

*May 13, 2019*

## **Venezuela: An Update, Part I**

On May 10, 2018, Nicolas Maduro was reelected as president of Venezuela. However, there were numerous irregularities during the vote and, as such, the U.S. and the Organization of American States (OAS) refused to view the election as legitimate. Shortly after Maduro was officially inaugurated on January 10, 2019, the National Assembly, which is controlled by Maduro's opposition, declared Maduro's election illegitimate and, following the Venezuelan constitution, installed Juan Guaido as the interim head of state until new elections are called. More than 50 nations have acknowledged that Guaido is the legitimate head of state; however, Maduro, supported by China, Nicaragua, Russia, Turkey and Cuba, remains in Miraflores Palace, the official residence of the Venezuelan president.

As a result, since late January, Venezuela has had two leaders. The U.S. has increased sanctions on Venezuela, including the overall economy and on individuals in the Maduro government. However, the impact of sanctions is somewhat limited given the terrible state of the Venezuelan economy. In addition, Venezuela has become something of a proxy conflict between the U.S. and Russia, with both sides allied with other nations. In a sense, Venezuelans have lost some degree of control over their destiny, complicating matters.

In Part I of this report, we will offer a short history of Venezuela to give readers some

context to the current situation. In Part II, we will examine the opposition's attempts to oust Maduro, the problems the opposition faces in removing the current leader and the interests of foreign players. As always, we will conclude with market ramifications.

### **Background**

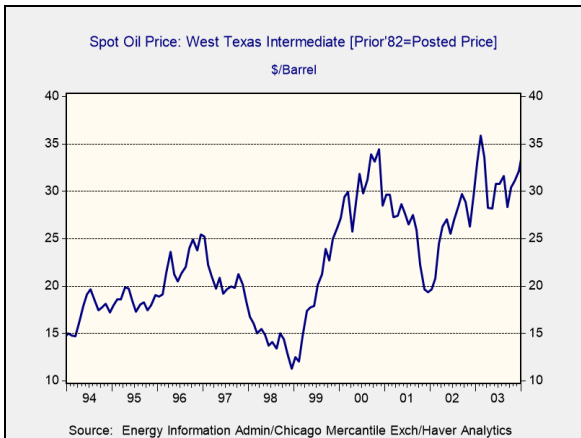
Although Venezuela had partially democratic governments from 1908 to 1945, a military junta controlled the state from 1945 until 1958. A coup in 1958 led Venezuela to return to democratic governments.

However, like many South American nations, Venezuela was mostly run by a moneyed elite and, since the country had significant oil assets, this elite was quite wealthy. The state oil company, PDVSA, was able to fund both the government and the wealthy, with enough left over to operate as a world-class oil company. Unfortunately, the poor, ensconced in hillside barrios and slums in the country's major cities, were without power and resources.

In 1992, Hugo Chavez, a lieutenant colonel in the Venezuelan military, attempted a coup. The sitting president at that time was Carlos Andres Perez, who was implementing austerity policies to reduce debt. These policies were unpopular and hurt the poor. Although Chavez's coup failed and he was imprisoned, he remained a popular figure in Venezuela.

In 1998, Chavez was elected president. In the years before his election, a market share war had developed between Saudi Arabia and Venezuela. Venezuela had adopted an

aggressive oil production expansion policy. The program was unusual for an OPEC nation because it included foreign investment in the oil sector. Much of Venezuela’s rising output was going to the U.S., which Saudi Arabia considered its primary customer. As the Saudi’s U.S. market share declined, the kingdom began a policy of increasing production to recapture the U.S. market. This oil expansion policy occurred during the Asian economic crisis of the late 1990s, which led to weaker global oil demand.



By late 1998, oil prices were heading toward \$10 per barrel. The drop in oil prices weighed heavily on the Venezuelan economy; as common with most OPEC nations, the country’s economy was heavily dependent on oil revenue.

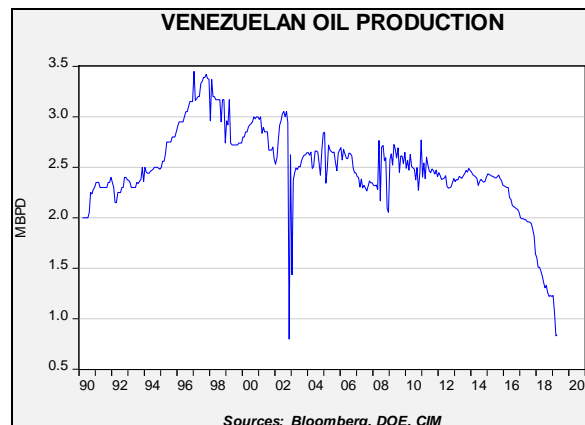
In his candidacy for president, Chavez vowed to address the oil price problem. Soon after his election, Saudi Arabia, Russia, Venezuela and Mexico agreed to cut production. Oil prices recovered rapidly and the Venezuelan economy recovered.

Chavez’s support came primarily from the urban poor. The poor were mostly organized by local gangs in the barrios, so Chavez had to make agreements with them. The leaders in the slums and barrios wanted funds, thus Chavez was going to need a

steady supply of funding to maintain support from the poor.

