Playing for time in Venezuela

By Jan Dehn

Venezuelan President Nicholas Maduro's commitment to pay principal on recently matured bonds indicates that he is playing for time. If he continues to pay coupons he does not face a principal repayment on cross-defaultable bonds until August 2018. Saudi Arabia's Crown Prince consolidates power, which bodes well for reforms. Mexico discovers a new oil field as the public finances improve sharply relative to expectations. Argentina presents a growth enhancing tax reform as S&P upgrades the sovereign credit rating. Good economic news in both South Korea and Brazil. In the global backdrop Jerome Powell outbids Yellen in the Fed Chair auction with an unbeatable offer of both easy money and financial deregulation as the Trump tax cut proposal moves into a more delicate phase.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.0	–	1.46%
MSCI EM Small Cap	12.9	–	1.29%
MSCI Frontier	11.8	–	-0.98%
MSCI Asia	12.5	–	2.07%
Shanghai Composite	13.0	–	-1.32%
Hong Kong Hang Seng	8.0	–	-0.35%
MSCI EMEA	10.3	–	0.60%
MSCI Latam	13.9	–	-2.72%
GBI-EM-GD	6.21%	–	-0.36%
ELMI+	4.01%	–	0.19%
EM FX spot	–	–	-0.34%
EMBI GD	5.26%	291 bps	0.14%
EMBI GD IG	4.05%	167 bps	0.50%
EMBI GD HY	6.57%	425 bps	-0.19%
CEMBI BD	5.01%	277 bps	0.19%
CEMBI BD IG	4.10%	186 bps	0.20%
CEMBI BD Non-IG	6.26%	400 bps	0.17%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.6	–	0.29%
1-3yr UST	1.61%	–	-0.01%
3-5yr UST	1.99%	–	0.14%
7-10yr UST	2.33%	–	0.65%
10yr+ UST	2.81%	–	2.05%
10yr+ Germany	0.34%	–	0.65%
10yr+ Japan	0.02%	–	0.29%
US HY	5.44%	339 bps	0.04%
European HY	2.44%	290 bps	0.47%
Barclays Ag	–	252 bps	0.45%
VIX Index*	9.58	–	-0.92%
DXY Index*	94.95	–	0.39%
EURUSD	1.1608	–	-0.37%
USDJPY	114.27	–	0.95%
CRY Index*	189.38	–	2.49%
Brent	62.6	–	2.71%
Gold spot	1270	–	-0.50%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

- **Venezuela:** President Nicholas Maduro announced last week that he will complete a large pending principal repayment on the PDVSA 2017 New bond and then seek a full restructuring or refinancing of the country's remaining stock of external bonds, which are worth about USD 66bn (total outstanding bonds by the sovereign and PDVSA, the national oil company). Brushing aside the wide range of possible interpretations of the words 'restructuring' and 'refinancing', the market immediately priced in the worst possible scenario of full default on all bonds with recovery rate as low as 20% before prices recovered moderately from these extreme lows.

Such extreme price action may yet prove to be a buying opportunity. After all, there is as of yet no actual default. Moreover, while Venezuela undoubtedly has liquidity problems the country is not insolvent and even moderate changes in macroeconomic policies could quickly generate additional resources to service the existing debt stock. In other words, the government faces a classic trade-off: to continue to make sufficient adjustment to pay, or to default.

It is worth remembering that former President Hugo Chavez was prepared to make big sacrifices in order to continue to service debt, including cutting civil service salaries during the 2003 PDVSA strike. So far President Maduro has also been willing to adjust in order to service debt, including restricting imports and devaluing the currency, albeit not without also drawing down the country's FX reserves, which now stand at about USD 10bn. These adjustments have until now enabled Maduro to stay current on Venezuela's bond debt against a backdrop of stable to modestly rising oil prices, continuing financial flows from joint venture partners and a recent boost to his political standing at home.

Maduro's announcement last week that he is seeking a restructuring does not necessarily signal an intention to default. Instead, he may be testing waters to see what is possible, while at the same time demonstrating his willingness to refinance in a bid to show that it is the opposition and the US government, who are putting obstacles in the way. In other words, his announcement may be politically motivated.

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Emerging Markets

This interpretation of Maduro's announcement is also consistent with the observation that Maduro explicitly stated that the government will complete sizeable payments on both the 2020 and 2017 New PDVSA bonds. Indeed, the day after Maduro's announcement officials stated that Venezuela is "absolutely committed to" paying its obligations, a message which was later repeated in an official government communique. The government also invited bondholders to meet with the government in Caracas on 13 November, which is an unusual move for a country intending to default (usually lawyers get involved in the event of default). PDVSA also issued a statement that both principal and coupon will be paid on the 2017 New bond.

