KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA GROUP

Venezuela/PDVSA Monthly Report
January 2017

Contrasting with the negative note on which the previous three years began, Venezuelan bonds took off right from the start of 2017 with a strong performance that slightly faded towards the end of the month (See Chart N°1). The main drivers were the stability in Brent/WTI oil prices above $50/bbl and continued capital inflows into Emerging Market funds (totaling over USD 5Bn in January, according to EPFR Global data). Furthermore, there is currently a preference for High Yield debt among the investment community - this asset class is perceived as less sensitive to rising interest rates than Investment Grade bonds-, and Venezuelan debt is still trading at attractive valuations *vis-à-vis* the rest of EM HY.

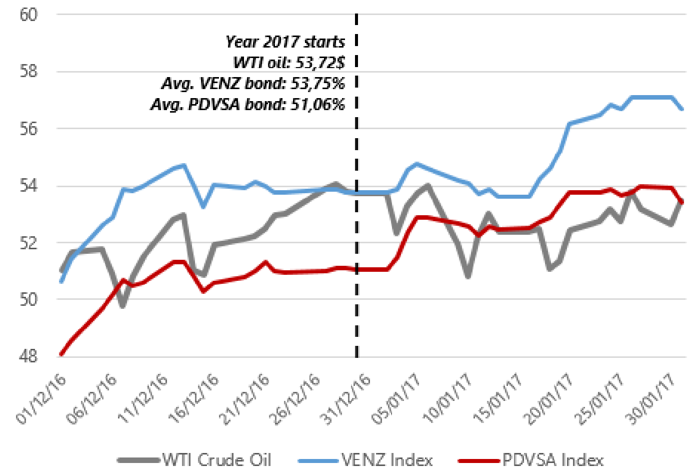


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Dec 2016 – Jan 2017). ***Source: Bloomberg BGN, own calculations.***

The coupon on VENZ 2034 (for USD 87mm), only debt payment due in the month, was paid in time and without issues. Against this backdrop, we saw continued demand in the short-and-medium term bonds (2017-2022 maturities), positions that express a bullish outlook for debt service, at least in 2017. Nevertheless, the worrisome trend of FX reserve depletion continues, with the BCV reporting a Reserves balance of USD 10.65Bn at the end of January (-3.5%).

In the domestic front, we witnessed significant changes in the government's power structure. The most significant was the appointment of the new VP Tareck El-Aissami, since president Maduro granted him decree powers in economic matters. Additionally, Ricardo Sanguino (former PSUV MP) was named for the presidency of the BCV. Lastly, the Board of Directors of PDVSA was restructured; among the new appointees, the most noteworthy are high-ranking civil and military officers with close ties to Maduro and the Sino-Venezuelan diplomatic relationship, such as new CFO Simón Zerpa (son of ambassador to China Iván Zerpa and chairman of Bandes and Fonden). The market did not react significantly to the new announcements, suggesting that investors anticipate a continuation of the current policy mix with the new authorities despite the major reshuffling among the government's power players.

Monthly Performance

Security	30/12/2016	31/01/2017	Total Return
VENZ 13 5/8 08/15/18	83.30	88.15	+6.84%
VENZ 7 12/01/18	64.45	73.75	+15.24%
VENZ 7 3/4 10/13/19	55.65	60.90	+10.35%
VENZ 6 12/09/20	48.15	52.90	+10.84%
VENZ 12 3/4 08/23/22	62.25	65.80	+6.99%
VENZ 9 05/07/23	48.05	50.90	+7.33%
VENZ 8 1/4 10/13/24	46.55	47.70	+3.89%
VENZ 7.65 04/21/25	45.35	46.60	+4.13%
VENZ 11 3/4 10/21/26	56.70	58.90	+5.50%
VENZ 9 1/4 09/15/27	51.85	53.40	+4.42%
VENZ 9 1/4 05/07/28	47.50	48.80	+4.28%
VENZ 11.95 08/05/31	56.60	58.65	+4.99%
VENZ 9 3/8 01/13/34	47.75	49.25	+4.43%
VENZ 7 03/31/38	43.60	44.90	+4.13%
PDVSA 5 1/4 04/12/17	89.55	93.65	+5.06%
PDVSA 8 1/2 11/02/17	79.90	87.05	+9.72%
PDVSA 8 1/2 10/27/20	73.90	77.90	+6.29%
PDVSA 9 11/17/21	53.20	57.35	+9.05%
PDVSA 12 3/4 02/17/22	61.90	66.05	+7.86%
PDVSA 6 05/16/24	39.25	40.30	+3.92%
PDVSA 6 11/15/26	38.50	38.25	+0.81%
PDVSA 5 3/8 04/12/27	38.05	38.00	+1.04%
PDVSA 9 3/4 05/17/35	48.85	50.50	+5.07%
PDVSA 5 1/2 04/12/37	37.60	37.90	+2.08%

