the Privy Council in the United Kingdom which acts as the final court of appeal.

A pegged exchange rate is maintained between the Bahamas dollar and the US dollar at a rate of BS\$1.0 to US\$1.0. Accordingly, monetary policy is inflexible and fiscal policy is the conduit through which the authorities exert influence over economic outcomes. The sovereign is ranked as one of the wealthiest Caribbean islands with per capital GDP estimated at US\$23,200 in 2016.

## Ratings Action

Moody's and Standard and Poor's (S&P) assign ratings of Baa3/stable and BB+/stable, respectively, to the sovereign. The credit is rated investment grade by Moody's which is one notch above the speculative ratings assigned by S&P. In December 2016 S&P downgraded the sovereign's credit ratings to speculative from BBB-/negative. The ratings agency is of the view that lower growth path and slower fiscal consolidation effort will lead to higher debt levels relative to peers. S&P opined that while the introduction of the VAT could lead to an uptick in that tax type, overall revenue growth will be inhibited by slow economic expansion. The ratings agency noted that this will pose challenges to the authority meeting the targeted fiscal numbers. S&P advised that the sovereign's creditworthiness reflected increasing external vulnerability against the background of rising external debt, high unemployment, growing non-performing loans in the banking system, and high household indebtedness.

Moody's downgraded the credit in early 2016 citing as its rationale low medium-term growth relative to peers and rising government debt. In its latest deliberation on the sovereign, the ratings agency hinted that it will maintain the sovereign's investment ratings, but expressed surprise in the worse than previously communicated fiscal deficit for 2015/16 by the authority. The ratings agency is expecting the debt to stabilize above 70% and underline the elevated risks that the sovereign faces due to its external vulnerability and low fiscal buffers.

## Economic Performance

The Bahamas is heavily dependent on tourism which accounts for well over 50% of total gross domestic product (GDP), estimated at US\$9.1 billion in 2016, and directly and indirectly employs over 50% of the labour force. The financial and agriculture sectors represent the other major segments of the economy and account for well over 20% of total GDP. Improved labour market conditions in the US will provide tailwind for the tourism industry and visitor arrivals are expected to grow through to 2019. Well over 5 million visitors arrived in the Bahamas in 2016 and of this amount more than 1.5 million (30%) travelled by air, the more lucrative part of the tourism product. Close to 80% of visitors via air travel are from the US. One of four segments of the controversial Baha Mar resort is completed, which brings on board another 2,000 rooms, pushing the existing room capacity to over 17,000 (10% higher). The hotel is slated to employ 5,000 persons and is likely to provide a boost to the tourism industry and the broader economy. The project however is mired in controversy, and it is unclear if the current administration will push the development forward given that it had made investigating alleged corruption by government officials in relation to construction a key part of its campaign promises.

Despite positive development in tourism, the economy is expected to grow by less than 2% per annum due to low domestic consumption, fiscal austerity measures and the unwinding of investment flows in the tourism industry. The unemployment rate has risen from 8% in 2008 to 15% in 2016, most of which is structural in nature. As a result of this household disposable income and spending power have fallen commensurately and in the process reduced the propensity of household spending to drive domestic demand and push the economy on a high growth path. The unwinding of investment activities at the Baha Mar will lead to lower overall investment flows to the tourism industry. Consequent, on these happenings the economy is expected to remain on a low growth path over the medium term despite the tailwind from projected increases in visitor arrivals from the US.

## Financial Services

As a result of changes in the international financial landscape, particularly efforts by G-20 countries to curtail tax evasion, low or no corporate tax and a harmonious investment climate are no longer sufficient conditions to incentivize and attract offshore financial companies. New financial regulations are adversely affecting operations in the Bahamas, like other Caribbean territories, including Bermuda and the Cayman Islands. Offshore financial companies are unwinding and outsourcing various parts of their operations, and it is unclear what the architecture of the sector will look like in coming years. What however is clear is that the proportion of persons employed by the sector and its share of GDP has fallen in the Bahamas.

## Government Finances, Debt Servicing and Debt Dynamics

Gradual and slow reduction is expected in the fiscal deficit over the forecast horizon in keeping with a number of measures imposed by the government. Slow economic expansion and subdued consumer spending will stymie faster upward adjustments in government revenues despite the imposition of the VAT. In addition to revenue measures, cuts are expected in subsidies to public enterprises but spending on aging infrastructure, reconstruction efforts and rising interest payments on the debt will only lead to gradual reduction in overall government spending, which reinforces the deficit path.

