VM Wealth Management Limited

Bond Analysis: Government of The Dominican Republic

VMWM Research | January 19, 2023

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- **Recommendation: OVERWEIGHT**

ABOUT THE DOMINCAN REPUBLIC

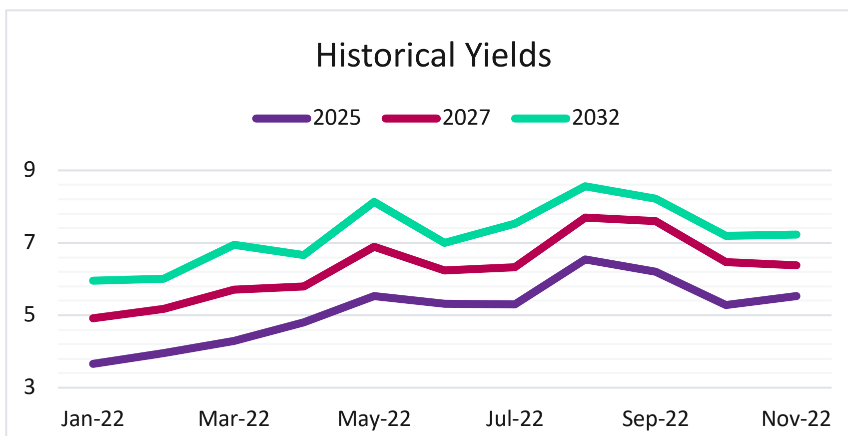
The Dominican Republic's (DR) economy has made a successful comeback from the pandemic, despite global forces that make inflation a challenge. In 2021, real GDP expanded by 12.3% as a result of widespread sectoral expansion, which included a rebound in tourism, with arrivals surpassing 2019 levels since the fall. For 2022 real GDP is estimated to have grown beyond 5.0%.

The DR also continues to show resilience to global shocks, supported by sound policies, monetary policy support, a nimble COVID vaccination campaign and a well-timed reopening that allowed the economy to make the most of the global rebound in 2021. This resilience and strong signals of policy sustainability are positioning the DR's economy to cope with emerging global challenges going forward.

It is taking longer than expected for inflation to converge; headline inflation is higher than the target range principally because of high inflation in the United States, rising energy and food costs globally, and supply chain disruptions. Notwithstanding, with adequate foreign direct investment (FDI) and a sizable build-up of reserves, the external position is strong. Despite the reduction in regulatory flexibility connected to the pandemic, the financial sector is nonetheless robust and remains supportive of economic growth. The outlook suggests a sustained recovery, though global developments pose risks.

Government of The Dominican Republic: Bond Term Summary			
Issuer	Government of The Dominican Republic		
Currency	USD		
Credit Rating/Outlook	Standard & Poor's (S&P): BB/Stable Moody's: Ba3/Stable Fitch Ratings: BB-/Stable		
Day Count Basis	30/365		
Use of proceeds	Refinance; General Corporate Purposes		
Maturity	**27-Jan-2025**	**25-Jan-2027**	**23-Sep-2032**
Coupon Rate	**5.500**	**5.950**	**4.875**
Issue Date	27-Jan-2015	25-Jan-2017	23-Sep-2020
Tenor	10 Years	10 Years	12 Years
Maturity Type	Bullet	Bullet	Bullet
Amount Outstanding	1.50 billion	1.70 billion	3.06 billion
Ask Yield to Maturity*	5.392	6.128	7.233
Ask Price*	100.202	99.371	83.774

*All prices/yields as of 16-Jan-2023 (intra-day)



Recommendation: It is apparent that the strengths and opportunities for the Dominican Republic outweigh its weaknesses and threats. Also, the IMF, Oppenheimer and external rating agencies express shared positive sentiments regarding the country, bolstering confidence in its fundamentals across the international community and thus lending credence to it being a good option for investors to add to their investment portfolios. We therefore recommend that Dominican Republic bonds be **OVERWEIGHT**, especially given the attractive prices currently being offered on the market. The IMF has observed a great degree of urgency and commitment shown by the authorities in building on previous successes and in their desire to overcome remaining challenges, especially through structural reform and fiscal reform by the broadening of the tax base, which should increase the government's revenue to better manage debt.

