



December 2018

## Ecuador Trip Notes

As part of our investment process, we travel to portfolio countries to assess current developments and investment opportunities. We visited policy makers in Ecuador recently, meeting officials at the Ministry of Economy and Finance, the US Embassy's office in Quito, political analysts, industry experts and other representatives of the public and private sectors.

Our takeaways from our meetings are summarized below.

### What We Learned

- Since President Lenin Moreno's inauguration in May 2017, Ecuador's government has shifted toward economic pragmatism, demonstrating willingness to adopt pro-business policies to address the structural challenges of the economy. Recent changes in key cabinet appointments reflect this change. Moreno has replaced loyalists of former president Raphael Correa with more pro-business members. In May, for example, Richard Martinez, formerly president of the Ecuadorean Business Committee, replaced Maria Elsa Viteri as the country's Minister of Economy and Finance. Viteri had served in the same role under Correa between 2008 and 2010.
- Representatives of the US Embassy observe that the relationship between Ecuador and the United States is as good as it has been in over a decade. During the Correa administration, the US curtailed support for Ecuador. According to the US State Department, Moreno has expressed interest in improving bilateral ties with the US; Vice President Mike Pence traveled to Quito in June 2018, the highest ranking official visit in over thirty years.
- Ecuador is cooperating with its Andean neighbors, working closely with Colombia to manage Venezuelan migration and to limit drug trafficking. According to the US Embassy, 600,000 Venezuelans are likely to enter Ecuador in the next twelve months and one-third of these migrants are expected to remain in Ecuador next year. Already, over 200,000 Venezuelans have migrated to Ecuador. Concern over the economic and social impact of drug smuggling escalated earlier this year when a narcotics terrorist group carried out attacks and kidnappings that lead to several deaths at Ecuador's northern border.
- Ecuador's government pursues an opportunistic approach to financing government spending, working with many sources of both short and medium-term financing, including the IMF, other multilateral lenders, China, and commercial banks. As an example, the government announced on 12 December 2018 that China Development Bank committed US\$900mm in a line-of-credit during Moreno's recent visit to Beijing, and that the country expects to secure up to US\$3.5 billion in additional funding from China.
- Ecuador's fiscal outlook remains tight. The Ministry of Economy and Finance estimates a financing shortfall of US\$600 million this year. If the government is unable to source new funds, arrears to private contractors will build. Total government financing needs are expected to be around US\$8 billion in 2019. Clearly, a large IMF program would provide significant relief.
- Based on our discussions with Ecuador officials, we believe the country is close to an agreement on a new IMF program as early as January 2019. The IMF staff completed its Article IV mission to Ecuador in July 2018. Under Article IV of the IMF Articles of Agreement, the Fund holds bilateral discussions with members, usually annually, including detailed analysis of a country's economic developments and policies. We understand that Economy and Finance Minister Martinez met with the IMF in Washington DC in early December. In our view, improving cooperation between Ecuador and the US suggests that the

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US will support an IMF program. In addition, Moreno's will to follow through on reforms that would be pre-conditions of a program currently appears high. Local political analysts reminded us that Moreno is not running for re-election. As a result, he is less susceptible to political pressures from an opposition that might object to IMF-mandated reforms.

- Ecuador's economy remains uncompetitive and has a bloated public sector, which accounts for roughly one-third of GDP. According to the IMF, Ecuador's growth rate is likely to range from 0.8% to 1% next year after posting 1.1% growth in 2018. Since the downturn in oil prices in 2014-2015, Ecuador has struggled to generate growth rates in the mid-to-high single digits as it had in the years immediately following the Global Financial Crisis. Local experts estimate that Ecuador's real exchange rate is overvalued by as much as 25% and observe that this overvaluation limits growth and creates constant liquidity challenges.
- Full dollarization of the economy has eliminated Ecuador's ability to pursue independent monetary and exchange rate policies. As a result, the country must rely on fiscal and structural policies to restore competitiveness, which will also require a sustained effort in helping rebalance the economy.
- For this reason, an IMF program is an attractive alternative for the Moreno administration. If a commitment to fiscal consolidation under a program comes to pass, we believe healthier growth can return over time. Ecuador has significant room to reduce its deficits by cutting capital expenditures, lowering public sector employee headcount, or both.
- In addition, local experts expect oil production to increase from 410,000 barrels per day up to 515,000 barrels per day by 2020 before edging lower. We believe this development further supports potential improvements in Ecuador's near-term capacity to repay debt.

