Argentina Q&A

By Jan Dehn

Argentina once again finds itself in the grip of financial turmoil. While the timing of Argentina's blow-ups always entail a high degree of uncertainty, seasoned EM investors are not the slightest bit surprised that Argentina once again finds itself in trouble.

After all, Argentina has a history of repeatedly failing the most basic macroeconomic policy challenges, neglecting deep structural reforms and regularly succumbing to rampant populism; and importantly, not establishing a proper domestic bond market based on a well-functioning pension system.

On the other hand, the very fact that Argentina has such a rich history of failure, often leads to excessive market reactions, which can present opportunities. For example, the market's wrongful expectation of default in 2009 was followed by a rally of more than 200% in Argentinian bond prices over the subsequent two years. Today, Dollar-denominated bonds trade at a yield close to 20% with spreads at a similar level to those encountered in 2009 (Figure 1).

Should investors buy, hold or sell? The answer depends on whether current prices are commensurate with the underlying risks. This report complements a recent Market Commentary by explaining the nature of Argentina's current predicament through a series of Questions and Answers.

We conclude that the recent sell-off in Argentinian assets has gone too far and that current prices constitute an opportunity to buy. We believe that investors should buy now, even if it may take a few months for markets to become comfortable, given the incentives facing the main political actors in Argentina ahead of the election on 27 October 2019.

The recent sell-off in Argentinian assets has gone too far. Investors should buy now, even if it may take a few months for markets to become comfortable

Fig 1: **Argentina sovereigns spread over US Treasuries**

Source: Ashmore, Bloomberg, JP Morgan.

[1] See: *'The path to averting a default in Argentina',* Market Commentary, 14 August 2019.

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The recent sell-off was triggered by more negative global sentiment and a radical shift in political expectations ahead of the 27 October presidential election

Question 1:
What has happened in Argentinian markets and what were the immediate triggers?

Answer: Between Monday 12 August and Wednesday 14 August 2019, the EMBI GD spread for Argentinian bonds blew out by 1000bps from 872bps to 1872bps, while USDARS rallied from 45.25 to 60.24. Merval, Argentina's stock market index, dropped from 44,355 on 9 August to a low of 27,231 on 20 August.

There were two immediate triggers for the violent price action. First, the global backdrop worsened as the prospect of a US recession slowly began to be priced into the market. Emerging Markets (EM) asset classes almost always experience temporary pullbacks whenever something new and scary happens on the global stage. When this happens, Argentina's high-beta markets are particularly prone to volatility due to the country's miserable policy record.

The other reason for the sharp decline in Argentinian assets was entirely home grown. The result of the presidential primary election, which was held on Sunday 11 August, indicated a significantly higher probability of a victory for the Alberto Fernandez/Cristina Kirchner team in the upcoming presidential election on 27 October. Fernandez, a Peronist, is not trusted by the market. The repricing of Argentinian markets reflects this mistrust.

Question 2:
How has the rest of EM been impacted?

Answer: There has not been much impact on wider EM markets from the specific events unfolding in Argentina. This is quite rational. After all, there are now seventy three countries and nineteen countries represented in JP Morgan's EMBI GD and GBI EM GD indices, respectively. At the end of July 2019, Argentina's weights in these indices were a mere 2.38% and 0.38%, respectively. As at close of business on 21 August 2019, the EMBI GD was up 12.7% ytd, while the GBI EM GD was up 7.63% (both in Dollar terms). Argentina is an idiosyncratic story and long-gone are the days, when troubles in a single country, unleashes contagion-havoc across the wider EM universe.

President Mauricio Macri made both political and economic mistakes, but the current policy mix is sound the IMF-sponsored adjustment program is working

Question 3:
Why did things go wrong again in Argentina?

Answer: In our view, President Mauricio Macri made two serious policy mistakes during his term in office, which have directly contributed to the dramatic change in the political outlook. His first mistake was political and the second related to economic policy. Politically, Macri failed to neutralise former President Cristina Kirchner after she left office and now she is back as Alberto Fernandez's vice-presidential candidate. Her presence is critical, because her loyal support of 20% in the polls is exactly the margin whereby Macri now looks set to lose the election on 27 October.

Macri's economic policy mistake was to attempt to stabilise the deeply distorted Argentinian economy gradually by relying on a combination of not very tight monetary policy, very loose fiscal policy, and heroic expectations of massive capital inflows to strengthen the currency. In other words, Macri's first economic team expected investors to return so much cash to Argentina that inflation could be extinguished solely through FX appreciation, thus entirely obviating the need for a recession to stamp out years of excess demand. In the end, this policy mix failed to bring down inflation, while massive government bond issuance crowded out private sector investment, so growth never took off either. As the first sign of global risk aversion in 2018, investors pulled out and the currency crashed. By then, Macri had wasted two years and was forced to restart the adjustment process without enough time to recover before this year's election. Voters now blame Macri for the current malaise. He cannot escape blame; if only he had acted earlier and more decisively he would not have found himself in this predicament.

