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CIO Flash Bulletin

Is Argentina back on track?

Investment Solutions **September 2017**

While MSCI[1] could reclassify Argentina from Frontiers[2] to Emerging Markets next year, we think that investing in local rates is the best way to access the positive cycle in Argentina, writes Stephane Monier, Chief Investment Officer

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Economic fundamentals and the outlook for reforms in Argentina have improved since the beginning of the year. After a symbolic victory in last month's primary elections, the current administration should be strengthened going into the mid-term elections in October. We believe that the probability of structural reforms that would make the economy more competitive is increasing and the country has the potential to grow in the coming years.

"Let's change" the politics

Elected president of the Argentine Republic in 2015, Mauricio Macri is trying to put the economy back on the growth path after a decade of economic mismanagement under the leadership of Cristina Fernández de Kirchner (2007-2015). On 13 August, the *Cambiemos* ("*Let's change*") alliance – led by Macri's former education minister Esteban Bullrich – tied with Cristina Fernández de Kirchner in the primary elections.

Cambiemos did better than expected, especially in the Province of Buenos Aires, and we believe that the positive results for Macri and his administration should be repeated in the October mid-terms. In the upcoming elections, one third of the seats of the Senate and half of the House of Representatives will be renewed. While Macri will probably still fall short a legislative majority in October, we think that the influence of Kirchner will be reduced and the opposition will be divided. In a nutshell, we expect *Cambiemos* to win the next mid-term elections, allowing Macri to implement structural reforms that would accelerate the macro normalisation of Argentina.

The "stop and go" theory

Argentina has experienced a "stop and go" macroeconomic cycle since 2010. Introduced during the Peronist administration in the late 1940s, this theory explains why periods of economic growth can be followed by years of recession. The "go" represents the expansionary phase stimulated by fiscal and monetary policies which lead to a balance of payments crisis due to an overvalued currency and insufficient international reserves. The scarcity of dollars creates a recession, imports decrease and the balance of payments improves. Therefore, solving the macroeconomic imbalances is a prerequisite to restore growth opportunities.

Investment takeaways

Economic prospects are improving in Argentina and we are constructive on the structural reform agenda of Macri's administration.

We believe that inflation-linked bonds and floating-rate debt may represent the more interesting opportunities due to the combination of a positive disinflation trend and high real yields.

[1]Morgan Stanley Composite Index
[2]A frontier market is a type of developing country which is too small to be classified as an emerging market

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Data as of 14 September 2017 unless otherwise stated.

During the Kichner years, inadequate monetary and fiscal policies created a vicious cycle. Between 2007 and 2015, international reserves were approximately halved due to the monetary financing of a high fiscal deficit. According to the IMF, government spending increased by around 12 percentage points (from 28% to 40% of GDP) during the same period. The introduction of price and capital controls stressed the high inflation and the scarcity of dollars. The vicious cycle was in place with a system of multiple exchange rates, price distortions, an overvalued currency and a lack of economic growth.

Opportunities and challenges

After his election in 2015, Macri addressed the monetary issues by eliminating capital controls and developing an inflation targeting framework. Inflation went from 45% in June 2016 to 23% in August 2017. While GDP fell by 2.3% in 2016, we expect the economy to grow 3% this year. In addition, Macri started to open up the economy to attract foreign investments. In July, BP, Total, Wintershall and Argentina's state-run oil firm YPF announced a US$1.15 billion joint investment in the Vaca Muerta shale formation, which is a major petroleum source rock. The increase in investments could support under-leveraged private sectors with a private debt-to-GDP ratio of only 26%. Thus, economic prospects are improving in Argentina and we are constructive on the structural reform agenda of Macri's administration.

While Argentina is on the right path, the country faces many challenges. Since the election of Macri, the political polarisation has delayed many reforms and Macri will probably need to manage an alliance to have a legislative majority in the Congress. Therefore, we hope that the structural reform agenda will not be impacted by future political divergences and that the administration will succeed in negotiating with opposition leaders. In addition, Argentina could suffer from a change in global risk aversion for emerging market assets especially with rising short-term rates in developed economies. Although our views on the medium-term outlook remains positive, we would reconsider our optimism should the upcoming mid-terms deliver a negative surprise or if we see a deterioration of macroeconomic imbalances and global liquidity conditions in Argentina.

In our view, Argentina is recovering, business confidence is growing and the country has good potential to growth. The main challenge facing Macri is to achieve economic normalisation by minting the disinflation process, by attracting foreign investments and by maintaining his popularity. Although macroeconomic imbalances persist, we believe that the country has started an expansionary period: the "go" phase is on track.

We recommend to invest in local rates

While MSCI could reclassify Argentina from Frontiers to Emerging Markets next year, we think that investing in local rates is the best way to access the positive cycle in Argentina. We believe that inflation-linked bonds and floating-rate debt may represent the more interesting opportunities due to the combination of a positive disinflation trend and high real yields.

Sources: Bloomberg, IMF

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