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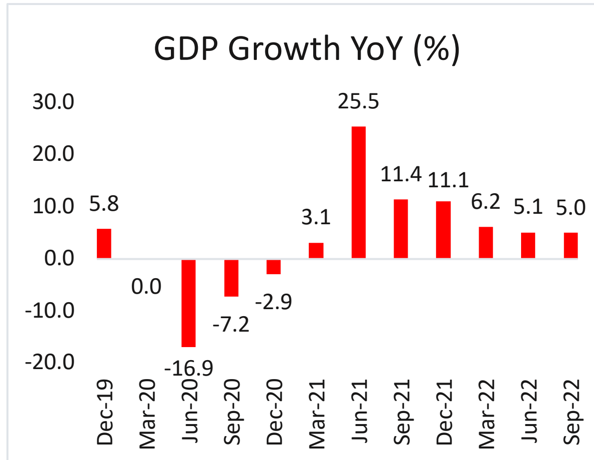
COUNTRY OUTLOOK

GDP Growth expected to end 2022 above 5.0%

The Central Bank (CB) announced that economic activity as at October 2022 increased by 3.8% YoY and 5.2% YTD. Despite slowing real GDP growth in comparison to 2021, real GDP for 2022 is expected to climb beyond 5.0%. The services sector led the expansion so far in 2022 posting a 7.0.% growth rate, supported by restaurants and hotels at 26.8%. Free zone manufacturing grew 6.3% and agriculture 4.6%. Mining fell 8.0%. In the third quarter of 2022 (3Q22), unemployment fell to 4.8% from 8.0% in the first quarter of 2021(Q121). The CB also noted the outstanding performance of the external sector[1], driven by 7.5 million tourists in Jan-Nov, a historical record. The International Monetary Fund (IMF) expects GDP to grow by about 4.5% in 2023, a gradual deceleration from 2022 but still a strong performance – indeed better than most regional peers. S&P expects that continued favourable GDP growth and policy continuity over the next 12-18 months should stabilize the government's debt burden.

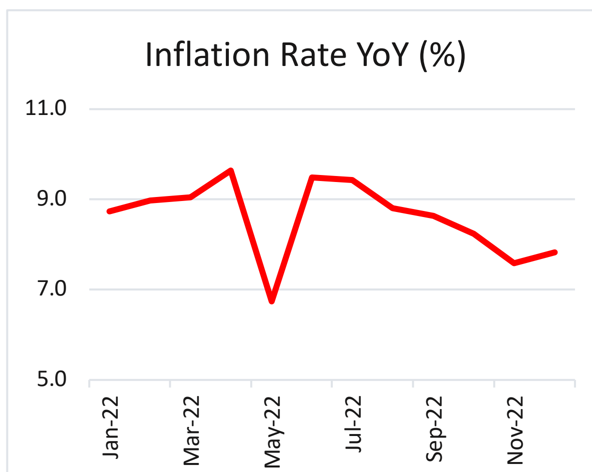


Record breaking Tourist arrivals in 2022

A full recovery in tourist arrivals relative to their pre-pandemic levels has materialized. The latest November 2022 data showed record cumulative long-stay arrivals of 7.5 million year-to-date (YTD) when compared to the 4.8 million recorded in the November of the previous year and the 6.4 million recorded in the November of 2019 (pre-pandemic). Tourism continues to be a key driver of the economy and we view its improvement and growth as a credit positive.

