Venezuela/PDVSA Monthly Report
June 2016

Venezuela and PDVSA bonds end June trading at their highest levels of the year, after a month of sustained gains. The positive behavior was generalized, with all bonds posting returns of at least +3,5% in the month, following the positive trends in the global commodity and credit markets. As most risky assets worldwide, Venezuelan bonds quickly shrugged off the *Brexit* shock and continued their upwards trend towards the end of the month (See Chart N°1).

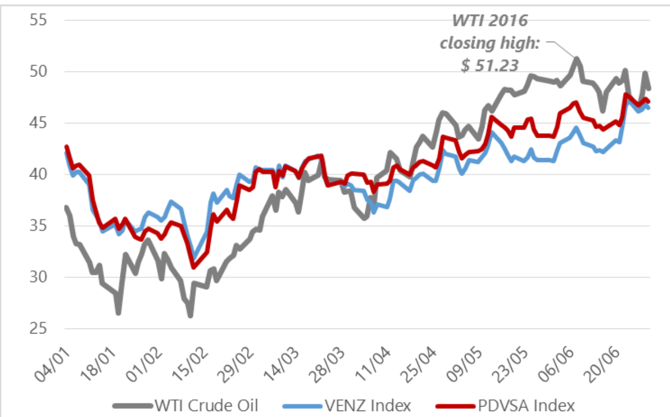
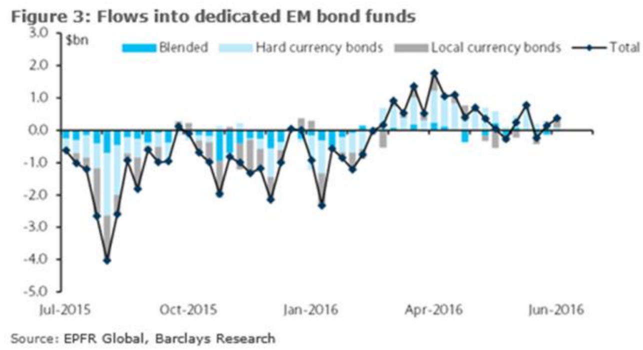


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (2016 year-to-date). *Source: Bloomberg BGN, own calculations.*

It was a light month in terms of debt service: there were only two bonds paying coupons (VENZ 2018 7% and VENZ 2020, totaling USD 80MM); this contributed to a slowdown in the pace of depletion of international reserves (which dropped by USD 38MM in June, a fraction of the average monthly decline in 2016 of USD 850MM). The absence of imminent capacity-of-payment risks was joined by ongoing rumors, published on the local press, that China would be guaranteeing a grace period of up to two years in principal payments on their oil-backed loans to Venezuela (translated into debt-service savings of around USD 6Bn). In the political front, the highlight of the month was the successful completion of the first step in the recall referendum request (validation of one-percent of the National Registry signatures), as well as the OAS Permanent Council sessions to discuss the political crisis in Venezuela, the latter against the will of the government of Nicolás Maduro.

The positive behavior of Venezuelan debt in the month – averaging a total return of +11,50% - took place alongside positive trends in the broader credit space, and particularly in Emerging Markets, a sector that has experienced healthy capital flows in the last months (See Chart N°2). Global trends of aggressive monetary easing and falling interest rates towards record lows, continue to fuel investor's appetite for high-yielding assets. Venezuelan bonds, because of its extreme price volatility (*High-Beta*), react to these positive drivers on a greater magnitude than other EM credits.



