KNOSSOS ASSET MANAGEMENT
AN AFFILIATED COMPANY OF MIURA

Venezuela/PDVSA Monthly Report
May 2017

The Venezuelan debt complex had a mixed performance during May (losses in the short end of VENZ coupled with gains in most PDVSA bonds), in a month characterized by low price volatility despite several domestic and foreign drivers. Bonds started the month under pressure, in line with the weakness in crude prices. The trend reversed in the second week of May (see chart N°1), after news broke out of an agreement between Russia and OPEC members to extend output cuts to stabilize the oil market, which reignited buying interest among investors and resulted in three straight weeks of advances in Venezuela and PDVSA bond prices.

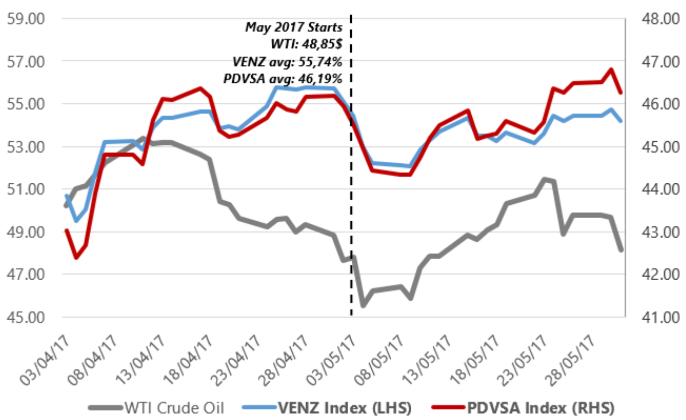


Chart N°1: VENZ and PDVSA avg. bond prices vs prices of WTI Oil (Apr-May 2017). ***Source: Bloomberg BGN, own calculations.***

The resilience of Venezuelan debt was put to the test repeatedly. Without any official communications coming from the issuer, the coupon payments on PDVSA 2021/24/35 bonds were delayed up to a week (only the PDVSA 2026 coupon was paid on time), in a similar fashion as the 'grace period' that took place last November. Analysts attributed the delays to 'operational setbacks' faced by the state oil co. and not due to an imminent issue of capacity to pay; hence, the market didn't show any signs of panic throughout. In parallel, the Central Bank board unveiled the new DICOM FX system, which replicates most of the features (as well as the limitations) of the previous mechanisms. Even though the new system underwhelmed analyst expectations (and also implies the risk of bond supply coming to the secondary market – in order to cover dollar sales), bond prices were little changed after the announcement.

Lastly, there was an unexpected jump in International Reserves at the end of the month (+749mm USD between May 24th and 25th). The reason behind the buildup in reserves was unveiled on Sunday 27th at night: the Wall Street Journal reported that Goldman Sachs Asset Management (GSAM) bought USD 2.8Bn face value of PDVSA 6% 2022 bonds from the Central Bank at 31.00 cents on the dollar, using little-known UK-based brokerage Dinosaur Group as a middleman. Goldman allegedly delivered USD 865 MM and in return got the lions' share of the issue, which curiously was born in October 2014 in a private placement but didn't change hands until now.

