

Argentina - primary results show strong support for the government

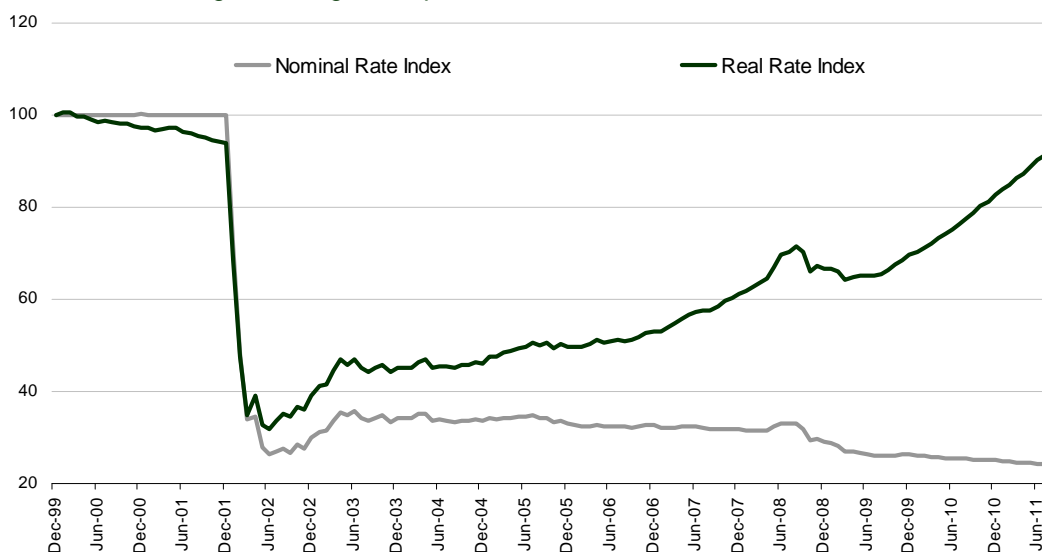
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Argentina's recent primary elections held on August 14th saw President Cristina Fernández de Kirchner garner just over 50% of the votes cast. This vote was a first for the country after election reforms passed last year mandated that candidates for the Executive and Legislative branches be selected through primaries. However, with each party putting forth a single candidate and voters not restricted across party lines, the process was in essence a federally mandated poll. In this sense it should give a reasonably good indication of what to expect in October's elections. With the President easily surpassing the 45% level needed to avoid a run-off, in our view we expect government policy to be basically more of the same going into 2012. From a markets standpoint, this means that Argentina becomes increasingly vulnerable to weak external conditions and returns in peso denominated sovereign bonds are likely to be muted.

Probably the most urgent and pervasive problem in the Argentine economy is inflation. While official numbers from the National Institute of Statistics and Censuses (INDEC) puts the year-on-year figure at 9.7% for July, unofficial sources and surveys estimate that the true rate is closer to 25%. Confirmation of these estimates can be seen in the labour market where wages are rising at an even faster rate; above 30% year-on-year in the private sector. This means that while the peso has been depreciating in nominal terms against the country's trading partners, in real terms it has been rapidly appreciating, stretching valuations and eroding trade competitiveness.

