Venezuela/PDVSA Monthly Report
July 2017

Venezuela/PDVSA bonds endured a second straight month of steep losses; the selloff accelerated in the last two weeks, driving prices down to 15-month lows (*See Chart N° 1)*. The negative sentiment among investors worsened in July, affecting short-end and high-coupon bonds disproportionately. Market activity was intense throughout the month; July 25th ended up as the busiest day of the year, with over USD 240mm face value of PDVSA bond trading volume reported to TRACE. The collapse in the last days of the month was due in large part to the imminent election for the National Constituent Assembly (also known as ANC) and threats by the US government of "swift and strong action" against Maduro and its government if he decided to go on with his plans of overhauling the constitution.

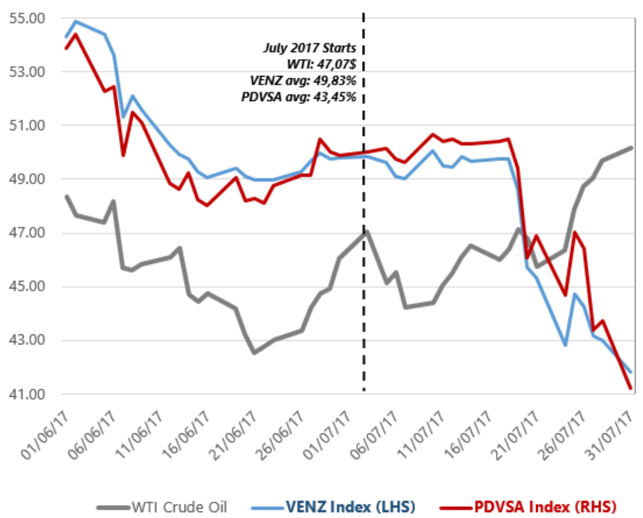


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Jun-Jul 2017). *Source: Bloomberg BGN, own calculations.*

Crude oil's strong performance (leading WTI futures to close in July around the 50$/bbl mark), as well as hopes of a last-minute negotiation between opposition and government after Leopoldo López was moved out of jail, lent support to the credit earlier in the month. However, selling flows seen in June apparently weren't absorbed by dedicated investors, who decided to stay on the sidelines. As a consequence, dealers were forced to keep inventories of Venezuelan debt in their books, leading to the diminished market liquidity and increased price volatility that characterized the latter part of July.

The crash in bond prices came after press reports suggested the Trump administration was weighing in an arsenal of economic sanctions against the Venezuelan government, including the possibility of a transactional and financial blockade over PDVSA. Such sanctions would have a devastating effect over the Republic's capacity to pay right from the start and would open the possibility of a disorderly credit event in 2017; the market's reaction, predictably, was panic selling.

Despite fear among investors about the possibility of sanctions to the oil and/or financial sectors, no such measure materialized by the end of July. Instead, the US Treasury Department included several key officials of the Venezuelan government in their blacklist of 'Specially Designated Nationals' (SDN), which in a first round (July 26th) included Tarek William Saab, Tibisay Lucena, Simón Zerpa and Erick Malpica Flores, among others. Finally, after the ANC took place in July 30th (and the government announced a turnout of over 8 million in the process), Nicolás Maduro himself was added to the SDN list and dubbed a 'dictator', joining an exclusive club of autocrats such as Bashar Al Assad, Robert Mugabe and Kim Jong Un.

Monthly Performance

Security	30/06/2017	31/07/2017	Total Return	Total Return (2017 YTD)
VENZ 13 5/8 08/15/18	75.90	59.00	-19.34%	-17.93%
VENZ 7 12/01/18	64.65	51.40	-19.37%	-13.58%
VENZ 7 3/4 10/13/19	51.25	42.75	-14.81%	-14.26%
VENZ 6 12/09/20	45.40	39.50	-11.70%	-10.41%
VENZ 12 3/4 08/23/22	54.00	44.40	-14.52%	-14.99%
VENZ 9 05/07/23	44.75	38.65	-11.57%	-8.01%
VENZ 8 1/4 10/13/24	43.50	38.25	-9.95%	-6.72%
VENZ 7.65 04/21/25	42.90	38.90	-7.53%	-3.94%
VENZ 11 3/4 10/21/26	52.00	42.20	-16.13%	-12.31%
VENZ 9 1/4 09/15/27	50.25	41.90	-14.23%	-7.92%
VENZ 9 1/4 05/07/28	44.65	38.35	-11.92%	-7.24%
VENZ 11.95 08/05/31	50.75	41.25	-15.19%	-13.05%
VENZ 9 3/8 01/13/34	45.25	40.00	-8.93%	-3.93%
VENZ 7 03/31/38	42.15	38.85	-6.04%	-1.14%
PDVSA 8 1/2 11/02/17	87.75	75.30	-12.90%	+0.35%
PDVSA 8 1/2 10/27/20	72.35	65.40	-8.13%	-4.58%
PDVSA 9 11/17/21	48.75	38.25	-16.80%	-15.09%
PDVSA 12 3/4 02/17/22	56.55	43.50	-16.21%	-13.75%
PDVSA 6 05/16/24	37.70	31.20	-10.87%	-6.93%
PDVSA 6 11/15/26	36.55	32.75	-10.37%	-6.06%
PDVSA 5 3/8 04/12/27	36.25	32.40	-8.51%	-5.86%
PDVSA 9 3/4 05/17/35	46.40	38.00	-14.51%	-8.88%
PDVSA 5 1/2 04/12/37	35.35	32.55	-7.49%	-4.48%

