KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report
April 2017

Venezuela and PDVSA bonds recouped most of their losses stemming from March's selloff and settle in April with double-digit returns in most parts of both curves. The negative trend reversed in the first week of the month, as fears among investors dissipated after PDVSA confirmed it would pay their April 12th maturity on time. Following the initial jump in bond prices, supported by a rally in WTI crude oil (which nonetheless broke down during mid-April and finished the month with a negative return), investment flows into the credit were sustained all the way through months'-end, especially in long-term Venezuela debt and low-dollar value PDVSA bonds (*See Chart N° 1 attached*).

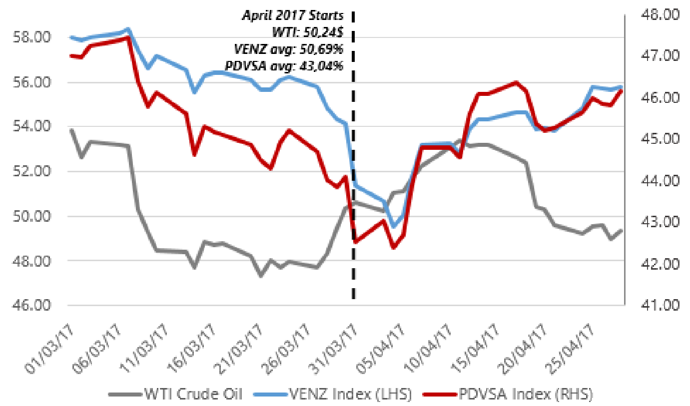


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Mar-Apr 2017). *Source: Bloomberg BGN, own calculations.*

Despite the weakness in oil prices, the dynamics of capital flows remained supportive for Venezuelan credit. April's debt service of around USD 2.9Bn among principal (P17o) and interest (VENZ 19/24/26 and PDVSA 17/20/27/37) was distributed to investors when the bonds were trading at the lowest levels in the month, which according to our view, stimulated a significant reinvestment flow into the curve. The impossibility of the Republic and PDVSA of placing new primary issues in the open market, given the distressed-level yields demanded, means that in practice each maturity reduces the supply of bonds in circulation, supporting the prices of the debt currently outstanding.

The global backdrop remains in a risk-on tone. The political uncertainty in the Eurozone dissipated after the defeat of extremist candidates in France's first-round parliamentary elections, which translated into renewed buying interest in risking assets globally, especially High Yield credit. Furthermore, Emerging Market debt funds reported an USD 8.38 Bn net inflow in April and a cumulative USD 26.88 Bn net inflow for 2017, according to EPFR Global data. Cumulative capital flows suggest that EM bond investments sit at their highest levels over the past four years (*See Chart N° 2*).

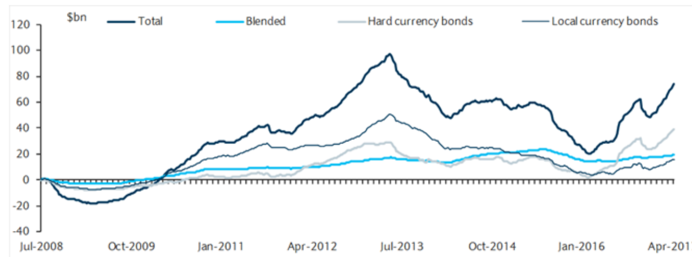


Chart N°2: Cumulative net flows into Emerging Market (EM) bond Funds, Since July 2008
Source: EPFR Global, Barclays Research

Monthly Performance

Security	31/03/2017	28/04/2017	Total Return	Total Return (2017 YTD)
VENZ 13 5/8 08/15/18	84.60	**85.50**	+2.25%	+7.71%
VENZ 7 12/01/18	69.80	**71.10**	+2.59%	+13.81%
VENZ 7 3/4 10/13/19	56.75	**60.85**	+7.73%	+13.60%
VENZ 6 12/09/20	49.95	**52.20**	+5.24%	+12.42%
VENZ 12 3/4 08/23/22	59.05	**62.30**	+7.01%	+6.54%
VENZ 9 05/07/23	46.80	**50.30**	+8.36%	+10.61%
VENZ 8 1/4 10/13/24	43.75	**47.95**	+10.14%	+8.64%
VENZ 7.65 04/21/25	42.50	**46.85**	+10.76%	+8.65%
VENZ 11 3/4 10/21/26	53.40	**58.60**	+10.36%	+9.91%
VENZ 9 1/4 09/15/27	46.70	**53.65**	+16.20%	+8.97%
VENZ 9 1/4 05/07/28	43.75	**48.20**	+10.89%	+7.74%
VENZ 11.95 08/05/31	53.05	**58.00**	+10.68%	+8.79%
VENZ 9 3/8 01/13/34	43.90	**49.00**	+12.60%	+8.41%
VENZ 7 03/31/38	40.60	**45.30**	+12.97%	+8.87%
PDVSA 8 1/2 11/02/17	84.20	**90.70**	+8.14%	+16.75%
PDVSA 8 1/2 10/27/20	74.30	**78.50**	+6.22%	+9.88%
PDVSA 9 11/17/21	48.50	**53.00**	+10.02%	+5.14%
PDVSA 12 3/4 02/17/22	56.95	**62.35**	+10.86%	+7.07%
PDVSA 6 05/16/24	36.85	**39.70**	+8.43%	+6.11%
PDVSA 6 11/15/26	35.15	**38.45**	+10.06%	+5.00%
PDVSA 5 3/8 04/12/27	34.50	**38.35**	+11.50%	+5.28%
PDVSA 9 3/4 05/17/35	43.70	**48.00**	+10.69%	+4.86%
PDVSA 5 1/2 04/12/37	34.00	**38.10**	+12.35%	+6.10%

