KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA GROUP

Venezuela/PDVSA Monthly Report
December 2016

Venezuela and PDVSA bonds experienced sustained gains during the month, to finish with the best performance among the Emerging Markets sector in the year, as well as the best yearly performance for the credit since 2009. The positive end to the year was brought by OPEC's decision to cut the cartel's output by 1.2 mm b/d in their meeting in Vienna the past November 30th (*See Chart N°1*). Unexpectedly, the decision was supported by all member countries, as well as by non-member countries such as Russia.

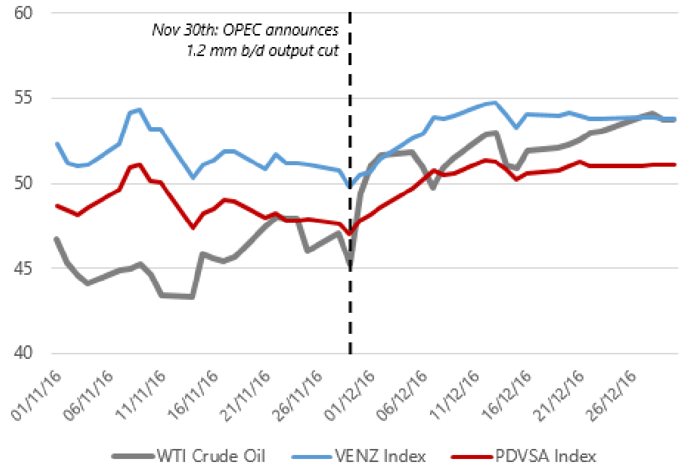


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Nov-Dec 2016). ***Source: Bloomberg BGN, own calculations.***

The rally in oil prices prevented a negative performance in the credit, as the month was characterized by unsettling news in the domestic front. The Bolivar suddenly plunged by up to -75% in the black market; soon after, the government announced a forced recall of the VEF 100 bill (initially within a 3-day deadline, which was later extended through January 20th 2017). This led to a severe drought of cash in circulation and brought a wave of social unrest and lootings in the countryside. Furthermore, news agencies reported that the Republic issued a new bond on December 29th (VENZ 6 ½ 12/29/36, for USD 5Bn) through a private placement with Banco de Venezuela and the Central Bank, without further information regarding the denomination and/or uses of proceeds.

Debt service during the month was limited to the coupon payments for VENZ 7% 2018 and VENZ 2038 (totaling USD 80mm). As a result, the Republic closed the year 2016 with a Reserves balance of USD 10.97Bn, around the multi-year-low where they have been since the October and November debt payments.

Globally, we highlight that Emerging Market bonds have started to recover after the losses sustained in November; the EMBI Global index advanced +2% in the month. However, capital outflows persisted, with an average -1.5Bn outflow per week during December (*See Chart N°2*).

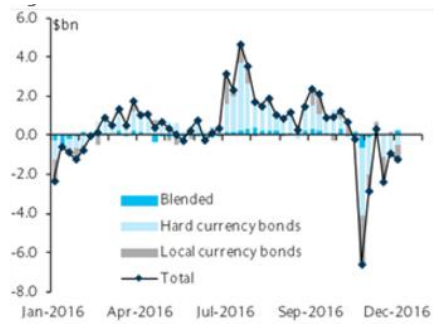


Chart N°2: Emerging Market Bond Fund flows, in Bn USD (last 12 months). ***Source: EPFR Global, Barclays Research***

