INVESTMENT AND SOVEREIGN RESEARCH

***SOVEREIGN*: ARUBA April-5-2019**

PLEASE REFER TO EXPLANATIONS ON RECOMMENDATIONS CONTAINED IN APPENDIX BELOW

Assessment of Aruba's Economy and Bond Recommendation

Executive Summary

Further sanctions imposed by the Trump administration on Venezuela will stall the planned completion of the refurbishing of the Citgo leased oil refinery in Aruba. The medium term growth outlook for the sovereign was heavily predicated on the completion of the refinery. With the project in limbo, real GDP growth over the medium term is scaled back by at least one percentage point, and will put pressure on the fiscal accounts.

Aruba is beset with serious fiscal challenges and is relying on the restart of operations at the facility to help boost revenue growth by 5% per year. With no set timeline as to when sanctions will be lifted on Venezuela, the outlook on Aruba's economy is negative. The sovereign has the hard choice of implementing additional austerity measures in order to help stave off a possible credit downgrade.

Whether or not the authorities act to cut the fiscal deficit, there is no guarantee that economic growth will move beyond 1% over the medium term given structural rigidities within the economy. In a nutshell the sovereign faces even tougher economic challenges ahead. Widening of the deficit could push the debt towards unsustainable levels and inevitably a rise in debt servicing costs.

Given the economic challenges that Aruba is likely to face over the medium term we are maintaining the UNDERWEIGHT recommendation for the sovereign bonds.

Table 1: SWOT Analysis of Aruba

Strengths	Weaknesses
• Strong political and legal institutions highly influenced by the Dutch government, and high per capita GDP • Currency peg with the US dollar limits currency risk of the external debt and minimises the pass through effect of external price rise. • Aruba lies outside the hurricane belt and therefore is not subjected to the sort of extreme weather related shocks like most of the other tourism-dependent Caribbean economies.	• Narrow industrial base - heavily dependent on imports of industrial goods and consumables. • Undiversified economy that is reliant on tourism which leaves the sovereign susceptible 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.
Opportunities	**Threats**
• The lifting of sanctions on Venezuela could result in completion of upgrading work at the refinery and help boost exports, real output and employment. • Fiscal space created by lowering of the debt will help the government to cut taxes and increase spending on projects with high economic return.	• Additional austerity measures increase political risk as it could lead to social unrest. • Continued economic sanctions on Venezuela will stall medium-term growth in Aruba as the oil refinery remaining shuttered.

Ratings: S&P, BBB+/negative; and Fitch, BBB-/negative ***Default: Never***

Macroeconomic Outlook

Sanctions imposed by the United States of America (USA) on Venezuela and the state owned oil company Petroleos de Venezuela (PDVSA) are likely to put a damper on Aruba's growth outlook over the medium term. In our update on the sovereign in Q4:18 we advised that the growth outlook was positive, but precariously poised as expansion in output was heavily dependent on tourism and petroleum production. Both of these activities to an extent are intertwined with the political economy in Venezuela, in particular the oil outfit.

The administration of Donald Trump has imposed tough sanctions on Citgo, the PDVSA owned company that has a 15-year lease on the oil refinery in Aruba. Under the sanctions customers of Citgo that are based in the USA are not permitted to make payments to the corporate for petroleum products that were purchased. The administration has recognised Juan Guido, head of the Venezuelan Congress, as interim president and has left the door open for payments to be made to accounts set up by the interim government to support its efforts.

Given the situation with Venezuela, and by extension Citgo, the planned refurbishing project of the oil refinery has been pushed back without any set timeline for recommencement. Already Citgo has given notice to the government of Aruba to lay off some of the 300 workers and four contractors employed at the facility. With the fluidity of the political situation in Venezuela we are unsure when sanctions will be lifted by the USA. If payments for oil are made to Mr Guido's interim government, we do not foresee these resources being used to continue upgrade works at the refinery, at least not in the near term, as Venezuela is facing chronic shortages of foreign currency to buy basic goods and services. With no set timeline for the restart of the project we have revised the growth outlook for Aruba from 3.1% to 1.2% in 2019.