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

Venezuela sovereign and PDVSA bonds fell by -13.9% on average in July and generated a negative -12.5% total return including interest. Even though some of the most 'defensive' bonds (long-end VENZ and PDVSA 20/*low-*

dollar-value) experienced smaller losses, the weakness was broad-based and led all securities to post negative returns in 2017 YTD. Short- and medium-term notes bore the brunt of the selling, especially VENZ bonds due in 2018, which fell around -20% in July.

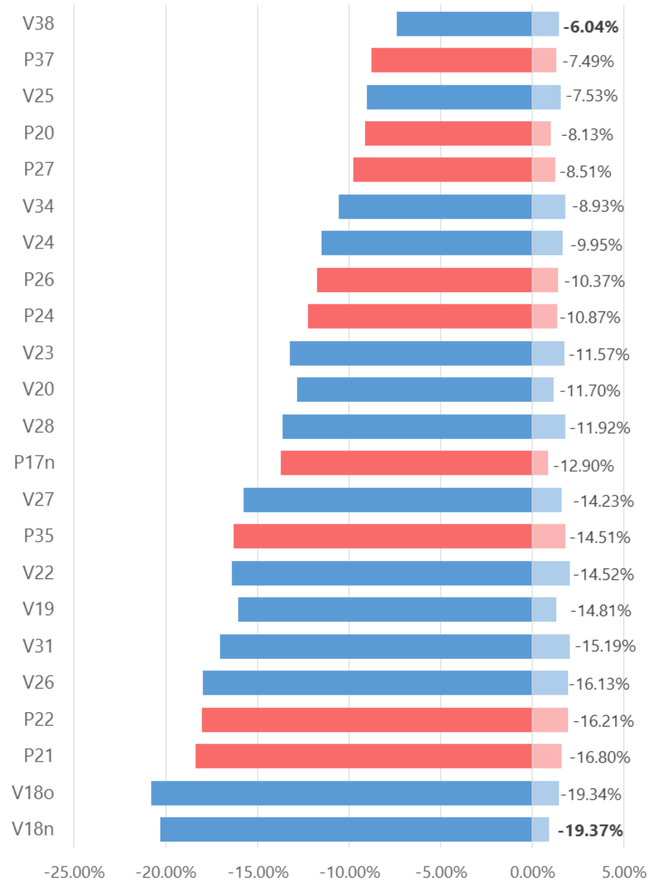
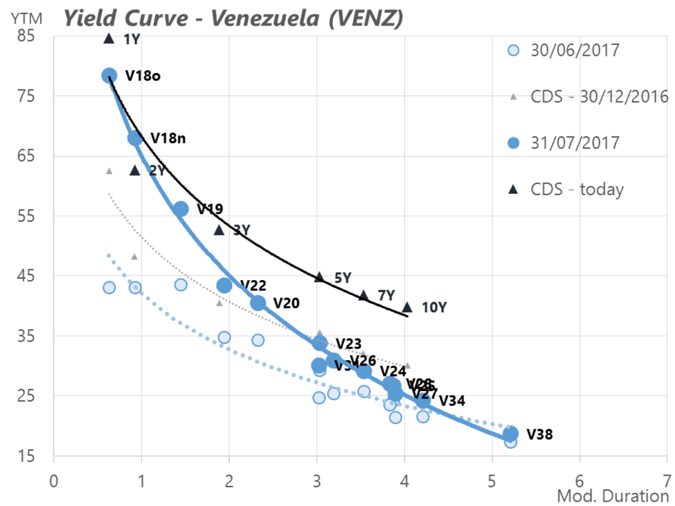


Chart N°2: VENZ/PDVSA bonds by Total Return, July 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

The following charts N° 3 and 4 plot the yield curves for Venezuela and PDVSA bonds in July of 2017, respectively, for both cash bonds and CDS. The Venezuela curve significantly shifted upwards an inverted massively, reflecting the underperformance in the shortest tenors seen in July. Yields went up by +850bps on average, but climbed as much as +3530bps on the VENZ 13.625% 2018; the bond is now trading at a yield to maturity of around 80%, an all-time high.



Graph N°3: Venezuela Yield curve changes, July 2017.
Source: Bloomberg CBBT.

