RBC Global Asset Management

Argentina

Brighter times on the horizon

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Graham Stock
EM Senior Sovereign Strategist
BlueBay Fixed Income Team

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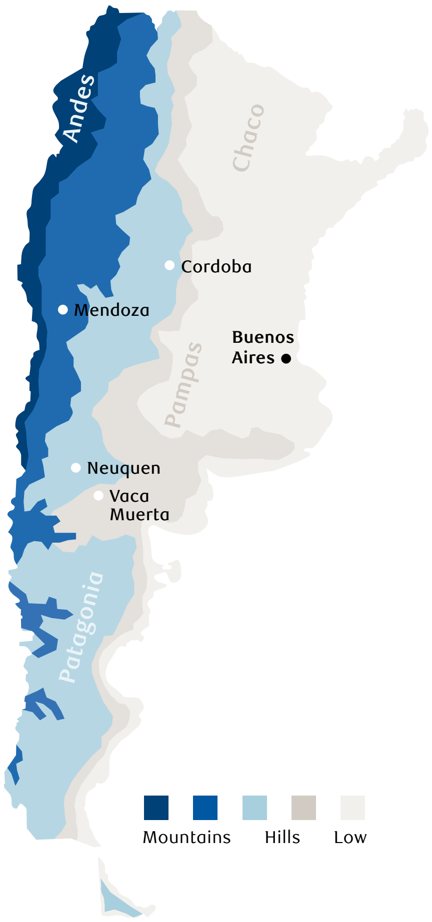
“Argentina has world-class companies developing its oil and gas resources in Vaca Muerta, facilitating digital payments across Latin America, and making wine in Mendoza.”

Argentina is famously a land of contrasts. The physical ones are easy to identify – between the semi-tropical heat of the north and the glaciers of Patagonia, or between the inhospitable heights of the Andes and the fertile grasslands of the Pampa. On my research trip around the country last week, however, the economic contrast between the micro and the macro was just as stark.

Argentina has world-class companies developing its oil and gas resources in Vaca Muerta, facilitating digital payments across Latin America, and making wine in Mendoza. Its universities in Buenos Aires, Cordoba and elsewhere turn out graduates that hold their own in competitive global sectors, such as medicine, programming and engineering. Even at the sub-national level, the provincial governments I met in Cordoba, Neuquen and Mendoza, as well as the City of Buenos Aires, are all running budget surpluses. In the case of the former, they showed me a cutting edge open-source transparency tool where anyone can access an online digital map and see whether the owners of real estate in the province are up to date with their property taxes.

And yet at the macro level, Argentina clearly remains mired in economic crisis. The annual inflation rate is over 100%. Net reserves are so perilously low that the government has to ration foreign currency, and resort to multiple exchange rate regimes in an attempt to encourage exports and restrict imports. This problematic operating environment undermines many of the promising micro stories. Profitable companies face delays in sourcing imported inputs or machinery. Digital nomads migrate to online payment platforms to avoid being paid in pesos (and therefore also avoid paying tax). Uncertainty about the future level and accessibility of the FX market deters foreign direct investment that is needed to take full advantage of the opportunities in oil and gas, lithium and agribusiness.



Source: Worldatlas.com

The conditions require tough medicine...

These challenges have been in place for a while. The economic solutions are relatively straightforward: adjust fiscal policy so that the Central Bank no longer needs to print pesos to finance the budget deficit, allow the currency to depreciate to a level where demand equals supply, and embed these changes in a policy framework that is sustainable to extend the investment horizon.

Politically, however, this medicine is unpalatable. The fiscal adjustment would hit spending in areas such as pensions, public sector wages and energy subsidies which are hot-button topics around the world. The devaluation would – in the short term – add inflationary pressure, further reducing real incomes. It was the sour taste of this medicine prescribed by the 2015-19 Macri administration that ushered in the current government – an uneasy alliance of left-leaning populists loyal to the former President and current Vice President Christina Fernandez de Kirchner, and more moderate centrists typified by the current Economy Minister Sergio Massa, nominally led by President Alberto Fernandez.

Our investment thesis has long been that this Peronist government would not be willing to carry out the necessary adjustment. However, in the absence of financing from either the external or domestic markets, the Fernandez administration would nevertheless have to keep enough of a lid on the budget deficit to limit inflationary financing from the Central Bank (because inflation hurts their electorate). The balancing act would not be popular or sustainable, and so the 2023 elections would likely induce a swing back to a more orthodox policy prescription. This is essentially also the rationale for the current IMF program, which pragmatically rolls over Argentina's liabilities in exchange for a modest adjustment, in the hope that better times are around the corner.