Performance – December, year 2016

Security	30/11/2016	30/12/2016	Return (Dec-2016)	Total Return (year 2016)
VENZ 13 5/8 08/15/18	82.50	**83.30**	+2.18%	+52.60%
VENZ 7 12/01/18	60.20	**64.45**	+8.02%	+55.53%
VENZ 7 3/4 10/13/19	50.30	**55.65**	+11.58%	+53.10%
VENZ 6 12/09/20	44.85	**48.15**	+7.95%	+41.94%
VENZ 12 3/4 08/23/22	57.90	**62.25**	+8.81%	+58.71%
VENZ 9 05/07/23	44.80	**48.05**	+8.87%	+41.79%
VENZ 8 1/4 10/13/24	43.25	**46.55**	+8.89%	+39.91%
VENZ 7.65 04/21/25	42.45	**45.35**	+8.16%	+38.09%
VENZ 11 3/4 10/21/26	53.75	**56.70**	+7.07%	+49.46%
VENZ 9 1/4 09/15/27	49.30	**51.85**	+6.42%	+43.52%
VENZ 9 1/4 05/07/28	44.00	**47.50**	+9.56%	+41.10%
VENZ 11.95 08/05/31	53.65	**56.60**	+6.86%	+47.50%
VENZ 9 3/8 01/13/34	44.50	**47.75**	+8.37%	+37.76%
VENZ 7 03/31/38	41.25	**43.60**	+7.00%	+34.44%
PDVSA 5 1/4 04/12/17	83.75	**89.55**	+7.36%	+88.81%
PDVSA 8 1/2 11/02/17	74.00	**79.90**	+8.88%	+82.46%
PDVSA 8 1/2 10/27/20	70.75	**73.90**	+5.40%	-2.09%
PDVSA 9 11/17/21	48.95	**53.20**	+10.16%	+51.65%
PDVSA 12 3/4 02/17/22	57.90	**61.90**	+8.23%	+58.86%
PDVSA 6 05/16/24	37.55	**39.25**	+5.81%	+21.54%
PDVSA 6 11/15/26	36.55	**38.50**	+6.56%	+20.18%
PDVSA 5 3/8 04/12/27	35.65	**38.05**	+7.81%	+18.94%
PDVSA 9 3/4 05/17/35	45.15	**48.85**	+9.89%	+40.48%
PDVSA 5 1/2 04/12/37	35.40	**37.60**	+7.37%	+18.48%

Table N° 1: Performance of Venezuela and PDVSA bonds, December and 2016 year

Venezuela/PDVSA Monthly Report
December 2016

Venezuela and PDVSA bond prices appreciated by +6.40% on average during December, with an average total return of +7.80% (including interest). The best performance was seen in medium-term bonds, which had underperformed the complex in recent months: VENZ 2019 (+11.6%) and PDVSA 2021 (+10.1%). The laggards were VENZ 13.625% 2018 (+2.2%) and PDVSA 2020 (+5.4%), two bonds with high cash prices and an overweight positioning among investors. There were no significant differences in return between the Sovereign (+7.85%) and PDVSA (+7.75%).

Monthly returns contrasts heavily with the 2016 full-year performance for the credit, marked by great differences among both curves (*See Chart N°3*). The PDVSA bonds due in 2017 were the clear winners, returning over 80% in 2016; followed by medium-term and high-coupon bonds (returning over 50%); and in last place came the low-dollar value bonds (PDVSA 24/26/27/37), which returned less than 20% in average during 2016.

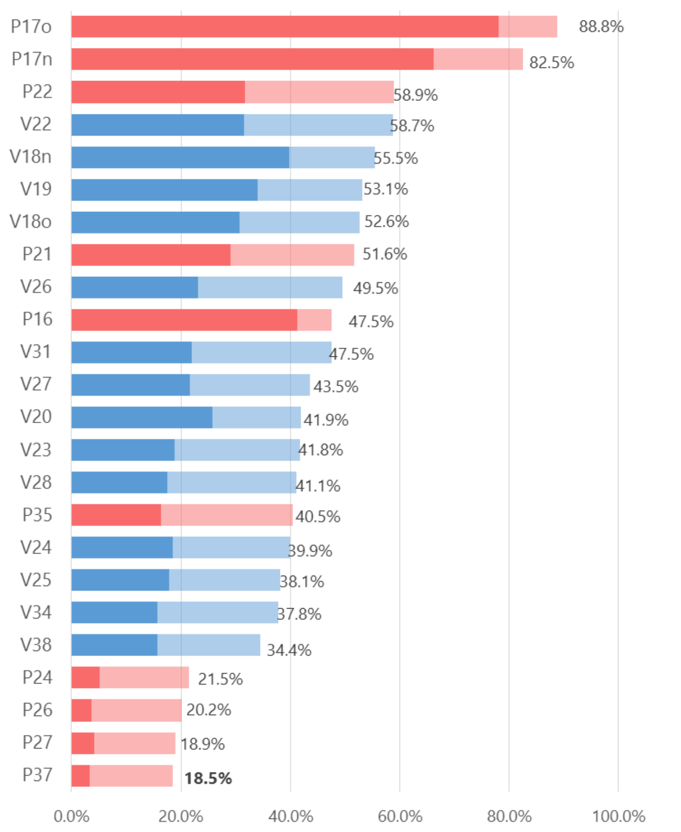
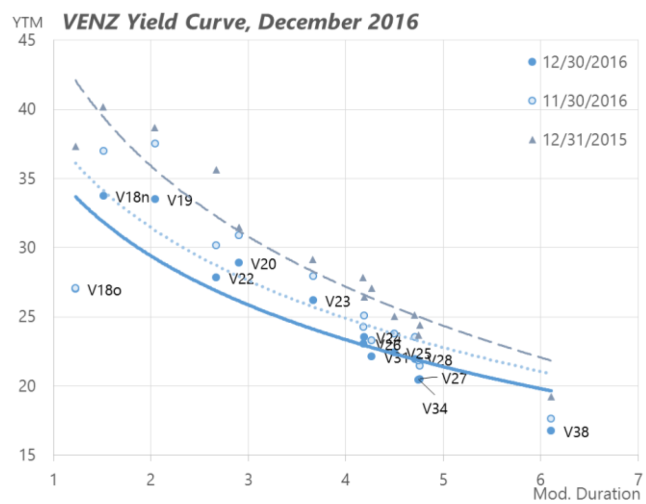