Government Finances

The government has not yet announced any changes to the fiscal programme relative to Q4:18. However, with further unplanned delays in the oil refinery we are expecting this to negatively affect revenues. Under the planned fiscal retrenchment programme brokered with the government of the Netherlands, the government of Aruba has programmed revenue growth of 5% per annum, with the majority of the flows coming from two sources – a crises levy and taxes from the refinery. The refinery restart delay will cut revenue growth by more than a half and shave off at least one percentage point from expansion in real output.

Given the state of the economy and narrow tax base, we are not expecting any overnight revenue measures and/or expenditure cuts that could prove disruptive. Therefore a modest rise in the fiscal deficit and debt is envisaged in FY 2019 at least. Assuming no action is taken by the government over the medium term to cauterize the deficit, debt to GDP will rise towards unsustainable levels. Under such a scenario the cost of servicing the debt would become more onerous and the sovereign could find itself spiralling in a vicious debt trap. It is reasonable therefore to assume that additional austerity measures will be adopted, perhaps later in the year, to help stabilize the fiscal situation, as the lack of action could push the sovereign over the fiscal cliff.

External Accounts

Aruba was expected to turn its small current account deficit (CAD) into a modest surplus commencing in FY 2020. This outlook has however changed due to the issues cited with the refinery. As a result the CAD, external reserves are expected to remain relatively unchanged over the forecast horizon. With external reserves estimated at US$1.0 billion (4.2 months of imports), marked erosion in the sovereign's external position could force downward pressure on reserves and put pressure on the peg. While we do not envisage any departure from the current exchange rate over the forecast horizon, this could change if conditions in the eternal economy were to become less benign than they are now. For example, a combination of a decline in tourism flows and higher external prices could cause serious challenges as the CAD would widen. Absent matching capital flows, currency adjustments would be required to preserve external reserves. Of course this has consequences for debt as more than half of it is denominated in foreign currency.

Rating Action

No ratings action has been taken against Aruba subsequent to our last report. The sovereign maintains its BBB+/negative and BBB-/negative ratings by Standard and Poor's (S&P) and Fitch, respectively. Given the outlook by both ratings agencies, should economic conditions remain unchanged over the next 18 months or so then it is highly likely that negative rating actions could be taken against the sovereign. A one notch credit downgrade by S&P would still see the sovereign keeping its investment grade status. On the other hand, a one notch credit downgrade by Fitch would push the ratings down to speculative/non-investment grade.

There are two possible scenarios that could play out over the next few months: 1) the government could take no action and allow the current economic status quo to run its course; or 2) the authority could institute further austerity measures to help curb the fiscal deficit, reign in the debt, and preserve the integrity of the external accounts in the process. Assuming that scenario one is pursued, absent strong real growth, the credit downgrade will definitely follow within the stated time frame.

Under the second scenario however, while no assurance can be provided regarding improvements in the fiscal accounts and growth over the medium-term, it will buy the authorities time and send a strong signal to the international investor public. A lot can happen over time, as increased activities in the tourism industry and more robust investment flows could help turn the economy around. We believe that the authority will pursue the second option to help stabilize the economy over the short- to medium-term, and in the process devise a strategy to help address long standing structural issues that inhibit economic growth.

Table 1: Some Key Statistical Indicators for Aruba

Indicator Name	2013	2014	2015	2016	2017	2018 (e)	2019 (f)	2020 (f)	2021 (f)	2022 (f)
Population	103,187	103,795	104,341	104,822	105,264	105,670	106,053	106,438	106,797	107,147
GDP per capita, USD	25,018	25,523	25,796	25,256	25,655	26,127	26,500	26,700	28,251	28,876
Real GDP, % y-o-y	4.2	0.8	-0.5	-0.2	1.3	0.7	1.2	1.0	1.1	1.1
Unemployment, % of labour force, ave	7.6	7.4	7.4	7.2	7.0	6.8	6.8	6.8	6.8	6.8
Inflation, % y-o-y, ave	-2.4	0.4	0.5	-0.9	-0.5	0.6	1.8	2.0	2.0	2.0
Central bank policy rate, % eop	1.00	1.00	1.00	2.00	3.00	3.00	3.00	3.50	3.50	3.50
AWG/USD, eop	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79	1.79
Total revenue, % of GDP	24.7	23.6	25.1	25.8	25.9	26.1	26.1	26.1	26.1	26.1
Total expenditure, % of GDP	31.1	31.4	28.7	28.9	28.7	28.8	28.2	27.9	27.8	27.7
Budget balance, % of GDP	-7.2	-7.9	-3.5	-3.1	-2.8	-2.7	-2.0	-2.0	-2.0	-2.0
Current account balance, % of GDP	-12.8	-5.2	4.1	3.7	0.9	-0.9	-0.7	-0.7	-0.7	-0.7
Capital account, % of GDP	0.1	-	-	-	-	-	-	-	-	-
Foreign reserves ex gold, USDbn	0.5	0.6	0.7	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Import cover, months	2.8	3.0	4.0	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Total government debt, % of GDP	74.0	81.9	82.5	86.2	87.0	88.3	88.2	88.1	88.1	88.1
Government domestic debt, % of GDP	38.6	42.2	39.5	41.4	41.8	42.4	42.0	41.9	41.8	41.6

