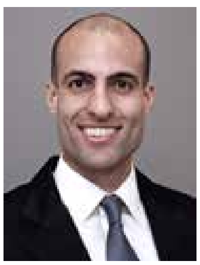
Venezuela's Debt Distress

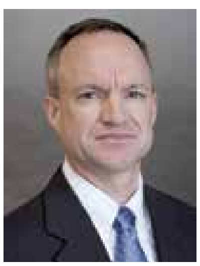
MFS® White Paper

Implications for investors in emerging markets debt

November 2017



Sean A. Cameron, CFA
Research Analyst, Fixed Income Strategic Solutions



Matthew W. Ryan, CFA
Fixed Income Portfolio Manager

Robert M. Hall
Institutional Fixed Income Portfolio Manager

In brief

- **Debt restructuring** — Venezuela recently announced its intention to restructure its $64 billion foreign debt, setting the country on a path to debt negotiations that will likely be complex and lengthy. We continue to believe that a full default remains a matter of time.
- **Contagion risk low** — We are not expecting any notable contagion effect — *i.e.*, idiosyncratic bad news in one country prompting more generalized investor flight from the asset class — following the recent announcement. First, Venezuela has been trading at distressed levels. Second, contagion risk in emerging markets debt (EMD) has fallen dramatically as the asset class has matured and the investor base has shifted toward more strategic holders.
- **Outsize index impact** — While Venezuela's weight in a key market-weighted benchmark index, the JPMorgan Emerging Markets Bond Index (EMBI) Global, has declined to under 2%, its impact on the index's spread has remained substantial, currently accounting for 72 basis points, or nearly a quarter of the total Index spread.[1]

The familiar reports of protesters and the famished have recently been supplanted by news concerning President Nicolás Maduro's announcement that Venezuela would need to restructure its foreign debt after making a $1.1 billion payment on bonds issued by Petróleos de Venezuela, S.A. (PDVSA), the state oil company.

The government has yet to formulate a clear strategy for the debt restructuring, though it has indicated a commitment to continuing to service the debt. A meeting on 13 November in Caracas that was to begin the negotiations yielded nothing of substance.

Given the lack of transparency in Venezuela's national accounts, it is not easy to gain a clear idea of what resources the country has at its disposal to pay the debt. Venezuelan authorities have in recent years employed a range of strategies to obtain funds, including monetization of receivables, sales of gold reserves and loans from China and Russia.

At present, it appears that the country's liquid reserves are less than $2 billion, with total reserves, including gold, tallying $10 billion. Dwindling hard currency reserves have been the result of collapsing oil export revenues, the country's primary revenue generator, in the face of persistent current account deficits, debt service payments and the absence of new investment (apart from China and Russia).

A debt deal with creditors is complicated by US financial sanctions imposed this summer along with the fact that Maduro named Vice-President Tareck El Aissami, an alleged narcotics trafficker, as the lead negotiator with bond holders, which means that US investment groups — the largest holders of Venezuelan debt — cannot enter talks with him. A long complicated debt restructuring looks increasingly likely as long as the Maduro regime remains in power.

Venezuelan bonds have sold off in response to the news, with prices moving deeper into distressed territory. To illustrate the level of distress, the spread above Treasury yields on Venezuelan domiciled bonds in the EMBI Global was just shy of 3,000 basis points at market close on 2 November and had increased to over 4,000 basis points by the close of business on 14 November — the equivalent of Venezuelan-domiciled debt in the index being worth only 28 cents for every dollar of notional bond exposure in aggregate.

Implications for emerging market debt

In this paper, we focus on the likely impact of the Venezuelan debt restructuring on investors in the EMD asset class.

Contagion effect

We are not expecting any significant contagion effect from Venezuela's distress. Moreover, Venezuela's debt servicing problems are not unexpected and are tied to its precarious political situation, which has imperiled the economy.

As the EMD asset class has matured and the investor base has shifted toward more strategic holders, contagion risk has fallen dramatically. In recent years, responding to events in countries like Brazil, South Africa and Ukraine, investors have demonstrated the ability to distinguish among credits, demanding a premium from those with significant credit issues, while maintaining confidence in others with a better risk profile.

