Emerging market bonds

Venezuela default fears intensify as oil prices drop

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- With oil prices having dropped nearly 20% since June, the risk that the liquidity-strained sovereign will not be able to meet an upcoming debt obligation of stated-owned oil producer PDVSA on 28 October has significantly increased in recent weeks.
- We believe the country still has enough cash to meet near-term obligations. However, credit fundamentals are deteriorating rapidly and President Maduro's leeway to implement reforms is shrinking. Without these reforms or a significant increase in oil prices, the country is at risk of running into a liquidity squeeze in 3–12 months, in our view.
- Although bond prices have corrected meaningfully, their downside potential is still considerable. This said, the bonds could receive temporary support should oil prices stabilize and the upcoming redemption payment be met.
- Thus, investors who can tolerate high risks and expect oil prices to recover somewhat might wait a little longer before selling exposure. All other investors are advised to start reducing exposure given the exceptional high risk of a credit event in the quarters ahead.

Oil exports are essentially Venezuela's only source of US dollar supply, accounting for 95% of export revenues. With oil prices tumbling to their lowest levels in years, the country is likely to suffer even further despite being already confronted with soaring inflation, chronic shortages of basic goods, medicines and foreign cash, rising crime and social tensions, and a severe recession.

Venezuela managed to pay back USD 1.5bn of debt that matured on 8 October, but fears have increased recently that it will not be able to meet its obligation to redeem the USD 3bn bonds of state-owned oil producer Petroleos de Venezuela (PDVSA) on 28 October. Spreads of Venezuelan sovereign and quasi-sovereign bonds have approached levels last seen during the financial crisis in 2009, and current credit default swap (CDS) contracts imply a nearly 50% probability of a default over the next two years.

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Many observers claim that the country is already in default, citing evidence that it has run out of dollars derived from different sources. Payment arrears are estimated at USD 21bn and include obligation to several international airlines that have already withdrawn flights to Caracas. The sovereign's rating downgrade to CCC+ by Standard and Poor's on 16 September, which already represents an exceptionally high level of risk according to the agency's definition, came before the latest plunge in oil prices, implying that the risk of a default has increased even more since then.

Oil prices the single most important factor to watch
Prices of the Venezuelan crude oil basket have dropped nearly 20% since their high in June and are now at USD 83/bbl. We believe the market has overreacted to global growth fears, not least because we expect US economic growth to remain solid and oil prices to recover over the coming months. Positive demand surprises and a potential moderation in excess supply from non-OPEC producers in 2015 will allow WTI crude oil prices – which typically trade close to the prices of the Venezuelan crude-oil basket – to recover toward USD 95/bbl next year. We also expect OPEC countries to exercise supply discipline at their upcoming meeting in November. And as supply growth in the US potentially slows next year, OPEC will be better placed to boost prices. This said, we cannot exclude further setbacks that could put further pressure on Venezuelan bond prices in the days and weeks ahead. For more details, please also see our recent publication *Crude oil: overreacting oil markets, 15 October 2014.*

Short-term relief possible, but risk of default has increased
We continue to think Venezuela will meet its obligation on the upcoming redemption of PDVSA's USD 3bn bonds, potentially supporting bond prices. Venezuela has shown a commitment to service its debt in the past, even during dire economic periods, and we think the country still has enough foreign cash to pay back this bond. In addition, PDVSA is seeking buyers for its US branch, Citgo. A deal could bring in proceeds of up to USD 10bn, which would be a welcome relief given the country's lack of US dollar liquidity and the upcoming bond redemption. However, such a deal is uncertain.

Maduro has reform measures at hand…
President Nicolas Maduro's administration still has several options available to adjust domestic policies and potentially ease pressure on Venezuelan bonds, including cuts in gasoline-price subsidies, further currency devaluation, and lower oil exports at preferential prices to neighboring countries. Any of these measures would lead to a tightening of Venezuelan bond spreads, in our view.

… but seems increasingly incapable of implementing changes
However, Maduro's popularity could be damaged by a combination of factors: increasing government intervention and controls on one hand, and rising scarcities, deepening economic contraction, and runaway inflation on the other. The administration's measures and decisions are likely to become less predictable, which suggests greater political and social uncertainty. Thus, we think time for much-needed reform is running out while Maduro seems increasingly incapable of implementing changes. The campaign for the 2015 legislative elections, set to begin in early 2015, will further limit prospects for reform.

Conclusions and recommendations
Venezuela continues to move rapidly toward the point of no return, as political and social pressure continues to increase due to rising scarcities, a deepening economic contraction, growing civil unrest, crime, and runaway inflation. This limits President Maduro's room to implement much needed

reforms significantly, in our view. Moreover, the recent drop in oil prices has put further strain on the country's ability to service its debt and meet domestic obligations, and has increased the probability of a default in the months ahead.

While the market is probably overestimating the risk of a near-term default, investors should be aware that holding Venezuelan bonds has become exceptionally risky. Moreover, although bond prices have corrected meaningfully already, the downside potential is still considerable. This said, the bonds could receive temporary support should oil prices stabilize and the upcoming redemption payment on 28 October to be met.

Thus, investors who can tolerate high risks and expect oil prices to recover somewhat might wait a little longer before selling exposure. All other investors are advised to start reducing exposure even at current levels given the exceptional high risk of a credit event in the quarters ahead.

Appendix

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