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MARKET COMMENTARY

The path to averting a default in Argentina

By Gustavo Medeiros

Investors are suddenly much more concerned about the political transition in Argentina.

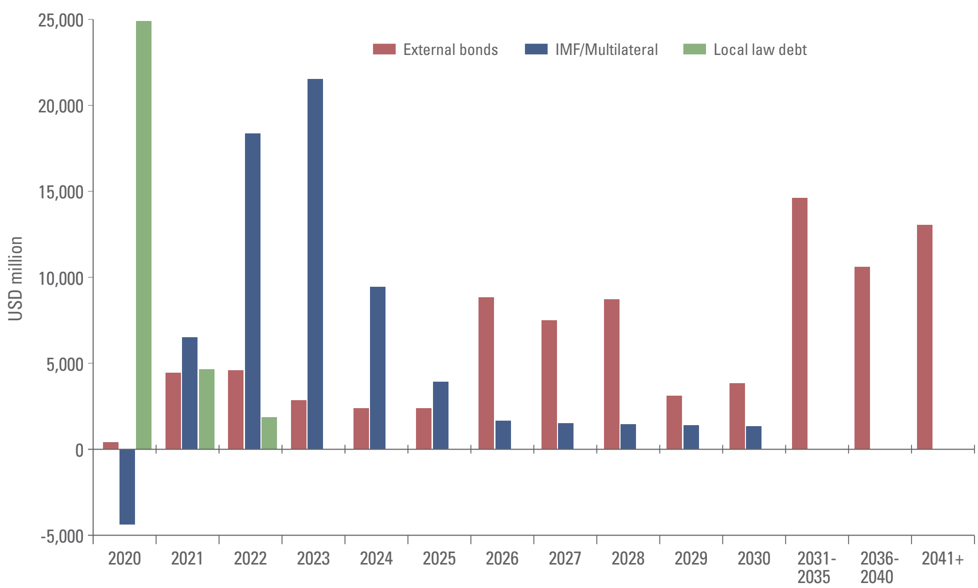
The country's stock of debt is large but not unmanageable, with a path to avoid default and to boost growth in sight. This path requires a strong commitment from politicians and a continuation of fiscal consolidation and is the path preferred by the population, by some politicians and by investors.

There are encouraging signs that the main contenders want to do the right thing. If they want to do so, they must move soon.

Events in Argentina surprised markets after Alberto Fernandez and Cristina Fernandez de Kirchner defeated incumbent president Mauricio Macri decisively in last Sunday's PASO (Open, Simultaneous and Obligatory Primary elections). Immediately the size of the Argentinian debt owned by private sector foreign investors came into focus and weighed on markets. The price action suggests that markets expect a default after the presidential elections later in the Autumn.

But, in spite of a fragile equilibrium, the country does not have to default again. There are no significant external sector debt maturities before 2021. The main short term issue for the country is its ability to roll its large local debt (both in ARS and USD) and to contain currency pressures. The IMF programme still has two tranches of USD 5.9bn to be disbursed, which should allow the country another year before they have to tap the markets again. The IMF is the single largest creditor to the country: repayments are only scheduled to start in 2021, but could be termed-out, as long as a strong commitment to fiscal adjustment is undertaken by the new government.

Fig 1: **Maturity profile: External debt – USD 88.2bn + IMF – USD 48.9bn + Local – USD 31.7bn***



* Source: Bloomberg, Morgan Stanley Research, IMF, Ashmore.
** Excludes Repo Collateral FX bonds, Monetary Financing, GDP warrants and public sector held debt.
*** Negative number = IMF disbursement.

With the currency weakness, the current account deficit has already declined significantly and it is expected to be c. 1-2% of GDP in 2019. Further currency depreciation means that the deficit will decline further, putting external accounts at a more sustainable level.

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Ashmore

The path to indebtedness

Macri had good intentions, but policy implementation was poor. At the beginning of his mandate the idea was to follow a 'gradual adjustment', funded by external debt. The economics team consisted of well-known former bankers with the ability to sell the adjustment dream to global financial markets. However, gradualism proved to be difficult to implement in practice. A combination of loose fiscal and monetary policies meant that inflation expectations were never fully anchored. As the peso adjusted to higher inflation, the large external debt stock quickly became much harder to bear. Macri had inadvertently committed what economists call 'original sin': borrowing too much debt in a currency you cannot print or control.