The PDVSA curve inverted even more aggressively, especially in the case of the next-in-line bond. Yields on PDVSA 8.50% 2017 went up by a staggering +8750bps in July and climbed to a historic high of 140%; on average, yields rose by almost +1500bps across the cash bonds curve. Surprisingly, the movement in the CDS market was not as aggressive: traders are currently pricing a 69% implied probability of default by PDVSA over the next year, only slightly above the 60% observed at the end of June.

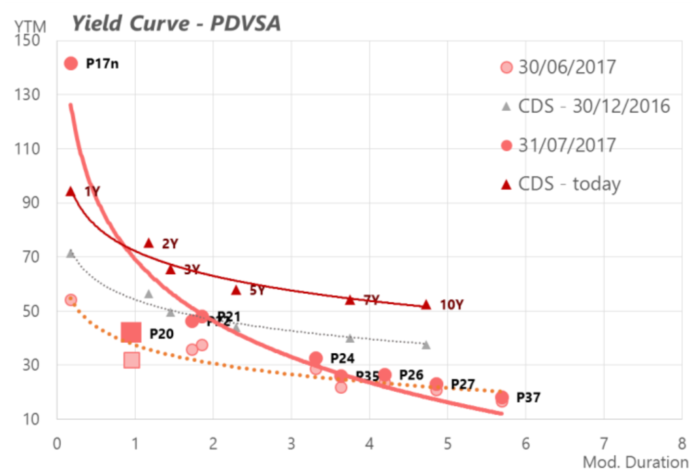


Chart N°4: PDVSA Yield Curve changes, July 2017.
***Source: Bloomberg* CBBT.**

Economic sanctions: An existential threat

Panic among investors at the specter of economic sanctions by the US is justified, in our opinion. The capacity and willingness to pay of the Maduro administration was already put to the test in the absence of such threats, as a consequence of factors we have discussed over the past months: low oil prices, sustained declines in oil output and exports, persistent external deficits and impaired access to the capital markets. In this sense, the possibility of an export ban to the US, or even worse, the threat of blocking Venezuela from transactions in US Dollars, are additional risk factors that worsen an already challenging credit profile; moreover, these threats risk triggering a disorderly credit event in the following months, especially in the October-November stretch, were more than USD 3.5Bn between principal and interest payments of both the Republic and the state oil company are due.

However, recent communications and actions undertaken by the Trump administration suggest that broad sanctions against the oil industry do not represent an imminent risk, at least for now. The key in the public communications by the White House is that their strategy would consist on a constant pace of escalation, prioritizing sanctions against individuals at an initial stage and leaving the measures of greater economic impact for a later stage of the political crisis. Press reports suggest that there's an internal debate in the US government, weighing in the potential negative effects of an oil and financial embargo in both the American and the Venezuelan economy. It is prudent to assume that the sanctions would worsen at a pace dictated by the steps taken by the Maduro government, in its plans of consolidating itself in power and eradicating all dissenting voices from the Venezuelan political landscape.

The external vulnerability and lack of reserve assets suggest Maduro would need help from geopolitical allies to stay afloat. In this context, Russia and China would be key conduits for access to the external financing that the Maduro administration needs to stay current on its external debt commitments. The strategic interest of eastern powers over Venezuela is evident, based on a review of the most recent signed agreements. For example, reports surfaced at the end of July suggesting that Rosneft was willing to unwind its 49.9% security interest in the capital stock of Citgo Holding in exchange of a larger participation in the national oil industry. The trend of the governments in Moscow and Beijing in recent month has been of reluctance extending new credit, and only lending money if tied to direct stakes in the Orinoco Oil Belt or in exchange for future oil sales. This dynamic will be key in the following months: as US sanctions against the country deepen, Venezuela's dependence to Russia and/or China will also be greater, both in the present and in the future.

Considering the scenario described above, is the market 'oversold' after two straight months of losses? The high uncertainty surrounding the credit makes it hard to assume that bond prices should stabilize at current levels. As a reference, bonds are trading on average around 5 to 8 points above their all-time lows (February 2016) in the case of long-term debt. If the political crisis deepens, it's logical to expect more and harder sanctions coming from the US, and thus a worsening of the country's credit fundamentals; a dump towards all-time lows would be a base-case scenario in this context. On the other hand, there's a surprise scenario: a breakdown within the military or the PSUV high ranks (as a consequence of the internal pressure generated after the recent sanctions, for example) which could lead to a normalization in the political front and a dialogue process mediated by the international community. Investors could react positively to such a scenario if they perceive this process as a prelude towards a government transition, and hence to a friendly debt restructuring process and an opening of the national economy to foreign direct investment. The current entry point offers an interesting opportunity to bet on the surprise outcome, especially on medium-term high-coupon bonds, which are now trading with a slight discount vs. *low-dollar-value* bonds in relative terms. However, this scenario looks more unlikely by the day, judging by the forced incarceration of Leopoldo Lopez and Antonio Ledezma back to the Ramo Verde prison in the dawn of July 31st.

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