Pending further government clarification the next indicator of Maduro's true intentions with respect to the debt will be payments of upcoming coupons. The test case will be the USD 80m coupon on the PDVSA 2027 bond, whose grace period, due to Venezuelan holidays, ends on 13 November 2017. Of course, the government may choose to clear this coupon payment and all the other pending coupons well before that. For what it is worth, the government paid the oil warrants last week.

Staying current on coupon payments buys Maduro a lot of time: he has until August 2018 before he has to make another principal repayment on cross-defaultable bonds. If Maduro is indeed playing for time where might he find wriggle room? Liability management, whether of the friendly or not so friendly variety, is not necessarily the easier option. The scope for refinancing has been restricted by US sanctions, which bar some financial institutions from acquiring newly issued bonds, while an unfriendly restructuring could backfire severely by increasing attachment risk for Venezuelan oil shipments, thus driving down prices of Venezuelan crude oil and ultimately costing the country more in lost revenue than it gains in savings on debt service. A default could also make it difficult to import the lighter grades of crude and petroleum, which Venezuela needs to mix with its heavier crude and keep its vehicle fleet on the road.

What about changing policies? Maduro's stronger political standing following the establishment of a Constituent Assembly with far-reaching powers and recent victories in local elections suggest that he may have sufficient political capital to make some adjustments. Venezuela is so dependent on crude oil exports that policy changes, or indeed lack thereof, which threatens powerful vested interests in the oil sector, could lead to calls for regime change from within the government itself. Defaulting may in fact be Maduro's least attractive option, because he risks cutting Venezuela off from working capital financing from joint venture partners.

Faced with such difficult trade-offs it makes sense for Maduro to play for time. Barring further bad news the market may find it difficult to maintain the current elevated levels of anxiety given extremely elevated yields. Recovery rates on Venezuelan bonds are also likely to be higher than where the bonds are currently trading. On the other hand, the decision to blame the US could be a pretext for blaming the US again when a restructuring proves impossible despite Venezuela's best efforts due to sanctions. In short, a balanced assessment of the risks here would suggest that this may be a good time to invest, but investors will need to see what options for refinancing are being contemplated and discussed with bondholders that can work with current US sanctions.

- Saudi Arabia: Crown Prince Mohammed bin Salman took a giant step to consolidating power as he ordered arrests of prominent Saudi princes and officials on anti-corruption grounds at the weekend. Bin Salman has presented an ambitious set of plans to modernise Saudi Arabia. The arrests will significantly increase the odds of success by removing powerful opponents to his reforms, in our view.

- Mexico: Pemex, the national oil company, has announced the discovery of a 1.5bn barrel oil field south of Veracruz. The find, which is the biggest onshore discovery in 15 years, follows another recent discovery by private operators. Reforms to PEMEX in President Pena Nieto's first term have contributed directly to these discoveries by channelling resources into exploration and production instead of just employment creation. In other news, the government has provided an update of the public finances for 2017, which have turned out to be far better than expected due to more efficient tax collection and spending moderation. The government revised its forecast for the primary surplus up to 1.4% of GDP from its previous estimate of 0.4% of GDP, while the Public Sector Borrowing Requirement has fallen to 1.4% of GDP from 2.9% of GDP. Natural disasters pushed growth into negative territory in Q3 2017 (-0.2% qoq saar versus -0.1% qoq saar), but the economy is likely to bounce back this quarter.

- Argentina: Following its success in the mid-term election the Macri Administration has now put forward its fiscal reform proposal. The principal objective of the reform is to improve Argentina's trend growth rate via removal of distortions. That should not prove too difficult, because the former Kirchner Administration maintained one of the most destructive tax regimes in the world. The new regime will be very similar to systems used in most OECD countries. The reform is designed to be revenue neutral over the medium term, but will initially cost the government 1.5% of GDP. Industrial Production expanded at a slower than expected rate of 2.3% yoy in September (the consensus forecast was 4.9% yoy). Standard & Poor's upgraded Argentina's foreign currency credit rating to B+ (stable) from B (stable).

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Global backdrop

- **South Korea:** A lot of good news in Korea. First, working day adjusted export shipments soared in October to 33.9% yoy from 20.6% yoy in September (October had 4.5 fewer working days than September to the unadjusted headline number was highly deceptive). Second, the core CPI inflation rate declined to 1.3% yoy in October from 1.6% yoy in September. Third, industrial production grew strongly at a rate of 8.4% yoy. Fourth, South Korea and China mended fences, so South Korea's growth rate could push well above 3.0% next year on the resumption of Chinese tourism, in our view.

