



## OUT OF CRISIS COMES OPPORTUNITY: A VISIT TO UNSTEADY ARGENTINA

SEPTEMBER 2018

We visited Argentina last month to obtain a deeper bottom-up and top-down perspective on the country's recent plight – which caught much of the investment community by surprise.

Tightening global liquidity – caused by the reduction of the US Federal Reserve balance sheet, rising US interest rates and the rising dollar – impacted the currencies of many emerging and frontier countries. It has particularly affected economies most dependent on external funding – which is USD\$30bn annually in Argentina's case.

This deteriorating market environment engulfed Argentina just as it experienced its worst drought for 50 years, which hit the country's crop production and US dollar export revenues. In addition, coming into this crisis, half of Argentina's USD\$60bn in central bank issued Lebac's – the one-month short-term notes – were held by foreigners<sup>1</sup>. While the notes should have been exclusively used by the banks for short-term liquidity, they were dumped by external investors immediately after the run on the currency began – which exacerbated the situation.

Encouragingly for Argentina's investment case, the current administration has some of the finest capitalist minds in the country. The response to this latest episode proves Argentina is choosing to take the path of orthodoxy to try escape the clutch of crises, which seemingly swamps the country every few years.

Firstly, the authorities utilised reserves in an attempt to defend the currency. Upon realisation it was futile, interest rates were immediately hiked from 27% to 40% and a significant USD\$50bn IMF standby agreement was agreed in a record time of just eight weeks.



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<sup>1</sup> Source: Central Bank of Argentina

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#### **MEETING THE MAN IN THE MIDDLE**

We were fortunate on this visit to meet the person who spent a month in Washington thrashing out the IMF deal, Argentina’s chief of staff Ariel Sigal. With the aid of the IMF money, Sigal revealed Argentina’s external borrowing needs until the end of 2019 was down to just USD\$3bn – from USD\$30bn. In addition, foreign ownership of Lebac has all but disappeared, with half of the outstanding USD\$30bn Lebac in circulation still owned by local retail investors. While it was agreed with the IMF to reduce this to zero within two years, the government hopes to accelerate this.

Sigal also reaffirmed the government’s commitment to meeting revised fiscal targets – which is to be in primary fiscal surplus by 2020. He also gave us a few examples of further actions the government could undertake if the target appeared unobtainable.

Following our visit, the Argentine currency came under further pressure – forcing the central bank to raise interest rates to 45%, then to 60%<sup>2</sup>. More aggressive fiscal tightening measures have also been announced in a bid to achieve a primary fiscal surplus in 2019. In an attempt to stabilise what looks like an overshooting currency, the government went back to the IMF to accelerate financial help and remove all external funding requirements in 2019. This is a positive development.

#### **ABUNDANCE OF CRISIS EXPERIENCE**

While still hostage to the global environment, in particular the path of the US dollar, Argentina’s situation appears to have stabilised for the time being. We are awaiting the imminent IMF response, but it is likely to do whatever it takes to help the administration stabilise the currency. As a consequence of the fiscal and monetary tightening, we believe Argentinian inflation is set to spike to about 40% and the country will enter a recession.

While the economic turbulence has been profound, Argentinian companies seemed relatively relaxed. Corporates are used to dealing with periods of crisis and have navigated this latest episode reasonably well – largely by cutting capex and dividends where necessary to increase buffers.

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<sup>2</sup> Source: Central Bank of Argentina

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Fortunately, many banks raised 'growth' capital towards the end of last year, providing a robust capital position to weather this storm. The economy has effectively suffered a short and sharp standstill, which will lead to rising non-performing loans, but it should not lead to a banking crisis. Therefore, the economy should be able to restart once the inflationary pressures begin to abate next year.

#### **POLITICAL NOISE POISED TO INTENSIFY**

When examining Argentina, politics must always be carefully considered. The country is set for a crucial general election in October 2019, with President Mauricio Macri likely to run for re-election. If Macri wins and obtains control of the lower house, the pace of reform can meaningfully accelerate – which could see Argentina finally escape decades of recurring crises.

However, a Macri victory is far from certain, with most reasonable commentators today giving him a 50% chance. The crisis has dented his popularity, with approval ratings falling from in excess of 50% to 36% at the time of our visit. However, if we look forward a year, it is possible the election will coincide with a growth acceleration.

While former president Cristina Kirchner continues to be touted as a rival to Macri next year, this ironically would likely lead to a Macri victory. Kirchner – who is currently embroiled in another corruption scandal – is extremely unpopular outside of her diehard supporters and would likely split the opposition Peronist vote. Most commentators are currently sanguine, expecting a reform-minded 'rational' Peronist candidate to emerge should Kirchner not run. We are not so confident. Nevertheless, it is going to be politically noisy over the next year – which is likely to result in bouts of market turbulence.

#### **ARGENTINA NOW A CHEAP MARKET**

For a few years up until January, we have been overweight Argentina, which generated significant outperformance. In response to a signal of caution from our Fixed Income team at the beginning of this year, well ahead of the current crisis, our overweight was cut to neutral. We are currently underweight Argentina, with our 13.5% position split between domestic companies and US dollar-based earners, which benefit from the current currency weakness.

In conjunction with our fixed income colleagues, we are constantly reassessing the outlook for Argentina's currency, economy and companies. We continue to be poised to pounce on opportunities to selectively increase our allocation to what is now a cheap market.

We continue to have faith in our Argentine equity positions and despite the volatility, we believe the broader market will continue to feel the tailwind of its upcoming upgrade from the Frontier Markets Index to the Emerging Markets Index next year.

**Key Risks** - The following risks are materially relevant to the strategy highlighted in this material:

Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates which may affect the value of an investment. Returns can be more volatile than other, more developed, markets due to changes in market, political and economic conditions. Investments are less liquid than those which trade on more established markets.

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