***SOVEREIGN*: Cayman Islands-September-28-2017**

PLEASE SEE IMPORTANT DISCLOSURES IN THE APPENDIX

Executive Summary

The Cayman Islands have a solid governance framework and low tax rate which contributes to the attractiveness of the sovereign as an offshore financial centre. However, the sector has come under intense scrutiny by G-20 countries and its share of GDP has contracted in recent years. However, real economic growth averages around 2% per annum over the last four years and is expected to maintain the same momentum into the medium-term due to increased activities in the tourism sector. Output in the sector is being buoyed by modest economic growth and positive job market conditions in the US which are driving tourism demand in the Cayman Islands.

The macro-fiscal dynamic is on positive path and no marked deviation is anticipated over the forecast horizon. However, the external accounts are vulnerable to shocks as the sovereign maintains marginal reserves and is highly dependent on capital inflows to plug the sustained-high current account deficit. This aside, the sovereign maintains a low debt ratio, one of the lowest in the region, and is expected to repay the only global bond it has on the international capital market (Cayman 2019) from its own coffers.

From a relative value perspective the bond is undervalued. Given this and the sovereign's macro-fiscal profile, and ability and willingness to repay, **we maintain the view that the CAYMAN islands is recommended as MARKETWEIGHT at this time.**

Credit Strength

- Strong institutional strengths backed by solid governance framework
- Viable off shore financial sector grounded in low tax rate and proficient labour force
- Relatively stable economy with low inflation, high per capita GDP and low debt-to-GDP

Credit Weakness

- Small island with a very narrow economic base which leaves the sovereign exposed and susceptible to external economic and weather related shocks
- Increased surveillance framework by G-20 countries to clamp down on tax havens could lead to capital flight
- Reliance on the financial sector as the engine of growth could have an adverse effect on economic outturn in the long-run in light of the current uncertainty with respect to ongoing changes in the tax code in North America and Europe

Ratings: Moody's Aa3/Stable; Fitch, N/A; and S&P, N/A

Overview

The Cayman Islands is a three-island group British overseas territory with a population estimated at around 60,000. The economy is heavily dependent on financial services and tourism. The industrial and agricultural production base is narrow and as such the sovereign is dependent on imports for a large proportion of goods consumed. The Cayman Islands is one of the wealthiest Caribbean islands, second only to Bermuda. Per capita GDP is estimated at around US$54,600 in 2016.

The sovereign has a rich democratic tradition with multiple parties participating in general elections. The head of state is the queen who appoints a governor to administer the undertakings of the crown. However the day-to-day affairs of the country are presided over by a 9 member cabinet headed by a premier. There are two houses of parliament – a lower and an upper house. Twenty members of Parliament are in the lower house of which 18 are elected directly by the people to serve 4-year terms. The other two – the Deputy Governor and the Attorney General - are appointed directly by the governor.

Two main political parties – the People's Progressive Movement (PPM) and the Cayman Democratic Party (CDP) - dominate the political landscape. However, in recent years a number of independent candidates have been appointed to the lower House. Following the general election in May the independent candidates won the majority of the seats, 9 out of 18, while the PPM won 8 seats. After making a number of concessions with independent members, the PPM forms a coalition government and Alden McLaughlin remains premier.

The Cayman Islands has no direct taxation. The sovereign therefore relies heavily on sales taxes, custom duties, registration fees, and other royalties to fund fiscal operations. The Cayman dollar (KYD) is pegged to US dollar at a rate of KYD 0.82 to 1 USD. Monetary policy is inflexible and as such fiscal operations are used as the medium to influence domestic economic activity.

Real GDP Growth: Tourism and Financial Services

It is envisaged that real output in the Cayman Islands will expand at an annualized rate of around 2% over the next three years driven by robust growth in tourism and to a lesser extent financial services. The sovereign is expected to generate fiscal surpluses and with the likely pay out of the global bond in 2019, debt service obligations will fall further over the forecast horizon. The current account deficit will remain high but is expected to narrow marginally while strong capital inflows should help to close the gap and thereby balance the BOP (balance of payments) account.