The new government which took office in May 2017 indicated that the previous administration understated the amount expended on hurricane reconstruction work by around US\$300 million. Consequently the fiscal deficit was adjusted and is estimated at around \$500 million (5.4% of GDP) in fiscal year 2016/17 relative to the initial forecast of \$100 million. While unplanned spending related to Hurricane Mathew is in part the cause, concerns have been raised in regard to the previous government entering into unfunded spending commitments amounting to \$300 million. Based on the expected deficit and economic growth path, the debt ratio is expected to stabilize at around 68% of GDP over the medium term. This is relatively high when compared to the period leading up to the 2008-2009 financial crises where the debt ratio was less than 34% of GDP.

**Table 1: Selected Macroeconomic Data for the Bahamas**

Indicator Name	2013	2014	2015	2016	2017 (e)	2018 (f)	2019 (f)	2020 (f)	2021 (f)
Population	377,240	382,169	386,838	391,232	395,361	399,285	403,095	406,839	410,556
GDP per capita, USD	22,582	22,525	22,844	23,223	23,203	23,878	24,480	25,026	25,589
Real GDP, %	0.0	-0.5	-1.7	-0.5	1.1	1.2	1.4	1.4	1.4
Unemployment, % of labour force, ave	15.4	15.0	15.0	15.0	15.0	15.0	15.0	15.0	15.0
Inflation Rate (eop)	1.4	0.2	2.0	0.8	2.2	2.0	2.0	2.0	2.0
Central bank policy rate, % eop	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
BSD/USD, eop	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Total revenue, % of GDP	16.9	19.5	20.0	18.5	18.5	18.5	18.5	18.5	18.5
Budget deficit, % of GDP	-6.4	-5.6	-4.4	-3.5	-3.6	-2.5	-2.1	-2.0	-1.9
Government domestic debt, % of GDP	49.5	54.0	57.0	55.0	53.0	53.0	52.0	52.0	52.0
Total government debt, % of GDP	55.4	60.2	64.5	66.9	69.3	69.6	69.2	68.7	68.4
Current account balance, % of GDP	-17.2	-22.7	-15.6	-11.2	-12.9	-12.1	-11.7	-11.6	-11.7
Foreign reserves ex gold, USDbn	0.7	0.8	0.8	0.9	0.9	0.9	1.0	1.0	1.1
Import cover, months	1.9	1.9	2.3	2.5	2.4	2.4	2.4	2.4	2.4

Source: Business Monitor International, IMF and JMMBIR

## External Position

No material change is expected in the current account deficit (CAD) over the forecast horizon. The CAD is expected at around 11.6% of GDP however the balance of risk is tilted towards deterioration in the event of a decline in terms of trade, particularly in the event of sharp upward adjustments in crude oil prices. As per our baseline projections, positive net capital flows, due in part to increased external financing, are expected to fill the gap in the balance of payments created the CAD thereby resulting in an incremental increase in foreign reserves over the forecast period.

## Relatively Low Political Risk

The Bahamas has a stable political environment with a strong institutional framework. Despite a new political administration taking over the reins of power, no shift is expected in the political environment as there are no clear ideological differences between the two main political parties. The landslide victory at the poll by the ruling FNM will allow the administration to push through policies and continue with fiscal reforms with relative ease. High unemployment and crime however pose a serious threat to social stability. Unemployment averages 15% over the last 5 years, with youth unemployment at even higher levels. This is fuelling discontent in the general population due to income inequality and a feeling of disenfranchisement by a large segment of the populous. Violent crimes and murders have increased and the sovereign currently boasts one of the highest homicide rates in the world at around 29 per 100,000 persons in 2012 and indications are it could reach as high as 59 per 100,000 persons in 2017. The government in the early part of 2017 called out the army to help cull escalating crimes, particularly violent crimes.

External shocks – an increase in oil prices and/or bad weather - could exacerbate the sovereign’s already weak external position and in the process force the abandonment of the currency peg. Under this scenario inflation would accelerate and further undermine household disposable income in an environment where the government lacks fiscal space to boost economic output and employment. This could further ferment social discord and undermine political stability. However, as per our baseline assessment, the Bahamas is expected to continue to maintain a stable political environment over the medium-term.