Table N° 1: Performance of Venezuela and PDVSA bonds, April 2017

Venezuela and PDVSA bonds appreciated by +8.1% on average during April, delivering an average total return of +9.4% including interest. VENZ 2027, April's best-performing security with a +16.2% total return, reflects the nature of the buying interest seen in the market throughout the month. Investors chose to position themselves in long-term, low-priced debt in detriment of short-end and 'belly' bonds, such as the worst performers VENZ 13.625% 2018 'olds' and VENZ 7% 2018 'news', which returned +2.3% and +2.6% respectively.

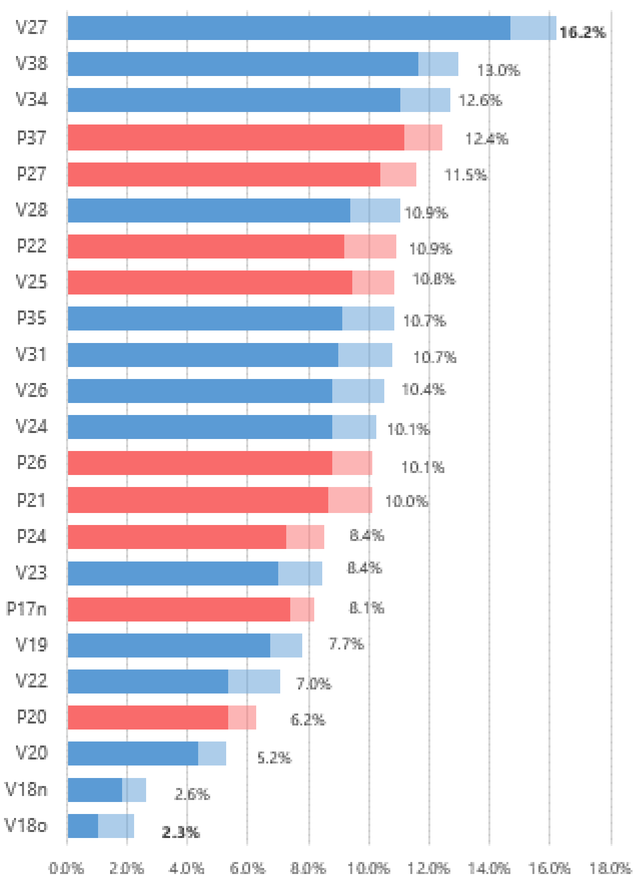
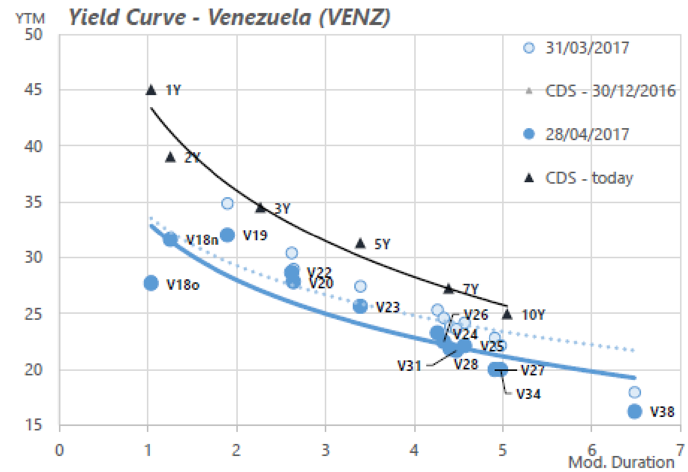


Chart N°3: VENZ/PDVSA bonds by Total Return, April 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Charts N°4 and N°5 attached show the evolution of Venezuela and PDVSA's yield curves on April 2017, for both cash bonds and CDS. The Sovereign curve moved downwards by -180bps on average, with the biggest compression seen on VENZ 2027s (-285bps).



Graph N°4: Venezuela Yield curve changes, April 2017.
Source: Bloomberg CBBT.