Like a number of other tourism-dependent countries in the Caribbean, the economy of the Cayman Islands is expected to benefit from an uptick in tourism activities over the medium-term. Continued modest growth and favourable labour market conditions in the US are likely to lead to further improvements in household disposable income and demand for leisure activities. With over 75% of visitor arrivals to the Cayman Islands coming from the US, these developments will provide tailwinds for tourism growth and expansion in real output.

Over the forecast horizon, international business services is expected to continue to generate a significant amount of revenues for the government and will play a role in driving economic growth, albeit headline GDP growth will be structurally weak due to the decline in the sector. The share of international business services relative to total exports has fallen from 42.8% in 2011 to 34.4% in 2016 and the sector has declined on average by 1.3% between 2008 and 2015.

The fallout of the sector comes due to a clamp down on tax havens by countries that are a part of the Organization of Economic Cooperation and Development (OECD), led by the US. In 2014 US businesses accounted for 90% of the US$5.7 trillion net asset in the investment management sector. That same year US regulators issued new regulatory restrictions on offshore financial activities which employed powers under the Foreign Account Tax Compliance Act (FATCA). The imposition of FATCA has resulted in many high net worth individuals and corporates moving funds out of the Cayman Islands. As the regulatory environment in OECD countries continues to evolve, sovereigns like the Cayman Islands with favourable tax codes that are deemed tax havens are seeing their comparative advantage slowly wither away.

Monetary Policy and Inflation

Subdued commodity prices and a fixed exchange rate have helped to limit the pass-through effect of external price increases and have helped to keep headline inflation low. The impact of the rise in commodity prices is reflected in the inflation expectation for 2017 and the outlook over the medium term. The Cayman Islands Monetary Authority (CIMA) maintains the current peg. The domestic currency trades at an exchange rate of KYD 0.82 to 1 US-dollar and no shift is expected over the forecast horizon owing to continued favourable developments in the BOP accounts which should see the sovereign accumulating reserves.

Fiscal Operations and Debt Dynamics

Table 1: Selected Macroeconomic Data for the Cayman Islands

Indicator Name	2011	2012	2013	2014	2015	2016	2017 (e)	2018 (f)	2019 (f)	2020 (f)	2021 (f)
Population	56,579.0	57,523.0	58,371.0	59,172.0	59,963.0	60,765.0	61,559.0	62,348.0	63,129.0	63,890.0	64,643.0
GDP per capita, USD	55,339	53,112	56,821	58,051	55,759	54,621	54,690	54,947	55,477	56,203	56,940
Real GDP growth, % y-o-y	1.2	1.3	1.5	2.4	2.0	1.7	1.8	1.9	2.0	2.1	2.1
Unemployment, % of labour force, ave	6.3	6.2	6.3	4.6	4.2	4.0	4.0	4.0	4.0	3.8	3.5
Inflation, eop	2.3	2.1	2.2	0.6	-2.4	1.4	1.7	2.0	2.5	2.5	2.5
Exchange rate: KYD/USD, eop	0.82	0.82	0.82	0.82	0.82	0.82	0.82	0.82	0.82	0.82	0.82
Total revenue, % of GDP	21.7	21.9	24.0	24.0	24.3	24.4	23.9	23.3	22.7	22.0	21.4
Total expenditure, % of GDP	24.9	23.9	22.3	21.5	21.3	21.6	21.4	21.0	22.4	21.8	21.3
Fiscal deficit/surplus % of GDP	-3.2	-2.0	1.7	2.4	3.0	2.8	2.5	2.3	0.3	0.2	0.1
Current account balance, % of GDP	-12.1	-21.6	-22.9	-25.3	-22.7	-23.3	-23.0	-22.7	-21.8	-21.0	-19.9
Total government debt, % of GDP	25.8	28.3	21.1	19.3	18.9	18.1	16.5	15.0	11.2	11.0	10.0