Inflationary pressures continue, but are expected to subside

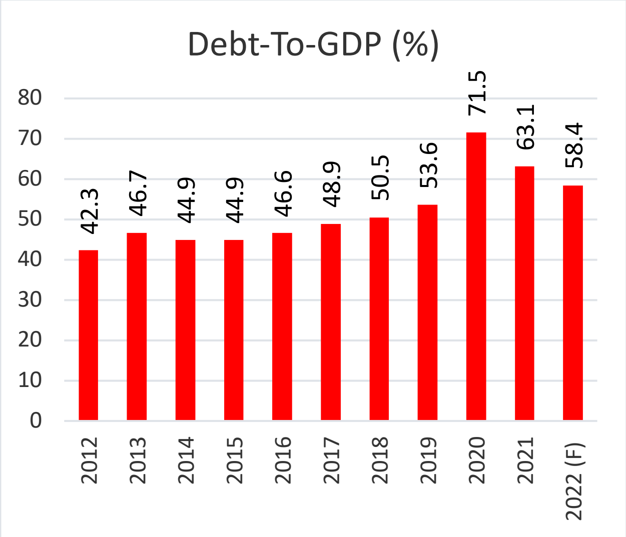
Inflation remains a challenge to the country's outlook, reaching 7.8% YoY as of December 2022, which was similar to the 7.6% rate in November, but below the 9.6% peak rate from April. Towards the end of 2022, the CB maintained the target policy rate at 8.5%, highlighting that the recent monetary policy tightening and fuel & agriculture subsidies have moderated inflationary pressures. In addition, the external environment is more supportive as commodity prices and transportation costs had begun to decline. The CB expressed that "the reference rate has reached an adequate level for annual inflation to continue falling in the coming months and converge to the target range before the end of the second half of 2023 (1H23)". This indicates that, the CB has no intention to tighten monetary policy further. The CB said, however, that it will continue monitoring external events and inflation expectations and that it is ready to adopt additional policy measures if necessary.



[1] The external sector of a country's economy refers to all international economic transactions between residents of the country (private and public sector) and the rest of the world.

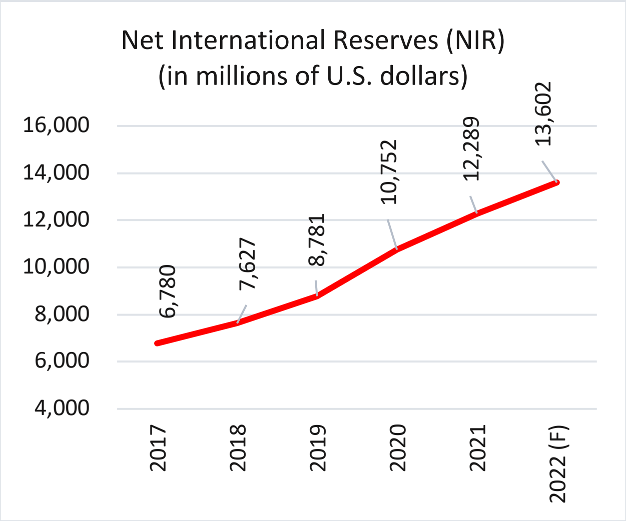
Debt-to-GDP falls from 2020 peak, expected to stabilize at 53.0%

Between 2012 and 2019, The DR's Debt-to-GDP ratio remained stable within the 40%-55% range. In 2020, it spiked to 71.5%, reflecting budgetary increases in response to COVID-19. Since then, the sovereign has made meaningful progress in reducing the Debt-to-GDP ratio. For 2022, it is estimated to have fallen to 58.4% from 63.1% in 2021. Rising foreign currency inflows from tourism, exports, remittances, and long-term foreign direct investment have all helped in moderating external debt vulnerabilities. Higher government revenue collection is also stabilizing the debt burden, although some infrastructure projects remain under-executed. S&P expects The DR's debt to stabilize at around 53.0% of GDP over the next three years, returning it to pre-pandemic levels.