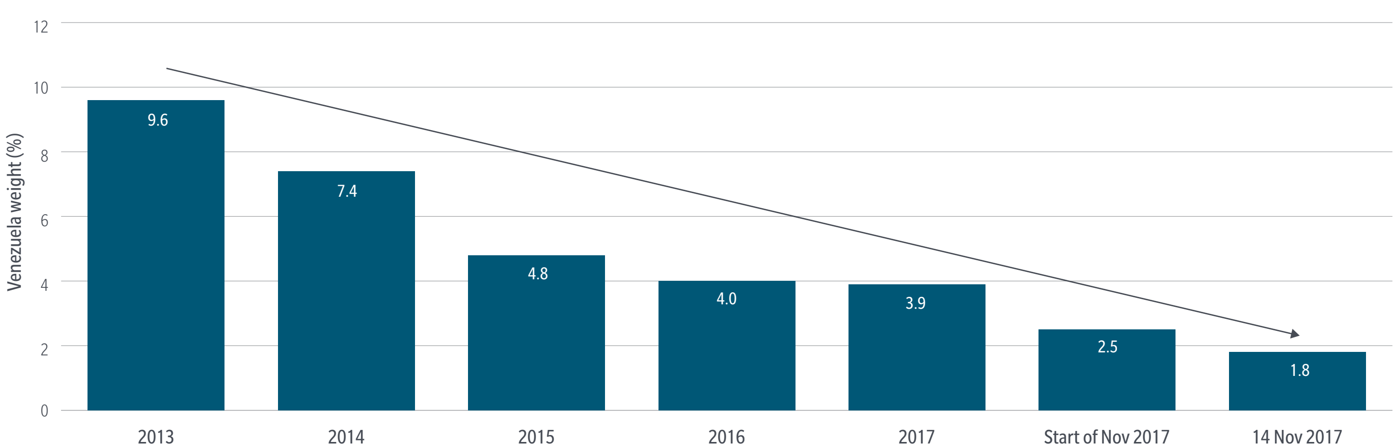
Venezuela's index weight

A key consideration for investors in EMD is Venezuela's weight in the key benchmark index, EMBI Global. Exhibit 1 shows that Venezuela's weight in the EMBI Global has declined from almost 10% to 1.8% over the past five years. The dollar value of the debt has declined as it has moved further into distressed territory. Five years ago, it was trading at par and is now at about 28 cents on the dollar.

Exhibit 2 details the bond spreads for Venezuela's debt, including sovereign and PDVSA-issued debt, the EMBI Global as a whole, and the index excluding Venezuelan-domiciled debt, as well as Venezuela's impact on the index spread. The gap reveals a difference of 72 basis points, showing the amount Venezuela currently adds to the index spread.

So, despite having only a 1.8% weight in the EMBI Global, Venezuela accounts for 72 basis points of the index spread, or nearly a quarter of the aggregate spread. This gap represents an uncommonly large proportion for a single country or issuer with the difference between the weight in the index and the contribution to spread notably large. By comparison, the spread on the US High Yield Index was 368 basis points and the US High Yield Index excluding the energy sector — a sector that has been relatively out of favor with investors — was 357 basis points, both on 14 November 2017, a difference of only 11 basis points. This order-of-magnitude difference in sectors or issuers is much more the norm than the one exhibited with Venezuela and the EMBI Global.

Exhibit 1: Venezuela's weight in the JPMorgan EMBI Global



Sources: Barclays POINT analytics and JP Morgan Index data, as of 14 November 2017.

The bars at the bottom of Exhibit 2 show the impact Venezuela has had on the EMBI Global spread over time — typically ranging from 60 to 100 basis points. While the country's weight in the index has fallen over time, Venezuela's spread has ballooned, and, consequently, the aggregate impact on the index has remained in the same range over the time period.

Venezuelan debt can remain in the index even post-default, provided the debt continues to trade with sufficient liquidity. We expect these conditions to be satisfied, as there will continue to be a secondary market in Venezuelan debt. However, it appears that a significant source of coupon income for EMD investors could well be interrupted — or at least remain unpredictable — for what could prove to be a long time to come.

In addition, Venezuelan exposure has been a key differentiator for active managers' relative performance in recent years — and will likely remain so as the market oscillates between hope and despair for eventual bond recovery values. While we believe bond prices ultimately follow fundamental factors, they can trade up or down, sometimes over extended periods of time, based on other considerations, including investor sentiment and technicals. Such is the case for Venezuelan debt.