Figure 1: Argentine peso bilateral FX rate versus US dollar

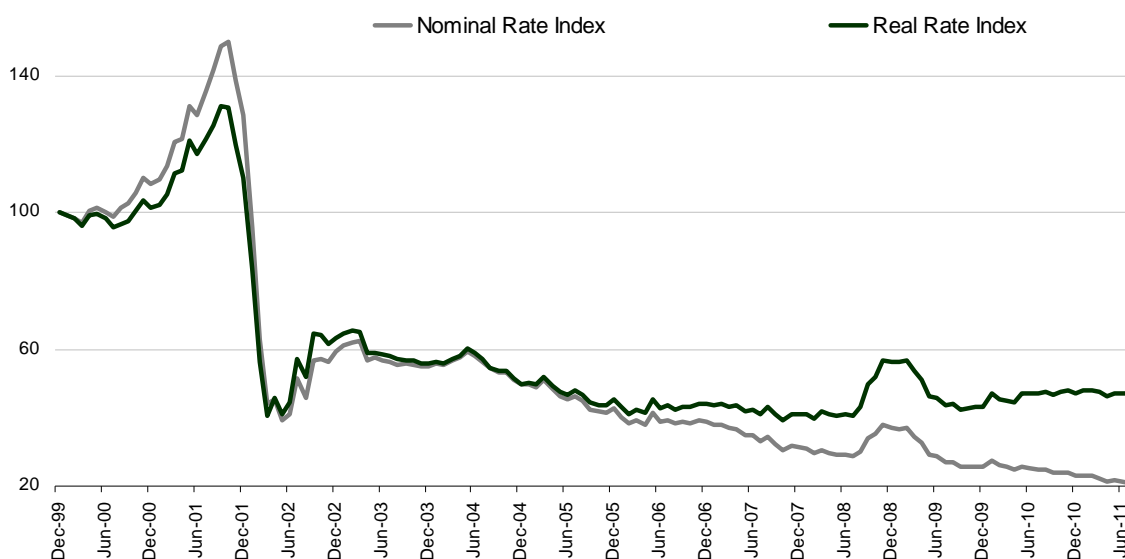


Source: Bloomberg, IMF, Rexiter estimates

As the above chart shows, the real value of the peso is returning to pre-crisis levels, although we don't consider it to be strongly overvalued yet. However, with the government choosing to not even recognise that there is an inflation problem, much less do anything about it, we will continue to see pressure on the trade balance and on capital flows.

On the positive side, the same relationship does not hold true for Argentina's biggest trading partner, Brazil. The strength of the real (BRL) coupled with a higher inflation rate than the US has helped keep the bilateral rate fairly weak. On the other hand, the inflation differential will continue to put upward pressure on the cross rate, which could be exacerbated by depreciation of BRL. We hold a reasonably high probability for the latter scenario occurring given worsening global growth prospects, down-trending commodity prices and the likelihood of Brazil slowing sharply after growing above potential for much of 2010/2011.

Figure 2: Argentine peso bilateral FX rate versus Brazilian real



Source: Bloomberg, IMF, Rexiter estimates

The inflationary trend, combined with external economic conditions, is starting to have a significant impact on the supply of dollars to the Argentine economy. On the trade front, the country has benefited from both high agricultural prices (primarily soybeans) and from record harvests in 2010/2011. At the same time, high economic growth with strong employment and wage figures has meant that import growth has exceeded that of exports in all but three months of the last two years. The government has responded with import restrictions on a raft of consumer and other goods, but such a move provides only a weak stopgap and is likely to add additional upwards pressure on inflation.

The capital account too is showing signs of strain as risk adverse Argentine depositors favour dollars over pesos. Foreign asset purchases are now approaching levels not seen since 2008; a time when both the Argentine farm conflict and the global financial crisis were causing havoc domestically and abroad. These imbalances will eventually need to be addressed, but what remains to be seen is what the government will choose to do. We believe that it will take some combination of falling central bank FX reserves, a faster depreciation of the peso and rising domestic interest rates to slow or halt outflows of capital and stabilise the current account. As reserves are being used in part to fund the government, a decline would hurt the quality of the country's USD denominated debt and cause spreads to rise. In local currency bonds, a weakening peso will more than offset the high yield on offer making these bonds less attractive relative to other emerging markets like Brazil.



On the debt front Argentina looks relatively well positioned and we do not believe that solvency in USD or peso bonds is much of an issue. Net debt is only around 25% of GDP, if you exclude intra-government held bonds such as those held by the national pension system ANSES. The fiscal numbers have also held up better than anticipated in the pre-election period, with the surplus from 2010 only slipping to a deficit of around 1% of GDP this year. GDP and tax revenue growth are still performing well and we believe that solvency ratios will remain strong. However, spreads over US treasuries will still be negatively affected in the shorter term by US dollar liquidity conditions.

It seems clear that without some substantial shifts in policy, Argentina will become increasingly exposed to external economic conditions, in particular, the price of soft commodities. Additionally, if capital outflows continue, it is likely that some combination of falling FX reserves, a more rapid depreciation of the peso and large hikes in domestic interest rates will occur. This means there is a very narrow range of outcomes under which local currency bonds will perform well in the short to medium term, although we may see more attractive entry points in Q1 2012.