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RESEARCH CENTRE

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Foreword

Dear Reader,

The CMMB Research Centre aims to be the premier source for economic intelligence on Caribbean capital markets and the leading think tank for analysis and research on Caribbean macroeconomic and financial issues. The Caribbean Financial Quarterly (CFQ) is designed to help you to:

- Better understand the region's markets
- Develop business opportunities
- Enhance business and budgetary planning
- Make more informed investment decisions

In an effort to enhance the content of the CFQ, your thoughts and feedback would be greatly appreciated. Please email CMMB Research Centre at research@mycmmb.com or call (868) 623-7815. I look forward to hearing from you.

Best Regards

Jwala Rambarran
Chief Economist/Head, CMMB
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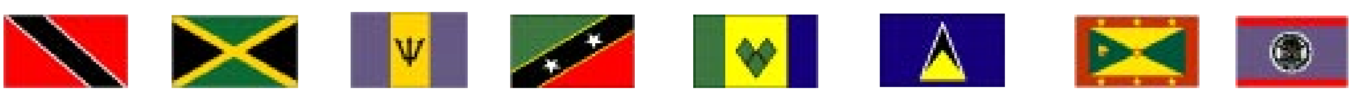
In this Edition

CMMB RESEARCH CENTRE

Caribbean Overview & Outlook

Caribbean countries have evinced fairly stable macroeconomic performances in the first half of 2006, but as international crude oil prices stay high and world interest rates edge upwards, many of these economies could face a more serious drag on growth in the remainder of the year. The start of another active hurricane season in the Atlantic belt has added to the general degree of uncertainty.



The Trinidad & Tobago economy is in its thirteenth consecutive year of expansion, mainly driven by greater capacity in the energy sector and buoyant crude oil prices.

Not surprisingly, concerns of overheating have surfaced in the context of historically low unemployment and emerging skill shortages as well as rising inflation risks. This has prompted the Central Bank of Trinidad and Tobago to further tighten monetary policy and to undertake unorthodox sterilisation measures while selling record levels of foreign exchange to partially quell excess demand pressures, some of which seem linked to capital flight. A curb on fiscal policy's very expansionary stance would help to ease the stabilisation burden on monetary policy and to assist in more firmly controlling inflation.

Jamaica: Strong tourism arrivals and increasing momentum in agriculture should boost growth in line with expectations.

Crime continues to taint the generally favourable outlook for Trinidad and Tobago.

In **Jamaica**, the government is moving in the desired direction of attaining a balanced budget, helping to pare total public debt whose ratio in relation to GDP is the third highest in the Caribbean. Strong tourism arrivals and increasing momentum in agriculture should boost growth in line with expectations, barring unforeseen negative shocks. Inflation has declined to within the lower end of the Bank of Jamaica's target range, manifested in falling interest rates. Jamaica's outlook is one of cautious optimism.

The risk of debt default is high in Belize. It seems that the government will have little choice but to enter into a comprehensive debt restructuring programme in the near future.

Feverish preparation for Cricket World Cup 2007 remains the key growth driver in **Barbados**, even though tourism and manufacturing have rebounded. The government's ambitious fiscal plan has contributed to increased external imbalances, placing undue pressure on the fixed exchange rate regime. The Central Bank of Barbados has paused its monetary tightening, instead focusing on demand management measures to dampen import spending and to protect international reserves.

Across the Eastern Caribbean, **Grenada** has entered into a three-year IMF-supported programme that seeks to gradually make sustainable the dire fiscal situation. Subsequently, Grenada has received debt relief from the Paris Club group of creditors, providing breathing space for the government in terms of meeting its debt service commitments. Elsewhere, the risk of debt default is high in **Belize**. It seems that the government will have little choice but to enter into a comprehensive debt restructuring programme in the near future, given its difficulty to secure additional financing to cover its large external gap in 2007. The International Monetary Fund (IMF) is expected to begin Article IV consultations with the authorities in August 2006, when the government's longer-term debt management strategy should be announced even though the risk remains that there will be further delays in finalising the plan.

Despite some signs of traction, Caribbean equity markets remain bearish so far in 2006. In Trinidad and Tobago, institutional investors continued to stay out of the market and positive corporate earnings reports failed to move stock prices. The Jamaican equity market displayed an even weaker performance, worsened by the cement crisis that gripped the construction and other related sectors. The market remains very unresponsive to new listings since the downturn last year. The Barbados equity market maintained its typically dormant characteristic. ■

Global Economy and Financial Markets

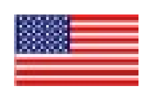
Global economic growth remained strong into the first half of 2006, but as energy prices stay high and inflationary risks mount, major central banks across the world have been tightening monetary policy, which could dampen the momentum going forward.

The US economy has rebounded solidly from temporary weakness in the final quarter of 2005, while activity in Japan is gaining strength. Conditions are supportive of a recovery in the euro zone. Strong growth is continuing in emerging markets, especially in China and India. The IMF in its latest forecasts expects global growth to remain above average pace of 4.9% in 2006 and to ease to 4.7% in 2007.

Crude oil prices have risen further in 2006. The price of West Texas Intermediate (WTI) rose by 30% in the first six months of 2006, reaching a new daily record peak of US$75 per barrel in April, well above the highs in September 2005 following the damage to facilities in the Gulf of Mexico caused by Hurricane Katrina. The market remains concerned about potential supply disruptions in Nigeria and the Middle East, particularly in Iran—the world's fourth largest oil producer. Long dated futures prices suggest that prices are likely to stay high for some time to come.

After a relatively strong start to 2006, the US economy appears to be slowing to a moderate pace.

United States



After a relatively strong start to 2006, the US economy appears to be slowing to a moderate pace. This is partly due to a gradual cooling of the housing market and the lagged effect of rising interest rates and elevated energy prices on growth. There are some indications that the US housing market is cooling, reducing the stimulus to private spending, residential investment and employment. The 30-year mortgage rate has risen to a four-year high and demand for housing seems to have slowed; home constructions, sales and mortgage applications are all well down from recent highs.

Despite rising interest costs, financing conditions are still accommodative and business sentiment is above long-run average levels. Reflecting the more optimistic state of the business sector, the labour market remains firm. Non-farm payrolls increased by an average of about 146,000 persons a month in January-May 2006. The US unemployment rate dipped to a five-year low of 4.6% in May, and firms are bidding up wages in order to attract and retain workers. Productivity levels are still showing moderate signs of resilience although resource capacity utilisation has been tightening, adding to inflationary fears. The further widening of the US trade gap suggests that the US current account deficit stayed around a high of 6-7% of GDP, reawakening investor concerns about a depreciation of the US dollar and a spike in long-term interest rates. On this basis, real GDP is expected to expand by around 3% in the second quarter of 2006, compared to an above-trend growth of over 5.0% in the previous quarter.

United States:
Recent readings on inflation are 'bothersome', spearheaded by elevated and volatile energy prices.

Recent readings on inflation are 'bothersome', spearheaded by elevated and volatile energy prices. Headline inflation crept up to 4.2% in the year to May 2006 while core inflation, excluding food and energy, rose by an annualised 2.4%. As strong energy and other commodity price pressures filter through the US economy and with spare capacity nearly exhausted, there is likely to be further inflation pressures over time.

Asia

The Japanese economy is now in its fourth year of expansion, and there are positive signs that the decade-long deflationary period seems to have ended. After growing by 4.3% in 2005, real GDP rose by 3.1% in the year to March 2006. The expansion has been broadly based. Export growth is due to strong demand in the US and in China as well as yen depreciation. Domestic demand is underpinned by rising employment and stronger balance sheets in both corporate and financial sectors. These improved conditions have flowed through the labour market where the unemployment rate fell to 4.1%, a seven-year low.

Japan also appears to be emerging from eight consecutive years of deflation. CPI inflation measured a positive 0.4% in the year to April 2006, while asset prices have been rising. Producer prices rose the fastest in 25 years during the second quarter of 2006 on surging energy and commodity costs. Property prices in Tokyo are now increasing after a 15-year hiatus.

China's rapid growth continues to provide a substantial impetus to the activity in the East Asian region. After growing by almost 10% in 2005, real GDP increased by a further 10.3% in the twelve months to March 2006. Revisions to the national accounts make China the fourth-largest economy in the world in US dollar terms and indicate a much larger output from the services sectors than previously estimated, but only minor changes to the expenditure components of GDP. Inflation remains fairly subdued in China despite strong economic growth and high commodity prices. Over the year to May 2006, inflation measured 1.4%. China recorded a US$13 billion trade surplus in May, forcing increased pressures on the government to permit the yuan to appreciate while limiting the effects of the central bank's attempts to control inflation and excess liquidity.

India's real GDP growth accelerated by 9.3% in the twelve months to March 2006, supported by a boost in manufacturing. Securing the fastest economic growth in two years, India is becoming increasingly integrated into the world economy. India forecasts an economic growth of 7.5-8% in the year to the end of March 2007, as the economy shows much resilience to increasing global interest rates.

Europe

Conditions remain supportive of a strengthening recovery in the euro area. The European Commission forecasts growth at 2.3% in 2006, the fastest pace since 2000. Strong external demand and a weaker euro should support the overall recovery, especially in Germany, the region's largest economy, where there is renewed optimism

Table 2.1 Policy Interest Rates* (end of period, %)

			2006					
	2004	2005	January	February	March	April	May	June
US	2.25	4.25	4.50	4.50	4.75	4.75	5.00	5.25
Euro Zone	2.00	2.25	2.25	2.25	2.50	2.50	2.50	2.75
Japan	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Trinidad and Tobago	5.00	6.00	6.25	6.50	6.75	6.75	7.00	7.25
Jamaica	13.80	12.60	12.60	12.60	12.60	12.60	12.45	12.45
Barbados	2.25	4.75	4.75	4.75	4.75	4.75	4.75	4.75

* For the US - Federal Funds Rate; For Japan - Overnight call rate; For the Euro area - main refinancing rate; for T&T - the repo rate; for Jamaica - 30-day repo rate; For Barbados - the minimum deposit rate.

about economic prospects. Consumer confidence rose to its highest in five years in May 2006 on the news of a jump in German retail sales and fall in unemployment. Elsewhere in the euro zone, growth was subdued in France and Italy, but was strong in Spain and the Netherlands. The euro-wide jobless rate fell to its lowest since April 2002 and was supported by a spurt in the manufacturing sector. Merchandise exports have picked up further, but recent euro appreciation against the US dollar could dampen gains going forward.

Euro-region annual HICP inflation accelerated to 2.5% in May 2006 compared with 2.4% in April and 2.2% in March. Inflation rates are likely to remain above the 2% ceiling of the European Central Bank (ECB) in 2006, reflecting much stronger than anticipated second round effects of past oil price increases.