Monthly Performance

Security	28/04/2017	31/05/2017	Total Return	Total Return (2017 YTD)
VENZ 13 5/8 08/15/18	85.50	78.90	-6.07%	+1.72%
VENZ 7 12/01/18	71.10	67.60	-3.49%	+9.87%
VENZ 7 3/4 10/13/19	60.85	56.30	-5.59%	+7.67%
VENZ 6 12/09/20	52.20	50.75	-1.35%	+10.93%
VENZ 12 3/4 08/23/22	62.30	60.40	-1.05%	+5.61%
VENZ 9 05/07/23	50.30	50.00	+1.48%	+12.31%
VENZ 8 1/4 10/13/24	47.95	47.55	+1.17%	+9.86%
VENZ 7.65 04/21/25	46.85	46.45	+1.04%	+9.74%
VENZ 11 3/4 10/21/26	58.60	56.20	-1.82%	+8.18%
VENZ 9 1/4 09/15/27	53.65	53.30	+1.14%	+10.18%
VENZ 9 1/4 05/07/28	48.20	48.60	+2.72%	+10.72%
VENZ 11.95 08/05/31	58.00	55.65	-1.97%	+6.92%
VENZ 9 3/8 01/13/34	49.00	48.60	+1.66%	+10.12%
VENZ 7 03/31/38	45.30	44.70	+0.36%	+9.27%
PDVSA 8 1/2 11/02/17	90.70	91.15	+1.36%	+18.30%
PDVSA 8 1/2 10/27/20	78.50	78.00	+0.45%	+10.38%
PDVSA 9 11/17/21	53.00	53.50	+2.63%	+7.95%
PDVSA 12 3/4 02/17/22	62.35	61.40	+0.67%	+7.81%
PDVSA 6 05/16/24	39.70	39.75	+1.77%	+8.02%
PDVSA 6 11/15/26	38.45	38.65	+2.51%	+7.67%
PDVSA 5 3/8 04/12/27	38.35	38.60	+2.34%	+7.61%
PDVSA 9 3/4 05/17/35	48.00	49.70	+5.50%	+10.69%
PDVSA 5 1/2 04/12/37	38.10	38.55	+2.74%	+8.84%

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

Venezuela and PDVSA's bond prices fell -1.05% on average during May, yet delivered a positive +0.35% return including interest. Short-end Venezuelan Sovereign bonds underperformed (VENZ 13.625% 2018 returned -6.1%, May's worst performer), while PDVSA *low-dollar value* bonds outperformed, especially PDVSA 2035 (May's leader with a +5.5% return). In general terms, there are two patterns driving price action: the *'pull-to-par'* of short-end maturities (especially PDVSA 17n/20, which represent a bet on sustained capacity to pay through Q4 2017) and the '*bear-flattening*' price compression on the rest of both curves, guided by the market's consensus view of a high probability of regime change – and a subsequent debt restructuring – in the short term.

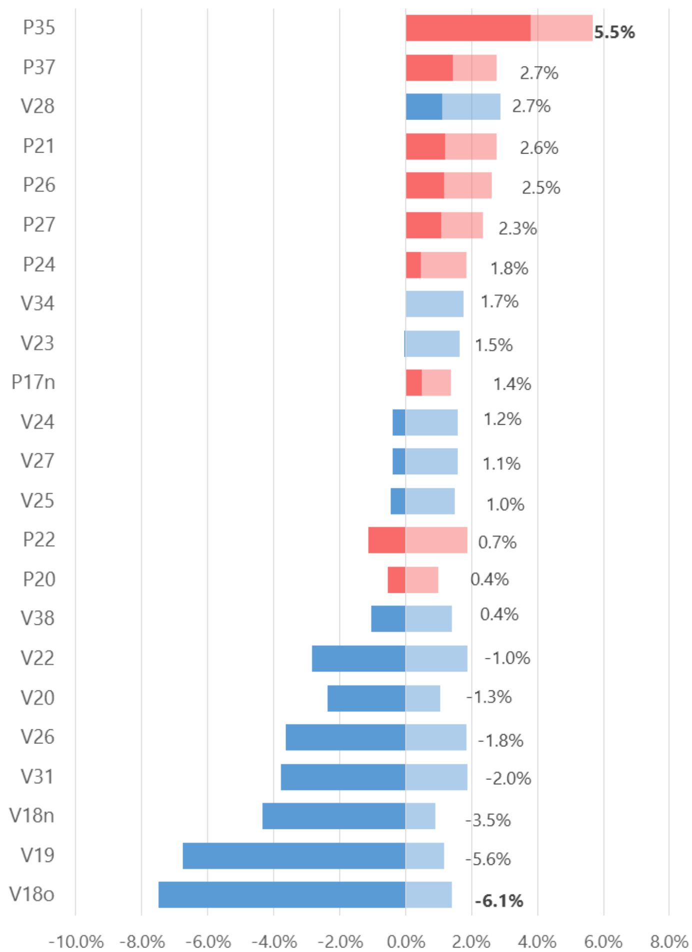
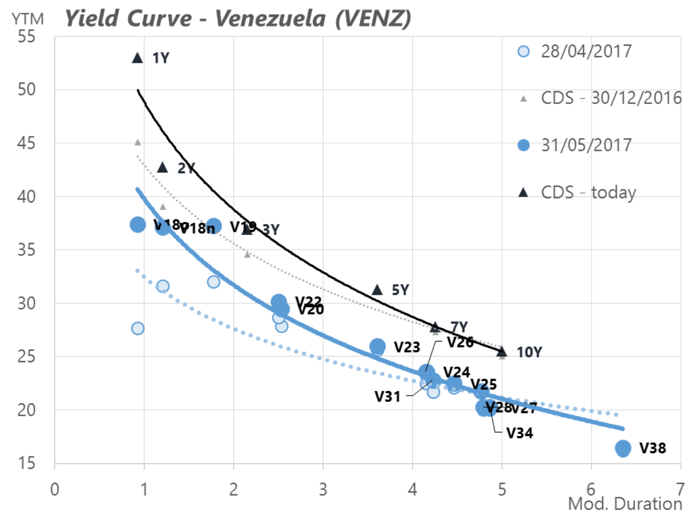