- **Brazil:** Brazil's ytd trade surplus hit an all-time high of USD 67.7bn in October following a surplus of USD 5.2bn in the month. Brazil now exports USD 18.9bn a month and imports about USD 13.7bn. Industrial production grew at a rate of 2.6% yoy in September versus the market's expectation of 3.1% yoy, but industrial confidence rose 2.8% mom in October from 0.7% mom in September. The rate of unemployment dropped to 12.4% in September from 12.6% in August. Unemployment peaked at 13.2% in March 2017. Finally, the public sector's primary deficit declined to BRL 21.3bn in September versus BRL 23.4bn expected.

Snippets:

- **Africa:** The IMF's Africa Department issued a new growth forecast for Africa, wherein the Fund says Africa growth rate will accelerate to 3.4% in 2018 from 2.6% in 2017.
- **Chile:** Unemployment hit 6.7% in September versus 6.5% expected.
- **Czech Republic:** The Czech National Bank raised the policy rate by 25bps to 0.5%.
- **China:** The Caixin services PMI rose to 51.2 in October from 50.6 in September, while the Caixin manufacturing PMI was unchanged at 51. Official PMI numbers moderated slightly in October. In a sign of successful deleveraging China's shadow banking sector declined relative to GDP in H2 2017, according to Moody's.
- **Colombia:** The rate of inflation increased marginally to 4.05% yoy in October from 3.97% yoy in September.
- **Hong Kong:** Retail sales were very strong in September, rising at a rate of 5.6% yoy in September versus a Bloomberg consensus expectation of 1.0% yoy and 2.7% yoy in August. Volumes were also almost twice as high as expected.
- **India:** The Nikkei services PMI accelerated to 51.7 in October from 50.7 in September.
- **Indonesia:** The CPI inflation rate was 3.6% yoy in October versus 3.7% yoy expected and 3.7% yoy in September. Real GDP growth expanded at a softer than anticipated 5.1% yoy in Q3 2017, but investment growth was strong (7.1% yoy), which bodes well for future growth.
- **Kenya:** Incumbent President Uhuru Kenyatta secured more than 98% of the votes in the re-run of the presidential election, which was boycotted by the opposition led by Raila Odinga. The PMI index declined to 34.4 in response to the unsettled political situation.
- **Malaysia:** The solid trade surplus continued in September on the back of export growth of 17.6% qoq saar and import growth of 20.4% qoq saar. The trade surplus was USD 2bn compared to USD 2.3bn in August and USD 1.9bn in July.
- **Nigeria:** The PMI index rose to 55.8 in October.
- **Peru:** The rate of CPI inflation was 2.04% yoy in October, down from 2.94% in September. The core inflation rate dropped to 2.35% yoy from 2.45% over the same period.
- **Poland:** October CPI inflation was 2.1% in October, down from 2.2% in September.
- **Singapore:** The manufacturing sector PMI hit a cycle high of 52.6 in October, up from 52 in September and stronger than the consensus expectation of 51.9.
- **South Africa:** The Absa manufacturing PMI increased to 47.8 in October from 44.9 in September. The result was better than expected.
- **Sri Lanka:** Headline CPI surged to a rate of 7.8% yoy in October from 7.1% yoy in September.
- **Taiwan:** The October Manufacturing PMI was a solid 53.6, albeit down from a sizzling hot 54.2 in September. The Q3 2017 real GDP growth rate was 3.1% yoy versus just 2.2% yoy expected.
- **Thailand:** Headline CPI inflation 0.86% yoy in October versus 0.83% yoy expected. Exports continued to be strong in September (13.4% yoy and 15.8% yoy in August).
- **Turkey:** A trade deficit of USD 8.1bn in September took the 12-month cumulative trade deficit to USD 67.8bn or roughly 8% of GDP. Inflation jumped to 11.9% in October from 11.2% in September.

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Global backdrop

Jerome Powell has been named as the next Fed Chairman, replacing Janet Yellen. Jerome is widely regarded as a continuity candidate, i.e. someone who will not make large changes compared to the current policy stance of the Fed. Jerome's policy preferences are likely to closely match President Trump's publicly stated preferences for low rates and a weaker Dollar. The main thrust of Fed policy in the coming years is likely to be the gradual reduction of the central bank's balance sheet as QE policies are unwound. If balance sheet adjustment is carried out without major mishaps and if the economy continues to expand (both of which should not be taken as given) the effect should be gradually to allow valuations in the extremely expensive US stock market to move into line with economic fundamentals and thus reduce the risk of a stock market crash in the event of either recession or inflation. As for rates, the Fed is likely to continue to want to hike rate in order to rebuild the capacity to cut rates when a recession strikes, but doing so only when it is safe, i.e. when hikes are fully priced by the market. Since hikes usually get priced during bouts of stock market optimism – such as now – the Fed is likely to continue to appear very pro-cyclical and ultimately beholden to sentiment in the stock market, which we think is actually the case. The Fed's real challenges will be how to handle either a recession or inflation returns, but based on data released last week the economy is expanding while wages and core PCE remain modest.