Policy Interest Rates

Major central banks worldwide have for some time been normalising interest rates after the very low levels reached in 2003. The exception to this trend had been the Bank of Japan (BoJ), which began the transition in March 2006 to a more normal policy setting, after a prolonged period of highly unorthodox quantitative easing that flooded the financial markets with excess liquidity while keeping overnight interest rates at zero. With an improved outlook and rising consumer prices, the BoJ is expected to raise the overnight uncollateralised rate by 25 basis points in the third quarter of 2006.

The US Federal Reserve, which started tightening in mid-2004, has the highest policy interest rate among the Group of Seven (G-7) major industrialised countries of the world. The Federal Open Market Committee (FOMC) raised its Federal Funds rate 17 times in almost two years to 5.25%, and the language of its latest released statement suggests that the process of normalisation may be nearing an end. Members of the FOMC acknowledged the possibility that lagged effects of high oil prices on inflationary pressures are presently affecting consumer spending, business investments and the labour market. In this context, '*the evolution of the outlook for both inflation and economic growth as implied by incoming information*' is of prime focus to the market, which expects another 25 basis point interest rate hike in the third quarter and a pause thereafter for some time.

In June 2006, the ECB increased its minimum bid interest rate by 25 basis points to 2.75% for the third time in six months in a move aimed to keep inflation at bay as economic growth gains momentum. Even after this increase, key ECB policy interest rates are still low by historical standards and monetary policy remains accommodative.

In emerging markets, the policy direction varied. Central banks in Chile and Israel raised their policy interest rates amidst good growth and inflation concerns but rates were lowered in Brazil, Mexico, Poland and Turkey in line with easing inflation risks. China hiked its key prime interest rate by 27 basis points to 5.85% early in April 2006—the first tightening of liquidity since October 2004— and the authorities are encouraging the People's Bank of China to raise its reserve requirements to curb lending.

Exchange Rates

Two major developments dominated global foreign exchange markets in the second quarter of 2006. First, the US dollar depreciated against the major currencies, coinciding with speculation that the US Fed would pause in its interest rate hikes. A burgeoning US external current account deficit compounded the situation, reigniting investor

The New Zealand dollar, Icelandic krona and Turkish lira all tumbled in a few weeks.

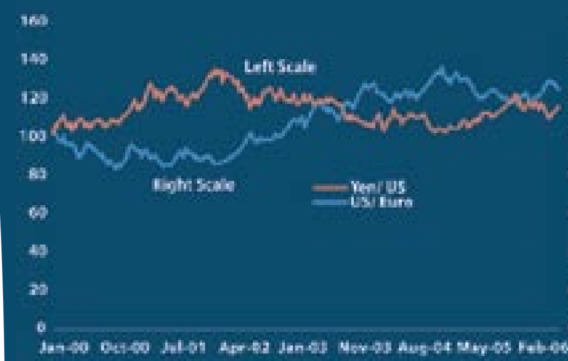
concerns about the size of the global imbalance and the impact of its resolution on financial markets. Second, the announcement by the BoJ on its new monetary framework triggered a reversal of the currency flows associated with the carry trade because investors feared that eventual yen appreciation might more than offset the interest differential between countries. Currencies of emerging markets, whose large external current account deficits have been partly financed by portfolio flows, were heavily affected. The New Zealand dollar, Icelandic krona and Turkish lira all tumbled in a few weeks.

Asian exchange rates have risen modestly against the US dollar reflecting favourable economic conditions and limited intervention by Asian central banks (except China) to slow the pace of currency appreciation. Since July 2005, the renminbi has appreciated by only 1.25% against the US dollar with heavy foreign exchange purchases causing China's official reserves to now exceed Japan's. Except for the Mexican peso, Latin American currencies appreciated slightly against the US dollar. Peso depreciation reflects Mexico's narrowing interest rate differential with the US.

Bond Markets

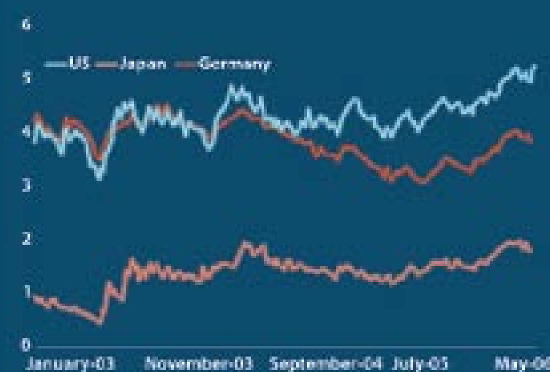
Rising global inflation risks and the prospect of almost simultaneous policy tightening in the major economies are starting to induce upward pressures on many government bond yields. Yields on US 10-year government bonds are currently trading above 5% compared with a

Figure 2.1
G-3 Currency Movements



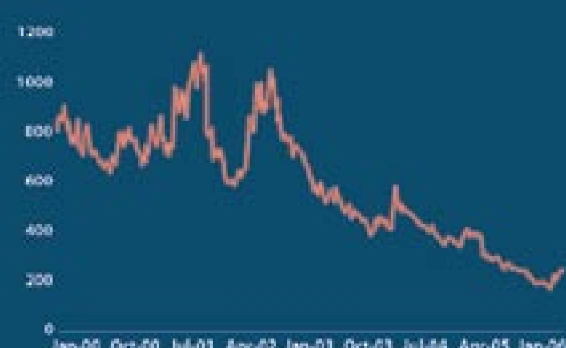
Sources: Bloomberg, CMMB Research Centre

Figure 2.2
G-3 10-Year Treasury Yields (%)



Sources: Bloomberg, CMMB Research Centre

Figure 2.3
JP Morgan: EMBI+ (Basis Points)



Sources: Bloomberg, CMMB Research Centre

In Japan, 10-year yields have been on an upward trend since mid-2005 and are currently trading around 2%, the highest since 1999.

range of 4-4.5% for much of the past two years. However, the US yield curve has been generally flat over recent months since long-term bond yields have risen broadly in line with the increase in the Fed funds rate. In Germany, long yields on government bonds rose to a high of almost 4.1% in mid-May 2006 and again in the latter part of June compared to almost 3% in late 2005. In Japan, 10-year yields have been on an upward trend since mid-2005 and are currently trading around 2%, the highest since 1999. Rising policy interest rates and government bond yields are yet to have a discernible impact on spreads on emerging market debt, which remain low. Spreads on the JP Morgan Emerging Market Bond Index narrowed to very low levels of 213 basis points by end-June 2006 from 239 basis points at the start of the year.

Equity Markets

After generating solid returns through the first four months of 2006 on the back of better-than-expected corporate profits, global equity markets sold off in May following fears of both higher inflation and interest rates. Earnings forecasts for the euro area were revised upwards at the fastest pace for some time, and those for the US were raised for the largest number of companies since early 2005. Only in Japan had the market already anticipated the improved outlook. Even as equity markets were rallying, however, there were signs of possible trouble ahead, with high valuations tending to amplify investors' response to any negative developments.

The US stock market suffered big losses during the last few weeks of May. The trigger was the FOMC's monetary policy statement suggesting further rate hikes "may yet be needed" in an attempt to contain inflation. Financial markets struggled to determine the magnitude of future interest rate increases and the potential impact on economic growth and corporate profitability. In May 2006 alone, the S&P 500 Index fell by 2.7%, the FTSE 100 contracted by 5.9% and the Nikkei 225 declined by 8.6%. For the first half of 2006, the S&P 500 fell by 2.3%, the Nikkei 225 declined 9%, while the FTSE 100 advanced by 0.2%. ■

Caribbean Fixed Income Markets

Trinidad & Tobago - Jamaica - Barbados - Belize - St. Lucia - Grenada

Trinidad and Tobago

Against the backdrop of a resilient global economy, Trinidad and Tobago continues to outperform the Caribbean and Latin American Region. The economy has been expanding at a phenomenal average rate of almost 8% in the last five years, benefiting not only from buoyant crude oil prices, but also increased capacity in the petrochemical sector. Additionally, the commercialisation of a new oil field has helped to boost oil production, which was previously on a decline. In the non-energy sector, construction has led the way through a sharp increase in government spending. Output in agriculture is on a secular decline.

The sustained rise in domestic demand has put pressure on prices, making inflation control a tremendous challenge for the Central Bank of Trinidad and Tobago (CBTT). Headline inflation accelerated to 7.9% in the twelve months to May 2006 from just above 7% in 2005. Core inflation, which is a better gauge of underlying inflationary pressures, also moved upwards. Not surprisingly, the CBTT has been tightening monetary policy. Toward the end of June 2006, it raised the repo rate by 25 basis points to 7.25% and requested commercial banks to deposit TT$500 million in an interest-bearing account at the CBTT. Looking ahead, inflation could rise even further with the implementation of the hike in electricity rates and possible adverse weather conditions associated with the start of the hurricane season.

For the first six months of fiscal 2005/06, the government recorded a surplus of TT$3.3 billion compared to a budgeted deficit of TT$2.0 billion. Revenue from the non-energy sector was substantially more than was budgeted, while oil revenue actually fell below expectations. There was an overall rein in government spending, with a decline in both current and capital expenditure. In May 2006, the government requested an additional allocation of TT$4.0 billion, of which more than TT$1.0 billion will be transferred to two savings funds and do not represent direct spending. The closely monitored non-energy deficit is expected to reach 21% of non-oil GDP in fiscal 2006. This deficit is a major contributor to the excess liquidity in the domestic financial system.

The country's external accounts remain solid, owing to higher energy prices and increased export volumes. In 2005, the balance of payments recorded an overall surplus of US$1.9 billion, equivalent to about 13% of GDP. At the end of May 2006, net international reserves stood at US$5.6 billion, compared to US$3.4 billion at the end of May 2005.