Of course, it is no small irony that voters now favour a new political team, whose members include the very people responsible for the bad economic policies, which necessitated the painful adjustments of the last few years. Still, that is politics. The silver-lining is that the current policy mix is sound and the adjustment program is working, undoubtedly due to the involvement of the IMF rather than former bankers.

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Bond holders face risks arising from capital flight and a possible maturity extension if IMF repayments are called into question

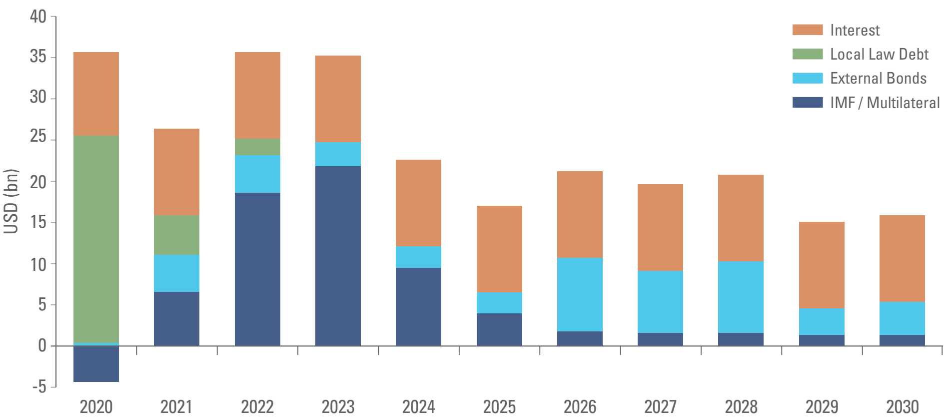
Question 4:
What are the main risks now facing bond holders?

Answer: Bond holders face two risks. The first is capital flight. A continuing slide of the Argentinian peso could induce Argentinians to convert all their assets to Dollars. The central bank's stock of gross foreign exchange reserves of USD 58.9bn would then quickly get depleted and the government (and corporates) could find themselves unable to access the Dollars required to meet external debt repayments. Defaults would ensue. This risk is directly attributable to one of Argentina's most serious structural weaknesses, namely the lack of a proper domestic bond market. Unlike most other established EM countries, which now obtain up to ninety percent of their financing from domestic markets, Argentina still borrows heavily in Dollars overseas precisely because it never developed a well-functioning domestic pension system. Argentina is therefore at the mercy of self-fulfilling prophecies, whereby mere volatility in external markets can quickly morph into genuine economic crisis if the country loses access to overseas' capital.

The other big risk facing bond holders is that Argentina's debt to the IMF is restructured and bonds get subjected to a maturity extension, i.e. a loss in net present value terms. If Argentina loses sufficient reserves, it may find itself unable even to repay the IMF. The risk is not insignificant. As Figure 2 shows, repayment obligations to the IMF rise sharply in the next few years, dwarfing repayments of both external and domestic bonds. Alberto Fernandez has also demanded a redesign of the IMF Standby Agreement.

However, a restructuring of IMF debt is not a given, especially if program targets continue to be met in which case the IMF will happily roll over the debt. A major failure of Argentina to meet program targets, however, could prompt the IMF to demand equality of treatment for bond holders. Hence, the importance of how Fernandez views the IMF program. More on that later.

Fig 2: **Maturity profile: External debt, IMF obligations and local debt**[2]



Source: Bloomberg, Morgan Stanley, IMF, Ashmore.

Argentina's debt stock, although large, is not unsustainable; the composition and holding structure of liabilities are critically important

Question 5:
What about the debt stock? Is it unsustainable?

Answer: Argentina has a large and particularly complex debt stock, which includes official and private sector debt, debt in multiple currencies, monetary financing instruments held by the central bank, GDP warrants, repo collateral, foreign and domestic law securities, local bonds in the hands of locals, ANSES and foreigners as well as conventional Eurobonds. However, it would be lazy and misleading to merely sum up all of all these securities and conclude they are excessive and apply a haircut. In reality, the precise composition and holding structure of the debt stock matters greatly to the government's ability to pay. For example, a substantial chunk of the debt is in local currency with fixed rates, which is currently being inflated away at a rapid pace. Also, no less than 37% of Argentina's total debt stock is held by public sector institutions, i.e. owned by the government itself. The critical repayments required of Argentina are the debts shown in Figure 2, namely USD 88.2bn in external debt, USD 48.9bn owed to the IMF and USD 31.7bn in domestic debt. Combined, the debt stock is roughly equivalent to 89% of GDP, which, although large, is by no means unsustainable, particularly if the adjustment envisaged under the IMF program, or something broadly similar, is maintained.[3,4]

[2] This excludes repo collateral, monetary financing, GDP warrant obligations and debt held within the public sector.
[3] Based on the June 2019 Article IV report. This report also includes a comprehensive debt sustainability analysis, which shows that the debt is sustainable, though not without risks. See https://www.imf.org/en/Publications/CR/Issues/2019/07/15/Argentina-Fourth-Review-under-the-Stand-By-Arrangement-Request-for-Waivers-of-Applicability-47116
[4] This excludes repo collateral, monetary financing, GDP warrant obligations and debt held within the public sector.

