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INVESTOR UPDATE

MAY, 2017

COSTA RICA "CONGRESS' INABILITY TO REACH CONSENSUS HURTING CREDIT QUALITY"

RECOMMENDATION: UNDERWEIGHT

This piece will attempt to provide a synopsis of the challenges as well as provide an update on any recent information that may be of interest to investors.

SYNOPSIS

The beginning of 2017 saw Costa Rica experience two one notch downgrades from two of the top three international rating agencies. One downgrade came from FITCH, from "BB+/negative" to "BB/Stable" and the other from Moody's, from "Ba1" to "Ba2" with the negative outlook maintained. Standard & Poor's (S&P) has not adjusted its rating or outlook on Costa Rica so far in 2017. Both FITCH and Moody's are actually playing catch up in our view as S&P downgraded Costa Rica to "BB-/negative" from as early as February 25, 2016.

Our last piece on Costa Rica was published on March 14, 2016 and in our opinion the fundamentals have continued to deteriorate because Congress has not been able to reach consensus on vital tax reform, which is needed to stem the deteriorating fiscal and debt situation. Taxes are needed to generate revenues. Increased revenues mean a reduction in the need to borrow; a reduction in the borrowing requirement should mean a narrower fiscal deficit and consequently a slower growth rate of the debt. Costa Rica has experienced relatively robust growth over the years, hence controlling the deficit allows economic growth to control the debt/GDP ratio and lead to its decline over time.

Proposals to increase taxes have been put forward for the better part of a year but no significant agreement has been reached.

The situation is made difficult by the fact that none of the six political parties represented in Congress hold more than 32% of the 57 seats. Further, based on the constitution, even individuals and some small groups like the anti-tax Movimiento Libertario party have the power to block voting on proposed reforms.

Since tax revenue growth has been weak because of the absence of new reforms, a greater portion of the government's revenues have to be targeted towards covering interest payments and other expenditures. That being the case, less money is available to improve public infrastructure and social spending. The situation is further exacerbated by the fact that Congress has not approved international debt issuances. This forces the government to seek financing from local sources, which puts upward pressures on local interest rates, further increasing the cost of financing and negatively affecting the fiscal deficit.

THE NEAR TO MEDIUM TERM OUTLOOK

Costa Rica has a dynamic economy that has continued to grow at a relatively robust pace over the last decade or more. Investors are attracted to the country because of its political stability, the relatively high level of education of its population and the incentives offered in its free trade zones. Traditional agricultural exports such as bananas, coffee, sugar and beef remain the backbone of the country's commodity export trade. However, the introduction of a variety of industrial and specialized agricultural products have diversified the export base. Microchips, medical equipment and plastic products are a part of the diversified thrust.

Over the last 10 years, Costa Rica's robust economic growth has led to a ***doubling of the sovereign's per capita GDP to US$11,667 in 2016 second only in Central America to Panama.***

This relatively strong economic base explains why growth has averaged in excess of 4.2% over the last seven years. ***However, when we look at the rest of the economic numbers and in particular the fiscal numbers, we see the challenges***. According to S&P estimates of the fiscal deficit, which includes central bank, state agencies and social security liabilities, Costa Rica has been sliding down a path of concern. Between 2010 and 2016, the sovereign's fiscal deficit has averaged 5.1% of GDP.

Most fiscal deficits tend to be financed by borrowing. Consequently as deficits are run consistently, barring the presence of commodity stabilization funds, the debt tends to climb. Costa Rica's debt/GDP ratio has deteriorated from a modest 30.7% in 2010 to a somewhat concerning 48.4% in 2016. Going forward, the base case assumption is for little activity in terms of tough fiscal decisions until mid-2018 after elections are decided and a new party in place. Consensus will then have to be reached, policies implemented and then allowed to bear fruit after about a year. Consequently, in a best case scenario, it is only at the end of 2019 going into 2020 that the fiscal deficit will really be arrested and the deterioration of the debt halted.

Over the last decade it is clear that confidence, as measured by the holding of domestic currency, in the Costa Rican economy has returned. If we look at the level of dollarization which speaks to the percentage of deposits held in hard currency/US dollars in the domestic banking system, we see that the ratio has declined over time. The foreign

currency share of bank deposits has declined from 73.3% in 2010 to 60.4% in 2016 and is forecasted to decline further to 57% by 2018. Note however, that while the number is headed in the right direction, it is still a source of vulnerability.

In summary, Costa Rica does have a twin deficit challenge; fiscal deficit plus current account deficit. However, this is masked by a dynamic economy producing relatively high and consistent growth. This is what prevents the debt ratios from deteriorating further. Nonetheless, the politics and the absence of consensus to allow for new tax policies to drive revenue, contract the consistently large fiscal deficits and reverse the direction of the debt/GDP ratio is a consistent theme throughout.

We are concerned because in a best case scenario, actual fiscal numbers potentially showing a reverse of the slide, don't roll in until the end of 2019 going into 2020. Recent data has also shown that good sovereigns can go bad, case in point Barbados. On the basis of this, we would prefer at this time to error on the side of caution. Consequently, we are changing our recommendation on Costa Rica **from MARKETWEIGHT to UNDERWEIGHT**.

CONCLUSION

Our recommendation is that investors reduce their exposure to less than 5% of their portfolio (UNDERWEIGHT).

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