Table 3.1 Trinidad and Tobago: Fiscal Performance (in millions of TT$)

	October 2004 - March 2005	October 2005 - March 2006			Variance FY05	Projected
	Actual	Actual	Budgeted	Variance	over FY06	FY 2006
Total Revenue	12,657	16,754	15,558	1,196	4,098	33,508
of which Oil Revenue	5,577	8,220	8,705	-485	2,643	16,440
Non oil Revenue	7,075	8,533	6,843	1,690	1,458	17,066
Total Expenditure	10,212	13,445	17,605	-4,160	3,234	31,891
Current	9,532	11,985	15,092	-3,107	2,452	23,970
Capital	679	1,461	2,513	-1,053	781	2,921
Overall Balance	2,449	3,309	-2,047	5,356	860	1,617
Memo items					-	-
Non-oil fiscal deficit	-3,132	-4,911	(10,762)	5,851	-1,779	-14,825
Non-oil fiscal deficit as % of non-oil GDP	-6	-7	(16)			-21
Average realised oil price (WTI)	US$48.96	US$61.63	US$35.00			

Source: CBTT

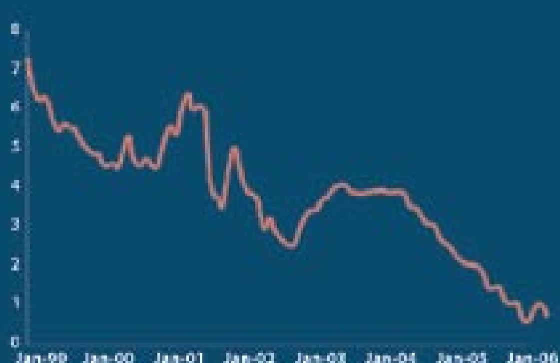
Figure 3.1
Inflation in Trinidad & Tobago (year-on-year, % change)

Sources: CMMB Research Centre,CBTT

Figure 3.2
T&T: Net Official Reserves (US$ m)

Sources: CMMB Research Centre,CBTT

Figure 3.3
90-day T-Bill Differential Between US and TT (Basis Points)



Sources: CMMB Research Centre,Bloomberg, CBTT

Jamaica

Recent data indicates that the agriculture sector has gained momentum and tourist arrivals have picked up strongly, suggesting that, barring any unforeseen shock, the typically volatile Jamaican economy might be on track to achieve growth of over 2% in 2006. Inflation has been declining, mainly reflecting prudent conduct of monetary policy by the Bank of Jamaica (BOJ) within the context of an inflation targeting framework. In the twelve months to May 2006, inflation fell to single digits of 8.6% from an annual average of almost 13% in 2005 and within the lower end of the BOJ's 9-10% target range.

Jamaica has historically been plagued by significantly high public sector debt, which has averaged more than 140% of GDP in the last five years.

Jamaica has historically been plagued by significantly high public sector debt, which has averaged more than 140% of GDP in the last five years. In the early 1990's, the country's debt burden was substantially reduced through Paris Club restructuring and fiscal adjustment under several IMF-supported programmes, the last of which expired in 1996. The banking sector crisis in 1996 resulted in a substantial weakening of the fiscal accounts, since the government guaranteed all liabilities, replaced bad loans with government debt and took over institutions and collateral on the loans. The country's total outstanding public sector debt currently stands at 137.9% of GDP. In the context of regional performance, the Jamaican public debt is the third highest in the Caribbean, just below St Kitts and Guyana.

The fiscal deficit will likely be about 1% of GDP in the current fiscal year, reflecting weaker-than-anticipated revenue and higher-than-budgeted expenditure in the face of increases in pension and allowances and relief work from flooding and road damages associated with the hurricanes. Revenue shortfalls reflect policy slippages and declining tax compliance, as some fiscal measures contemplated in the FY2005/06 budget were not implemented. Production and consumption taxes have not kept up with inflation. The government is committed to achieving a balanced budget by FY 2007/08.

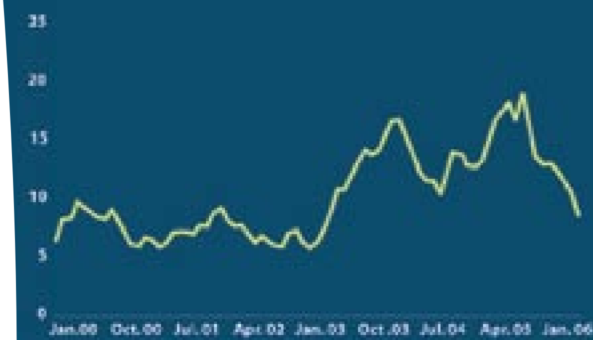
Periodic instability in the foreign exchange market seems to be linked to a realignment of investor portfolios to address the effect of inflation on real rates of return on Jamaican dollar assets. The continued tightening of US monetary policy is narrowing the interest differential between Jamaican and US dollar assets, and would also have influenced investment decisions. The BOJ has absorbed J$ liquidity by selling GOJ securities and foreign currency directly to the market. The government successfully tapped the global financial markets in 2005 to finance the budget, taking advantage of relatively favorable spreads. This, together with the stronger private inflows, strengthened the capital account. As a result, the country's net international reserves increased to US$2.1 billion at the end of May 2006 from US$2.0 billion at the end of 2005. Gross official reserves remain comfortably above 3 months of estimated imports of goods and services.

Barbados

In the first three months of 2006, the Barbadian economy recorded its seventh consecutive quarter of economic expansion above 3%. Growth was 4.4%, driven mainly by the booming construction industry. There was also an up-tick in tourism and manufacturing activity. Sugar output continued its downward trend. Ongoing tourism projects and government infrastructural projects in preparation for Cricket World Cup 2007 are contributing to buoyant construction activity, which advanced 9.7%, after growing 16% a year earlier. Inflation has been on the rise, owing to higher energy prices. At the end March 2006, the inflation rate was at 5.9%, slightly moderating from 6.1% at the end of 2005.

Credit growth continued to outpace deposit accumulation, which led to further tightening of liquidity. As such, there was a sharp increase in Treasury Bill rates, which moved from 3.3% at the end of March 2005 to 6.2% in March 2006. The Central Bank of Barbados minimum

Figure 3.4
Inflation in Jamaica
(year-on-year, % change)

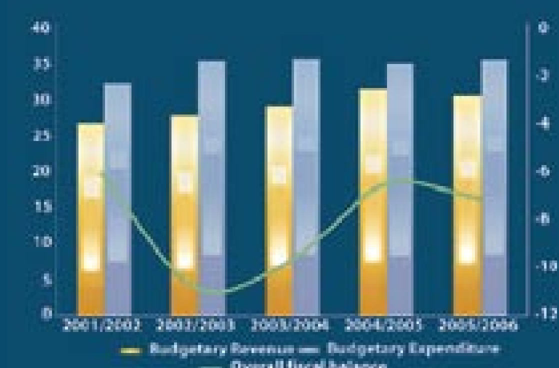


Source: JMMB

Figure 3.5
Jamaica: Net International Reserves

Sources: CMMB Research Centre, Bank of Jamaica

Figure 3.6
Jamaica: Government Operations
(in % of GDP)



Sources: CMMB Research Centre, IMF

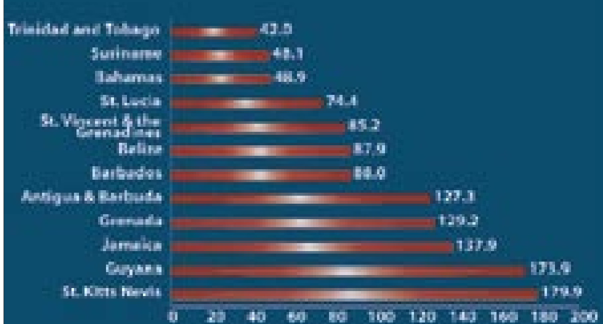
savings rate, which is the benchmark rate, has remained at 4.75%.

Aided by an expansion of 25% in total government revenue during the quarter, the fiscal accounts recorded a surplus of BD$114.3 million. The government managed to achieve a higher direct tax take, despite lowering personal, corporate and property tax rates and raising personal allowances, due to robust economic activity. Also contributing to the exceptional revenue performance were prepayments of VAT and import duties made in 2005, which were recorded in early 2006. Total government expenditure was up by 4.8% in the review period. While there was a 3% increase in current expenditure, on-budget capital expenditure was up 4.2% as the government continues its preparations for Cricket World Cup. For the fiscal year ending March 2006, the budget deficit was estimated at 2.1% of GDP, compared to 2.5% in the previous fiscal year.

Barbados:
S&P warns that failure to balance the budget deficit in fiscal 2006 would increase external imbalances and put pressure on the fixed exchange rate regime.

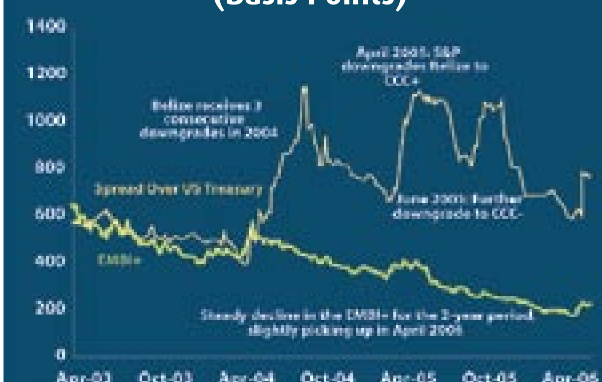
According to Standard and Poor's (S&P), Barbados' negative outlook reflects fragility of the government's ambitious fiscal plans. It warns that failure to balance the budget deficit in fiscal 2006 would increase external imbalances and put pressure on the fixed exchange rate regime, which would further weaken the sovereign's credit worthiness. S&P adds that if the government is successful in implementing its fiscal plans, the debt burden will ease, reducing vulnerabilities.

Figure 3.7
Caribbean Indebtedness



Source: CMMB Research Centre

Figure 3.8
Belize Sovereign Risk Premium (Basis Points)



Source: CMMB Research Centre

Belize

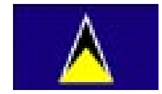
On 13 June 2006, S&P affirmed its CCC- credit sovereign rating on Belize, one notch above Selective Default (SD) and kept its negative outlook. The credit rating on Belize is constrained by several factors, including the uncertainty surrounding the government's ability to meet its external debt commitments in the context of limited access to commercial external financing.

The Belizean government faces US$70.4 million (of which amortisation is US$36.6 million) in public sector external debt servicing from June to December 2006. This compares to current international reserves of less than US$80 million. If one adjusts the country's stock of reserves for support to the Belizean peg and the amounts set aside as part of a 2005 private placement, then international reserves are considerably lower. The government should be able to meet its 2006 obligations, thanks to bilateral support from Taiwan and Venezuela. An expected improvement in the fiscal position should see government debt reverse its upward trend. The 2006/07 Budget contemplates a rein on capital spending and cut in oil subsidies while seeking to implement a 10% VAT from 1 July. On this basis, the general government debt, which is estimated at around 97% of GDP in 2005, should decline to about 87% of GDP by the end of 2006.

Belize's public-sector external debt due for repayment stands at US$137 million in 2007, which makes debt servicing quite a challenge.

However, 2007 could prove to be the turning point. Belize's public-sector external debt due for repayment stands at US$137 million in 2007, which makes debt servicing quite a challenge. The country's external current account deficit, which is estimated at around 9% of GDP in 2006 and 2007, will come under further pressure as international crude oil prices soar and the preferential arrangement for sugar has ended. Additionally, tourism revenues can easily be eroded as Belize is susceptible to hurricanes and tropical storms.