Confidence is key

The main problem now is confidence. Currently market participants do not believe policymakers will be able to bring inflation down in the future. Therefore, the market has quickly repriced the currency lower at the same time that local and external debt risk *premia* overshot in order to compensate for the risk of future currency depreciation. Lower asset prices hit confidence further. A vicious cycle has started to kick in.

But these dynamics can be reversed. Milton Friedman correctly said: *"Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output"*. It is no different in Argentina. It is the expectation of loose monetary and fiscal policies that renders the debt dynamics unsustainable.

Argentina was already facing this last year. In order to address the situation, the IMF prescribed the Central Bank of Argentina a zero monetary expansion, which, if sustained, would drive inflation down over time. It did temporarily stabilise the ARS and confidence in the economy slowly started to improve. So much so, that market participants increased exposure hoping for an economic recovery that would help Macri with his re-election bid. After all, the opinion polls seemed to indicate that Macri's chances were improving.

It's politics, stupid!

But politics has now got in the way of the IMF plan. The PASO results show that Macri has in fact lost credibility in front of inflation-weary Argentines. The protest vote and poor population sampling by pollsters have delivered big negative surprises just at the time that Argentina was attempting to navigate turbulent macro waters globally, characterised by the US/China trade war, a global economic slowdown and geopolitical uncertainties.

Who is Mr. Alberto Fernandez?

Alberto Fernandez does not have market participants' trust at the moment because of his past and political allies. Alberto was a former minister for both Nestor and Cristina Kirchner. He has reunited different factions of the Peronist party by putting himself at the top of the presidential ticket with Cristina as vice president.

A pragmatist at heart

But the populist narrative is not sound. Alberto is a political veteran who was around before the Kirchners. He has proven before to be his own man in the past while working for his current running mate. Alberto first appeared in national politics as a National Superintendent for Insurance under President Carlos Menen. He subsequently worked in the Buenos Aires City Legislature on the conservative ticket *'Accion por la Republica'*, led by former Economy Minister Domingo Cavallo. As with many savvy politicians before him, he changed his political allegiance to become Nestor Kirchner's Chief of Staff in 2003, and retained the position when Cristina was elected in 2007. But roughly one year later, Mr. Fernandez resigned from Cristina's government over disagreements on agricultural taxation policies.

In 2008, Cristina Kirchner announced higher taxation on soya bean exports in order to balance the fiscal accounts, increasing taxation by decree. But a strong wave of protests battered the president's popularity. Parliament rejected the tax increase by one vote and Cristina backtracked, revoking the tax increase. That is when Alberto resigned. He subsequently became a harsh critic of Cristina Kirchner's management style and forged ties with other factions of Peronism.

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Mr. Fernandez has, therefore, all the elements to construct a market friendly narrative. Under Argentina's presidential system, the President is vested with all the authority making the vice president largely irrelevant, so he will not depend on Cristina.

Searching for a sustainable model

Mr. Fernandez also may find inspiration by looking at his neighbouring country, Brazil. There, in 2002, markets plummeted when leftist presidential contender Lula was leading the polls against pragmatic incumbent Fernando Henrique Cardoso. Back then, Brazil was in a similar situation to that which Argentina is in today. Highly indebted in foreign currency with fragile fiscal accounts, the central bank had to keep monetary policy at a much tighter level than usual to control inflation and could only succeed in its task if it developed, nurtured and maintained market confidence.

That is when Lula proved himself to be a shrewd politician. Understanding the situation required a confidence boost, while still campaigning for the presidency Lula composed a 'letter to the nation' pledging to maintain an austere fiscal policy in order to preserve the purchasing power of the Brazilian currency, the Real. As markets convulsed, his economics team and the incumbent administration staged a series of interviews in which they demonstrated that they were working together and had the expertise and a strong commitment to implement policies which would allow Brazil to navigate its debt crisis and remain current on its debt. Lula would be remembered as the most popular president in history thanks to a little help from the external scenario. But it only happened because he averted default, benefiting millions of Brazilians who would otherwise suffer severely from the return of inflation in a default scenario.