Source: BMI/JMMBIR

(e) estimated and (f) forecast

Political Risk

The ruling, coalition having made some unfavourable fiscal adjustments in the second half of 2018, is now faced with the unenviable task of implementing further belt tightening measures in the face of lower than expected revenue intake. Absent these measures the debt will grow and the sovereign will be viewed as being less desirable by the investing public. Therefore the difficult decision is best made now as opposed to waiting later on in the political cycle where the fiscal situation could get even worse. Further fiscal adjustments will not sit well with the populace, but we do not anticipate any upheaval in the event that such decisions are made in order to afford the country a better chance of a brighter economic future. Overhauling the fiscal accounts will help the debt to steadily decline to more sustainable levels and in the process help to free-up fiscal space.

In our opinion the impact of the Venezuelan crises on Aruba's economy has now bottomed out. As noted in previous publications the sovereign is affected by Venezuela's dire economic situation in two ways - lower tourism numbers and the possibility of non-completion of the oil refinery within the designated time frame. Total tourists arrivals have levelled off following significant reductions in arrivals from Venezuela. Given the funding issues with the oil refinery the worst of the worst has materialized. The economy will deviate from the expected macroeconomic path that was envisaged, at least in the short run. Over the medium-term, increased downside risks resulting from further polarization of Venezuela in the wold economy would have subsided. While not a factor in our baseline scenario, improvements in Venezuela's political situation could bode well for Aruba. This however is assigned a very low probability.

Despite the challenges that Aruba is facing the sovereign's strong ties with the Netherlands and high per capita income are given due consideration in our risk weightings on the economy. In the recent past the Dutch government has interceded in the sovereign's fiscal affairs by forcing the government to agree terms and implement corrective measures to put the economy on a sustainable fiscal path. We believe that the Dutch government would provide assistance to Aruba if the sovereign were to face more severe economic challenges in the future than it already is facing.

Aruba Global 2023: Description and Relative Value

Aruba has two global bonds – Aruba 2023 and Aruba 2029. The global 2029 is a variable rate bond while the global 2023 is fixed rate bond. Both bonds make coupon payments semi-annually. The issue size of Aruba 2023 is US$253 million, it pays coupon of 4.625% and can be purchased in a minimum block of US$200,000 with increments of US$1,000 thereafter. The current yield to maturity on the instrument is 3.47%. The issue size on the Aruba 2029 is US$153 million and the instrument pays coupon of 3.55% over the 10-year US Treasury. The bond currently yield 6.39% and can be purchased in a minimum block of US$500,000 and increments of US$1,000 thereafter.