Chart N°3: VENZ/PDVSA bonds by Total Return*, 2016 year.
***NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume reinvestment of interest**
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Graphs N° 4 and 5 below show the evolution of Venezuela sovereign and PDVSA yield curves during December, versus November's and last year's closing levels. In the case of Venezuela, the curve compressed significantly, with yields falling by -450bps on average in 2016 (up to -1025bps in the case of VENZ 13.625% 2018). In the PDVSA curve, the changes were larger, both in magnitude and dispersion. We saw a sharp compression in the short end, of up to -2365bps (PDVSA 5.25% 2017), coupled with rising yields in the low-dollar value segment of the curve (PDVSA 2024 yields rose +102bps). On average, PDVSA yields fell by over -550bps during 2016.



Graph N°4: Venezuela Yield curve changes, December 2016. *Source: Bloomberg CBBT.*

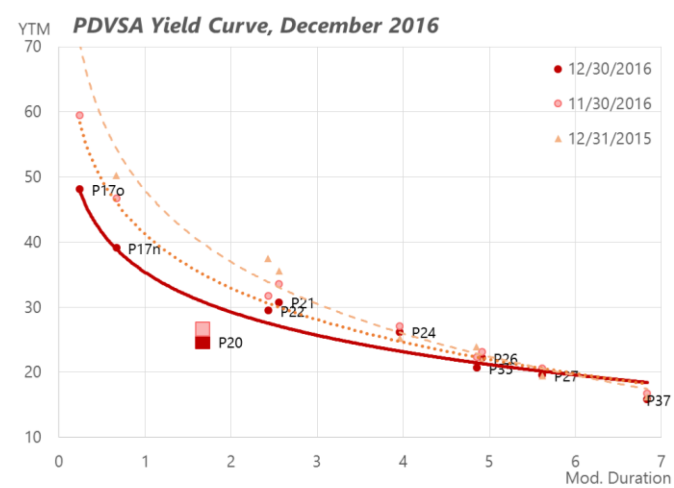


Chart N°5: PDVSA Yield Curve changes, December 2016. *Source: Bloomberg* CBBT.

2017 Credit Outlook: Oil is the key

In order to have a high conviction on Venezuela and PDVSA bonds for 2017, one needs to assume that oil prices will continue to climb during the year. We are concerned that the Republic is starting 2017 with less than USD 11Bn in reserves (after falling by a third in 2016) and with most of their external assets either liquidated or collateralized, including the "crown jewel": CITGO Holding. This makes Venezuela, more than ever, dependent on a positive evolution in the oil market and new external financing sources to close its balance of payments gap, which we expect it to remain in deficit for a sixth straight year.