Source: Business Monitor International/JMMBIR

Revenue as a percentage of GDP is expected to fall slightly over the medium-term, which will result in an erosion in the fiscal surplus as spending adjustments are not likely to match pace with the decline in revenues as a share of GDP. The fall in revenues is a direct consequence of the unwinding of offshore financial activities, a major source of government revenues. Taxation is not levied on incomes in the Cayman Islands and as such the government generates the lion share of revenues from taxes on goods and services and international trade. Therefore as financial companies wind down their operations in the wake of a clampdown on tax havens, the flow of revenues to government is expected to fall which is not likely to be offset by increased revenue flows from tourism and domestic taxes.

The Government is expected to use the buffer accumulated from the fiscal surpluses generated in the past to repay the 2019 global bonds. This should see the debt ratio falling by around 4 percentage points relative to GDP to 11.2%. Modest fiscal surpluses and a relatively consistent GDP growth rate have resulted in the debt falling around 8 percentage points from 25.8% of GDP in 2011 to 18.1% in 2016.

External Accounts

The external account is relatively weak but this is balanced by low debt levels and debt servicing needs. The Cayman Islands have traditionally run large current account deficits (CAD) that are greater than the average for the region. The narrow resource base means that most goods and services are imported from abroad. The CAD is expected to fall from 24.4% in 2016 to 21.4% by 2021. The decline reflects lower outflows from the primary income account due to contraction in the financial services sector. Strong capital inflows are however expected to offset the CAD and therefore reserves should increase. There has been a steady increase in reserves. Relative to the previous year, reserves increased by 7.4% in 2016 to US$155.5 million or 3 months of import cover.

The threat to the economy due to the sovereign's wide CAD does not represent a major issue at this time due to the low debt burden and growing reserves. External debt to GDP fell from 24.3% in 2011 to 18.1% in 2016 and the trend is likely to continue into the future. The sovereign however remains vulnerable to external shocks. High dependency on international business, tourism and imported fuels mean that the slowdown in economic growth in the US and increase in commodity prices could result in the widening of the CAD.

