

# Emerging market bonds

## Venezuela: Waiting game

Chief Investment Office Americas, Wealth Management | 25 January 2018 10:35 pm GMT  
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- Investors are being kept in the dark regarding Venezuelan bonds payments and restructuring plan, with no official communication in over a month. Even though the ruling party looks in control of domestic political and social dynamics at the moment, local economic conditions continue to worsen and oil production is nosediving. The political base case remains one in which Chavismo continues to radicalize and walk down the path of isolation, but a sudden, non-linear regime change remains a clear possibility.
- With dirty prices in the USD 25-27 range, Venezuelan sovereign bonds offer investors an affordable option-like exposure to regime change. In other words, the payoff structure looks asymmetric. The total return upside for select Venezuelan bonds in more benign scenarios exceeds the downside in the negative scenario. We believe investors with longer time horizon, willing and able to tolerate losses should maintain a moderate exposure to the country's bonds in the context of a broadly diversified portfolio. Investors with low risk tolerance and no appetite for an uncertain debt-restructuring process should refrain from holding or adding Venezuelan bonds.
- Tired of Venezuela and looking for alternatives? Although there are no other issuers under CIO coverage experiencing such deep distress as Venezuela, investors could explore positions in some troubled Latin American corporate names such as Odebrecht Oil & Gas. Sovereign and corporate high-yield bonds from countries we overweight in our emerging market credit model portfolio could also be of interest to investors.

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**For further reading:****Recent CIO coverage of Venezuela:**

- Venezuela: What have we learned since Maduro's big speech?, 21 November 2017
- Venezuela: Severe market reaction, not a good time to sell, 6 November
- Venezuela: Murkier outlook, better valuations, 25 October
- Venezuela: US administration turns up the heat, 29 August
- Venezuela: Buckle up, tensions set to reach new highs, 31 July
- Venezuela: Recent developments support regime change scenario, 12 June
- Venezuela: Adding exposure as political transition looks more likely, 8 May

**Investors in limbo**

The majority of Venezuela sovereign and quasi-sovereign bonds have seen their grace periods expire by now without investors receiving their money. There has been no official communication regarding bond interest payments since an 18 December coupon payment for the PDVSA 2027 bond. There has been no news regarding Maduro's plan to restructure or refinance external debt since a meeting between Venezuela's restructuring committee and a small number of bondholders took place in Caracas on 13 November. Investors are being kept in the dark. To the best of our knowledge, international investors haven't so far requested the acceleration of defaulted bonds nor initiated legal actions against the country in NY courts.

### Downward spiral on domestic macro and oil production dynamics continues

Venezuela has entered what we expect to be its fifth consecutive year of recession, now accompanied by inflationary forces well into the hyperinflation territory. The trends affecting the country's black market exchange rate make Bitcoin's price appreciation dynamics look like child's play (see Fig. 1). Importantly, the International Energy Agency reports that Venezuela's oil production stood at just 1.61 million barrels per day in December 2017, almost 500 thousand barrels per day less than a year prior (see Fig. 2). The nose-diving of Venezuela's oil output can likely be explained by the combination of US sanctions affecting the willingness of oil service companies to support Venezuelan operation, and the deep changes in PDVSA's management that took place in December on the back of a political purge within Chavismo. The increase in oil prices of recent months will not be enough to compensate the country's production decline, especially considering CIO's view that global energy prices are likely to trade downwards from current levels.

### Presidential elections in 1H18

Negotiations between Chavismo and the opposition were taking place in the Dominican Republic, mediated by the international community. These were disrupted by Maduro's commitment to move the date of the presidential elections forward to 1H18 in order to take advantage of his regime's current position of relative political strength. In fact, the Constituent Assembly this week set the voting date at 30 April the latest. Regardless of their timing, we would expect such elections to be held without a level playing field for the opposition. The political base case remains one in which the ruling party continues to radicalize and walk down the path of isolation. We would expect international pressure to remain high, as the recent adoption of sanctions on seven Venezuelan officials by the European Council illustrates.

### What should I do with Venezuelan bonds?

Even though the ruling party looks in control of domestic political and social dynamics at the moment, a sudden, non-linear change in these conditions remains a clear possibility. A look at the emerging market hyperinflation periods of the last 40 years reveals that in the large majority of cases these led to changes in political regimes. The hard-to-reverse oil production decline in Venezuela is making it increasingly difficult for the regime to keep its supporters appeased.

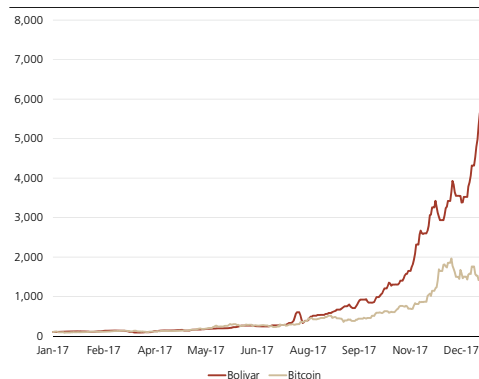
With dirty prices in the USD 25-27 range, Venezuelan sovereign bonds offer investors an affordable option-like exposure to regime change. In other words, the payoff structure looks quite asymmetric. The total return upside for select Venezuelan bonds in more benign scenarios exceeds the downside in the negative scenario, in our view. We believe investors with longer time horizon, willing and able to tolerate losses should maintain a moderate exposure to the country's bonds in the context of a broadly diversified portfolio. Investors with low risk tolerance and no appetite for an uncertain debt-restructuring process should refrain from holding or adding Venezuelan bonds.