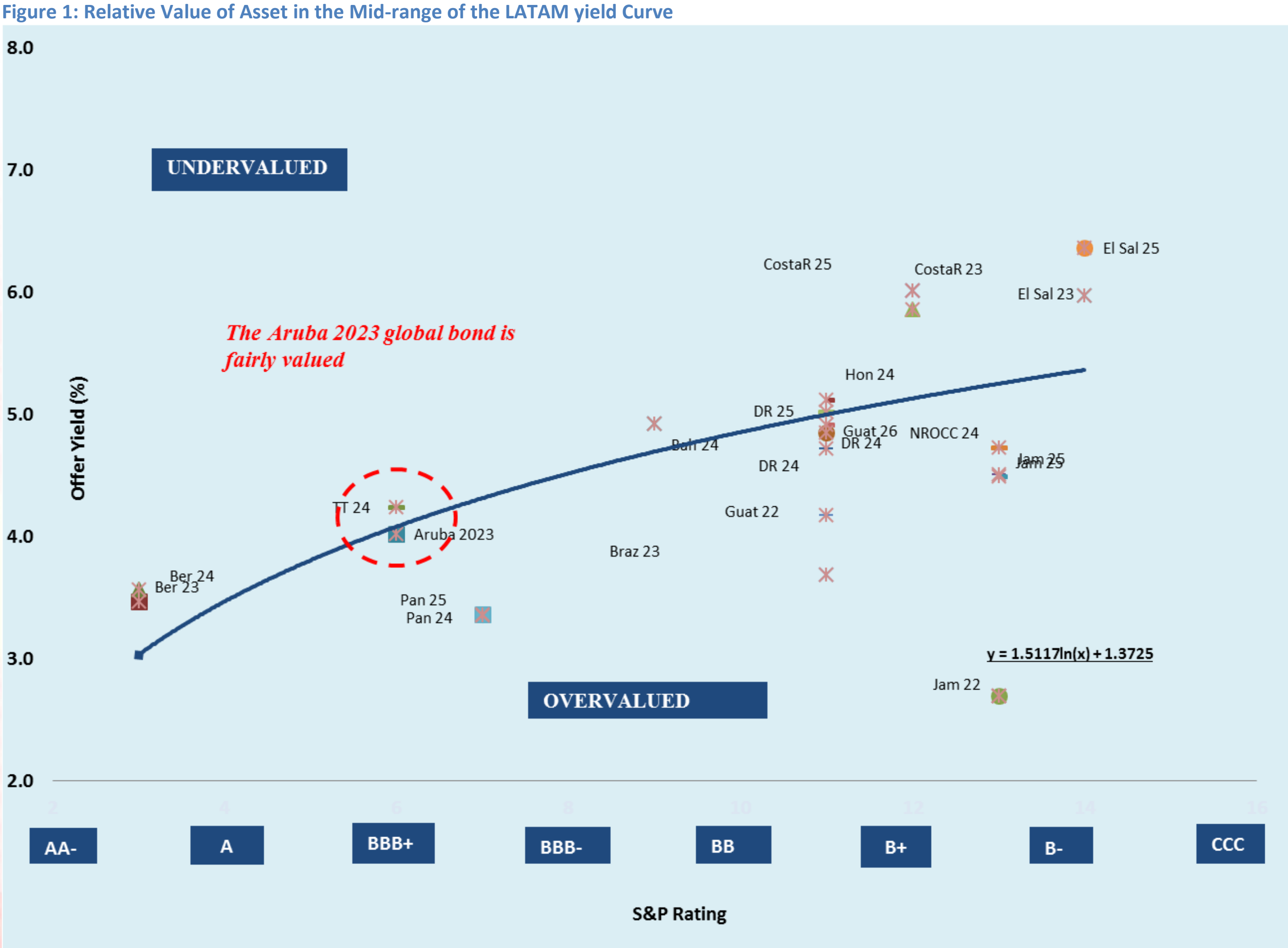
From a relative value perspective the Aruba 2023 is fairly priced when compared to Latin America and Caribbean (LAC) sovereign and quasi-sovereign bonds with relatively similar ratings and tenor. On the other hand, the Aruba 2029 appears to be undervalued. The bond is currently trading over 150 basis points higher than where it is expected to be trading given the credit risk.

Table 2: Summary of global bonds feature

Maturity date	Coupon	Yield	Principal outstanding	Payment Type	Increment ($'000)	M. Duration
2023	4.625%	3.470%	$253 mn	sinking fund	200/1	4.037
2029	6.220%	5.761%	$125 mn	bullet	500/1	7.247

