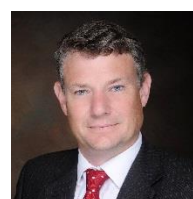




NOTES FROM THE ROAD
TRAVELING THE FRONTIER MARKETS
Argentina

DECEMBER 2018

OUT OF CRISIS COMES OPPORTUNITY: A VISIT TO UNSTEADY ARGENTINA



Oliver Bell
Portfolio Manager,
Frontier Markets
Equity Strategy

We visited Argentina recently 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.

KEY TAKEAWAYS

- The government seems committed to the fiscal targets; if the economy begins to grow again and the currency stabilizes, then it could look very different in a year from now.
- Next year's general election could be source of volatility.
- We believe the broader market will continue to feel the tailwind of its upcoming upgrade from the MSCI Frontier Markets Index to the MSCI Emerging Markets Index next year.

A CLOSER LOOK

Tightening global liquidity—caused by the reduction of the U.S. Federal Reserve balance sheet, rising U.S. interest rates, and the rising dollar—has 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.

As many investors know, this deteriorating market environment engulfed Argentina just as it experienced its worst drought for 50 years, which hit the country's crop production and U.S. dollar export revenues. In addition, coming into this crisis, half of Argentina's USD \$60bn in central bank-issued Lebacs—the one-month short-term notes—were held by foreigners. 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 that Argentina is choosing to take the path of orthodoxy to try escape the clutch of crises, which seemingly swamps the country every few years.

First, the authorities utilized reserves to defend the currency and raised interest rates significantly, committed to much stronger fiscal consolidation, signed an agreement with the International Monetary Fund (IMF) and have let the currency run. The government seems committed to the fiscal targets; if the economy begins to grow again and the currency stabilizes, then it could look very different in a year from now.

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. Sigal revealed that, with the aid of the IMF money, Argentina's external borrowing needs until the end of 2019 were down to just USD \$3bn—from USD \$30bn. In addition, foreign ownership of Lebac's has all but disappeared, with half of the outstanding USD \$30bn Lebac's in circulation still owned by local retail investors. While the government and IMF agreed 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.

ABUNDANCE OF CRISIS EXPERIENCE

While still hostage to the global environment, the environment and the path of the U.S. dollar, Argentina's situation appears to have stabilized for the time being. Because 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.

Fortunately, many banks raised "growth" capital toward 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 nonperforming 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 reelection. 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 more than 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 party 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 2018, we had been overweight Argentina. 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 positions split between domestic companies and U.S. 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 MSCI Frontier Markets Index to the MSCI Emerging Markets Index next year.

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