## Bond Analysis: Price Comparatives Relative Value

Figure 1: Bond Comparatives: Bahamas versus other Latin American Sovereigns



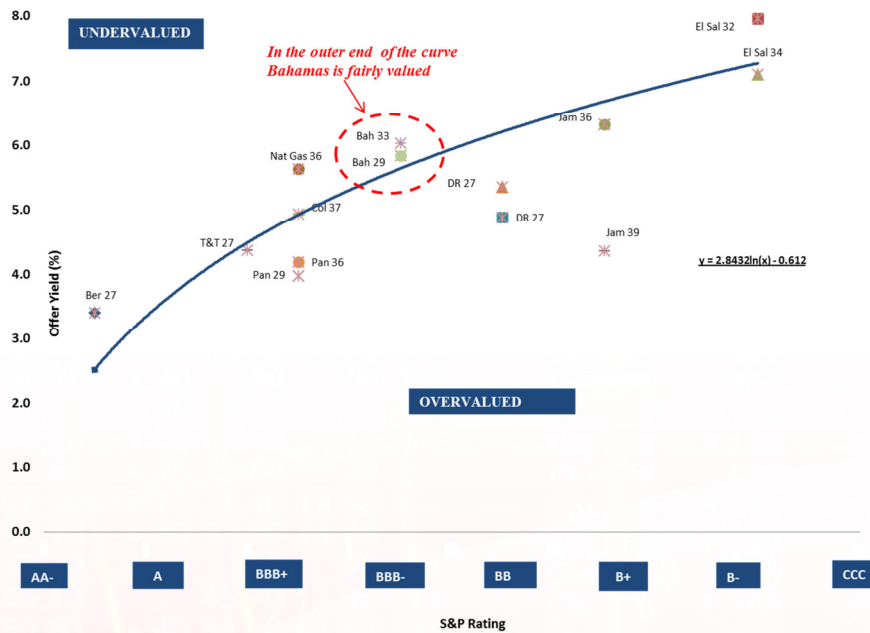
The Bahamas government debt is relatively evenly spread over a long time horizon. Currently the sovereign has four Eurobonds totalling US\$1.0 billion with average coupon of around 6.6%. Government debt issuances are taken up primarily by domestic market players, in part due to stringent capital restrictions imposed by the central bank. For comparative purposes, we pair the three most liquid bonds for the sovereign - Bahamas 2023, Bahamas 2029 and Bahamas 2033 – with other Latin America and Caribbean sovereign (mainly) and a few corporate credits.

In the middle the middle of the curve, the Bahamas 2024 global bond is trading some way from the relative

Source: Bloomberg/Oppenheim/JMMBIR

value curve and appears to be under-valued compared to the other Latin America and Caribbean corporate and sovereign bonds of almost similar tenor. The Bahamas 2029 appears to be fairly valued but the 2033's appear to be slightly undervalued compared to the universe of Latam assets on the long end.

Figure 2: Bond Comparatives: Bahamas versus other Latin American Sovereigns



### Recommendation:

The Bahamas sovereign credit is rated speculative by S&P and the lower end of investment grade by Moody's. Both ratings agencies view the economic outlook as stable, but this was prior to the revelation of undisclosed excess spending by the government last fiscal year, which has contributed to a higher than programmed fiscal deficit and government debt.

Low economic growth will weigh on the government's fiscal consolidation efforts and will constrain faster growth in revenues while there are no clear indications of accelerated cuts in expenditure to aggressively reduce the fiscal deficit. The limited fiscal space and growing debt impair the

Source: Bloomberg, Oppenheim, and JMMBIR

government's ability to accelerate economic growth through higher spending.

The Bahamas will face increasing debt payments in coming years due to debt buildup and deterioration in credit quality. The sovereign has demonstrated the ability to meet debt obligations in the past, but this was in an environment of low debt to GDP and low debt servicing costs relative to the budget. It is unclear if the sovereign will prioritise interest/principal payments relative to other government spending in the event of a fiscal shock. This scenario is uncharted waters for the sovereign and will be made especially difficult in an environment of elevated unemployment and increasing social tensions. Having considered the acceleration in gross debt and debt servicing in relation to the sovereign's external vulnerability and other variables, we are of the opinion that the **Bahamas will continue to service its debt, albeit with increased risk. Given all considerations, it is our view that investors should UNDERWEIGHT the assets at this time.**

Source:

Bloomberg, Business Monitor International, <https://www.cia.gov/library/publications/the-world-factbook/geos/cj.html>, 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.

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