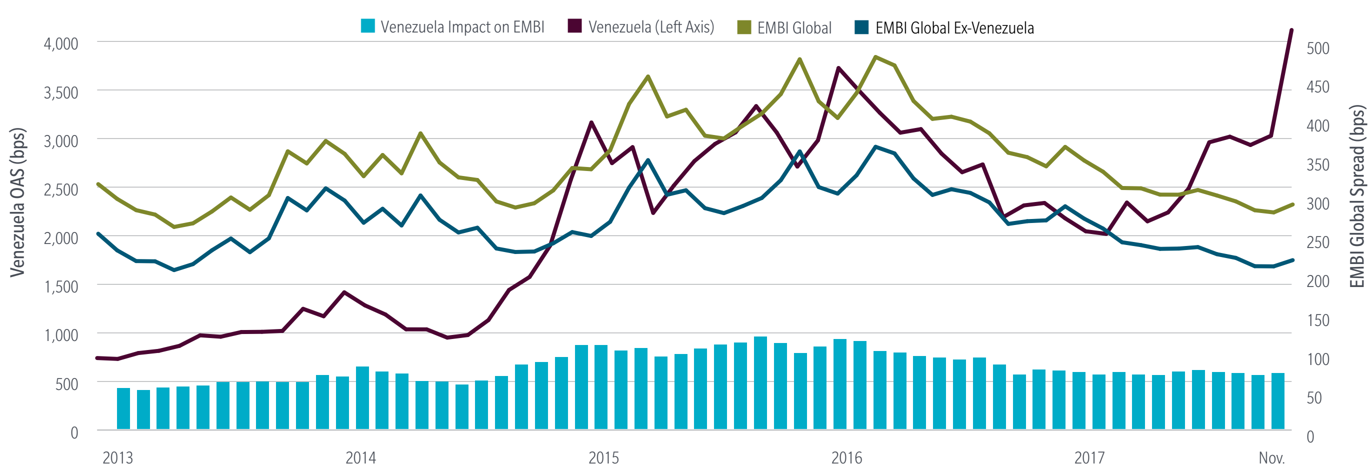
In 2016, for example, investors who chose to ignore fundamentals and took overweight positions in Venezuelan debt reaped a shorter-term reward, as the Venezuelan sub-index of the EMBI Global gained 53% for the year, contributing 212 bps to the aggregate index return of 10.2% for the year. This year, however, the same sub-index is down -25%, benefiting managers who have positioned themselves more cautiously. Passive strategies without the ability to overweight or underweight the credit have, of course, been subject to all the vagaries of these performance gyrations.

Moreover, the Venezuela sub-index of the EMBI Global has exhibited more than four times the total return volatility of the overall index,[2] suggesting that, notwithstanding tighter spreads on the EMBI Global stripping out the impact of Venezuela on overall index spreads, we think bond holders can still benefit from a return-per-unit of volatility stream that can be improved by favoring exposure to credits outside those of the most speculative, such as Venezuelan-domiciled assets.

Conclusion

Despite possessing the world's largest proven oil reserves, Venezuela is now in the unenviable position of needing to restructure its $64 billion face value in foreign debt. While Venezuela's debt woes will likely have limited spillover effects for the asset class more broadly, investors who have been overexposed to Venezuelan debt may experience further pain, though to some extent the additional downside will be mitigated by pricing which already reflects a default with a relatively low subsequent recovery. That said, the analysis presented shows that Venezuela accounts for an unusually high proportion of the EMBI Global spread and investors should be aware of this as they assess the emerging market debt landscape with an eye toward prudent country and security selection within the asset class.

Exhibit 2: Venezuela, JPMorgan EMBI Global and JPMorgan EMBI Global Ex-Venezuela Spreads



Sources: Barclays POINT analytics and JP Morgan Index data, as of 14 November 2017.

Endnotes

[1] Source: Bloomberg, Barclays POINT Analytics referencing JP Morgan Emerging Market Bond Index holdings as of 14 November 2017. Information has been obtained from sources believed to be reliable but J.P. Morgan does not warrant its completeness or accuracy. The Index is used with permission. The Index may not be copied, used, or distributed without J.P. Morgan's prior written approval. Copyright 2017, J.P. Morgan Chase & Co. All rights reserved.

[2] November 2012 through October 2017 using monthly return data per JP Morgan Markets referencing the EMBI Global and EMBI Global Venezuela sub-index returns.

Index definitions

JPMorgan Emerging Markets Bond Index (EMBI) Global tracks debt instruments in the emerging markets (includes a broader array of countries than the EMBI Plus).

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