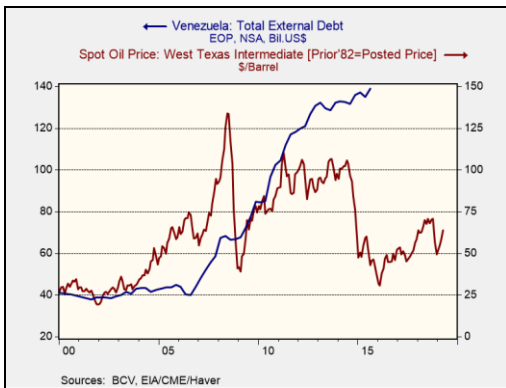
Simply trying to “soak the rich” was problematic as capital can flee and, over time, much of it did. Another source of funds was PDVSA. The Venezuelan state oil company had been allowed to operate with a high degree of autonomy; this increased its proficiency but also made it a “state within a state” in Venezuela. As Chavez tried to pull revenue from PDVSA, the leadership of the company opposed him. And, the elites in the country were never comfortable with his leadership. Consequently, in April 2002, there was a coup against the Chavez regime. It failed, mostly because the opposition lacked unity; the only thing it agreed on was that Chavez needed to go but it could not establish its own leaders. Thus, Chavez was able to return to power.

Later that year, PDVSA supported a large general strike against the government. Although the labor action continued from August 2002 into early 2003, with varying degrees of participation, Chavez outlasted the strikers and systematically began replacing PDVSA workers with “Bolivarian” loyalists. This gave Chavez control of the company and its revenues at the cost of falling production.



On the above graph, the strike in 2002 is obvious. Although production ranged roughly around 2.5 mbpd until 2016, it never recovered to the pre-strike levels of 3.0 mbpd. For much of the last decade, oil prices were elevated due to rising Chinese demand; high prices masked the impact of weakening technical capabilities at PDVSA. But, after the 2008-09 Great Financial Crisis, the drop in oil prices reduced government revenue and made it difficult for Chavez to maintain funding support for his followers.

As funding became more difficult, Chavez turned to foreign borrowing to maintain support.



The Venezuelan government has stopped publishing official data on foreign debt but the current level of foreign debt is around \$156 bn.<sup>1</sup> China was owed around \$50 bn, but through restructuring that level is down to around \$20 bn.<sup>2</sup> Russia is a major creditor as well and owns a large minority interest in Citgo. What is interesting about the previous chart is that debt levels were rising with strong oil prices. The drop in oil prices, coupled with the output decline

<sup>1</sup><https://markets.businessinsider.com/news/stocks/venezuela-debt-explodes-to-156-billion-report-2019-3-1028013380>

<sup>2</sup><https://www.wsj.com/articles/china-counts-the-costs-of-its-big-bet-on-venezuela-11549038825>

shown above, has put the Venezuelan economy in a precarious position.

After the Great Financial Crisis, Chavez steadily extended his control over more parts of the country, applying price controls on consumer goods. As any Econ 101 student can explain, price controls that force producers to provide goods at “attractive” prices usually result in widespread shortages. Price controls and general economic mismanagement triggered capital flight and brain drain; as the elites and educated gradually left the country, maintaining economic growth became increasingly difficult. Chavez needed support and Cuba was willing to offer help in exchange for low-cost oil. During his later years in leadership, personal popularity and Cuba’s support in bringing the military under the regime’s control allowed Chavez to stay in power.

In 2011, Chavez was diagnosed with cancer. Over the next two years, he endured at least two surgeries in Cuba along with chemotherapy. While Chavez was ill, he was forced to consider a successor. As is often the case with autocrats, they are fearful of selecting anyone that would be a potential threat to their power. As a result, Chavez selected Maduro as his “stand-in” during his illness. Maduro possessed little of Chavez’s personal popularity. While Chavez had credibility with the military due to his service, Maduro had never been in the military. Chavez was an electrifying public speaker; Maduro was not. But, Maduro was loyal and would not be a threat to ousting Chavez before he died.

Although Chavez did manage to win another term in office in 2012, his condition steadily deteriorated and he passed away on March 5, 2013. Six weeks later, Maduro won a special presidential election. He tried to

hold the election as soon as possible after Chavez’s death to “piggyback” off his predecessor’s popularity. Maduro did win the election, but it was by a slim margin, only getting 50.6% of the vote.

Since winning his first election, the economy has continued to deteriorate. Maduro has become increasingly dependent on Cuba and Russia for security and economic assistance. Persistent protests and growing opposition led the National Assembly to swing to Maduro’s opposition in 2015. In response, Maduro used the Supreme Court to strip the assembly of power and to call for new elections. On May 20, 2018, Maduro claimed victory in elections that were viewed as corrupt. The majority of nations did not accept the

results, therefore when Maduro was inaugurated in January of this year the National Assembly rejected his presidency and, following the constitution, declared Juan Guaido as interim president.

## **Part II**

Next week, we will conclude this report with an analysis of the opposition’s attempts to oust Maduro, the problems the opposition faces in his removal, the foreign players and market ramifications.

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