Update on Argentina
09 May 2018

The Argentinian equity market has suffered a dramatic set-back over the last week with many stocks down by over 20%. It is not yet clear what the resolution to the current situation is but I will try and outline why it has happened and what the sign posts are for a positive and negative resolution.

President Macri inherited a country in November 2015 on the brink (and some would say well over the edge) of financial disaster. Extremely high inflation, a contracting economy and debt defaults were the outcome of ten years of populist economic mismanagement. The reform process outlined in Macri's election campaign was well constructed and addressed all of the main economic challenges, crucially for the long term. However, when there is no money with which to solve short-term problems, a percentage of the population will always feel worse off as reforms begin.

Settling with foreign debt holders (which rapidly led to new borrowing ability), reducing subsidies, removing export tariffs on agricultural products, devaluing the currency and keeping very strong control of government spending were all major successes of the first six months of the Macri administration.

The impact however of high, though falling inflation, removal of subsidies and a cut to government wages and pensions was inevitably an income squeeze amongst some sections of the population. Making the politically difficult reforms at the start of a presidential term was definitely the right approach as it allows the reforms to start to generate real income growth by the time of the next elections. However maintaining political stability through this process is always a difficult balancing act in any serious reform process.

The recent currency weakness (down 21% YTD) has been brought about by the simultaneous convergence of a number of internal and external factors, which individually would have been brushed aside as normal by-products of reform but have come together to create a crisis of confidence in financial markets, very different at this stage from a financial crisis.

Firstly, the inflation numbers for the first quarter of 2018 have remained stubbornly high at 25% (against the Government target of 15%). One of the main reasons for this was that subsidies continue to be removed at a very fast pace despite significant political opposition. This should definitely be seen as a positive as this government continues to demonstrate its commitment to the reform process. In addition, Argentina is experiencing its worst drought in 50 years causing an increase in food price inflation.

Secondly, last week the central bank imposed a 5% capital gains tax on the bills that it issues, causing foreign investors to lock in untaxed gains by temporarily selling the bills and buying dollars. This coincided with the global strong dollar/weak EM currency moves which created a further source of volatility in the Argentine Peso.

A country like Argentina with a history littered with bouts of hyperinflation and significant currency depreciation is very susceptible to the confidence of Argentines to keep their money in Peso's. Whilst the last two and a half years of stability and reforms have seen some confidence restored the recent Peso instability has led to fears of capital flight. The response of the central bank to increase overnight rates from 28% to 40% in the space of a few days only heightened those fears. A country with USD 56bn (even after spending USD 6bn to defend the currency) of foreign reserves should not be susceptible to these kind of currency moves; however history seems to be playing a significant role here.

The latest announcements from President Macri on seeking a huge USD 30bn IMF standby facility are a clear indication that the administration understands that this is a confidence issue and will do whatever it takes to restore confidence. The long-awaited passing of the capital markets bill this week should also help to reaffirm the government's commitment to reform.

The implications of the recent rises in interest rates, currency weakness and a falling stock market are clearly negative for companies' cost of capital, their willingness to invest, and therefore for economic growth rates. A short-term resolution and return of confidence will have no noticeable impact however the longer the uncertainty persists the more negative the environment for economic growth.

In light of this uncertainty we have taken the decision to reduce some portfolio exposure to Argentina. Whilst all stocks suffer equally in a sentiment driven sell-off, our experience is that there is money to be made by being in cheap stocks in the right companies and sectors when the market returns to looking at fundamental value and drivers.

Whilst the political will and the population's support of reform remains, with economic indicators likely to improve we will retain a weighting to Argentina through companies that remain robust under current conditions. We expect inflation will start to fall as subsidy removal lessens, the high base effect kicks in and currency flows will improve for agriculture as the May harvest begins. If a change in political outlook was likely to cause a straying from this reform path we would reduce the exposure further or exit the market.

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The opinions expressed in this document are those of the author.

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