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INSIGHTS

Venezuela: An Unfolding Crisis

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EXECUTIVE SUMMARY

- U.S. investors that allocate to emerging market debt may have exposure to Venezuela[1].
- The Venezuelan government ("Republic"), along with its state-owned oil and natural gas company, Petróleos de Venezuela, S.A. ("PDVSA"), are issuers of U.S. dollar denominated debt and are components of hard currency emerging market debt indices.
  * As of July 31, 2017 Venezuela's weight (inclusive of PDVSA) in the J.P. Morgan EMBI Global Index was 2.8% and its weight in the J.P. Morgan EMBI Global Diversified Index was 1.6%.
- Venezuela's political and social situation has worsened over the past several years driven, in part, by a collapse in oil prices that started in 2014 coupled with economic policies that many have argued were poorly designed.
- EMD managers' active positioning in Venezuela has had and will continue to have a meaningful impact on managers' relative performance and tracking error in the near-term.
- In recent months, spreads on Venezuelan bonds have widened meaningfully as the default expectations among market participants have heightened. Importantly, there may be rational reasons to hold Venezuela bonds: 1) High current yield 2) Views on the timing of default and the likely recovery value.
- The deepening crisis in Venezuela has prompted the U.S. government to take stronger escalatory measures in the form of sanctions.
  * Further sanctions by the U.S. Government might impact secondary trading and index eligibility.

Venezuela Background

While the political and social turmoil in Venezuela has certainly been exacerbated by falling oil prices, its root causes can be traced, in part, to the Venezuelan government's price and currency controls, farm and factory nationalizations, and other populist policies. Although Venezuela has shown an extreme willingness to service its debt (it has not defaulted to date), its ability to do so has become increasingly challenged. However, few bonds mature within the next couple of years and thus far Venezuela has seemingly made the calculation that the country is better served by paying bondholders on a timely basis rather than willingly default (both the Republic and PDVSA have strategic assets abroad and the consequences of not paying would likely be punitive). Importantly, the range of outcomes from a bondholder's perspective is quite wide and, while the situation has certainly worsened, it is possible that the country avoids default over the short-term.

More recently, the Constituent Assembly elections that took place on July 30th represented President Nicholas Maduro's most overt attempt to date to suppress Venezuelan democratic institutions. Due to the worsening humanitarian crisis and the apparent erosion of democracy, the U.S. government announced on August 25th that it would level additional sanctions on Venezuela[2]. The most important elements of the sanctions are outlined below:

- The sancations prohibit U.S. persons from engaging in primary transactions related to new PDVSA and Republic debt.

[1] U.S. investors likely have negligible or no exposure to Venezuelan equities as the country was removed from the MSCI Emerging Market Equity Index in 2006.

[2] Previous U.S. sanctions had targeted Maduro's personal assets and the personal assets of several of his close associates.

- Within General License 3, the U.S. government outlined certain PDVSA and Republic debt that can be traded in the secondary market[3].
  * Debt that is not listed is subject to general prohibition.
  * It is Rocaton's understanding that each of the 21 Republic and PDVSA bonds in the JP Morgan EMBI Global benchmark are listed in the exemption list.
  * In sum, secondary trading of debt securities that EMD investors may own has not been impacted to date.

- In addition, U.S. persons are also permitted to engage in transactions related to CITGO Holding (owned by PDVSA).
  * This is an important element of the sanctions, as CITGO Holding is among the most valuable assets which might serve as collateral in the event of a default by PDVSA.

Figure 1:

Venezuela Index Spread

Source: J.P. Morgan. Based on daily data through August 24, 2017

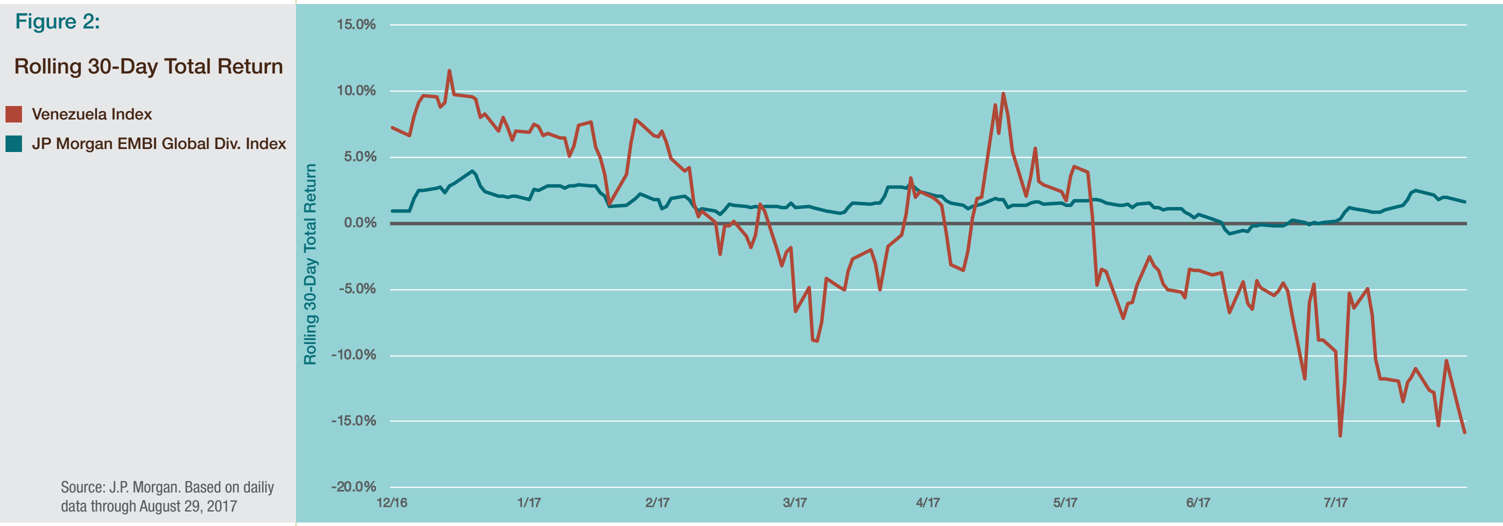
While Venezuela was less than a 3% weight in the JP Morgan EMBI Global Index as of July 31st, the yield on the index excluding-Venezuelan bonds is approximately 70 basis points lower (5.5% vs. 4.8%). It is the expectation of most market participants that the bonds will default at some point (with recovery rates likely to be far below par), which suggests that the stated yield to maturity on the bonds, and the index broadly, is unlikely to be realized and therefore may overstate the return potential. As evidenced by Figure 1, spreads on the Venezuela sleeve of the JP Morgan EMBI Global Index have widened significantly year-to-date as its bonds trade closer to the market's perceived "recovery value" in the event of a default.

Importantly, the volatility of Venezuelan bonds has been outsized relative to the volatility of the hard currency index (see Figure 2) as the perception among market participants of the likelihood and timing of default has evolved. While there is a great deal of headline risk and price volatility associated with these bonds, the thesis, among asset managers, for holding Republic or PDVSA bonds is twofold: 1) the bonds, particularly the long-dated bonds, offer an attractive current yield and 2) they have specific views on the timing of default and the likely recovery value. It is interesting to note that relative results in 2016 for a number of active emerging market debt strategies were affected positively by holding greater than benchmark positions in Venezuelan debt.

[3] General license 3 is part of Executive Order 13808 dated August 24, 2017. The document covers additional sanctions with respect to the situation in Venezuela.

Figure 2:

Rolling 30-Day Total Return



Source: J.P. Morgan. Based on dailiy data through August 29, 2017

Conclusion

While U.S. institutional investors likely do not have exposure to Venezuelan equities, investors with an allocation to emerging market debt hard currency strategies may have exposure to the Republic or PDVSA issues. From a purely investment perspective, we would expect the political turmoil in Venezuela to:

- Affect the relative performance of active emerging market debt managers, as managers' active positioning in Venezuela will have a meaningful impact on excess returns in the near-term.
- Cause bond prices of Venezuelan debt to be quite volatile.
- Perhaps, prompt further escalatory measures from governments that could impact index eligibility and secondary market liquidity.

The challenges facing Venezuela underscore the importance of hiring skilled and experienced portfolio managers in the emerging market debt asset class. Investors should be mindful of the potential for tracking error and/or material under- or outperformance by their active emerging market debt strategies. Lastly, from an asset allocation perspective, investors should be aware that the return potential from the emerging market debt asset class may be overstated when looking solely at the index yield, if Venezuela defaults.

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