Argentina: 5 Key Questions

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1. **What happened? The unexpected and shocking defeat of President Macri and his center-right party in the Argentine primaries on August 11 has led to a significant repricing of Argentina assets.** Polls for the primary had been projecting that the opposition candidate would have about a 4 percentage point advantage over incumbent Macri, which would have portended a closer first round on October 27 and a possible second round in November. Instead, primary results showed that the Fernandez center-left ticket had a 15 percentage point lead (47% versus 32%). According to Argentine election law, a candidate can win in the first round if they secure more than 45% of the vote. In the important gubernatorial primary in the Province of Buenos Aires, the center-left Kirchner-linked candidate (Kiciloff) also led the popular incumbent governor by 17 percentage points.

   Given these results, we anticipate that the chances of the opposition winning in the first round has increased considerably. What the market and polls underestimated was the discontent of the Argentine public with high inflation, a weak economy, and desire for change. The weak economic situation was also what helped get Macri elected in 2015, but the voting public seems to be saying, "we tried your version of policies, and they have not worked, so let's try something else." **Our base case is that the Fernandez ticket wins the election in October.** The actual election could be closer than anticipated by the primary, but it would seem to be a high hurdle for Macri to win. The market volatility is also likely working against him.

2. **How did the markets react? Argentina dollar and euro denominated hard currency bonds are down more than 25 points. Most of the debt along the curve now trades in the low $50s. Bonds that mature in 2021 and 2022 trade a bit higher. The currency traded off more than 20% initially, and CDS widened by almost 1,500 bps, pricing in a probability of default of almost 80%. The central bank hiked rates 1,000 bps to 74%. Argentine equity markets were down 38% on the day after the election.** Inflation will likely pick up on a month-over-month basis to an average of 3-3.5% for the remainder of the year, rendering an annual rate of about 46-50% by December. In all likelihood, economic activity will remain negative into 2020; we project a contraction of 0.5% next year (see Figure 1 below). The technical positioning of investors with an overweight positioning by most dedicated investors is exacerbating the situation and causing a larger price drop than what might otherwise seem reasonable.

3. **What could cause a short-term positive confidence shock?** In order for the markets to stabilize, the FX would need to stabilize and short-term roll-overs would need to go smoothly. This is unlikely to happen. We are in a period where focus will be on market indicators—the currency, rollovers, dollarization, and capital flight. In the short term (up to elections, in the period after elections, and until the new administration potentially takes office on December 10), the market will be focusing on what Presidential candidate Alberto Fernandez says, and whether those comments calm the market. **The candidate came out overnight and commented that he does not want to default.** However, he accused Macri of putting the country in a vulnerable position. The center-left and populist focus of the Fernandez ticket (Cristina Kirchner, who is running a Vice President, was president from 2003-2015, a period where unorthodox policies caused major macro distortions) has not instilled confidence that a regime change would lead to a continuation of the IMF program and of making bond payments. It is likely that the incentive for Fernandez to calm the markets is lower now and more likely after the election (assuming they win). **Current bond prices assume a default within a year.**

4. **What factors should observers watch?** The IMF is currently reviewing its next disbursement. **The September disbursement (about $5.5 billion) is in question given the uncertainties arising from the primary election results, yet we think the IMF will disburse.** Additionally, the market is waiting to see who the Fernandez team indicates their Minister of Finance or Head of the Central Bank might be. Most importantly, focus will be on the currency and the extent to which reserves are used to support the ARS. **We also need to watch the roll-over of local denominated debt over next few months totaling between $10-11 billion (Letes) and the roll-over of Central Bank notes (Leliqs).** There are estimates that there is about $20 billion in the banking system deposits that could be dollarized. All of this has implications for the level of reserves. Gross foreign exchange reserves are currently $66 billion and

net reserves are closer to $20 billion. **We think Macri and team will not use significant reserves to support the currency, but will want to have some available to handle the rollover schedule. There is also the possibility that capital controls are imposed.** With the new election developments, the external liquidity conditions are challenged, and confidence needs to stabilize.