### Significance of What We Learned

- We believe markets over-estimate the political cost of securing an IMF program and that President Moreno fully supports negotiations with the multilateral lender, improving the likelihood of a program in the near term.
- While finances are tight, Ecuador has financing alternatives. If growth and revenues do not materialize as planned, authorities reminded us that they have ample room to cut fat in the public sector.

### Investment Conclusions

- In addition to support from China, we believe Ecuador is likely to agree on an IMF program which will materially ease financing pressures in 2019.
- We believe the market's estimation of near-term default risk is too high. At current levels of bond prices and credit spreads, we see attractive investment opportunities in Ecuador's US dollar-denominated sovereign debt.

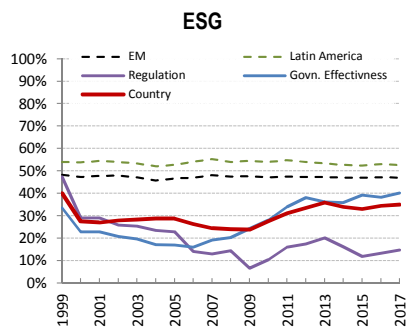
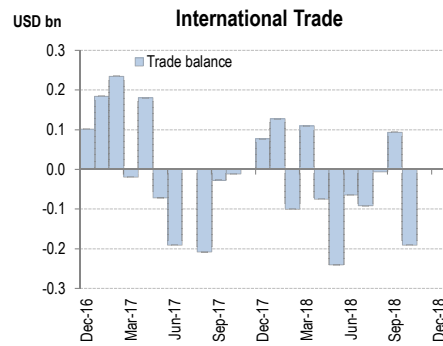
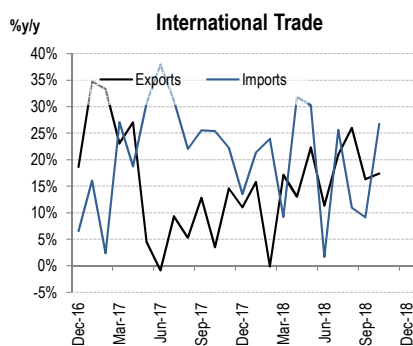
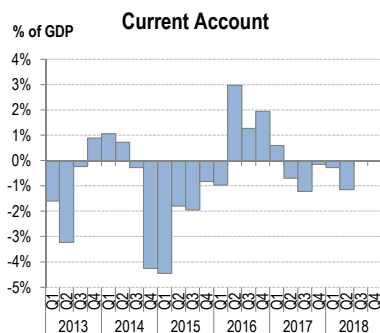
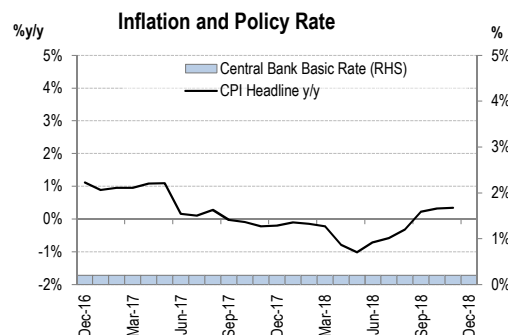
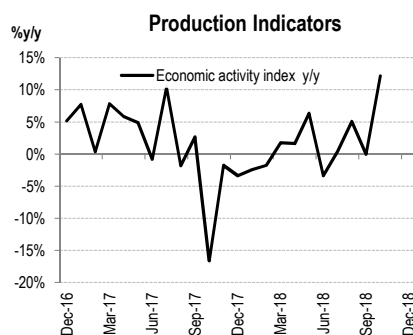
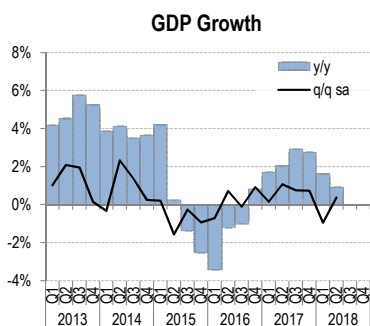
# Ecuador