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

Venezuela and PDVSA bond prices appreciated by +4.6% on average during January, with an average total return of +6% including interest. The bonds maturing in the next four years outperformed in the month (with returns of up to +15.2% in the case of VENZ 7% 2018). In contrast, long-end low-dollar-value PDVSA bonds underperformed and finish practically unchanged in January. The worst performer was PDVSA 2026, closing lower in price terms on the month and +0.8% in total return terms.

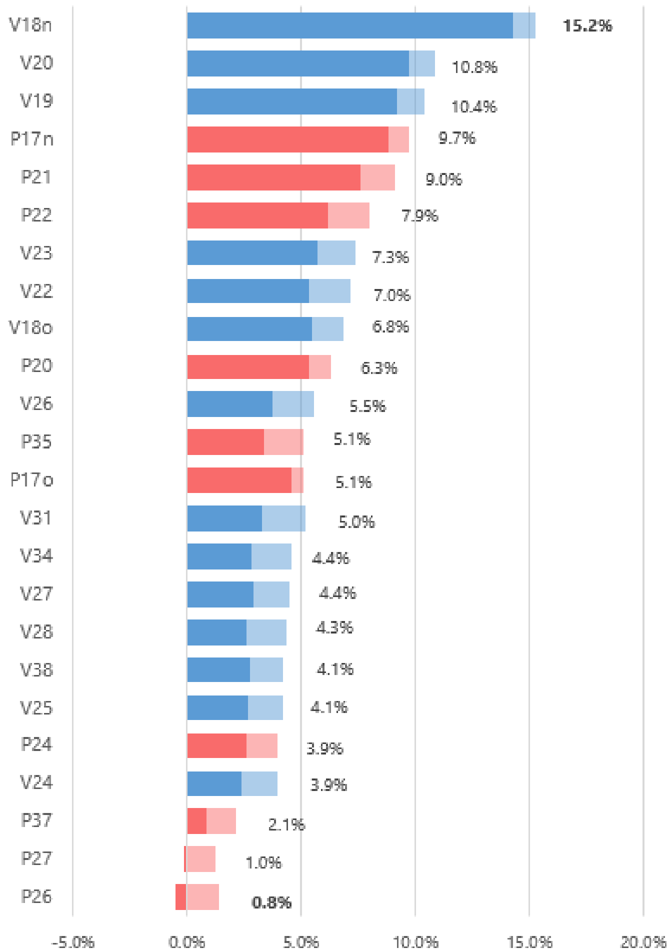
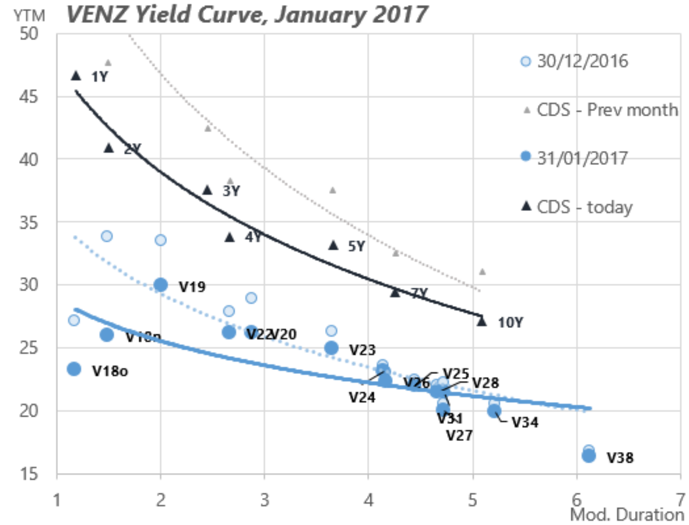


Chart N°3: VENZ/PDVSA bonds by Total Return, January 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.