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Macri's new economic team have so far responded sensibly to the outbreak of volatility

Question 6:
What is the Macri Administration doing to fix the problem?

Answer: The Macri Administration has already responded to the rapidly changing financial conditions in important ways:

1. The government announced new fiscal stimulus measures to the tune of about 0.3% of GDP. This is a modest stimulus, which will neither jeopardise the IMF program nor overturn Macri's deficit in the polls ahead of the election, in our view.
2. More importantly, newly appointed Finance Minister Hernan Lucanza has identified currency weakness as a major risk factor and begun to intervene in the currency (selling Dollars). This addresses the capital flight risk head on, although the government cannot intervene forever. After all, the present issue to which markets have reacted is mistrust of a future Alberto Fernandez/Cristina Kirchner Administration, which cannot be addressed simply by spending hundreds of million Dollars to defend the currency.
3. Equally importantly, the government has begun to take advantage of the low current bond prices to reduce its outstanding liabilities. This week Argentina repaid a repo loan, which reduced the government's outstanding repo-related collateral liabilities by a whopping USD 15.4bn.
4. The IMF is on the way to Argentina to review the Standby Agreement. Since Argentina is likely to have met or even exceeded some IMF program targets, it is possible that IMF disburses the next USD 5.9bn tranche in quick order. Another tranche of similar size is also available, albeit not immediately.
5. Most crucially, the government has reached out to Alberto Fernandez and his economic team. Alberto Fernandez says that he will not default as president. Former Finance Secretary Guillermo Nielsen, a close associate of Alberto Fernandez, stated this week that a Fernandez government would not want to restructure Argentina's bond debt. These are strong statements. An indication from Fernandez that his government will continue the current sensible economic policies should go a long way towards stabilising the currency and ameliorate the risk of serious capital flight.

Election front-runner Alberto Fernandez's political incentives change dramatically after the election, when he will have an interest in extinguishing any sense of crisis

Question 7:
How does the election on 27 October impact political incentives?

Answer: The presidential election is only about two months away. It is therefore critical to understand that what the political actors say may not entirely reflect what they will eventually do. With the polls showing that Argentinians blame Macri for the current economic malaise, for the time being this works in Fernandez's favour, wherefore the latter has an interest in maintaining a sense of crisis. On the other hand, Fernandez will also be aware that much of the heavy lifting with respect to fiscal adjustment and inflation management has already been done by Macri, so he can look forward to taking power just as the economy emerges from the toughest part of the long and painful adjustment. Fernandez's incentives therefore change dramatically before and after the election; he benefits from contributing to the sense of crisis before the election and has a strong interest in absolutely extinguishing any sense of crisis after he wins. Markets should therefore expect considerable uncertainty at least until 27 October, but possibly substantial improvement afterwards.

As for Macri, he really has no choice but to continue with his current program in the hope that he can somehow claw back some political momentum. Even if he loses, however, his legacy is clearly best served if the adjustment he began bears fruit. He therefore has every incentive to work as hard as he possibly can to get Fernandez to stick to the current adjustment program.

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Investors should buy now even if there will be plenty of volatility leading up to the election

Question 8:
What should investors do?

Answer: The broad case for EM remains strong and returns are solid.[5] Whatever happens in Argentina will not change this, if only because of Argentina's small share of the investable EM universe.

Fernandez may struggle initially to obtain the same trust in markets as Macri, at least in the early stages. Such is the legacy of Peronism. The recent shift lower in Argentinian asset prices after the primary election is certainly justified, but we do not think prices have moved commensurately with the risks. The market has likely overpriced the default risk associated with a future Fernandez government, in our view. If, for the reasons outlined in the previous section, Fernandez ends up piggy-backing on Macri's adjustment program and pursues broadly market friendly policies after he takes office there is clearly upside for Argentinian assets.

Even though Argentina is a buy in our view, we expect plenty of volatility in the next few weeks due to the time inconsistent incentives facing Fernandez in the run-up to 27 October. The main risk arising from buying into the current weakness is that Fernandez misreads his opportunity and turns more heterodox in his policy choices, just like Cristina Kirchner did during her time in office. This would be a serious mistake, which would soon force Fernandez into major financial problems and eventually a default due to the much larger stock of external debt today compared to the past. Fernandez would probably not survive politically due to the resulting economic and political turmoil. Does he really want to go there?

On the other hand, we are not worried about Cristina Kirchner. Vice presidents in Argentina do not wield power. Only further down the line, after Fernandez' political capital is depleted, in accordance with the natural order of things in political life, does she potentially pose a potential risk.

[5] See: *'The 2019-2023 EM fixed income outlook',* The Emerging View, 6 December 2018.

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