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El Salvador Strategy Flash

Some additional thoughts on the recent developments

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Giving some additional depth to our initial piece (please click here), while the short-term financial issues surrounding the operation remain clear, the medium to long-term outlook that arises from the transaction is not clear cut, especially as all indicators point at El Salvador entering an IMF program shortly. As we stated in our previous piece, it is clear that the country is looking to ensure a successful return to international markets, with both the tender offer and the macro-linked security pointing in that direction. The country is prepared to bundle a conventional security, similar to the current issuances, and a macro-linked security, and will trade separately in the secondary market. Allegedly, its design envisages an initial coupon of 0.25%, which may step up to 4%, if El Salvador fails to sign a deal with the IMF in the following 18 months, or if it fails to attain a credit rating of B or more in the same timeframe. While there is heavy speculation regarding El Salvador entering an IMF program soon, we believe that, if this structure comes to materialize, it is then a clear indicator of the country heading towards said scenario. By including the second clause, regarding the obtention of a B credit rating, we believe that it is designed to function as an escape clause for the administration, as to be able to still pay less interest payments if the agreement with the IMF is botched. However, this second clause reduces the chance of an IMF program going through, as it gives the administration some maneuvering space not to commit to the Fund. Beyond the speculation of a deal being in the works, the instrument clearly aligns the incentives of the country to enter a program, or at least to maintain a solid fiscal performance. The cost of not conforming to either clause would be substantial, but not prohibitive. If the country can issue between USD750mn and USD1000mn, then the macro-linked security would generate interest payments for around USD2.5mn to USD1.88mn initially, albeit these could spike to between USD30mn-USD40mn if it fails to sign an IMF deal. This represents between 6.6%-8.8% of current yearly interest payments for the external debt up to 2030, which is quite substantial, and clearly points towards an IMF program sooner rather than later.

From the investor's POV, the signing of the IMF program is a long-term demand, which would anchor the institutional program and give some additional transparency to a Bukele government that has not been as successful in those areas. However, it would also introduce a super-senior creditor to the sovereign curve and load the payment profile even further.

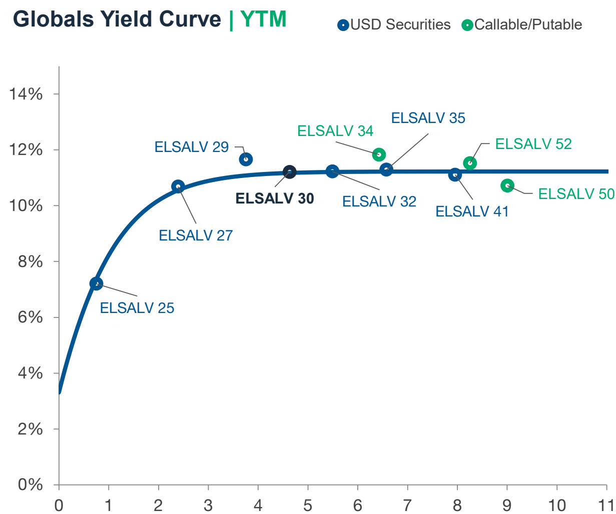
From the investor's POV, the signing of the IMF program is a long-term demand, which would anchor the institutional program and give some additional transparency to a Bukele government that has not been as successful in those areas. However, it would also introduce a super-senior creditor to the sovereign curve and load the payment profile even further. Since 2020, international investors have entertained the possibility of El Salvador entering a program with the IMF. And what initially was seen as a contentious issue, in recent years has become a demand, as the administration performed stellarly in the fiscal department, and investors looked at an IMF deal with kinder eyes. Such a program would increase transparency while also introducing an auditor to economic policy, which would ensure the sustainability of the current administration path. The market envisages an IMF deal as the perfect complement to the administration's policy bias, as it ensures the good work of the government on the fiscal side continues going forward. However, you should be careful of what you wish for, as an IMF program also introduces a super-senior creditor for the country, and puts an additional burden on the debt profile, all to provide some extra short-term cash, which is not especially needed, in addition to a policing ability which is not as infallible as believed. With debts outstanding to the IMF being senior to international debt payments, an agreement with the country displaces bondholders from the highest-seniority creditor, placing them second to the fund. Therefore, the issue is that, while the specifics of the deal are still to be determined, it is likely that a significant chunk of the payments to the IMF will fall in the early 2030's period, which is a sensitive time for the sovereign curve, as it accumulates significant maturities, which will then have to compete for

funding against the IMF payments, which have seniority. In addition, while the program is bound to have quantitative criteria to bind the economic policy path, it is also true that the IMF's policing ability is not ironclad, and the country could fail to meet the targets and muddle through the program while servicing the IMF debt, as Argentina did in 2023. So, the gamble the investors are willing to make is that the policy enforcement the IMF would provide to El Salvador outmatches the risk of introducing a super-senior creditor to them and loading the maturity schedule of the country. While we agree that an IMF program is bound to generate some additional commitment to desirable policies, it is not clear at all that the cost is worth it in terms of the country's repayment capabilities. The inclusion of the alternative criteria of ensuring a B rating comes to shore up a weak side of the proposal, which had to do with the policy path if the IMF deal falls through, providing an escape clause for the administration to maintain a low-interest rate via an alternative route, which is also desirable for investors. However, being an or, not an and, does not require the country to have a solid rating if the IMF program goes ahead.