St Lucia



The St Lucian government presented the 2006/07 fiscal package on 25 April 2006. The largest to be presented in Parliament, the EC$1.1 billion budget represents an increase of 17.3% over the previous fiscal year, and was aimed at enhancing social amenities as well as the long term growth and development of the St. Lucian economy. The table below gives a summary of the budget:

	EC$ Millions	In % of GDP
Current Revenue	621.6	24.3
Current Expenditure	611.6	23.9
Current Account Balance	-10.0	0.0
Capital Revenue & Grants	85.7	3.3
Capital Expenditure	421.4	16.5
Overall Balance	-325.7	-12.7

Source: Budget Speech, April 2006

Recurrent expenditure is budgeted at around EC$611.6 million, representing 54.5% of the total expenditure, while debt amortisation accounts for 7.9% of planned total expenditure and is forecasted at around EC$88.5 million. Capital expenditure is budgeted to increase 25.5% and accounts for almost 40% of the total budget. According to the Finance Minister, the sizeable rise in capital spending is reflective of ongoing capital projects and the re-budgeting of EU-grant financed projects since the funding was not received in the last fiscal year. The EC$1.1 billion budget is expected to be financed by:

- Recurrent revenue of EC$621.6 million
- Capital revenue of EC$9.2 million
- Excess revenue and the re-budgeting of bonds from FY 2005/06 and grant funding of EC$76.5 million.

The government has also made provisions for the restructuring of the banana industry, as well as an agricultural diversification programme. Since 1990, the production of banana and other export products has been declining. Banana exports have suffered from rising costs and the gradual erosion of preference margins in the EU market.

St. Lucia is experiencing an economic recovery, driven by a strong rebound in tourism, construction and manufacturing. Real GDP picked up a momentum of 5.4%

in 2005 from 3.6% in 2004. Growth is expected to continue at this pace throughout 2006 and into 2007 in light of an upswing in tourist arrivals coupled with a strong rise in public and foreign investment for Cricket World Cup 2007. Unemployment amidst recent economic expansion dipped to a low of 15.7% during October to December 2005, a record that dates back to 1992. A healthy outlook on the labor market is expected in 2006 as construction activity booms, alongside a robust tourism industry.

Grenada

The IMF has granted the Grenadian government an immediate disbursement of US$2.2 million of a US$15.2 million three year arrangement under the Poverty Reduction and Growth Facility (PRGF). The arrangement will support the government's comprehensive medium-term economic reform programme. Grenada made moderate progress in 2005, with the economy estimated to have expanded by 1.5%, compared to a contraction of 3% a year earlier, primarily driven by construction activity, and supported by a revitalised cruise tourism sector, while conditions in the agricultural sector remains relatively subdued. An average of 4% growth rate is targeted over the next few years.

The programme compasses a fiscal package that will gradually improve the primary balance to a surplus of 2.5% of GDP by 2008 from a deficit of 2% currently. This will reduce the debt-to-GDP ratio from 130% of GDP to about 60% by 2015. The government has outlined an expenditure plan in the context of this programme. The expected capital expenditure programme amount to EC$229.8 million in 2006. Of this amount, EC$54.9 million is earmarked for expenses related to Cricket World Cup, EC$118 million goes towards the reconstruction efforts and the remainder represents ongoing capital spending. However, as government continues to spend on rebuilding and restoring infrastructural services the overall deficit is projected at around 15% of GDP in 2006.

Following the IMF's approval of Grenada's PRGF programme, the Paris Club agreed to restructure the country's external public debt. This is expected to reduce the debt service due to the Paris Club creditors by more than 90%, by rescheduling US$16 million consisting of arrears of about US$12 million and US$4 million in maturities falling due from 1 January 2006 to 31 December 2008. ■

Grenada:
The programme compasses a fiscal package that will gradually improve the primary balance to a surplus of 2.5% of GDP by 2008 from a deficit of 2% currently.

Sovereign Risk Report

The Republic of South Africa BBB+/Stable/A-2

1. Introduction

South Africa is located at the southern tip of the African continent and is one of the more advanced nations in sub-Saharan Africa (a term used to describe those countries of Africa south of the Sahara desert). South Africa has in fact experienced a significant deviation from most African nations, mainly as a result of considerable European immigration and high levels of mineral wealth which played an extremely important role during the Cold War. The country is endowed with a variety of natural resources, including gold, coal, iron ore, gem diamonds, platinum, copper, and natural gas. The South African economy is the largest and the most developed on the continent. The stock exchange is one of the largest in the world. However, economic growth has not been able to improve the labour market as the unemployment rate is at extremely high levels, and the country still faces daunting economic problems from the apartheid era. This two-tiered economy currently faces challenges in terms of division of labour between the formal and informal sectors and highly uneven distribution of income and wealth.

2. Sovereign Credit Fundamentals

Credit fundamentals in South Africa are supported by the following factors:

Improved Growth Performance and Well Contained Inflation

Growth in South Africa has been ably supported by sound economic policies and a robust policy framework,

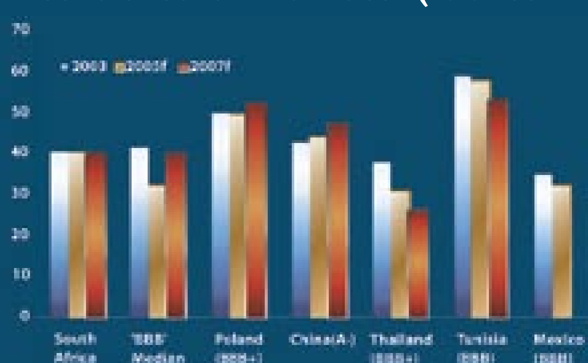
Figure 4.1
South Africa Peer Group Comparison - Real GDP (% change)

Sources: Standard & Poor's, CMMB Research Centre

Figure 4.2
South Africa Peer Group Comparison - Consumer Price Index (% change)

Sources: Standard & Poor's, CMMB Research Centre

Figure 4.3
South Africa Peer Group Comparison - General Government Debt (% of GDP



Sources: Standard & Poor's, CMMB Research Centre

in addition to a favourable external environment. Real GDP growth gained momentum in 2005, expanding at an estimated 5% from 4.5% in 2004. There was a substantial increase in the primary sector; particularly agricultural output expanded 5.5% compared to a 1.5% contraction in 2004. The manufacturing sector has been on the decline. In the first quarter of 2006, real GDP picked up 4.2%, up from a revised growth rate of 3.9% in the final quarter of 2005. The South African Reserve Bank (SARB) expects that overall growth in 2006 will remain relatively in line with potential output. Inflation remained well contained during 2005. Core inflation stayed well within the official target range of 3-6% moderating to 3.9% in 2005, from 4.3% a year earlier. Rand appreciation and tempered food prices helped to control consumer inflation; however, there was a simultaneous up-tick in producer prices, mainly due to the persistently high crude oil prices.

Strong Democracy

The African National Congress (ANC) currently dominates the political scene, and since 1994 the democratic process has taken root. In the April 2004 election, President Mbeki was reelected for a second term. However, the opposition is still fragmented and ineffective, political violence is rare and the country's democracy system is strong by emerging markets standard. The ruling ANC is expected to remain the leading political force in South Africa in the medium-term, although there are some risks associated with policy disagreements, which can lead to delays on the essential reform agenda.

Prudent Fiscal Policy

The management of the fiscal accounts by the South African government has been quite commendable, with the average budget deficit at just around 1.5% of GDP over the last five years. This has given the government more flexibility to adopt a more expansionary but still prudent fiscal stance going forward. For the fiscal year 2004/05, the general government deficit came in at 2.4% of GDP, well below the budgeted deficit of 3% of GDP. This performance was attributed to buoyant indirect tax collections, in addition to lower than expected debt service costs. For the fiscal year 2006/07, the general government deficit is projected at 1.7% of GDP. The budget includes hikes in social and capital expenditure and modest tax cuts. The general government debt is estimated at around 39.8% in 2005, slightly above the BBB median of 31.8%. The fiscal deficit is expected to remain below 2% of GDP in the medium-term, despite the more expansionary position.

In 2005, foreign currency reserves increased by a massive 41% to a comfortable US$18.5 billion, which is equivalent to an estimated 3.3 months of import cover.

Strong Foreign Currency Reserves

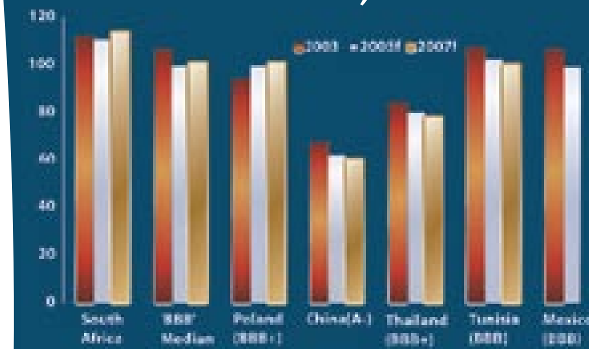
Large inflows of capital have enabled a significant pick-up in international reserves despite the narrowing of the interest rate differential between South Africa and the euro zone, as well as the US. In 2005, foreign currency reserves increased by a massive 41% to a comfortable US$18.5 billion, which is equivalent to an estimated 3.3 months of import cover. By the end of May 2006, foreign exchange reserves had risen to US$24.1 billion.

Credit fundamentals in South Africa are constrained by the following factors:

Weakening Balance of Payments

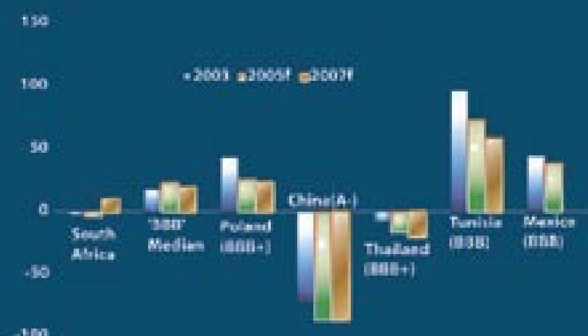
Although South Africa has historically had lower external current account deficits than its peers, the gap has worsened over the past few years. A combination of rand appreciation on exports and rising imports has seen the external current account deficit worsen from a mere 1.3% of GDP in 2003 to an estimated 5% of GDP in 2005. Weaker export performance coupled with higher volumes and value of oil imports contributed to further widening of the current account deficit in the first quarter of 2006. The outlook is for further deterioration in the current account deficit, which is being easily funded by capital flows. However, as global liquidity conditions continue to tighten and as domestic demand softens, the inflow of capital may wane, possibly affecting the country's external liquidity position.