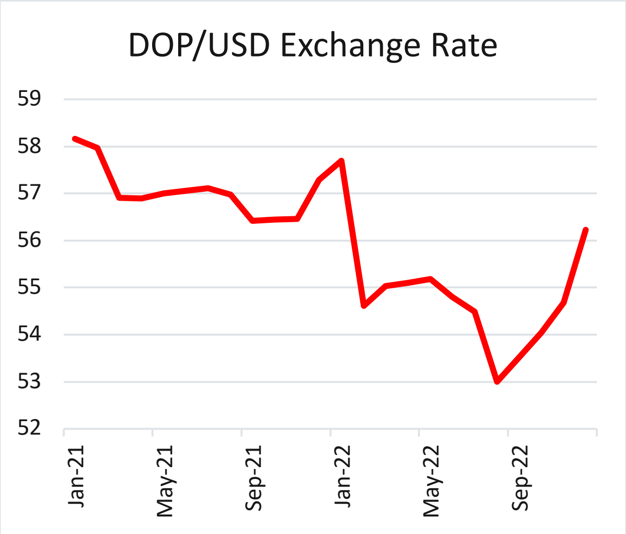
In 2022, the Dominican Peso (DOP) appreciated and the Central Bank accumulated reserves; The current account deficit widened, but should stabilize at around 3.0% up to 2025

The IMF estimates that in 2022 the current account had a deficit of 3.3% of GDP, driven primarily by commodity price increases (especially fuels), despite robust growth in exports and remittances. This is higher when compared to deficits of 1.7% and 2.8% reported for 2020 and 2021 respectively. Despite the sizable deterioration in the current account deficit, the Dominican peso had appreciated throughout 2022, while the Central Bank continued to accumulate reserves, which indicates that external risks are relatively contained and sustainable. The IMF and S&P expect that the current account should gradually narrow to around 3.0% over the next three years. The IMF also expects that reserves should continue to grow to USD $15.2 billion in 2023.



Fiscal front historically challenging, but improved institutions bode well for the outlook

The country has historically faced political and social challenges in passing structural reforms to reduce fiscal deficits, despite recent improvements in the heavily subsidized electricity sector. Notwithstanding, The DR has gradually strengthened its public institutions, demonstrated through its capacity to maintain high economic growth rates and improve its fiscal planning and debt management. The lack of political polarization between parties has also led to some consensus on economic policies, mostly pro-business and market friendly. Nonetheless, the government's decision to postpone a long-standing tax reform and the temporary suspension of electricity tariff hikes demonstrate shortcomings in its ability to undertake forceful and timely measures to strengthen public finances. S&P does not expect a meaningful tax reform during the next two years, despite the government having working majorities in both chambers of Congress and high popularity. However, S&P believes that there could be complementary measures to maintain pro-investment policies and other steps to boost tax



revenues and contain spending. Higher government revenue collection during 2022 has helped in reducing the fiscal deficit from its 2020 peak and stabilizing the debt burden. According to the IMF, expenditure rationalization and tax administration efforts should help maintain a gradual fiscal consolidation, putting public debt on a stronger downward trajectory than previously projected while protecting investment and social spending. The use of temporary fiscal measures to contain the impact of commodity price shocks on domestic fuel and food prices is appropriate, as well as continuing with electricity sector reforms and improved targeting of subsidies and social assistance.

The financial sector passed a tough resilience test

According to the IMF's 2022 Article IV report on the DR, the financial sector passed a tough resilience test. Despite the withdrawal of COVID-related regulatory flexibility and the legacy of the crisis on credit quality, capital and liquidity buffers remained sufficient. Credit growth rebounded with the recovery, though distressed loans (notably, restructurings in the service sector) are still elevated. Deposits growth remained strong. A recent liquidation of a very small bank, due to issues pre-dating COVID, was handled appropriately and had no visible effect on the market.