12/12/2018

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	2011	2012	2013	2014	2015	2016	2017	2018(f)	2019(f)
Real GDP Growth (%)	7.9	5.6	4.9	3.8	0.1	-1.2	2.4	1.1	0.7
Investment (% of GDP)	25.8	27.0	27.6	27.2	26.6	25.1	25.4	...	...
Nominal GDP (\$bn)	79	88	95	102	99	100	104	...	...
GDP per capita (\$)	5,193	5,665	6,030	6,347	6,099	6,046	6,217	...	...
Population (mn)	15.3	15.5	15.8	16.0	16.3	16.5	16.8	...	...
CPI Inflation (%)	5.4	4.1	2.7	3.7	3.4	1.2	-0.2	0.7	0.1
Fiscal Balance, General Government (% of GDP)	-0.1	-0.9	-4.6	-5.2	-6.1	-8.2	-4.5	-2.7	-2.3
Public Debt, Gross (% of GDP)	16.8	17.5	20.0	27.1	33.8	43.2	45.4	48.4	50.2
External Debt (% of GDP)	19	18	20	24	28	34	38	...	...
External Debt (\$bn)	15.3	16.0	18.8	24.1	27.6	34.5	40.0	...	...
Credit, to private sector (% of GDP)	26.7	27.6	28.2	28.7	28.4	29.9	33.4	...	...
Exports (% of GDP)	29.1	27.9	26.9	26.1	19.2	17.4	18.8	...	...
Imports (% of GDP)	29.5	27.9	27.5	26.2	20.8	15.9	18.5	...	...
Workers Remittances (% of GDP)	3.4	2.8	2.6	2.4	2.4	2.6	2.7	...	...
Current Account Balance (% of GDP)	-0.5	-0.2	-1.0	-0.7	-2.2	1.3	-0.4	-0.5	0.7
Foreign Direct Investment (% of GDP)	0.8	0.6	0.8	0.8	1.3	0.8	0.6	...	...

Source: Haver Analytics, IMF, IMF WEO Forecast



Sources for ESG data: Yale Center for Environmental Law & Policy and Center for International Earth Science Information Network (CIESIN) at Columbia University, in collaboration with the World Economic Forum and others, CATO Institute, Fraser Institute, Friedrich Nauman Foundation, Worldwide Governance Indicators: World Bank, Brookings Institution, and Natural Resource Governance Institute, Transparency International. You should not assume that any investments in regions identified or described were or will be profitable. Investing entails risks, including possible loss of principal. For illustrative purposes only.

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- Institutional fixed income investment firm focused on credit risk strategies and asset allocation.
- 100% employee-owned
- Many team members have been together for nearly 30 years
- Offices in New York, Chicago, London, Singapore and Melbourne.
- Total assets under management: USD 29.35 billion as of 30 September 2018

Emerging Markets Debt management team, many of whom have worked together for nearly 30 years spanning a variety of market events and stages, have established a lengthy track record managing portfolios in emerging sovereign and corporate debt markets denominated in developed and local currencies. As a dedicated portfolio management team they are able to supplement intensive credit work with extensive travel to visit with decision makers in emerging markets. The 14 member portfolio management team averages over 20 years of investment experience. Resources include:

- 12 Portfolio Managers
- 4 Dedicated Emerging Markets Corporate Credit Specialists
- 9 Global Credit Industry Analysts
- 2 Economists (both developed and emerging markets)
- 11 Quantitative and Risk Analysts
- 2 Dedicated Emerging Markets Desk Analysts

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## Index Definitions

The J.P. Morgan EMBI Global Diversified (EMBI Global Diversified) limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.

The J.P. Morgan GBI-EM Global Diversified consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. The weightings among the countries are more evenly distributed within this index.

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Multi-Sector Credit	Investment Grade	Global High Yield	Emerging Markets
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