After the maturity of the PDVSA 5.25% 2017 'old', the yield curve of the state oil company compressed significantly, with yields coming down by -340bps on average. The PDVSA 8.5% 2017 'new', the biggest beneficiary of April's reinvestment flows according to our view, led the yield compression (-1200bps) and is now trading inside the 'fair value' interpolated curve. This suggests that investors are reducing their credit risk assessment regarding the maturities due in Q42017.

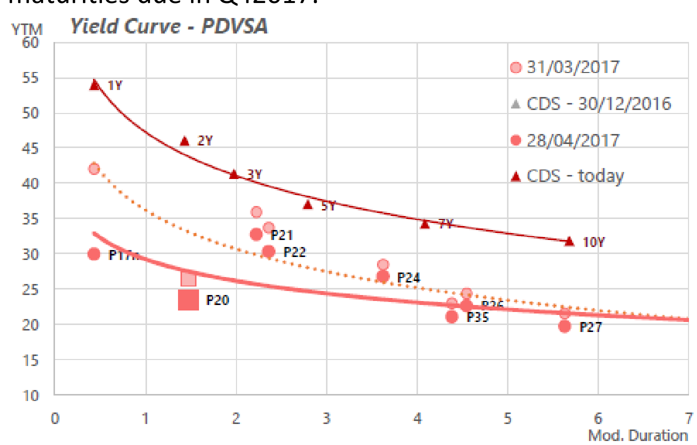


Chart N°5: PDVSA Yield Curve changes, April 2017.
***Source: Bloomberg* CBBT.**

Regime-change bets?

After a month of protests against the government of Nicolás Maduro, the pressure shows no sign of cooling down. The opposition-led agenda of street protests represents the biggest display of civil disobedience against the government since 2014 and far from easing, the pressure is becoming stronger over time. Protests can be tracked down to the sentences #155 and #166 of the Supreme Court of Justice dated March 28th 2017, which had the implicit objective of enabling the Executive to sign contracts of national interest without the review nor approval of the National Assembly; all of this with the final goal of securing alternative sources of external financing. Nonetheless, there have been no new credit agreements signed to date (or at least none has been made public), which suggests that the government's strategy – assuming an invaluable political cost – backfired. As an aggravating factor, the opposition has continued its international campaign against prospective financiers of the Maduro administration. In this context, we highlight a strongly-worded letter from Natl Assembly Chairman Julio Borges addressed to John Cryan, CEO of Deutsche Bank. Borges mentioned a gold 'swap' deal the European bank was allegedly negotiating with the Venezuelan Central Bank and reiterated the illegality (and consequently, a promise of certain repudiation in the future) of this and any other credit operation not explicitly approved by Parliament. The closing paragraph of the letter clearly shows the opposition´s stance:

*"I see myself in the obligation to warn you that by supporting said gold swap you would be incurring in actions in favor of a government recognized as dictatorial by the international community **[…] This would set a negative precedent for investment banks that support dictatorial governments** in their eagerness to stay in power"*

Hopes for an imminent change in government drove market action during April. The observed patterns of outperformance in the long end of both curves and the decoupling between bond and crude oil prices were explained by analysts as a direct consequence of the current climate of unprecedented political instability. According to this view, foreign investors are buying Venezuela and PDVSA bonds because the probability of a regime change in the short term has increased substantially, as the result of the breach of the constitutional order that's perceived as unsustainable (both politically and financially), and the possibility of a new pro-market administration coming to power, capable of engineering a 'friendly' restructuring plan in tandem with a macroeconomic stabilization program.

The excessive optimism embedded in bond prices is, in our view, a *déjà vu* of the Parliamentary elections of late 2015. In that occasion the market rallied sharply in anticipation of an opposition victory and after the results, the market suddenly reversed following the realization that the *de facto* power structure was left intact, and the weakness in the oil market returned to the spotlight. It appears that the history could repeat itself this time; the growing disconnect between bond and oil prices increases the risk of a market meltdown in the following months, under the assumption of no immediate change in the government and a sustained downward trend in crude prices.

On the other hand, there are reasons to believe that the outcome might be different this time around. Far from losing momentum, the opposition protests have gathered increasingly bigger crowds and have incorporated a much broader political base than on previous occasions, reflecting the generalized discontent among society that has pushed down the approval rate of President Maduro to under 20%, according to local pollsters. The international community has stepped up the tone in their denouncements against the government, while the base of allied countries in the OAS and the UN is thinning out. Lastly, the government's reaction of further escalating the political crisis, crystallized in the announcement of an Executive-led National Constituent Assembly that seeks to rewrite the constitution and bypass free elections, represents an extremely risky political play with the potential of an irreversible destabilization of the equilibrium among the government's main power groups. The public denunciations of General Prosecutor Luisa Ortega Diaz against the Supreme Court's decisions and the strongly-handed repression of protesters by law enforcement agencies are a clear example of Chavismo's internal impasse and lend support to investors' hopes that the end of the status quo is near.

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