Figure 4.4
South Africa Peer Group Comparison - Gross External Financing Needs (% of Current Account Receipts, Usable Reserves)



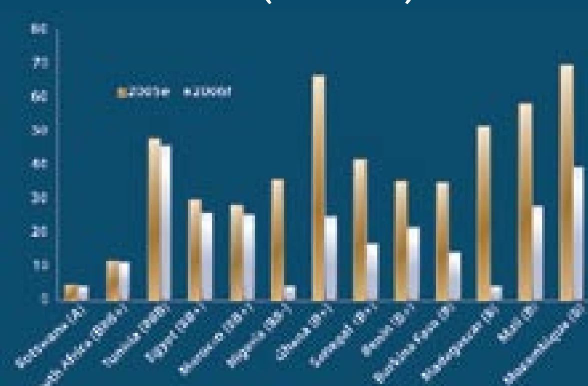
Sources: Standard & Poor's, CMMB Research Centre

Figure 4.5
South Africa Peer Group Comparison - Net External Debt (% of Current Account Receipts)



Sources: Standard & Poor's, CMMB Research Centre

Figure 4.6
African Sovereigns Public Sector External Debt (% of GDP)



Sources: Standard & Poor's, CMMB Research Centre

Structural Economic Weaknesses

Although growth prospects are improving, there still remain many structural problems in the South African economy. Low savings negatively impacts on investments. The March 2006 budget contained policy recommendations aimed at raising the level of economic growth and investments as well as improving the labor market. The unemployment rate in South Africa has historically been very high, averaging 28% in the last five years. Large structural and skill mismatches, centralised wage bargaining, and relatively high minimum wages in certain sectors impede the labour market.

The rand has recently weakened against the US dollar, losing almost 13% in the month of May 2006 alone. The decline in the rand may help to spur export growth and reduce the current account deficit.

Key Developments to Watch

The rand/ US$ exchange rate

The rand has recently weakened against the US dollar, losing almost 13% in the month of May 2006 alone. However, like most emerging markets, which are fundamentally sound, the decline has been attributed to the tightening of global liquidity, rather than domestic factors. For instance, the Brazilian real lost 13% and the Turkish lira declined 20% over May. The decline in the rand may help to spur export growth and reduce the current account deficit.

Rising Interest Rates

Despite a benign inflationary environment, the South African Reserve Bank (SARB) lifted the benchmark repo rate by 50 basis points to 7.50% in June 2006, and further tightening is expected in the year. This is based on Rand depreciation worsening inflation.

Political Turbulence

The current impasse between the South African government coalition and the ruling ANC could erode investor confidence in the medium-term. A year ago, President Mbeki fired Deputy President Zula on corruption charges and divisions within the ANC. Since then, Zula has been re-instated and his public support has been increasing. The ruling party is expected to elect a new leader next year. The most likely successor will be Zula, making him a strong contender in the 2009 Presidential elections.

Outlook

The outlook on the South African economy is stable in the medium-term. The economy is expected to slow moderately on account of the sluggish performance of the export sector, which will pose a significant drag on activity. However, this slowdown is expected to be only temporary given the supportive fiscal and monetary policies as well as stronger investment growth. Inflation is relatively subdued, well within the official target range. The fiscal accounts should remain disciplined. However, if Zula wins the presidential elections in 2009, which is highly likely, this may not be viewed optimistically by the market. ■

Caribbean Equity Markets

Trinidad & Tobago - Jamaica - Barbados

Table 5.1 Caribbean Stock Market Summary (%)

April-June 2006	Index Value at June 30th	% Change Quarterly	Year To Date	Year on Year
Trinidad				
TTSE Composite Index	920.33	-3.94	-13.73	-20.89
All T&T Index	1168.38	-0.10	-11.66	-20.08
Jamaica				
All Jamaica Composite Index	85108.21	-2.06	-17.97	-24.44
JSE Main Index	79663.62	-7.15	-22.93	-34.60
JSE Select Index	2182.25	-6.90	-23.36	-32.37
Barbados				
BSE Composite	971.06	-5.74	-6.17	-5.14
Local	3,872.31	-1.31	-1.47	-1.78
Cross-list	2,019.96	-11.55	-12.17	-9.43

Trinidad and Tobago

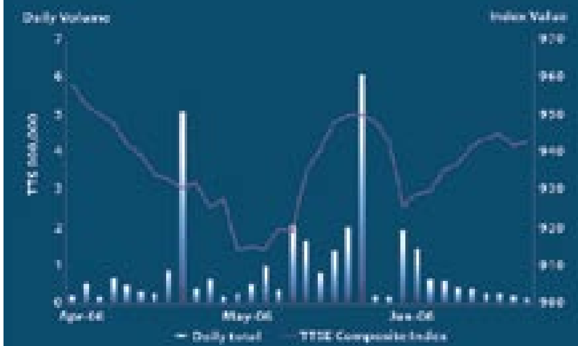
Although the equity market maintained its bearish mode in the second quarter of 2006, it began to show signs of traction late in the period. The TTSE composite index fell from 958.04 at the start of April to a low of 914.35 in early May, before starting a slow ascent to reach 920.33 points by end-June. There was little positive correlation between price movements and financial results. The market continued to lack demand from institutional investors. Investors can now buy shares of companies which were previously considered "blue chip." Four sectors declined (Trading, Manufacturing II, Property and Banking) and 3 advanced (Manufacturing I, Non-Bank and Conglomerates), highlighting the bearish mode of the market.

Low volume demand continued into the second quarter as stocks struggled to move even with positive corporate earnings report. The value of stocks traded also fell compared to the previous quarter from TT$707.9 million to TT$562.5 million. The advance/decline ratio showed 11 stocks advancing, 15 declining and 8 trading firm. The major advances came from Trinidad Publishing 28.8%, Guardian Holdings Limited 20%, National Flour Mills 16.7% and National Commercial Bank (Jamaica) Limited 12.5%. Major declines came from Prestige Holdings Limited 40.9%, FCIB 16.9% and CCMB of 11.3%.

In terms of price movement, GHL made a positive turnaround as its share price increased by 20% in the second quarter, after disappointing results for the three months ended March 2006. The Group reported a diluted loss per share of TT$1.92 compared to the diluted EPS of TT$0.73 for the first quarter of 2005. A major cause of the Group's poor performance was a 21% increase in expenses. Operating Loss reported for the period was TT$354 million, a decline of 293% from the profit made in the comparative three-month period of 2005.

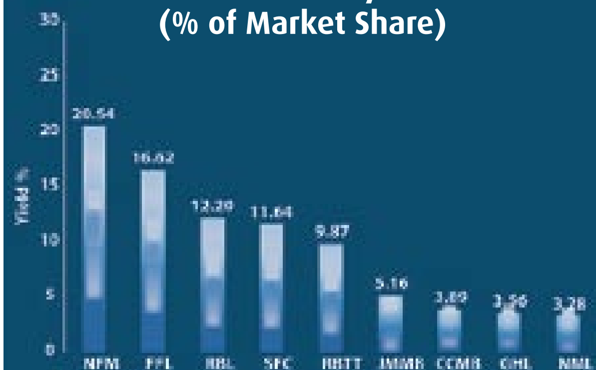
The Neal and Massy Group (NML) registered a good performance in its half-year ending March 2006. Group Third Party Revenue grew by 12%, while Operating Profits increased by 21% over the corresponding first half of 2005.

Figure 5.1
Performance of the TTSE Composite Index and Daily Trading Volume



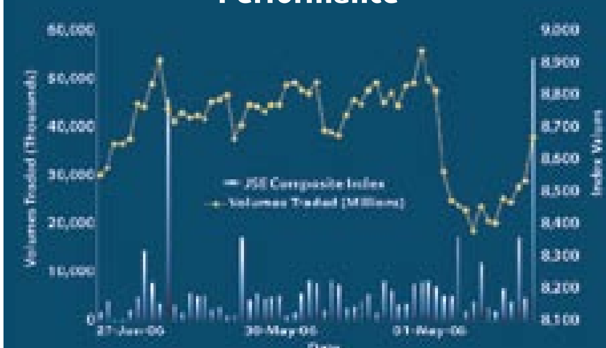
Sources: CMMB Research Centre / Trinidad and Tobago Stock Exchange

Figure 5.2
TTSE Most Actively Traded (% of Market Share)



Sources: CMMB Research Centre / Trinidad and Tobago Stock Exchange

Figure 5.3
Jamaica Stock Exchange 2nd Quarter Performance



Sources: CMMB Research Centre / Jamaica Stock Exchange

Profits from Associate Companies weighed on the Group's performance, reflecting a smaller contribution from Barbados, Shipping and Trading (BS&T). EPS grew 11% year on year to TT$1.36 (up from TT$1.22) and management expects to surpass the EPS target of TT$3.00 for 2006.

For the quarter, BWIA made another request to the SEC to keep trading of its shares suspended after the TTSE rejected the initial application. The share remains suspended at TT$0.97.

Jamaica:
The recall of 500 tonnes of sub-standard cement triggered a cement shortage in the market which led to industry layoffs, hence lower disposable incomes, and reduced sales in complementary products like steel and paints.

Jamaica

The JSE Composite enjoyed an improved second quarter 2006 performance with a marginal loss of 2.1% when compared to 16% in the first quarter, however, the bears continued to hold sway as the half-year negative return of 18% was even more dismal. The cement crisis that disrupted the construction sector may have partly contributed to the disappointing out-turn. The JSE Index seemed to be buoyed by the overall improvement in price performance of cross-listed stocks, considering that the All Jamaica Index, which tracks only stocks resident in Jamaica, worsened with a first half-year negative return of 24%. The market remained weak and overall earnings staggered as 15 of the 21 released results of listed companies reported lower profit levels when compared to the prior year.

The cement crisis set ablaze by Caribbean Cement Company (CCC) in Jamaica was the main catalyst for the soft corporate performance of companies like Hardware and Lumber, Kingston Wharves and Berger. The recall of 500 tonnes of sub-standard cement triggered a cement shortage in the market which led to industry layoffs, hence lower disposable incomes, and reduced sales in complementary products like steel and paints. This situation is expected to be remedied by cement imports in the short-term and completion of Carib Cement's first phase of expansion.

A steady rise in volumes each month since January 2006 gave new hope that the Jamaican equity market had indeed "bottomed out" in late April. Trading activity improved from January to April based on a daily trading average of 3.4 million and 7.6 million, respectively. In May, however, the average daily volume fell to 5.4 million but rebounded to 16 million in June. Renewed interest was spurred as stock prices especially in the Conglomerate and Non-Banking Sectors fell.

On 9 June, the JSE welcomed the relisting of Pulse Investments at J$2.30 with a share offering of 253,670,362 shares. The stock is no newcomer, having being suspended some nine years ago and delisted for five. Pulse has since suffered a worse fate than Supreme Ventures Limited which listed in February as the Jamaican equity market has been less responsive to new listings since the downturn in market conditions in 2005. Trading activity in Pulse shares and price movement seemed to be stagnant as the price traded firm at J$2.30. Meanwhile many companies with listing intentions have deferred entrance until market performance strengthens.