Against the complicated macro backdrop, our base scenario is that economic policy, as it has become customary in the Maduro administration, will remain without structural changes. The stabilization in oil prices that took place in 2016 pushed away the urgency for economic reform, and the response of the authorities to worsening inflation and scarcity consisted in deepening price controls and regulations, in detriment of lasting solutions for the underlying macroeconomic imbalances. We would be surprised to face either a more pragmatic (positive) or a more radical (negative) regime, as we consider that the incentives to maintain the *status quo* among decision-makers are aligned.

As in the economic front, we do not expect a significant political transformation in the country for 2017. The MUD failed to trigger elections in 2016, amid its internal differences and stonewalling from the Supreme Court and the Electoral Council. Furthermore, the Vatican-brokered dialogue at the end of last year cemented this outcome; the PSUV-led Executive and Judiciary branches, in exchange for minor concessions, strengthened at the expense of a weakened opposition and Parliament. In the current state of affairs, it's likely that the MUD will remain unable to enforce political change; and any change in government, if any, will be led either by the PSUV or the military sector, in a sort of "in-house" transition for 2017, keeping a political orientation similar to the current administration's stance.

The *status quo* scenario will shape the community of investors involved in Venezuelan debt during 2017. We expect the exit from the market of players that were considering a government transition as an imminent event (the so-called 'regime-change bets'), and the proliferation of players betting on a Republic-PDVSA 'muddle-through' scenario, either by positioning on the short end of the curve (and thus speculating on a fast pull-to-par on the 2017 and 2018 maturities) or high-coupon bonds (on a speculative carry trade). Low-dollar price bonds should continue to lag the rest of the curve, as they have a lower current yield and valuations aren't very attractive.

In this sense, we envision a year where bond prices will remain range-bound, with nonetheless some interesting trading opportunities. Given that bonds are trading at prices well above their recovery values, we don't think the sustained upward trend of last year will repeat in 2017. For the same reason, volatility will be present as long as uncertainty regarding the level of oil prices - and hence the Republic and PDVSA's capacity to pay- remains. Another key driver will be the management of external debt policy. As we have seen in recent years, bond issuances in Venezuela are typically undergone through private placements with government entities (we got two exhibits in 2016: the USD 3Bn of PDVSA 6% 2022, and the USD 5Bn of VENZ 6.5% 2036 bonds), which then proceed to distribute the bonds to the market progressively, either by directly selling in the secondary market, or as payment for debts in arrears with multinational companies. This irregular flow of supply will impact the market and offer entry opportunities at better levels than the current ones.

Lastly, we review some "surprise factors" to keep in mind in 2017 and which could generate additional trading opportunities. There's the possibility of a new debt swap with the 2017 maturities, in order to modify a maturity profile of almost USD 10Bn (*See Chart N°6*); some market participants have suggested the possibility of oil warrants as a sweetener in a hypothetical debt exchange. In another front, if the fraudulent transfer lawsuits seeking to undo the CITGO collateral lien (brought by Crystallex and ConocoPhillips in separate cases) are rejected by US Courts, the PDVSA 2020 senior secured bonds should outperform significantly, as current levels aren't properly pricing in the consensus valuation of CITGO Holding's shares. Furthermore, if any the outstanding ICSID lawsuits advance towards final awards during the year, the Republic would have to face bigger liabilities than currently estimated, which would lead to worsening capacity-to-pay issues and would increase the risk of a credit event in the short term.

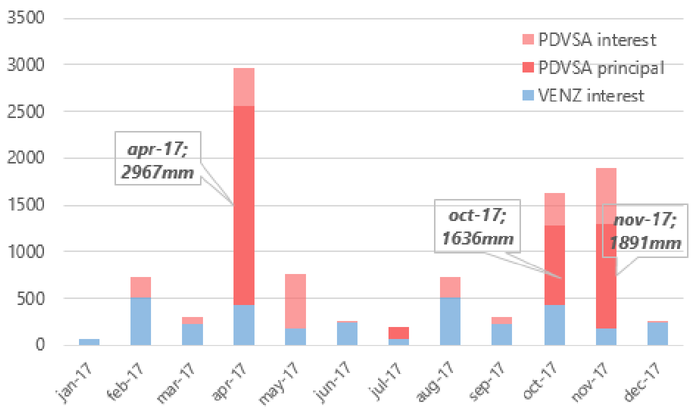


Chart N°6: 2017 Venezuela/PDVSA maturity profile (total: USD 10.08Bn)
Source: Bloomberg, Knossos Asset Management.