

CIO Flash Bulletin

Is Argentina back on track?

Investment Solutions

September 2017

While MSCI¹ could reclassify Argentina from Frontiers² to Emerging Markets next year, we think that investing in local rates is the best way to access the positive cycle in Argentina, writes Stéphane Monier, Chief Investment Officer

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 *Cambienos* (“Let's change”) alliance – led by Macri's former education minister Esteban Bullrich – tied with Cristina Fernández de Kirchner in the primary elections.

Cambienos 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 *Cambienos* 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.

¹Morgan Stanley Composite Index

²A frontier market is a type of developing country which is too small to be classified as an emerging market



Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

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.

Important information: Please see important information at the end of this document.

Publication of Lombard Odier – Contacts: Investment Solutions, CP-INVESTMENT@lombardodier.com

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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.

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SWITZERLAND

GENEVA

Bank Lombard Odier & Co Ltd¹

Rue de la Corraterie 11 · 1204 Genève · Suisse
geneva@lombardodier.com

Lombard Odier Asset Management (Switzerland) SA

Avenue des Morgines 6 · 1213 Petit-Lancy · Suisse
Support-Client-LOIM@lombardodier.com
Management Company regulated by the FINMA.

FRIBOURG

Banque Lombard Odier & Cie SA · Bureau de Fribourg¹

Rue de la Banque 3 · 1700 Fribourg · Suisse
fribourg@lombardodier.com

LAUSANNE

Bank Lombard Odier & Co Ltd¹

Place St-François 11 · 1003 Lausanne · Suisse
lausanne@lombardodier.com

VEVEY

Banque Lombard Odier & Cie SA · Agence de Vevey¹

Rue Jean-Jacques Rousseau 5 · 1800 Vevey · Suisse
vevey@lombardodier.com

ZURICH

Bank Lombard Odier & Co Ltd¹

Utoschloss · Utoquai 29-31 · 8008 Zürich · Schweiz
zurich@lombardodier.com

EUROPE

AMSTERDAM

Lombard Odier (Europe) S.A. · Netherlands Branch²

Herengracht 466 · 1017 CA Amsterdam · Nederland
amsterdam@lombardodier.com
Credit institution supervised in the Netherlands by De Nederlandsche Bank (DNB) and Autoriteit Financiële Markten (AFM).

BRUSSELS

Lombard Odier (Europe) S.A. Luxembourg · Belgium branch²

Avenue Louise 81 · Box 12 · 1050 Brussels · Belgium
brussels@lombardodier.com
Credit institution supervised in Belgium by the Banque nationale de Belgique (BNB) and the Financial Services and Markets Authority (FSMA).

GIBRALTAR

Lombard Odier & Cie (Gibraltar) Limited

Suite 921 Europort · P.O. Box 407 · Gibraltar
gibraltar@lombardodier.com
Authorised and regulated by the Gibraltar Financial Services Commission (FSC) to conduct banking and investment services business.

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LONDON

Lombard Odier (Europe) S.A.²

Queensberry House · 3 Old Burlington Street · London
W1S 3AB · United Kingdom
london@lombardodier.com

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Lombard Odier Asset Management (Europe) Limited

Queensberry House · 3 Old Burlington Street · London
W1S 3AB · United Kingdom
london@lombardodier.com

Investment firm authorised and regulated by the Financial Conduct Authority (FCA register No.515393).

LUXEMBOURG

Lombard Odier (Europe) S.A.

291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com

Credit institution authorised and regulated by the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg.

Lombard Odier Funds (Europe) S.A.

291, route d'Arlon · 1150 · Luxembourg · Luxembourg
luxembourg@lombardodier.com

MADRID

Lombard Odier (Europe) S.A. · Sucursal en España²

Paseo de la Castellana 66 · 4^a Pl. · 28046 Madrid · España · madrid@lombardodier.com
Credit institution supervised in Spain, by the Banco de España and the Comisión Nacional del Mercado de Valores (CNMV).

Lombard Odier Gestión (España) S.G.I.I.C, S.A.U.

Paseo de la Castellana 66, 4^a Pl. · 28046 Madrid · España · madrid@lombardodier.com
Management Company supervised by the Comisión Nacional del Mercado de Valores (CNMV).

MILAN

Lombard Odier (Europe) S.A. · Succursale in Italia²

Via Santa Margherita 6 · 20121 Milano · Italia
milano-cp@lombardodier.com
Credit supervised in Italy by the Commissione Nazionale per le Società e la Borsa (CONSOB) and la Banca d'Italia.

MOSCOW

Bank Lombard Odier & Co Ltd · Representative Office Moscow

82 Sadovnicheskaya Street · 115 035 Moscow · Russian Federation · moscow@lombardodier.com
Under the supervisory authority of the Central Bank of the Russian Federation.

PARIS

Lombard Odier (Europe) S.A. · Succursale en France²

8, rue Royale · 75008 Paris · France.
RCSPARIS B 803 905 157 · paris@lombardodier.com
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BERMUDA

Lombard Odier Trust (Bermuda) Limited

3rd Floor, Victoria Place · 31 Victoria Street · Hamilton
HM 10 · Bermuda · bermuda@lombardodier.com
Licensed to conduct Trust and Investment Business.
Supervised by the Bermuda Monetary Authority (BMA).

DUBAI

Bank Lombard Odier & Co Ltd · Representative Office Dubai

Conrad Business Tower · 12th Floor · Sheikh Zayed Road · P.O. Box 212240 · Dubai · UAE
dubai@lombardodier.com
Under the supervisory authority of the Central Bank of the UAE.

HONG KONG

Lombard Odier (Hong Kong) Limited

Museum Tower, 7th floor · 4 Berkowitz Street · Tel Aviv 6423806 · Israel · telaviv@lombardodier.com
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Israel Representative Office · Bank Lombard Odier & Co Ltd

3901, Two Exchange Square · 8 Connaught Place · Central · Hong Kong · hongkong@lombardodier.com
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MONTREAL

Lombard Odier & Cie (Canada), Limited Partnership

1000 Sherbrooke Street West · Suite 2200 · Montreal (Quebec) · Canada H3A 3R7
montreal@lombardodier.com
Regulated by the Autorité des Marchés Financiers du Québec.

NASSAU

Lombard Odier & Cie (Bahamas) Limited

Goodman's Bay Corporate Centre · West Bay Street · P.O. Box N-4938 · Nassau · Bahamas
nassau@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Securities Commission of the Bahamas.

PANAMA

Lombard Odier & Cie (Bahamas) Limited · Representative Office in Panama

Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
Supervised by the Central Bank of the Bahamas and the Superintendencia de Bancos de Panamá.
Lombard Odier (Panama) Inc.
Oceania Business Plaza Torre 2000 · Oficina 38-D · Blvd. Pacifica · Urb. Punta Pacifica · Corregimiento de San Francisco · Panamá · panama@lombardodier.com
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SINGAPORE

Lombard Odier (Singapore) Ltd.

9 Raffles Place · Republic Plaza #46-02 · Singapore
048619 · singapore@lombardodier.com
A merchant bank regulated and supervised by the Monetary Authority of Singapore.

TOKYO

Lombard Odier Trust (Japan) Limited

Izumi Garden Tower 41F · 1-6-1 Roppongi, Minato-ku · Tokyo 106-6041 · Japan · tokyo@lombardodier.com
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