In the second quarter of 2006 trading activity fell 27%. Cable and Wireless was the most favoured stock with 83 million shares changing hands; representing 20% of overall trades. CWJA reported a healthy performance for 2005 due to better management of operating costs and building the mobile and broadband services. Some 452 million shares were traded in the second quarter. Supreme Ventures was the second most actively traded, as some 66 million shares moved since its initial listing in February. The stock has since gained a reputation of high price volatility, with a high of J$3.00 and a new low of J$1.88 in June after the release of less favourable half year results. SVL was one of the top decliners, shedding 20% of its value in this period. NCBJ accounted for 13% of the total trades in the second quarter in which it also entered the telecommunications sector after acquiring a controlling stake of CVM television as well as the health services sector with a major stake in the United General Insurance Company (UGI).

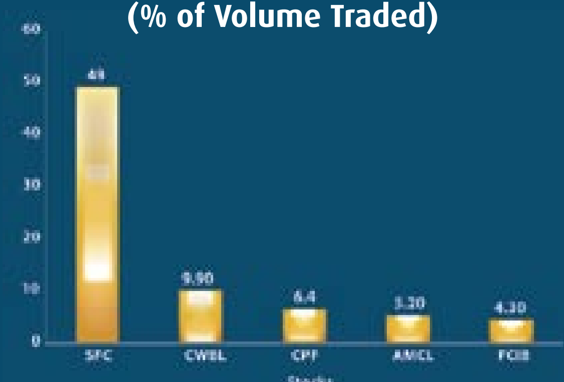
Figure 5.4
JSE 10 Most Actively Traded (%)

Sources: CMMB Research Centre / Jamaica Stock Exchange

Figure 5.5
Barbados Stock Exchange
2nd Quarter Performance

Sources: CMMB Research Centre / Barbados Stock Exchange

Figure 5.6
BSE 5 Most Actively Traded
(% of Volume Traded)



Sources: CMMB Research Centre / Barbados Stock Exchange

Indicative of a weak showing on the JSE declines lead advances 29 to 9; Mobay Ice led the retreating stocks, falling some 39.2%. Ciboney and Cable and Wireless Jamaica declined by 37% and 31%, respectively. Pan Caribbean Financial Services is expected to surrender its merchant banking license in its transition to a commercial bank. FCIB presented the best return with a 12% gain. Pegasus and Carreras followed with returns of 11.8% and 8.1%, respectively. The Manufacturing sector is expected to come under pressure as crude oil on the international market continues to surge. Stocks in this sector may suffer from higher production costs which could weigh on their bottom line.

The outlook for the Jamaican stock market remains cautiously optimistic. Although Jamaican indices remain in negative territory the loss in values is slowing. Economic activity is expanding, inflation is slowly retreating and the government remains committed to fiscal consolidation. However weak corporate results have failed to rekindle healthy investor confidence levels. Investors are expected to continue to stay out of the market until signs of a turnaround appear despite existing bargain prices.

Barbados

In the second quarter of 2006, the Barbados Stock Exchange was characterised by low trading activity and falling stock prices despite good corporate earnings. The BSE Composite fell 1.4%, while the Cross-List Index lost 11.5% of its value as cross-listed stocks like TCL and GraceKennedy contained growth of the main index. Soft market conditions caused the much anticipated listing of Duty Free Caribbean (DFC) to be deferred. Following from the first quarter, low trading volumes weighed on market activity as only 2.8 million shares moved, which represents less than half of that traded in this period last year. Sagicor Financial Corporation (SFC) emerged as the most favoured stock, trading 1.3 million shares or 49% of total shares traded and yielded the best return in value of 17.4%. This is not surprising given its stellar performance for year ending 2005; the best in five years as its strategy of operational streamlining and geographic and product expansion begins to bear fruit. Also Cable and Wireless seemed to be a choice stock for investors as 10% of total trades was focused on the telecommunications provider.

The Fortress Caribbean Property Fund (CPF) accounted for 6% of total shares traded based on improved half-year results; despite this, the stock price retreated by 4% for the period. Top decliners included GraceKennedy, which fell by 29.2% followed by Cable and Wireless (20.4%) and BS&T which lost 15% in price value.

The explosion of construction and infrastructural upgrades, as the count down to Cricket World Cup 2007 continues, is not being reflected on the equity market since companies in construction or real estate are insufficiently represented on the BSE. The companies representing real estate and tourism are CPF, Trinidad Cement Limited (TCL), and Almond Resorts Inc (ARI). The outlook for the Barbados market remains moderate, given no new local or cross-listings, overall mediocre corporate returns and persistent low investor confidence. ■

Barbados:
Soft market conditions caused the much anticipated listing of Duty Free Caribbean (DFC) to be deferred.

Corporate Report

Guardian Holdings Limited (GHL)

Table 6.1: Key Events in GHL's History over the last five Years

Year	Event	Region	Main Line of Business	Method of Financing
2001-2002	Exits the Residential Property Development business with the Divestment of Guardian Properties Limited	Trinidad and Tobago	Property Development	n/a
2001	Acquisition of Caribbean Home Insurance Company, NEMWIL and Risk Management Services Limited	Trinidad and Tobago	General Insurance	—
2002	Acquisition of ING Fatum	Dutch Caribbean	Life Insurance	Combination of debt (US$ 35 M) and Cash
2003	Finalisation of acquisition of Link Insurance Group	United Kingdom and Gibraltar	General Insurance	Debt and Equity
	Integration of NEMWIL and Caribbean Home Insurance	Trinidad and Tobago	General Insurance	n/a
	Sold off portion of RBTT holdings for a realised gain of TT$681 million. Able to market to market the remaining portion of RBTT in accordance with IAS 39	Trinidad and Tobago	n/a	n/a
2004	Launched operations of Guardian Asset Management	Trinidad & Tobago	Asset Management Services	—
	Acquisition of Nemwil Holdings (Gibraltar) Limited	United Kingdom and Gibraltar	General Insurance	—
	Divestment of Qualsure at a loss of TT$56 million	Florida, USA	General Insurance	n/a
2005	Finalisation of acquisition of Zenith Insurance Group	United Kingdom and Gibraltar	General Insurance	Equity Right's Issue
	Acquires 20% of Grupo Mundial Tenedora SA	Panama, Latin America	Life, Health & Pension Insurance	—
Jan 2006	Sale of Risk Management Services	Trinidad & Tobago	Risk Management	Management Buyout

Highlighted rows represent Divestments

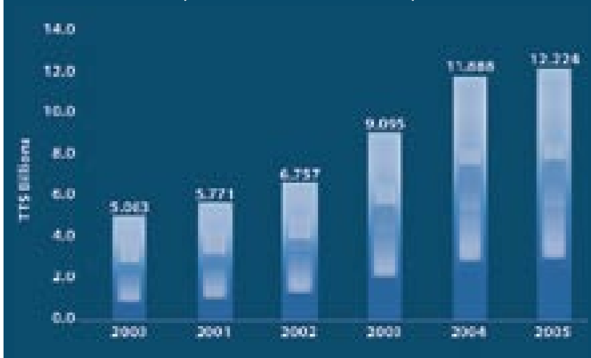
Company Profile

Guardian Holdings Limited (GHL) is the parent company for an integrated financial services Group whose business focus is in life, health, property and casualty insurance, pensions, asset management and private equity. The Group's operations are organised into three main lines of businesses:

- Life Insurance, Pensions & Health Insurance
- Property & Casualty Insurance
- Asset Management Services

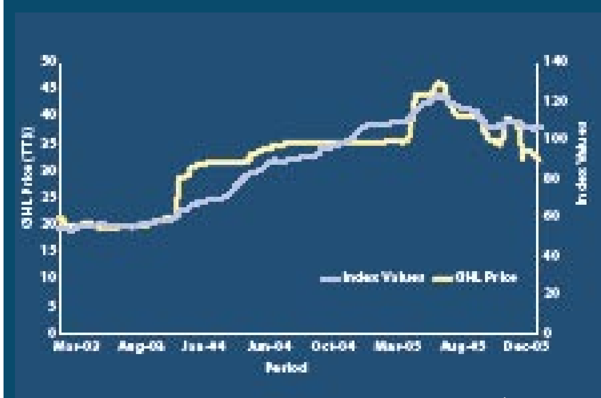
An analysis of the changes in the strategic direction of GHL suggests two clear trends. The first is a definitive move out of the Property Development line of business and an expansion into the Property and Casualty Insur-

Figure 6.1
GHL- - Non Current Asets (Net of Goodwill)



Sources: CMMB Research Centre

Figure 6.2
Comparative Performance of GHL and TTSE Composite Index (2003-2005)



Sources: CMMB Research Centre, TTSE

ance business. The second is that GHL has entered into an aggressive acquisition phase.

The combined effect of these two changes has more than doubled GHL's asset base (Net of Goodwill) over the years 2001- 2005. Another key change has been increasing levels of diversification both across geographic region and across lines of business (away from the dominant life insurance business). Finally, with the adoption of IAS 39 in 2001, the performance of the Group has become increasingly exposed to the volatility of the returns of GHL's investment portfolio.

What caused the accelerated decline in GHL's share price? Should investors sell down their holdings of GHL stock? What is the outlook for GHL?

Review of Fiscal Year 2005 Performance

On 19 April 2006, the share price of Guardian Holdings Limited (GHL) stood at TT$18.00, down 77% since the beginning of the year. This raised several burning questions. What caused the accelerated decline in GHL's share price? Should investors sell down their holdings of GHL stock? What is the outlook for GHL? To answer these questions, shareholders and investors alike would need to take a more detached and holistic view of GHL rather than give in to emotion-driven investment choices.

GHL ended its fiscal year 2005 with a significant decline in profitability with EPS down 38% from TT$2.98 to TT$1.85. Management has attributed this to GHL's choice under the new financial reporting standards to take any unrealised fair value gains or losses to income, as well as the existence of a large equity portfolio. Equity is currently 47% of the Trinidad investment portfolio, of which 70% represents shares in RBTT. In 2005, both the TTSE and JSE were down 1% and 7%, respectively. GHL's largest equity holding, RBTT, reported a small positive change of 1.3% in share price. Given the performance of RBTT's share price, one can reasonably question whether it was the remaining 30% of the portfolio or GHL's holdings of Jamaican equity securities which accounted for the significant fall in fair value gains.

For 2005, fair value gains related to GHL's equity holdings fell from TT$528 million to a loss of TT$24 million. A small gain on investment properties of TT$31 million offset the loss resulting in a net gain of TT$7 million. With such a large exposure to one company, volatility will continue to plague GHL's results, especially given the current weak outlook for regional stock markets. Management has indicated an intention to rebalance the portfolio but would like to maximize value from any sell-off decision.