Chart N°2: VENZ/PDVSA bonds by Total Return, May 2017.
NOTE: total return separated by changes in market value (dark) and accrued interest (light section); return figures do not assume coupon reinvestment
Source: Bloomberg, Knossos Asset Management.

Evolution of the curves

Charts N°3 and N°4 attached show the evolution of Venezuela and PDVSA's yield curves on May 2017, for both cash bonds and CDS. The Sovereign curve inverted significantly: yields in bonds maturing on 2018-2019 rose by +640bps on average, while the rest of the curve saw an average +65bps rise in yields.



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

The PDVSA yield curve shifted upwards in May (+50bps) with significant differences throughout the tenors. We highlight the +275bps rise in the yield of PDVSA 8.5% 2017 'news' – despite the fact that the bond appreciated slightly in price terms during the month – and the -66bps fall on the PDVSA 2035, which represented the biggest yield compression seen in both curves on May.

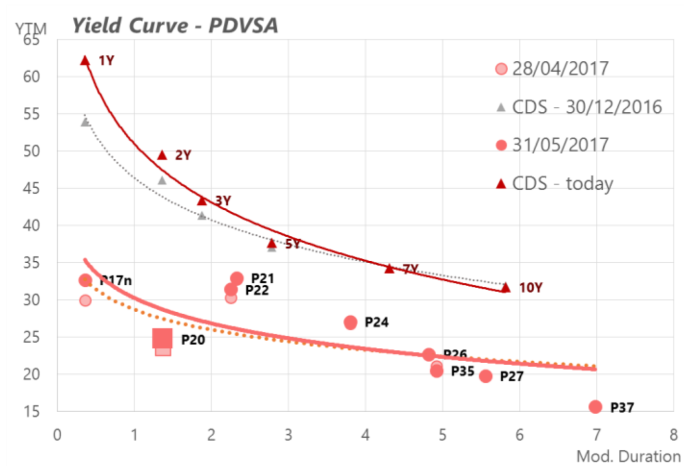


Chart N°4: PDVSA Yield Curve changes, May 2017.
***Source: Bloomberg* CBBT.**

Civil disobedience and 'Hunger Bonds'

The opposition-led street protests against the Maduro government have taken place almost daily for two months now, and yet the playbook hasn't changed. The toll of dozens of dead and thousands of detentions has brought massive support by the international community but little tangible benefits for the opposition bloc; even though it has opened rifts among Chavismo's ranks, the only significant defector has been General Prosecutor Luisa Ortega Diaz, and her public appearances haven't had significant implications so far. As the days go by and the opposition's convening power wanes, the situation evolves into an 'attrition war' where the time plays in favor of the band setting the agenda; meanwhile, the civil disobedience deepens at all levels, threatening to turn into full-blown anarchy.