### Tired of Venezuela and looking for alternatives?

Although there are no other issuers under CIO coverage experiencing such deep distress as Venezuela, investors looking for very

**Fig. 1: The depreciation of the Venezuelan Bolivar has outpaced Bitcoin gains**

USDVEF (black market) and XBTUSD exchange rates, 1 Jan 2017 = 100



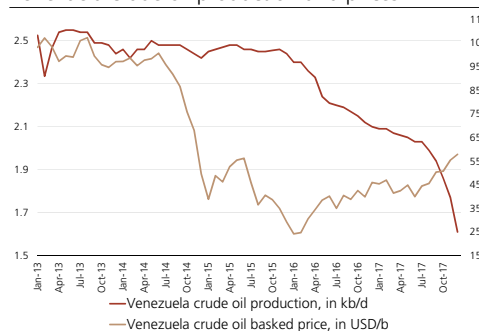
Source: dolartoday.com, Bloomberg, UBS, as of 24 January 2018

### On Venezuela's bond trading convention:

The convention for trading Venezuelan sovereign bonds changed starting 9 January. Trades now settle at a "dirty" price without payment of accrued interest. This move, which does not yet apply to quasi-sovereign bonds, has improved liquidity in the market at the margin.

**Fig. 2: Venezuela oil production nosediving**

Venezuela crude oil production and prices



Source: Bloomberg, IEA, UBS, as of 24 January 2018

high yield alternatives could explore positions in some troubled Latin American corporate names. In particular, our regional corporate credit analyst Donald McLauchlan believes Odebrecht Oil & Gas - which recently completed its debt restructuring - could be an interesting alternative to Venezuela risk. Please see our 16 January report, *Substandard LatAm credits: Looking a bit better*, for more information.

Sovereign and corporate high-yield bonds from countries we overweight in our emerging market credit model portfolio - Argentina, Brazil, South Africa, Turkey, Bahrain, Côte d'Ivoire, and Kenya - could also be of interest to investors, though these bonds trade at much higher prices than Venezuelan ones currently do.

## UBS CIO risk views

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### Credit risk flags

CIO attaches a credit risk flag to the instruments under its coverage. Credit risk is assessed based on the remaining tenor and / or instrument type. The flag indicates the likelihood that a holder of the instrument will not receive a coupon or principal payment when it comes due. For subordinated and hybrid instruments, which are usually callable and have a remote or no fixed maturity date, we apply one uniform credit risk flag per issuer and instrument type. The idea is to reflect the possibility of contractual trigger events or regulatory intervention occurring. Either can impose losses on bondholders regardless of the remaining term of the instrument or a specific issuer default event. Credit risk flags only indicate our view of the riskiness of a particular instrument. Credit risk flags should not be seen as recommendations to buy, hold or sell. In fact, any combination of risk flags and relative value recommendations is possible.

#### Very low credit risk



We believe that the probability of debt payments not being made when they come due is very low (cumulative probability of less than 2%).

#### Medium credit risk



We believe that the probability of debt payments not being made when they come due is low to medium (cumulative probability of non-payment between 2% and less than 20%).

#### High credit risk



We believe that the probability of debt payments not being made when they come due is at least one in five cumulatively.

### Issuer credit outlook

We complement the instrument-specific risk information of the credit risk flags by indicating our outlook for the credit quality of an issuer over the next 12 months. Depending on instrument pricing, all combinations of an issuer credit outlook and relative valuation recommendations are possible.

**Improving:** We expect the credit profile of the issuer to improve, to an extent that may result in upgrades by rating agencies.

**Stable:** We do not expect the credit profile of the issuer to change meaningfully.

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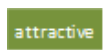
## UBS CIO valuation views

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### Relative value bond recommendations

Our relative value bond recommendations are based on an average investment horizon of six to 12 months. They reflect our assessment of a bond's attractiveness relative to comparable instruments under CIO coverage. Comparable instruments typically exhibit similar credit quality, are denominated in the same currency, belong to the same segment of the bond market, and have a similar remaining tenor until redemption.

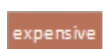
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Bonds seen as "attractive" are expected to generate a total return exceeding the average return of comparable instruments. Our recommendation can stem from a positive view on the issuer's credit profile not fully reflected in the price, unduly high risk premiums, our take on an instrument's call probability, the risk of coupon deferrals, and external factors including regulatory intervention.



Bonds seen as "fair" are expected to produce a total return broadly in line with the average return of comparable instruments.



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### Sell recommendations



A Sell recommendation is assigned when the risk of an adverse outcome for an instrument exceeds what is reflected in its current valuation. Such situations can include those in which the instrument appears likely to post negative total returns until redemption, either due to a highly negative yield to maturity or an imminent call at a price below market valuations.

## Appendix

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