It should be noted that, despite the negative impact of the marking to market of the RBTT investment, on the whole total revenue increased by 22%, partly due to the inclusion of revenue from Zenith acquired in 2005. Net Premium income which represents new income was up 56% for Guardian Life of the Caribbean. Thus GHL continues to be a major force within the Caribbean insurance market.

The strategy of diversification has been successful to some extent; revenues from outside the Caribbean region now account for 74% of Guardian General's profits.

GHL's clearly stated strategy has been one of diversification both by geography and by product line. Based on this, GHL acquired Link and Zenith which are based in the UK and which fall under the Property and Casualty line of business rather than the dominant Life Insurance segment. The strategy of diversification has been successful to some extent; revenues from outside the Caribbean region now account for 74% of Guardian General's profits. Noteworthy is that Guardian General accounted for the largest proportion (54%) of the Group's profit. This is clearly a step in the right direction for a company that has previously been predominantly driven by revenues from its Life Insurance segment.

However, concerns remain about the current softening of the UK general insurance market which has been characterised by aggressive price cutting by larger market players.

However, concerns remain about the current softening of the UK general insurance market which has been characterised by aggressive price cutting by larger market players. How long this situation will continue is debatable, given that many in the industry believe that premium rates need to rise in order to compensate for the growth in the cost of claims. There is inevitably some concern about profitability in the industry. As small players in the relatively mature UK insurance market, Link and Zenith would have little control over the downward movement in general insurance rates.

In 2005, net claims increased by 45% which were attributed mostly to Zenith and largely responsible for the deterioration in the Group's operating profit margin from 23% to 11%. In fact the combined ratio (sum of incurred losses and expenses to earned premium) for the Group's international division increased from 76.4% to 98.4%. Management has chosen to focus on cost control rather than revenue growth to combat these difficult conditions. On the whole, GHL has managed to keep its combined ratio below 100% at 95.3% (Budgeted Target: 87.7%).

The management of GHL has indicated that, while concerns may have surfaced about the performance of the Group, the long-term prospects remain sound. GHL is committed to a strategy of acquisition, geographical expansion and investment of new lines of business around the core Life Insurance segment. The fruits of these diversification efforts are being realised with revenues from its Property and Casualty business now exceeding 50% of total revenues. From a geographical standpoint this is also evident, with a substantial amount of GHL's revenues derived from outside the active Atlantic hurricane belt (Caribbean region). Unfortunately, the hedging strategy is under strain, since both the Life and Property segments are experiencing challenging conditions due to the simultaneous softening of the regional equity markets and the UK insurance industry.

GHL ended its 2005 fiscal year trading at close to book value. The share price is not expected to fall much further.

GHL: Selected Financial Indicators

Financial Indicator (%)	2001	2002	2003	2004	2005
PROFITABILITY					
Profit Margin	18.90	12.10	37.30	20.90	8.30
Operating Margin	19.80	14.00	19.30	30.30	11.20
PERFORMANCE					
ROE	15.08	10.73	41.96	18.35	9.88
ROA	3.59	2.51	9.13	3.77	2.13
CAPITALISATION RATIOS					
Debt to equity	3.20	3.26	3.60	3.34	3.65
Debt to Assets	0.76	0.77	0.78	0.68	0.78
Price/Earnings	10.82	18.68	14.32	11.78	17.34
Price/Sales	2.04	2.26	1.87	2.40	1.38

Source: GHL Annual Reports (various years)

Current Review (First Quarter ended March 2006)

GHL reported a significant loss for the first quarter ending 31 March 2006. The Group reported negative earnings per share of TT$1.92 (fully diluted) as compared to a profit of TT$0.73 for the corresponding quarter of 2005. The Management has attributed most of this adverse performance to the valuation adjustment of its investment portfolio, which is heavily weighted in equities. The region's equity markets continued to be soft in 2006 with the Trinidadian and Jamaican market falling 10% and 17%, respectively.

During that period, RBTT's share price fell 22.7% to TT$31.30. It is notable that the mark to market adjustment in the first quarter of 2006 alone has resulted in the erosion of more than 95% of the profit reported by GHL in 2005. Based on this, GHL's senior management has been very vocal, urging investors to focus on the performance of the Group's core business and its long-term strategic direction.

Nevertheless, the performance of GHL cannot be totally attributed to the investment portfolio's return. Like its 2005 financial year, the Group's operational performance has faced challenges. Top line growth has been erratic given the number of acquisitions over the last two years; insurance premium revenue fell by 2% in the first quarter of 2006. The amount ceded to reinsurers fell by a much larger 22.6% resulting in an overall improvement of 7.6% in net insurance premium revenue.

A significant fall in other revenue from TT$348 million to a loss of TT$132 million combined with a 7% increase in net insurance benefits and claims and a 21% increase in expenses resulted in a net operating loss of TT$354 million. This compares adversely to a corresponding operating profit of TT$183 million in 2005. Part of this jump in expenses was attributed to "one-off" events associated with the UK Property and Casualty businesses. In addition, Fatum was required to make a significant reserve increase following the localisation of the operations.

An increase in the Share of Profits from Associated Companies was more than eroded by an increase in Finance Charges, resulting in an even further diminishing of the bottom line. The Profit after Taxation Attributable to Equity Holders fell from TT$141.5 million to a loss position of TT$394 million. GHL's share price stood at TT$20.00 as at 31 March 2006.

The majority of GHL's revenue now comes from its international operations (primarily United Kingdom), markets in which GHL is very small, niche player.

Outlook

Given the dominance of GHL in the local markets, a strategy of active expansion and growth is welcome and even necessary in order to keep maximising shareholders' value. However, the returns of the major investments are yet to meet expectations, while at the same time they have introduced a significant amount of precariousness to GHL's operations. This uncertainty surrounds the fact that the majority of GHL's revenue now comes from its international operations (primarily United Kingdom), markets in which GHL is very small, niche player.

On the whole, however, GHL maintains a firm track record of growth and expansion. Return on Equity has averaged 19% over the last five years. GHL is now trading at a trailing negative EPS of TT$0.80 and its share price performance has been characterised by some "panicked selling". It is uncertain whether a possible recovery in the regional equity markets in the second half of the year and an improvement in UK market conditions will be enough produce a net profit for 2006. This, combined with the ongoing 2006 hurricane season, does not bode well for GHL in the short to medium-term.

From a risk perspective, GHL's level of diversification both by product line and geography is commendable. Investors with a long term view should consider this as an opportunity to acquire a leading insurer fairly cheaply. The management of GHL needs to remain committed to being open and transparent about the strategic direction and investment decisions being taken in order to repair and improve on current investor morale and sentiment.

The management of GHL needs to remain committed to being open and transparent about the strategic direction and investment decisions.

CMMB RESEARCH CENTRE

Dollarisation

A Final Solution to Caribbean Exchange Rate Arrangements

Jwala Rambarran, Chief Economist, CMMB

All Caribbean countries should initiate official dollarisation, that is, adopt the US dollar as legal tender and stop issuing domestic notes and coins.

CARICOM comprises 15 countries with 9 different currencies. Its exchange rate regimes span the spectrum from currency board (Eastern Caribbean) to quasi-currency board (Belize and Barbados) to heavily managed float (Trinidad & Tobago) to more freely floating (Jamaica and Guyana).

Official dollarisation will help to promote increased trade and investment between the US and the Caribbean, providing a fillip to bilateral and multilateral arrangements.

The idea that any country would willingly give up its currency seems like political dynamite. I am increasingly convinced, however, that the answer to the age-old question of what is the most appropriate exchange rate arrangement for CARICOM is "none." All Caribbean countries should initiate official dollarisation, that is, adopt the US dollar as legal tender and stop issuing domestic notes and coins. In so doing they would join 14 other officially dollarised independent countries.

Full dollarisation offers many benefits. First, it eliminates the risk of currency and balance of payments crises. A government cannot devalue a currency that does not exist. Caribbean countries with weak institutions or poor track records in the conduct of monetary policy (nearly all) can achieve monetary stability in a single move. Even the Eastern Caribbean with one of the more successful examples of a currency board is seeing the model come under pressure from high public debt and weak growth prospects. Of course, country risk would not disappear.

Second, dollarisation will force governments to strive for fiscal discipline and to reduce high budget deficits, because they can no longer print money to finance deficit spending. Caribbean governments ran an average fiscal deficit of 6% of GDP from 2000-2005, double the average fiscal deficit in 1990-1997. Governments would then have to borrow from the capital markets to meet their financing requirements, placing their performance (or lack thereof) under greater scrutiny. For example, it is central bank financing of the government's spending within the domestic economy that is the main reason behind the liquidity overhang in Trinidad & Tobago and which spills over into the foreign exchange market. I am aware that dollarisation will not produce magic changes in fiscal performance but it will make the price of mismanagement easier to see in the form of a higher risk premium.

Finally, official dollarisation will help to promote increased trade and investment between the US and the Caribbean, providing a fillip to bilateral and multilateral arrangements. Imagine no longer having to manage business operations through 9 currencies and 9 central banks, many with varying degrees of capital controls.

Despite such strong and compelling arguments, official dollarisation still has not become the obvious choice for policymakers in the Caribbean. The hesitancy has to do with the costs attached to abandoning a national currency including the loss of seigniorage revenues, the loss of monetary independence and the loss of a national symbol. Seigniorage is the difference between the cost of putting currency in circulation and the value of the goods the currency will buy. Currently, the US earns over US$250 billion in seigniorage revenue every year, and stands to obtain additional profits if dollarisation were widespread. There is therefore a strong case for the US to enter into a sharing arrangement with any legally dollarised economy to remit part of this revenue stream. The loss of seigniorage for Trinidad, Barbados and Jamaica is estimated to range between 2%-6% of GDP over time.

Full dollarisation demands that the Caribbean central banks completely give up their monetary policy to the US Federal Reserve. In some aspects, this feature of monetary policy making already obtains in the Caribbean, as central banks keenly monitor movements in the Fed funds rate and react accordingly by adjusting their own policy rates to maintain suitable interest rate differentials. Widespread dollarisation could bring pressure to bear on the Fed to broaden its focus beyond issues that affect US economic conditions.

Perhaps the most passionate objection to adopting the US dollar is not economic, but political.

Perhaps the most passionate objection to adopting the US dollar is not economic, but political. The national currency is seen as a symbol of sovereignty and national pride. This is an inappropriate claim. Arguably the more fundamental concept is not sovereignty but individual freedom of choice, manifested in the distinct preference Caribbean people show for the US dollar.

