Latin America overview: Venezuela a classic debt rescheduling candidate

Christian Gaier und Felix Dornaus

- **Analyst: Venezuela will not be able to benefit from its oil reserves for a while**
- **Chaotic, costly restructuring expected**
- **Peru, Columbia, and Chile with solid fundamentals**

Venezuela is in crisis: the economy is collapsing, and the GDP has halved (in USD) over the past five years. The volume of crude oil exports – the only important source of revenue for the country – has fallen drastically. And to make matters worse, said exports have recently been burdened by sanctions from the USA. In the past two years, more than two million people are reported (Source: IOM) to have fled to the neighbouring countries, given that there is no money for vital imports. The stand-off between Nicolás Maduro and his opponent, Juan Guaidó, and their respective supporters continues. A change in government driven by "the man on the street" seems possible.

What does the crisis mean for Venezuelan bonds?

The country has been a classic candidate for debt restructuring for quite some time. A change of regime would only expedite this. "The hope of many market participants for a change in government has driven the secondary market price of Venezuelan bonds up in recent weeks. However, the current development looks a bit like naïve optimism," says Felix Dornaus, Senior Fund Manager for emerging markets bonds with **Erste Asset Management (Erste AM).**

The South America expert has good reasons to substantiate this claim: since 1 February 2019, the US Department of Finance has banned United States persons from trading bonds from the governmental oil company PDVSA or from the Republic of Venezuela until further notice. This also comes with repercussions on transactions between non-US (i.e. in tax terms, foreign) persons. Liquidity has been on a massive decline due to the fear of the aforementioned non-US persons to become targets of the USA.

USD 10bn worth of loans secured by oil deliveries

"Although the country holds the world's biggest crude oil reserves, it will not be able to benefit from its reserves for a while," says Dornaus. The excessive debt is massive, and loans from China and Russia, estimated to amount to USD 10bn each, are already secured by oil deliveries. Half of the biggest asset abroad, i.e. the CITGO group in the USA, has already been collateralised as well. Meanwhile, significant mining rights within the country have been sold to Russian companies. "Due to the lack of resources, in the event of a restructuring, a massive haircut will likely become necessary, not the least for private creditors," as Dornaus continues.

Given the status quo, the expert feels that the current asset prices may reflect overly optimistic levels of revaluation. On top of that, it is difficult to ascertain who holds what claims ("reconciliation"). "We are heading for yet another problem of the hold-out variety, much like in the most recent debt restructuring of Argentina. This restructuring will be chaotic, lengthy, and expensive for the bond holders," concludes Dornaus.

Positive outlook for Peru, Columbia, and Chile

The combination of rising US interest rates, weakening economy, and the trade conflict between the USA and China was burdening the risk sentiment in 2018. This unique cocktail initiated a re-pricing of risk. "In an environment of higher volatility, we have seen widening spreads, weaker currencies, and increasing local yields, at least compared to previous years. But looking further back into history, this is a process of normalisation and looking forward, we expect volatility to remain at these levels," explains Christian Gaier, Head of Fixed Income Rates, Sovereigns & FX.

If we believe the International Monetary Fund (IMF), which predicts stable commodity prices for 2019, the path seems pretty laid out in front of other Latin American countries. The cyclical recovery in the Andes (Peru, Columbia, and parts of Chile) should continue. "Attractive yield levels in connection with a stable growth outlook, which is underpinned by a healthy combination of private consumption and investment, form the basis for attractive, long-term investment opportunities," complements Gaier.

As low-beta instruments, the bonds of these countries should also be less affected by fluctuations in global risk sentiment. As far as Argentina, Mexico, and Brazil are concerned though, a healthy dose of caution is advisable. "In addition to domestic politics in the respective countries, a higher beta constitutes a possible risk factor. This means that these countries are more susceptible to global risk fluctuations. Investors will have to focus on the local news flow and the local macroeconomic developments in order to be able to seize short- and medium-term investment opportunities," concludes Gaier.

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