Even though regime-change optimism seems high among market participants, recent signs suggest that time is playing in favor of the government. PDVSA ended up paying May's debt service without tapping Central Bank reserves (and thus securing several additional months of leeway, since upcoming debt payments will be relatively light until the October-November maturities). In parallel, President Maduro keeps on pushing through the National Constituent Assembly (ANC), which already counts with an electoral committee and a scheduled election date; even further, the Supreme Court has ruled that *"it is not necessary, nor constitutionally-binding, to hold a referendum prior to convening the ANC"*. Additionally, the opposition's protest agenda is starting to get repetitive, with the potential of alienating popular support, which stands overwhelmingly against the current administration but could stop supporting opposition leaders due to their lack of a concrete roadmap to execute their stated objective of a pacific government transition in the country. Lastly, state law-enforcement bodies have relentlessly repressed protests nationwide (both peaceful and violent ones) without showing any obvious signs of exhaustion among troops or internal differences among the military high ranks.

This month, we were witnesses of a public-opinion debate regarding the moral implications of investing in Venezuelan debt amid the current juncture. The 'Hunger Bonds' have become viral in the press and social media alike, courtesy of a Project Syndicate piece of the same name written by one of the most prominent critics of the government's external debt policy, Ricardo Haussmann. The massive investment undertaken by GSAM - discussed previously in this report – reinforced the heated debate, which keeps on in full force at the time of writing. Consistent with the spirit of our firm, we want to separate between the moral implications of investing in Venezuelan debt (which are, by definition, subject to the realities of each investor) and focus on the objective aspects of the matter.

We acknowledge there has been a conscious decision by the Maduro government to prioritize debt service above all other economic policy objectives. We consider that, to a great extent, this has to do with the short-term risks of an unfriendly debt default (seizure of external assets; commercial blockade; political instability, with possibility of regime change) which haven't been faced by the policymakers but have instead been constantly deferred by means of an unsustainable policy of indebtedness (at distressed-level costs) and external asset depletion. In sum, Venezuela is facing a vicious circle of growing liabilities and increasing short-term risks/costs of defaulting, which enhances the incentives to maintain the *status quo* and keep the willingness to pay at all costs, betting on an elusive recovery in oil prices that allows the government to maintain their macroeconomic policy regime without the need of a debt restructuring. In the absence of a significant appreciation in crude prices, the logic conclusion is a credit event, once the Republic has depleted all its external resources and finds itself without no additional sources of financing.

Based on our assessment, the implications of the Goldman deal for the credit market are mixed. GSAM has publicly stated that the position amounts to a 'regime-change bet', which suggests that their investment horizon is tied to political events in Venezuela, not necessarily to their vision over capacity to pay. We consider unlikely that GSAM has a legal prohibition against trading the securities on the secondary market, so we have to consider the potential flow of supply that could come along this route. **In a positive scenario, GSAM retains conviction on its trade and hence keeps on its position in the PDVSA 6% 2022,** taking out USD 2.8Bn of potential supply out of the float; we consider this positive for bond prices in the short term, especially if events in the political front indicate that a government transition is likely (and hence, that the market would drift towards a new equilibrium with significantly higher prices). **In a negative scenario, GSAM loses conviction on the trade and decides to unwind its position on the PDVSA 6% 2022.** This would be clearly credit-negative, as the market would be forced to digest the equivalent of two months of secondary-market supply (based on *Dealer-to-Client buys* reported last month to Finra's TRACE database). Additionally, there's an investor base with the same orientation of Goldman and which would probably take the decision to sell at the same time. In such a scenario, the market consensus would now deem regime change unlikely and the focus would return to the credit fundamentals of PDVSA and the Republic, which continue to deteriorate with the passage of time.