There are two routes through which it makes sense for Caribbean countries to adopt the US dollar. First, their economies are small, open, trade is concentrated on the US dollar bloc and shocks are similar. These are the standard optimum currency area arguments. The second and more appealing is when there seems no way of restoring confidence in economic policy making. We might be already down the second path. ■

Slow Grind at the Mills

What's Next For NFM? - by Stacey Ramjattan, Research Analyst, CMMB

National Flour Mills (NFM) has recently been in the spotlight but on the industrial relations front. Issues faced by the company include increasing competition, high cost production, weak export markets and significant changes to management have sent the share price to a low of TT$0.68 from the highs of TT$5.51 where it traded in June 2000. What is the next step for NFM; a company 51% owned by Corporation Sole via NEL?

Financially, the company remains weak. Over the past year, NFM struggles were compounded by the effects of Hurricane Katrina in conjunction with the continuous surges in international oil prices, which disrupted shipments and affected overall profitability.

In the local market, the flour segment is small and as competition stiffens, inefficient players will be eliminated.

The ongoing exodus by senior management accepting VSEP packages currently leaves the company in a quandary. Over the past year, revenue fell by 11% attributed to a fall in sales of flour, soyabean and oils. Also, operating costs were high and increasing, placing overall net profit margin at 1.8% from 2.5%. Operating expenses were affected by an accident at the edible oil complex, which resulted in an exceptional medical expense of TT$3.2 million. As a result, net profit after taxation fell by TT$6 million or 37% to TT$10.3 million. While the latest VSEP package will reduce this expense, a heavy one-off cost will be incurred in fiscal 2006. To deal with the competition, NFM was forced to reduce the price of its products and employ strategies to defend market share. It also built a new flour mill which was completed in 2005. The cost incurred has sent up the long-term debt to capital ratio. Profitability as measured by the ROE has fallen to 3.6% in 2005 from 5.6% in 2004 which now gives it a five year average of 8.1%. The ROA currently stands at 2.1% with a five-year average of 4.9%.

In the local market, the flour segment is small and as competition stiffens, inefficient players will be eliminated. A past estimate placed local flour consumption at approximately 100,000 tonnes annually and as the number of players increases, improvements at NFM are essential to ensure that its reputation for high quality products is maintained – a standard that has eluded it on occasion. Since the launch of Country Pride by Nutrimix Flour Mills, the playing field is being levelled. The Nutrimix mill is supposed to produce flour at a lower cost, which should filter down to consumers. Nutrimix is positioning itself to cut into the market share now enjoyed by NFM both locally and in the Caribbean. Also, on the competitive field is another flour plant based in Point Lisas, Republic Flour Mills. It is smaller and older than the Nutrimix plant but will take advantage of opportunities in Trinidad. This business is expected to also target the Suriname and Eastern Caribbean markets, but with cheaper costs, is expected to be competitive on the regional markets.

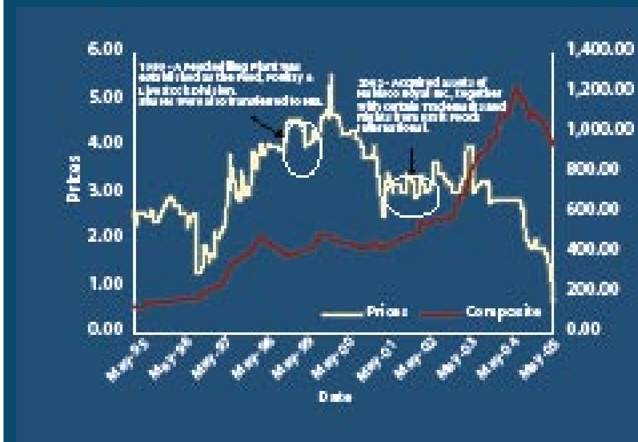
Problems at NFM stem not only from obsolete equipment and a large work force but also high overheads. Changes to prices as a result of increases in cost are simply passed on to the consumer without improvements to the level of operational efficiency. NFM has not operated as a monopoly since 1995, when the government opened up the market, initially with a reduced tariff. That tariff has since been reduced across the board and entrepreneurs have been importing rice and flour in direct competition with NFM. The company having ruled as a monopoly for close to 40 years, now has a brand-new CEO. among whose challenges will be the consequences of CSME and FTAA on the opening up of markets. The responses fashioned will be critical to NFM's survival.

To deal with the competition, the company implemented a new business model and an organisational restructuring, which is expected to be completed by the second quarter of 2006. The restructuring will involve hiring new management to replace the migration of senior management. An agreement between NFM and the Seamen and Waterfront Workers Trade Union (SWWTU) on workers' Voluntary Separation Package (VSEP) ignited the changes

Many stalwarts of the company accepted VSEP and departed from a company which they have been a part of for many years.

in management. This saw many stalwarts of the company accepting the package and departing from a company which they have been a part of for many years. This raises a further issue: that of institutional memory loss. A smooth transition requires some measure of continuity to be maintained in the person of key individuals with

Figure 8.1
NFM Price vs. Market Movement



Sources: CMMB Research Centre

insight and knowledge of the company's history and who understand much of its internal functioning. Systems of socialisation, governance, and economic control are also conserved in the form of institutional memory, as rules, procedures, technologies, beliefs and culture.

NFM operates mostly in mature and highly competitive markets that limit its capability to grow. Competition has intensified in the local market, resulting in a fall in sales, and the company has been forced to reduce the price of its products, further hampering revenue. In addition, operating costs are still high, affecting the overall profit margin. Given this, prospects for NFM will depend on how the management responds to the many challenges. Utilisation of the new facility to its full capacity has some drawbacks, given that the forecast for growth in sales is flat over the next two years.

Book Value now stands at TT$2.38 and the share is currently trading at a P/E of 17.4. The dividend discount model provides a value of TT$0.95. At its current price, NFM is trading at a significant discount to its book value, which makes it an attractive target for acquisition. ■

CMMB RESEARCH CENTRE

Waiting for the Grim REPA?

Regional Economic Partnership Agreements & the Caribbean

Vangie Bhagoo, Research Analyst, CMMB

Caribbean countries, which have traditionally relied on exports of their sugar and bananas under preferential market access to the European Union, now face a complete overhaul of their historical trading arrangements.

Exports from CARICOM to the EU are worth more than US$1 billion and account for over 12% of total regional exports. It is no wonder that some countries feel as if they are waiting for the grim REPA - Regional Economic Partnership Agreement – the new proposal advocated by the EU to replace the Lomé Arrangements, under which African Caribbean and Pacific (ACP) countries enjoyed preferential access to the EU market for more than 25 years.

Sunset Provisions have now been invoked and market access could end by December 2007. Will the Caribbean gain more with the implementation of a REPA, or will this instrument act as a further obstacle to the region's development?

Will the Caribbean gain more with the implementation of a REPA, or will this instrument act as a further obstacle to the region's development?

There are three main principles of the proposed REPA.

Reciprocity The Lomé provisions give ACP countries almost free access to the EU markets, but the reverse does not apply; the ACP market is not a guaranteed export market for the EU. Reciprocity under the REPA would require that ACP countries open their markets to the EU while imposing regional tariffs on on-EU trading partners such as the US and Latin America. Imports by the Caribbean from the EU amount to over US$1.3 billion and could rise even further with the implementation of a REPA.

Regions The EU encourages ACP countries to sign free trade agreements, not individually but collectively as regional groups. This would limit the number of agreements (there are now 77 ACP countries) and contribute to sustaining regional integration efforts. It is up to the ACP countries to take the initiative to eventually entrust their negotiating mandate to a regional grouping. This may not be a challenge for CARICOM, given its history and experience negotiating on behalf of the entire region.

Special Treatment for LDC's Some 39 least developed ACP countries (LDCs), in view of the special fragility of their economies, are not obliged to sign REPAs in order to retain their present level of access to the EU. If they do not wish to open their own markets to the EU, they can choose to keep existing non-reciprocal trade preferences

Table 9.1 CARICOM: Tariff Revenue (2002)

	Tax Revenue/ GDP (%)	Import Duty/ Tax Revenue (%)	Import Duty/ GDP (%)
Antigua and Barbuda	18.3	15.30	2.81
Bahamas	16.64	49.92	8.31
Barbados	30.97	9.86	3.05
Dominica	23.64	12.1	2.86
Grenada	24.2	12.08	2.92
Guyana	29.3	8.53	2.50
Jamaica	25.25	9.92	2.50
St Kitts & Nevis	22.26	15.89	3.54
St Lucia	22.75	13.97	3.18
St Vincent & Grenadines	26.65	9.85	2.63
Trinidad & Tobago	21.99	6.88	4.85

Source: Latin America and the Caribbean - A time to choose - Caribbean development in the 21st century Vol. 1 of 1 (English)

and are assured that whatever happens they will continue to have free access to the EU market for 'essentially' all products from 2005 at the latest. The LDC's in the Caribbean region are Haiti and Belize.

The third phase of negotiations for a REPA between Caribbean countries and the European Union was launched in St Lucia in September 2005, and this phase was aimed at defining the structure and scope and to determine the approach to trade liberalisation, with a view to promoting sustainable development in the Caribbean region. Both the EU and the Caribbean noted the importance of development in the context of the REPA, in terms of deeper regional integration, and to promote international competitiveness of the private sector, as well as to increase trade and investments in the region.

Although there are clear advantages of the REPA in terms of direct investment flows from the EU to the Caribbean, it appears that the region will have to shoulder the burden of adjustment, partially lessened through EU technical and financial assistance. This is because many Caribbean governments collect substantial revenue from trade tariffs, which typically account for close to 15% of total tax intake. In some countries like the Bahamas, custom duties generate almost half of total revenue. This source of funding is likely to diminish under a REPA. And with the region already facing severe fiscal constraints, this may further staunch development.

The proposed REPA may also hinder diversification of Caribbean trade with non-EU trading partners. In fact, it may divert trade away from a lower-cost (more efficient) supplier outside the trade bloc to a higher-cost (less efficient) supplier within the bloc. Caribbean countries may have to import from the EU, which may be the less efficient supplier, because the option of importing for the more efficient 'rest of the world' is simply not there, thus imposing a negative welfare effect on the region.

CARICOM Ministers have also expressed some serious concern with the European Commission's assessment of agricultural trade in the region. Even under severe pressure, agriculture still accounts for about 10% of regional GDP. The Ministers therefore disagreed with the EU's perception that agriculture has no future in the Caribbean. Underlining the importance of the sector, the Ministers called for revision of the assessment of the region's agriculture sector and to make significant provisions for it in the REPA. Further, they called for the insertion of an agricultural development strategy into the REPA.

The intention of the REPA is to simultaneously attain several objectives. A REPA is expected to strengthen integration between the ACP and the EU, promote economic liberalisation of ACP economies, deepen the regional integration process, and increase access for European companies to the ACP markets. It is difficult to envisage how one instrument can achieve these commendable but yet conflicting objectives, especially at the same time and when the Caribbean faces other multiple threats including persistently high crude oil prices and global terrorism.