However, the key issue hinges on why El Salvador is willing to enter an IMF deal going forward, and what has made its stance regarding a program change, as it determines whether the news is credit positive, or credit negative. The inclusion of the alternative criteria does skew the interpretations to the more benign scenario.

However, the key issue hinges on why El Salvador is willing to enter an IMF deal going forward, and what has made its stance regarding a program change, as it determines whether the news is credit positive, or credit negative. The inclusion of the alternative criteria does skew the interpretations to the more benign scenario. So, from the country's POV, it is not clear what has forced Mr. Bukele's hand into considering an IMF deal. The president has been adamant in highlighting that the country does not need IMF assistance in previous years and has refused to enter a program with the fund since the start of its tenure, even amidst heavy speculation, especially as the introduction of Bitcoin as legal tender drew a sizable wedge between the country and IMF officials. So, the key question is what has changed for El Salvador now to be willing to accept entering an IMF deal? The reasons can be crudely split into two groups. The positive interpretations suggest that, in order to reopen market access and reduce its financing costs, the government is finally willing to budge to investor demands, as they see an IMF deal with good eyes. Additionally, now that Mr. Bukele has ensured another term as president, he might be willing to commit to an IMF program, which might require some unpopular policy biases that wouldn't be suitable for an electoral period. We find that, given that the government also considers maintaining fiscal discipline going forward, even outside an IMF deal given the alternative rating target, this conclusion seems the most likely. However, it might also be possible that the shift might signal some trouble going forward. Primarily, it might suggest that fiscal discipline, the main bulwark of the government's economic policies, might start to falter, as the government might enter an IMF deal, not triggering the step up, and then see a deterioration in fundamentals. After December's spending spree, which dented the fiscal balance significantly, the administration did return to exhibit some fiscal prudence in January and February, which made us tag the episode as transitory, and cyclical due to the electoral race. However, in conjunction with the news of the administration looking to secure significant funding, it might be a sign of coming fiscal indiscipline. Or, this willingness could be a sign of brewing trouble in the pension system or the real economy, which would require the administration to secure additional funding. While we can only speculate on the true reasons, the bias of the event hinges on the usage of the funds the administration will acquire, which in turn largely depends on the reasoning behind the attitude shift. If the administration is using the agreement with the fund to open up market access and plans to maintain fiscal discipline going forward and use the funds to buy back its outstanding debt, then the issuance would be credit positive, as the yield obtained from obtaining more funding sources would make the external debt more sustainable and reduce the risk premium. On the other hand, if the increase in funding sources is dilapidated in further public expenditure and results in the loss of fiscal discipline and primary surplus, then the news is credit negative for the sovereign curve, as it would mean straining further the debt profile while introducing a super-senior creditor to bondholders.

Figure 1: The new issuance could come near the 11.25% mark



Source: TPCG Research based on TPCG Trading Desk

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In terms of pricing the coming issuance, while the administration is poised to offer a premium in the primary auction, the offered option could place the final rate somewhat below the market rate but will largely depend on the investor's valuation of the instrument. With the administration planning to issue a security maturing in the early 2030's the current yield curve puts the fair value of the bond between 11.18% and 11.22%, as the term structure of the curve is very flat, meaning that by 2030 there is little sensitivity to duration. However, the initial IPT suggests a low 12% rate for the issuance. The last time El Salvador tapped international markets, back in 2020, the administration offered a 60bp premium relative to its bond curve, which suggests that, in addition to its fair value, the government might offer between 50bp and 70bp in issuance premium, which would put the final rate of the security near the 11.75% mark. However, then there is the issue of the option the administration is offering. We find the pricing of the macro-linked interest-paying security is heavily dependent on the likelihood of either the administration signing an IMF deal or improving its credit ratings to at least a B. We believe said probability is quite high, which would make the option less valuable. However, with the option paying at best a 3.75% increase in coupon, in 18 months' time, it is relatively easy to tailor the value of the option for each probability distribution. Assuming a 10% chance of the country failing both conditions, then the option's FV would round the 37bp. An agnostic, 50/50 view would yield a 188bp price. In our view, the market prices a likelihood of 15% of El Salvador failing to attain any of the two objectives, which would result in an 56bp price for the option. In that scenario, then our pricing for the bond, compounding its FV, the issuance premium and the price of the option suggests the security coming out at an 11.25% rate.

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