Our view

We are moderately optimistic that Argentina will avoid a repetition of its 2001 default. Valuations are attractive after the knee jerk sell-off. But it is the evidence from the Fernandez team and the dynamics of the political situation that provides for the optimism.

His economic advisors resemble more moderate Social Democrats than Socialists, in our view. The commitment to service the debt is there (Mr. Fernandez has already said he favours servicing the debt and sticking to the IMF programme). The difference from the current administration's strategy is on the format of the adjustment. They understand it is not sustainable to roll short term local debt at 60%+ interest rates and that inflation has to come down to make external debt sustainable. Their plan seems to be to bring fiscal accounts onto a more sustainable path by increasing taxes, rather than more austerity. We agree with both the diagnosis and the medicine for the country's malaise.

- **The political-economic situation**

  The dynamics are encouraging. Alberto Fernandez has not won the election yet. To be declared president in the first round of voting on October 27th he needs to receive 45% of the total valid votes, or 40% with a 10% margin over the second best candidate. That is a similar margin to the one he secured in the primary on 11th August. If he fails to secure a sufficient vote-share during the first round, a run-off is scheduled for November 24th.

  Had Mr. Fernandez won the primary by a narrow margin, as polls incorrectly predicted, he would have an incentive to see more 'blood on the street'. Further depreciation of the ARS harming the purchasing power of Argentinians would be blamed on the incumbent, boosting the odds of a political transition. But after winning the primary by such a large margin, the ball is in his court. His future policies will be the main factor driving today's market performance, so he will have to emphasise his willingness to fix the situation in order to avoid Macri blaming the sell-off on him.

  Most importantly, Mr. Fernandez is now the favourite. He is already thinking about his tenure which starts in 2020. And anybody would prefer to start their presidential term with a delicate, but balanced situation than to assume responsibility for a broken country with a vicious cycle of negative confidence undermining its debt and its economy.

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- **The bull case scenario**

  Mr. Fernandez has every incentive to get his economic advisors to sit down with the IMF and to agree on a strategy which can stabilise markets. That should be followed by continuous public announcements, showing that both politicians and the IMF are committed to a sustainable solution for the country.

  This would pave the way for a re-profiling of IMF repayments. Over time, with more confidence in the future, local banks and foreign investors would be encouraged to buy longer tenor debt denominated in ARS. That would allow the Treasury to reduce liquidity risk and to replace USD debt with local currency debt – a more balanced dynamic – and to repay the IMF.

  Private sector investors would be encouraged by better dynamics and follow through. Argentina offers promising projects in a country where the exchange rate is undervalued and the population is educated. With growth returning, complemented by prudent fiscal and monetary policies, the debt situation would look sustainable and a vicious cycle would turn into a virtuous cycle.

- **The bear case scenario**

  If Mr. Fernandez turns out to be an ideologist, as some fear, he may look to Venezuela instead. In this scenario, populist policies would go hand-in-hand with a protracted stand-off with the IMF and bondholders. The ARS would depreciate and bond prices would sell off further. Inflation would return with gusto with the Argentine population suffering the most.

  After Monday's shock, bond prices already incorporate this scenario to a certain extent trading at 40-60 cents on the US dollar. Prices can go lower but eventually a restructuring would have to be agreed. History shows that bondholders have considerable power to drive the terms of a restructuring. This is a potentially powerful element to limit the medium-term downside of investments and to provide time and space for the politicians to commit to the appropriate policy mix.

- **Value investing**

  It is the large potential upside vs. the smaller downside which makes an investment attractive. We have seen this many times before with markets overshooting on the way down after events, leading to above-average returns thereafter. In Argentina just now, value is being created which presents an opportunity. Over the long run, such opportunities can generate superior returns for investors. In our opinion, now is the time to focus on valuations, rather than to panic along with the headlines.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
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