Argentina at a Crossroads

Key opportunities in less cyclical stocks as uncertainty prevails.

May 2019

NOTES FROM THE ROAD
Traveling the Frontier Markets

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The fortunes of Argentinian stocks are being driven by domestic factors, where electoral uncertainty and economic growth at a trough are setting the backdrop for share price performance. The country faces a presidential election in October and a second round in November—with a small chance of left-leaning populists Alberto Fernandez and Cristina Kirchner (as his deputy) gaining power. While unlikely, this scenario could pave the way for the reintroduction of capital controls, would pose a risk to the performance of all financial assets, and could lead to another sovereign default.

A key challenge for incumbent President Mauricio Macri's reelection hopes is that, faced with a potential return to power of Cristina Kirchner, on-the-ground developments could lead to a vicious cycle of currency weakness, higher inflation, and weaker economic performance that, in turn, would reduce Macri's chances ahead of the election.

Domestic economic equilibrium is currently very fragile: A recovery in real wages is anticipated and the currency appears to be stabilizing, but electoral trends or an external shock could undermine these positive developments.

We are finding pockets of opportunity on an individual stock level, though, including companies with real assets and those that have more diversified, and therefore less cyclical, earnings streams. On our recent trip to Argentina, we had conducive meetings with the management teams of many of these companies. Furthermore, we advocate avoiding utility companies, which are sensitive to domestic developments, while banks could offer attractive risk/reward characteristics in the case of an improvement in the macroeconomic backdrop.

Taking Stock of Economic Conditions

While there are some bright spots in the economic landscape, the negatives currently outweigh the positives. A USD $57 billion support package that Argentina has agreed with the International Monetary Fund, dictating the implementation of strict monetary rule and fiscal targets, has brought about a degree of currency stability, while financing needs for 2019 have pretty

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2%

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However, the economy is in a recession, with gross domestic product contracting by 2.6% in 2018 and expected to contract by a further 1% this year. Inflation ended the year at around 47%, and recent month-on-month inflation prints have been heavily scrutinized. Interest rates remain high at 50%.

Politics—Taking the Reform Route or Succumbing to Populism?

October's presidential election will signal whether Argentina is likely to continue on a path of reforms and macroeconomic normalization or pursue a more populist agenda. Incumbent President Mauricio Macri is seeking reelection, but his support has taken a hit amid high inflation and a severe economic downturn. Former President Cristina Kirchner surprised some investors in announcing her intention to run as vice president under the leadership of Alberto Fernandez.

Macri's lead in the polls has narrowed, but we still believe that a victory for the Fernandez and Kirchner ticket is unlikely. We anticipate the markets will rally in the case of an "anybody but Cristina" election outcome. Inflationary trends should moderate given the recessionary conditions and the free-floating currency. Wage adjustments and export growth should go some way to supporting consumption and a broader economic recovery. We believe that markets have overreacted to the negative trends, driving many asset prices to excessively cheap levels: This could make for an attractive entry point.

Much hinges on the evolution of the economy in the coming months, particularly trends in inflation, real wages, and the exchange rate. One concern is that an external shock triggers a run on the peso. Any downturn in economic conditions is likely to increase Kirchner's chances. Meanwhile, even modest improvements would allay market concerns and increase Macri's chances of reelection.

Searching for Investment Opportunities Against a Volatile Backdrop

Despite the economic and political uncertainty, pockets of opportunity exist for investors capable of conducting rigorous on-the-ground research. On our recent trip, we met with the management teams of several promising investments that we believe can weather the potential turbulence ahead.

Leading cement producer in Argentina. While volumes fell 15% in January, a recovery is expected in the second half of the year. The company has been able to implement price increases to the tune of 75%, in excess of inflation. The coming online of a new cement plant, L'Amali, should help boost profit margins, while the company has a strong balance sheet.

Supplier of steel pipes and related services. The firm has limited direct exposure to Argentina, only around 10% of operations, and is on track to enter the Russian market, which should provide a modest boost to earnings margins. It is generating free cash flow in excess of USD $1 billion per year, which should leave it well placed to increase dividend payments.

Bank. The environment facing banks is weak loan demand and rising delinquencies. However, margins have been resilient in a high interest rate environment, while liquidity is ample. The investment case for Argentinian banks in the case of a Macri electoral win is attractive, given loan-to-GDP ratios of 15%.

Online marketplace operator and digital provider of financial services. The company is a leading provider to both consumers and businesses. It is underpinned by a large profit pool, its base of existing merchants offsetting the cost of investments to acquire new customers. The company is focused on expanding into new categories and improving logistics. While the company has exposure to Argentina, more than half of its earnings come from Brazil and the Latin American region more broadly.

WHAT WE'RE WATCHING NEXT

We continue to have exposure to several companies in Argentina that feature attractive risk/reward propositions. We will closely monitor economic and political developments, and how these come to impact domestically focused companies and those with less cyclical earnings streams. Our preference remains for the latter, and we will continue to closely monitor their performance amid the unfolding backdrop.

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ID0002293 (05/2019)
201905-857206