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

Performance in the month

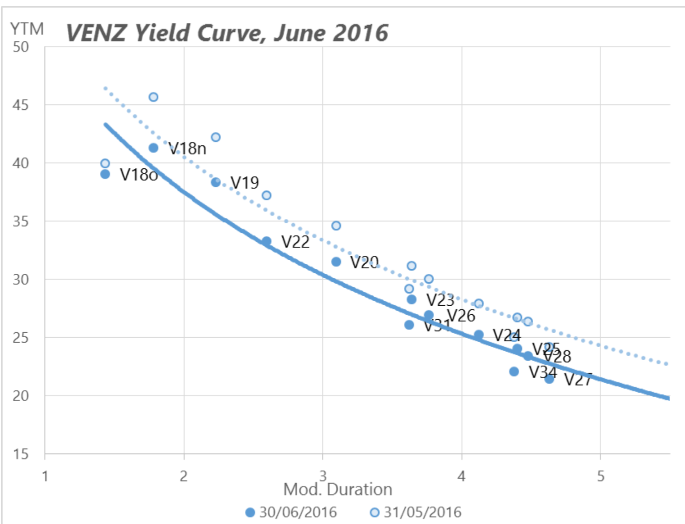
Security	31/05/2016	30/06/2016	Total Return
VENZ 13 5/8 08/15/18	63.50	**65.45**	+4.58%
VENZ 7 12/01/18	45.65	**50.55**	+11.96%
VENZ 7 3/4 10/13/19	40.80	**45.40**	+12.51%
VENZ 6 12/09/20	36.90	**41.15**	+12.04%
VENZ 12 3/4 08/23/22	45.55	**51.30**	+13.87%
VENZ 9 05/07/23	38.35	**42.90**	+13.58%
VENZ 8 1/4 10/13/24	37.40	**42.05**	+13.88%
VENZ 7.65 04/21/25	36.25	**41.00**	+14.47%
VENZ 11 3/4 10/21/26	42.35	**47.70**	+14.38%
VENZ 9 1/4 09/15/27	42.85	**48.80**	+15.04%
VENZ 9 1/4 05/07/28	38.40	**43.75**	+15.74%
VENZ 11.95 08/05/31	42.10	**47.45**	+13.85%
VENZ 9 3/8 01/13/34	38.30	**43.85**	+15.01%
VENZ 7 03/31/38	35.50	**40.40**	+14.95%
PDVSA 5 1/8 10/28/16	86.95	**90.80**	+4.86%
PDVSA 5 1/4 04/12/17	60.80	**62.75**	+3.94%
PDVSA 8 1/2 11/02/17	64.80	**70.20**	+9.38%
PDVSA 9 11/17/21	38.30	**43.45**	+15.22%
PDVSA 12 3/4 02/17/22	45.05	**50.65**	+13.67%
PDVSA 6 05/16/24	32.75	**35.35**	+9.24%
PDVSA 6 11/15/26	32.45	**35.10**	+9.59%
PDVSA 5 3/8 04/12/27	32.70	**35.05**	+8.32%
PDVSA 9 3/4 05/17/35	38.25	**40.55**	+8.03%
PDVSA 5 1/2 04/12/37	32.70	**34.90**	+8.01%

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

Venezuela and PDVSA bonds are finishing the month with an average 10,25% increase in prices and an average total return of +11,50% factoring interest. VENZ 2028 bonds returned +15,75% in the month, the best performance among both curves. The worst performance was seen in PDVSA 2017 5,25% (+3,98%).

Evolution of the curves

Graphs N° 3 and 4 plot the changes in VENZ and PDVSA yield curves during the month. In the case of Venezuela, yields compressed by an average of 300 basis points in June; the biggest fall was seen in VENZ 2018 7% (-433 bps).



Graph N°3: Venezuela Yield curve changes, June 2016. *Source: Bloomberg CBBT.*

The behavior in the PDVSA curve was mixed: yields fell by an average of -236bps, and bigger movements were seen in the short end of the curve. While the yield on PDVSA 2017 8,50% - amortizing - fell almost 700 basis points, the yield on PDVSA 2017 5,50% - non-amortizing bond – rose 350bps in the month to a YTM of almost 80%, the highest in the Venezuelan debt universe.