5. **Will Argentina default?** **While a default cannot be ruled out, liability management may prove a much more effective tool to buy the next government badly needed time to restructure the economy and get government finances in order.** Financing needs are high when all public sector maturities and interest payments are considered over the next few years. **With anticipated currency weakness, public sector debt as a percent of GDP will likely be greater than 90%, so the issue of external solvency is relevant.** Out of a total of approximately $325 billion of public sector debt, only $77 billion is external law debt. It is of note that maturities for external law bonds are manageable with the support of the IMF. External law bonds have maturities next year totaling $400 million, $4.5 billion in 2021, and $4.7 billion in 2022. On the surface, this is very manageable. **However, the IMF program in its current form requires repayments beginning in 2021. The IMF program totals more than $56 billion (out of which about $44 billion has been disbursed so far), and repayments over the next five years range between $3 billion to $6 billion. If Macri were to be re-elected, it was expected that the IMF would have converted the current program into an Extended Funds Facility (EFF), which would have pushed out maturities. That is less likely to happen now. If the IMF has to extend maturities, it may require that other external debt is included in any liability management.**

In addition to these external financing requirements of the government, there are local law rollover and amortizations that are denominated or linked to USD, as well as those denominated in pesos. We can assume that local markets, and in particular local public sector entities, could absorb some of these rollovers in pesos and dollars Interest payments are meaningful over the next couple years totaling close to $19 billion per year. A balanced current account and trade surplus helps. All of this would seem to suggest that some debt reprofiling or restructuring is in order given the negative confidence shock and the new macro dynamics.

The relevant question is what type of debt restructuring occurs: will it be market friendly or will there be a "hard" default? Assuming the next government is run by Alberto Fernandez, it is in his best interest to work with the IMF and investors. The new government can blame the liability management or restructuring and weak economic situation on Macri and can likewise still commit to adjust the fiscal to keep the IMF on board. In this scenario, local institutions can be called upon to extend maturities of local debt (denominated in dollars and pesos) and external law debt need only incur a maturity extension or coupon revision, if anything at all. **Done in the right context, with the support of the IMF and a credible policy framework, this scenario could see a "recovery" in bond prices from current levels to closer to the $70s or higher. This is our base case and under this scenario, we see prices much higher than current levels.**

Current prices in the $50s reflect a lot of downside. In the short term before the October 27 election, prices could fall a bit further given the weak technicals (most dedicated investors are overweight). Over the medium term, in order to stabilize the situation, the next government would need labor, tax, and social security reform. It is not clear how committed the next government will be to such reforms, but if Fernandez wants to have a successful administration and stable macroeconomic conditions, he is likely to be pragmatic.

A less friendly "hard default" could lead to recovery values in the $40s. If the market continues to deteriorate through December, the probability of this increases. We expect that after Fernandez is elected, he would move to calm the markets, thereby reducing the probability of this scenario.

Investment Strategy: Given the primary election shock, the dramatic price drop, and weak technicals, it would seem unwise to reduce exposure to Argentine hard currency assets at these levels. The negative impact to performance has already occurred, and we see upside over the medium term. Therefore, we are inclined to hold current positions until we have more clarity.

Our base case assumes a Fernandez victory: if and when a reprofiling or restructuring on hard currency external law debt occurs, we estimate that recovery values will be meaningfully higher than current levels (see Figure 1 on the following page).

Figure 1: PGIM Fixed Income Macro Forecasts for Argentina

	2013	2014	2015	2016	2017	2018	2019	2020
GDP, % YoY	2.4	-2.5	2.7	-2.1	2.7	-2.5	-2.4	-0.5
Curr Acct Bal, % GDP	-2.1	-1.6	-2.7	-2.7	-4.9	-5.1	-1.6	-1.1
FX Reserves, $bn	28.1	29.0	23.4	36.3	53.0	64.0	55.8	52.2
Govt Debt/GDP, %	39.3	41.2	52.9	53.2	56.1	85.5	89.6	91.9
Primary Balance, % GDP	-2.4	-3.5	-4.1	-4.2	-3.8	-2.6	-0.5	0.0
Fiscal Balance, % GDP	-3.7	-5.0	-6.2	-5.8	-5.9	-5.2	-3.5	-3.3

Source: PGIM Fixed Income as of August 2019.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of August 2019.

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2019-3922

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PGIMJ201908140884