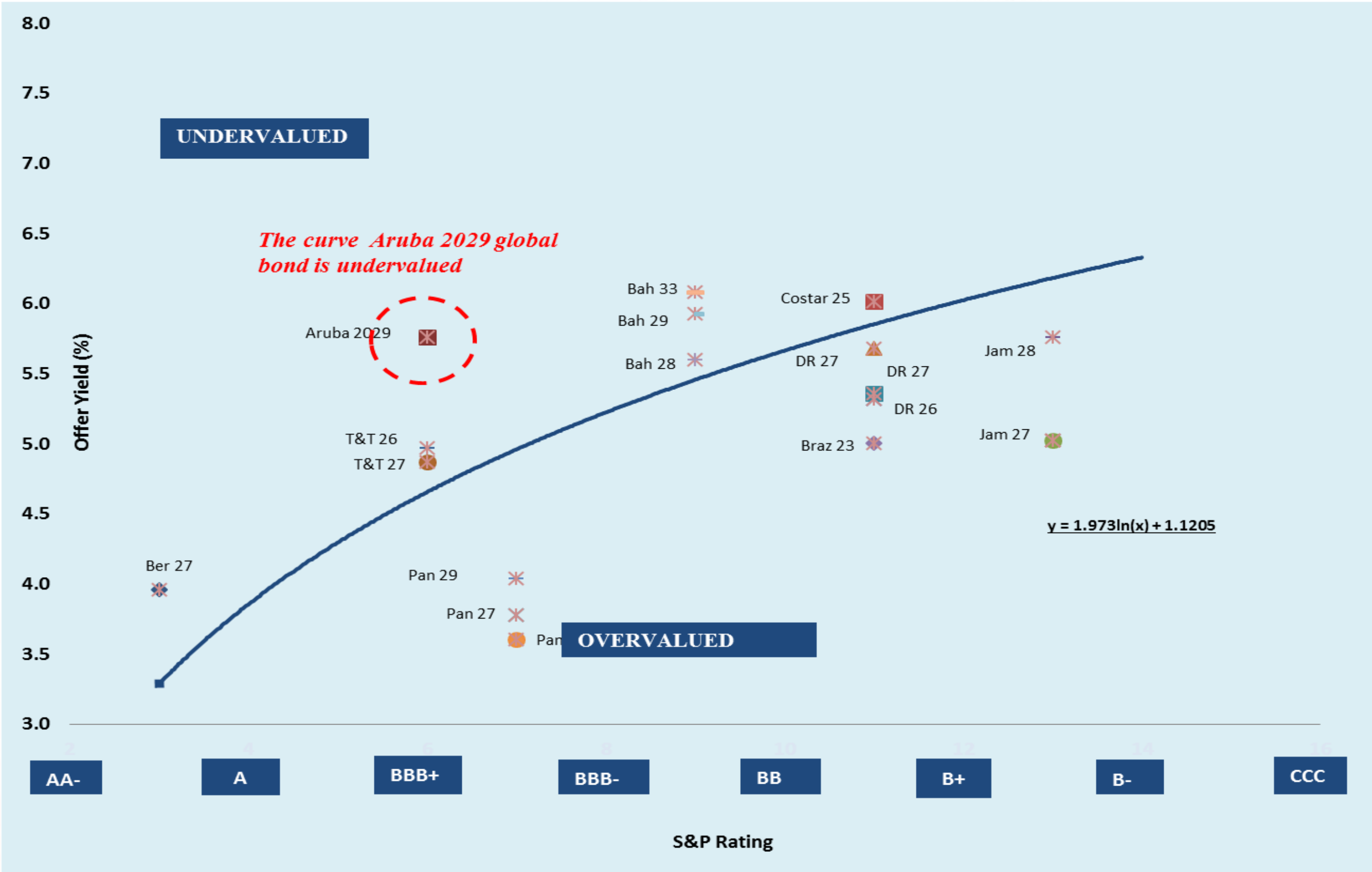
Source: Bloomberg

Figure 1: Relative Value of Asset in the Mid-range of the LATAM yield Curve



Source: Bloomberg, Jeffries and JMMBIR

Figure 2:



Source: Jefferies and JMMBIR

Analyst's Recommendation

As was noted in our previous publication, the growth outlook over the medium term was highly predicated on the reopening of the oil refinery in 2019. With this not materializing as was anticipated and no set time for a restart, we expect a wider fiscal deficit and slower real GDP growth in 2019 relative to our previous position. Absent any action by the fiscal authority over the medium term, debt to GDP will grow and debt servicing cost will become more burdensome. Corrective measures however are likely to be politically unpopular and could result in even slower economic growth, at least over the short- to medium-term. As such the near term fiscal risks are high given the sovereign's narrow economic base and austerity measures that have already been implemented.

Given Aruba's fiscal position and overall economic risk we are maintaining our recommendation on all the sovereign bonds as UNDERWEIGHT.

Source: Bloomberg, Business Monitor International (BMI), International Monetary Fund (IMF), Jefferies

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.

VERWEIGHT/BUY—EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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