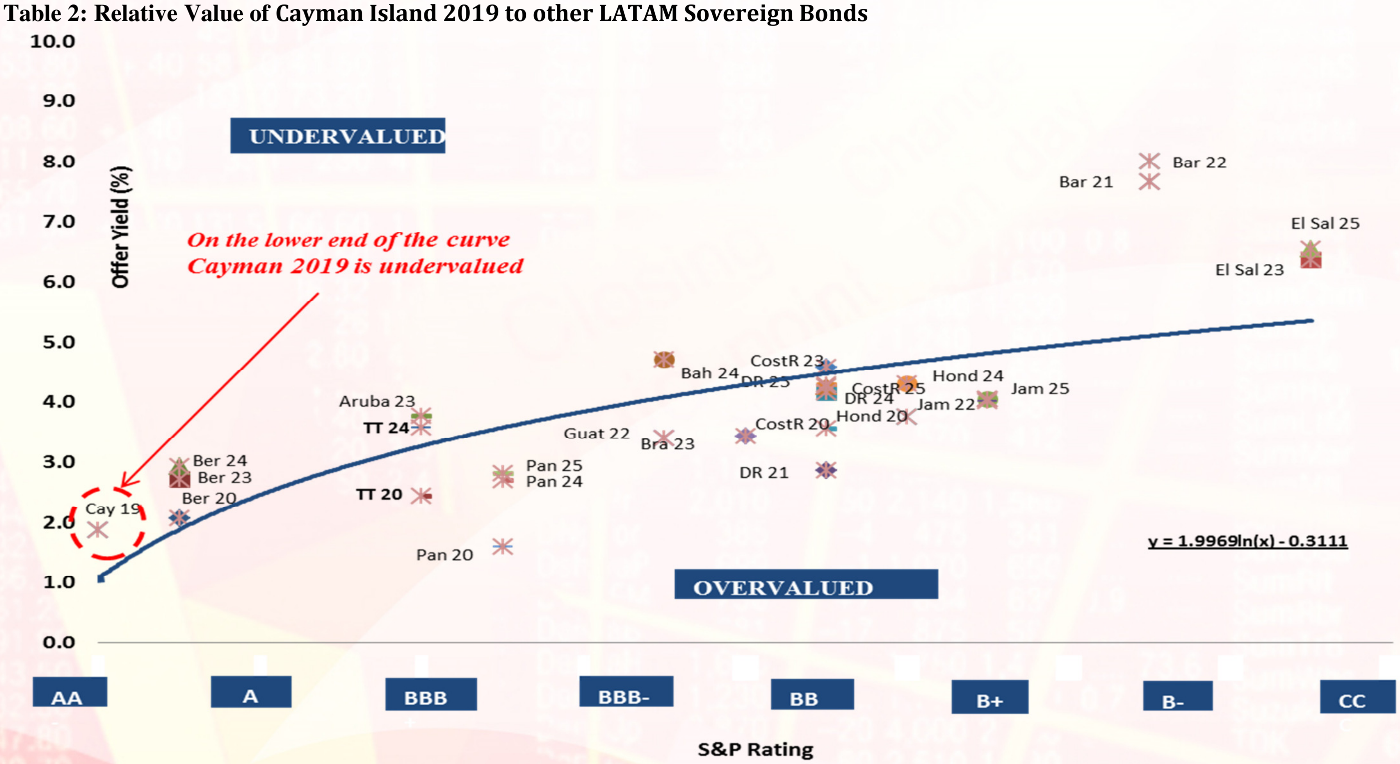
Political Risk

The PPM dropped a seat in the general elections in May resulting in the party receiving 8 out of the 18 seats up for grabs while independent candidates received the majority of seats, 9. After much concession, the PPM formed a coalition government with three independent candidates with varying political views and Alden McLaughlin remains premier. To advance its policy agenda the PPM is likely to make further concessions to the independent candidates, as the party will need their ascent to pass legislations. We do not however envisage any major deviation from the PPM's infrastructure- and economic development-focused policy.

Low unemployment and high per capita income will help to stymie social unrest over the forecast horizon. Growth in real output from higher tourism flows will contribute to further reductions in unemployment. This will help the government to maintain its policy agenda and not deviate much from the current macroeconomic policy approach despite the spectre of having to make concessions to the independent political candidates who are part of the governing coalition.

Relative Value Analysis

Table 2: Relative Value of Cayman Island 2019 to other LATAM Sovereign Bonds



Source: Jeffries/JMMBIR

The Cayman Islands has only one global bond, the 2019s. The principal amount is US$312.0 million and the current yield is 1.87%. The security matures in November 2019 and is traded in blocks of US$100,000.0, which may make it a little challenging for retail clients to gain access to it. The instrument is relatively illiquid and the lion share is held by domestic institutions that have a buy-and-hold mentality and therefore tradability in the bond is restricted. Relative to other Latin America and Caribbean bonds of similar tenor the instrument appears to be undervalued.

Recommendation

The Cayman Islands economy is undergoing structural changes as a result of adjustments in the international business environment. This is a direct consequence of a clampdown on tax havens. Modest economic growth is envisaged over the medium term driven by increases in tourism activities. The government's revenue stream is expected to remain robust as taxes generated from tourism-influenced consumption activities and international trade are projected to continue. The fiscal consolidation efforts of the government has borne fruit and as result debt to GDP is on a downward trajectory and is the lowest in the Latin America and Caribbean region. There is a strong possibility the government will repay the global bond from its coffers when it matures. Downside risks exist, which could derail fiscal operations and erode external reserves. These risks however appear relatively low at this time and the probability is weighted in favour of continued positive economic outturn over the medium term.

Given the macro-fiscal path of the Cayman Islands and the ability and willingness of the sovereign to repay their debt, **we maintain the view that the CAYMAN Islands should be rated at MARKETWEIGHT** at this time**.**

Source:

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