RATINGS ANALYSIS

Standard & Poor's (S&P): BB/Stable

On December 19, 2022, S&P upgraded the DR's credit rating to 'BB' from 'BB-' while maintain a stable outlook for the sovereign. The rationale for the rating was based on the DR's fast-growing and resilient economy. Despite its vulnerability to external shocks, the country has proven its capacity to rapidly bounce back in the aftermaths, thanks to somewhat predictable economic policies. The stable outlook reflects the expectation of ongoing positive GDP growth and policy continuity over the next 12 to 18 months, which should likely stabilize the government's debt burden.

Moody's: Ba3/Stable

On October 26, 2021, Moody's affirmed the DR's rating at 'Ba3', reflecting its sustained strong economic growth, balanced by its relatively small sized economy and reliance on tourism. Governance was determined to be relatively weak overall, albeit improving in terms of institutional framework and policy effectiveness. Moody's assessed the country to have significant fiscal challenges, including a relatively high debt burden and foreign exchange risk.

Fitch Ratings: BB-/Stable

On December 6, 2022, Fitch Ratings affirmed the DR's rating at BB- with a stable outlook, supported by a track record of robust economic growth, a diversified export structure, high per-capita GDP and social indicators, and governance scores that compare favourably to peers' after sustained improvement in the past decade. The rating is constrained by fiscal weaknesses including a high interest burden and subsidization of a loss-making electricity sector, improved but still relatively narrow external liquidity buffers, lingering weaknesses in the macroeconomic policy framework, and heavy sovereign reliance on external bond market financing that could pose a vulnerability amid tighter global conditions.

S.W.O.T Analysis

Strengths:	Weaknesses:
• The economy is recovering well after the contraction experienced in 2020. Real GDP growth projected by IMF at 4.5% for 2023. • The DR economy remains relatively more diverse than peers such as Barbados, the Bahamas, and Trinidad & Tobago. • The DR benefits from a stable, democratic, political institution, with general consensus towards economic policies and the stabilization of the national debt. • Adequate credit ratings from S&P, Moody's and Fitch. In particular, S&P recently upgraded the sovereign's rating to 'BB' from 'BB-' reflecting an improved economy and creditworthiness since COVID-19. • Overall confidence in country expressed by international community.	• Inflation remains a challenge to the outlook and could dampen the economic outlook. • Heavy reliance on tourism for economic output. • Fiscal inefficiencies continue to be a challenge
Opportunities:	**Threats:**
• The country has the opportunity to better diversify the economy through continued pro-business and market friendly policies. • DR benefits from a strategic location, which provides the opportunity to become a logistics hub. Proximity to key source tourism markets such as the US and Canada are also beneficial. • The new government has a strong mandate and popularity, providing the opportunity to correct some of the fiscal inefficiencies being experienced.	• Natural disasters such as hurricanes and earthquakes • Exogenous shocks such as the war in Ukraine also make the country vulnerable as a small, island economy. • Spill over effects from the possibility of a recession in major economies such as the US, China and those in Europe.

Conclusion

It is apparent that the strengths and opportunities for the Dominican Republic outweigh its weaknesses and threats. Also, the IMF, Oppenheimer and external rating agencies express shared positive sentiments regarding the country, bolstering confidence in its fundamentals across the international community and thus lending credence to it being a good option for investors to add to their investment portfolios. We therefore recommend that Dominican Republic bonds be **OVERWEIGHT**, especially given the attractive prices currently being offered on the market. The IMF has observed a great degree of urgency and commitment shown by the authorities in building on previous successes and in their desire to overcome remaining challenges, especially through structural reform and fiscal reform by the broadening of the tax base, which should increase the government's revenue to better manage debt.

SOURCES

Bloomberg, IMF, S&P, Moody's, Oppenheimer, Fitch Ratings, Central Bank of the Dominican Republic

DISCLAIMER

DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.
- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.
- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.