The only real difference we see between Jerome Powell and Janet Yellen is that Powell is likely to favour deregulation of financial markets far more strongly than Yellen. This difference may indeed have been the decisive reason for Powell's appointment, since, absent a sudden productivity miracle in the US economy, the only way to keep the party going in the stock market is to add more punch to the bowl. The desire to keep the party going is also the main rationale for the Trump tax cuts, which have now moved into a far more delicate phase. As the Fed gradually tightens policies in the coming years, the safest way to avoid a recession between now and the next election will be to ramp up fiscal stimulus. The failure to repeal Obamacare means that the more debt will have to be issued and that savings must be found elsewhere in the Budget in order to finance the tax cut. This will not be easy, so noise levels are likely to rise from here. The tax cut is unlikely to improve the underlying productivity of the US economy. In fact, productivity may ultimately end up declining as a result of the tax cut as debt issuance will transfers yet more resources from the productive US private sector to finance the pork barrel-laden unproductive US public sector. If so, the tax cut will push down the Fed's long-term target interest rate, r*, and thus eventually turn out to be dovish.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.64%	33.45%	30.60%	6.49%	5.11%
MSCI EM Small Cap	0.43%	27.55%	24.14%	5.34%	5.76%
MSCI Frontier	-0.25%	26.03%	26.90%	0.40%	8.99%
MSCI Asia	1.11%	38.90%	34.15%	9.67%	8.79%
Shanghai Composite	-0.64%	10.87%	9.99%	13.65%	12.40%
Hong Kong Hang Seng	0.82%	28.44%	27.26%	6.77%	5.40%
MSCI EMEA	-0.19%	12.92%	17.49%	-1.01%	-0.90%
MSCI Latam	-1.28%	20.87%	15.57%	-1.08%	-2.81%
GBI EM GD	-0.61%	10.39%	5.16%	-1.17%	-1.72%
ELMI+	-0.15%	8.57%	5.55%	-0.30%	-0.87%
EM FX Spot	-0.46%	2.98%	-0.89%	-7.31%	-7.30%
EMBI GD	-0.18%	9.20%	6.34%	5.99%	4.76%
EMBI GD IG	0.17%	8.50%	4.52%	4.60%	3.32%
EMBI GD HY	-0.49%	9.99%	8.38%	7.22%	6.61%
CEMBI BD	0.03%	7.62%	6.34%	5.38%	4.81%
CEMBI BD IG	0.02%	6.08%	3.80%	4.14%	3.92%
CEMBI BD Non-IG	0.04%	9.91%	10.25%	7.06%	6.24%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.51%	17.50%	26.42%	10.95%	15.23%
1-3yr UST	-0.04%	0.58%	0.11%	0.64%	0.63%
3-5yr UST	0.01%	1.43%	-0.45%	1.49%	1.15%
7-10yr UST	0.25%	2.92%	-1.70%	2.31%	1.62%
10yr+ UST	0.93%	7.03%	-1.24%	4.19%	3.20%
10yr+ Germany	-0.15%	-2.15%	-4.18%	4.46%	5.45%
10yr+ Japan	0.24%	-0.18%	-3.22%	4.79%	5.03%
US HY	-0.01%	7.44%	9.72%	5.54%	6.21%
European HY	0.29%	6.78%	8.36%	6.14%	8.00%
Barclays Ag	0.16%	5.30%	3.94%	4.07%	3.87%
VIX Index*	-5.89%	-31.77%	-57.44%	-29.92%	-45.51%
DXY Index*	0.42%	-7.10%	-2.18%	7.88%	17.78%
CRY Index*	0.97%	-1.63%	3.77%	-29.63%	-36.27%
EURUSD	-0.33%	10.34%	5.14%	-6.20%	-9.42%
USDJPY	0.55%	-2.33%	9.38%	-0.82%	42.22%
Brent	1.92%	10.08%	37.23%	-24.51%	-43.68%
Gold spot	-0.09%	10.21%	-0.91%	11.22%	-25.99%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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