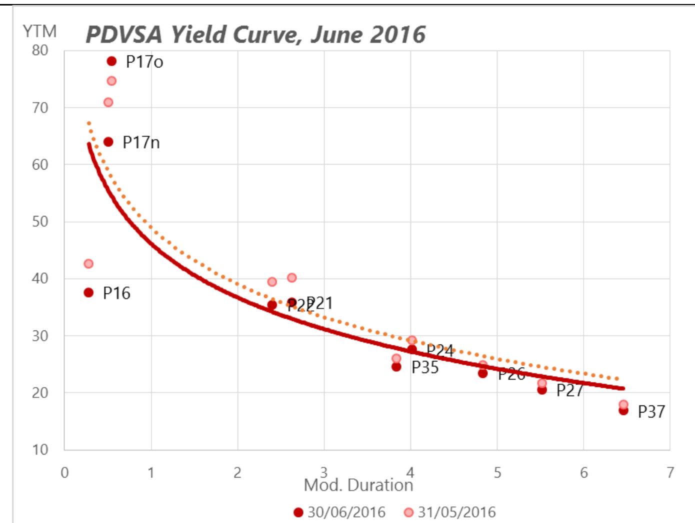


Chart N° 4: PDVSA Yield Curve changes, June 2016. *Source: Bloomberg CBBT.*

Willingness "at all costs", and political survival

The context of extreme uncertainty over the future of Venezuela remains unabated at the end of the first half of 2016. The macroeconomic trends continue to worsen; the acceleration in inflation and the external liquidity crunch, has recently been joined by a sharp contraction in crude oil output, estimated by OPEC at 2,3MM bbl/day at the end of June (a YoY fall of over a quarter million barrels a day). While there are several short-term positive drivers that could act as counterweight (low debt service for July – USD 70MM -, sizeable gains in the country's gold positions, possible rebound in oil output due to recently-signed refinancing agreements with oil service providers), it's evident that the country's outlook will continue to worsen in coming months, especially if the Executive maintains its stance of paralysis in macro policy.

Having said this, our view stated at the beginning of the year regarding the intention of the Maduro administration of keeping their willingness to pay "at all costs", even at the risk of greater social and economic deterioration, seems to be materializing with each passing month. The arithmetic of the Government's debt-service capacity, at first sight, is limited to calculate the pace of depletion of the nation's external assets; and with a balance of USD 12 Bn at the end of June, the international reserves would be enough to repay principal and interest payments due on Venezuela and PDVSA for the remaining of 2016 without the need of incurring a debt swap with private bondholders. With public sector holders (which according to analyst estimates, own up to a third of PDVSA short-end bonds) there's a possibility of a voluntary exchange, in a similar manner as PDVSA has done with its previous bond maturities. Thus, and to the extent that the BCV reserves can be considered an adequate gauge of capacity-to-pay – with the data-transparency limitations that this implies -, the payment of this year's debt commitments would be determined by the other key variable: *willingness to pay*.

The determinants of willingness to pay are eminently political in nature. There's conviction that the political survival of Nicolás Maduro is tied to his government's capacity to pay external debts, as well as its capacity of postponing the recall referendum. Therefore, we expect the Maduro administration to maintain its strategy of looking out for fresh financing with all possible candidates; in this sense, the two next options in line for Miraflores are the country's remaining position in IMF Special Drawing Rights, and loans from multilateral institutions. In the electoral front, Maduro understands the imminent electoral defeat if he were to face the ballot box, and hence his administration will keep all their efforts in postponing, or even avoiding altogether, the realization of a recall referendum, or any other outcome that translates into him losing power in 2016.

The government's strategy (which has consisted in cutting imports, depleting external assets, negotiating credit facilities and repurchasing short-end bonds; in essence, prioritizing external debt service above all else), is consistent with the repayment of PDVSA maturities due at the end of the year. The total lack of transparency in the government's finances, and the increasing risk of social unrest, make it impossible for anybody to have full certainty of this scenario; but judging by the decisions taken by the Maduro administration so far this year, everything points to this as the most likely outcome.

The big question, *to default or not to default*, would be relegated to the first months of 2017. The political scenarios, still uncertain and in full swing, will set the tone; but everything points at a necessarily more defensive positioning with respect to Venezuelan debt after the October-November repayments, considering the total lack of visibility with respect of what could happen in the country after the sizable debt repayments.