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

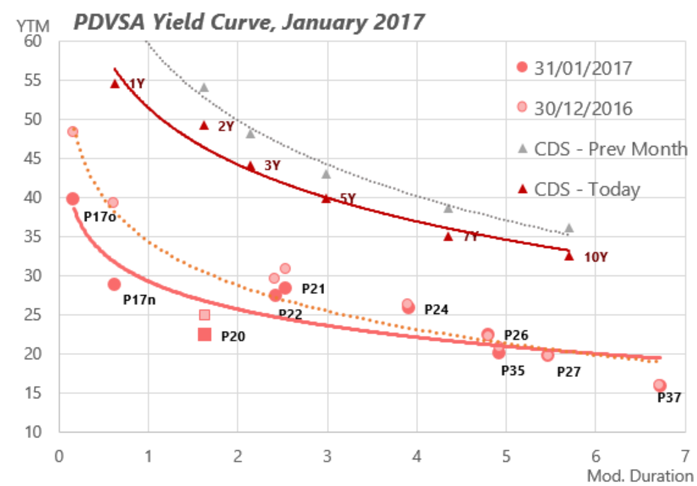


Chart N°5: PDVSA Yield Curve changes, December 2016. *Source: Bloomberg* CBBT.

Evolution of the curves

The following charts N° 4 and N° 5 respectively show the evolution of Venezuela and PDVSA yield curves (both cash bonds and CDS) during January. In the case of Venezuela, the curve compression observed last year continues. Yields on the 2018-2020 maturities tightened by -450bps or five times more than the average on the rest of the Sovereign curve and the biggest shift took place in VENZ 7% 2018 (-810bps). The PDVSA curve showed a similar pattern of bull-steepening, led by PDVSA 8.50% 2017 (-1030bps). However, yields on PDVSA 2026 (+21bps) and 2027 (+9bps) rose on the month.

The 'status quo' remains at the start of 2017

The market consensus on the political front was confirmed after the 10th of January passed without a Recall Referendum and all signs suggest that it has been ruled out for this year as well. In contrast with the expectations of the opposition bloc, the Maduro administration has successfully postponed elections and has emphasized 'The Dialogue' as a meeting point to establish ground rules for coexistence. Nonetheless, the polarization and conflict between public powers persist, signaling there has been little to no progress in the construction of a common policy agenda.

With the absence of a credit story such as the one we had in 2016 (where expectations of regime change and/or a credit event reached their limits) there doesn't seem to be any clear directional plays in Venezuelan debt from the current starting point. Furthermore, the political stagnation has spread a feeling of complacency towards the bonds so far in the year. Traded volumes have fallen sharply, as well as the interest of the global investment community in the country's situation. We expect VENZ and PDVSA to remain in the background for the foreign investor in the foreseeable future, in no small part due to the ruling party's sufficiently proven capabilities to maintain the political-economic status quo at stable-to-rising oil prices, and its secure grip on the electoral timetable.

The market's perception of near-term default probability has come down significantly, as measured Sovereign and PDVSA 1y CDS which are pricing in a less than 50% default probability for the first time since September 2016. Predictably, the market's preferred trade has consisted on a bull-steepening of the short and medium end of the curves. However, we believe that the outperformance in the 2018-2022 tenors is hitting its limits. In our view, the strategy of seeking a pull-to-par appreciation on the 2017 bonds doesn't offer an attractive risk-reward profile at current levels; neither does the 'belly' of the curves, which are trading at lofty valuations with respect to recent history. Furthermore, we consider that Recovery Values in PDVSA and VENZ unsecured debt have deteriorated in the last months as a consequence of the recent debt issuances and the progressive liquidation of the country's external assets.

Due to all of the above, we conclude that the current environment calls for a conservative investment profile, emphasizing active trading. We expect the reduced interest in the credit to affect market liquidity and efficiency, providing for interesting short-term trading opportunities. In this context, we consider that the PDVSA 8.50% 2020 secured bond continues to offer a superior risk-reward profile than PDVSA unsecured debt, especially in a negative scenario for the credit. Another interesting approach to take advantage of the stable environment would be through carry trades on long-end, high-coupon bonds, especially when market supply considerably cheapens some of these issues in relative value terms. The evolution of variables such as oil prices, EM fund flows, primary market supply (through either VENZ 2036 and/or PDVSA 6% 2022), as well as the ongoing litigations faced by the state oil company over the collateral of the PDVSA 2020s, will continue to be our guides to navigate the Venezuelan debt market.