Until late last year, therefore, the question was essentially whether relative stability could be maintained until the transition at the end of this year. Then the weather put another fly in the ointment. It was still unseasonably hot while I was on the ground, but the preceding heatwave and drought in the key soy-producing regions of the Pampas and the Gran Chaco were of a severity not seen since records began in 1961. The resulting fall in output and exports is estimated to be around USD20 billion, fully one half of expected agricultural production. The resulting shortage of foreign exchange requires further compression of imports, through either more rationing or an inflationary and politically very costly devaluation, and therefore a further drop in activity and real incomes.

...but rehabilitation is still within reach

In the short term, the challenge is no longer just to muddle through to the elections but now also to tighten belts until relief comes in a couple of important ways. First, just the resumption of more normal weather patterns should lead to the recovery of normal crop yields. Good rains in the main wheat-producing areas of the southern Pampas suggest that the winter harvest will be at least normal, and possibly even a bumper year. A return to normality would put those USD20 billion back into the balance of payments in the 2023-24 season. Second, after over a decade of discussing the potential of the Vaca Muerta shale deposits, the benefits are literally almost in the pipeline.

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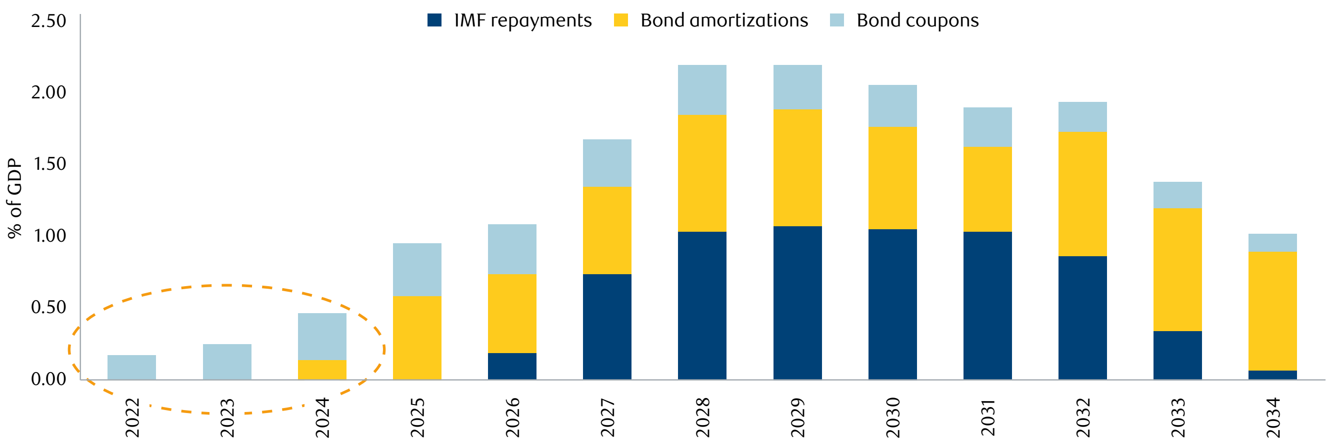
Specifically, the Nestor Kirchner gas pipeline (named after the former President Cristina's late husband) is on track for completion in the third quarter of this year. It will initially bring 11MMBtu of natural gas to Buenos Aires, replacing expensive imported LNG shipments. In later phases, the capacity will increase further, allowing even for export of Argentine gas via Bolivia to the Brazilian market around Sao Paulo. Meanwhile, exports of Vaca Muerta oil to Chile by pipeline across the Andes and to the Atlantic via the expansion of the pipeline to Bahia Blanca are also set to grow, facilitating a doubling of oil production by 2028.

With this relative bonanza on the horizon, it was encouraging to hear the current government committing to measures that do indeed tighten the metaphorical belt. A politically motivated pension give-away that was rushed through Congress in March will be regulated, to minimise the number of people who qualify for the new more generous payments without having contributed to the system. The segmentation of energy subsidies by income level will be accelerated such that the wealthiest households start paying the full cost of their electricity usage. A partial devaluation through a cheaper FX rate for exporters of agricultural products was also unveiled days after my visit. These measures are either explicit or implicit in the latest IMF review of the Extended Fund Facility program, meaning that the Fund loan will likely continue to be rolled over.

Looking further ahead, I witnessed a striking degree of consensus on the way forward. Opinion polls show a clear preference for a change of government, and the economic teams working for the various candidates in the *Juntos por el Cambio* opposition coalition all propose only slight variations on the theme of fiscal adjustment and devaluation. To their right, the anti-establishment libertarian, Javier Milei, has maintained strong support with more radical solutions to embed small government settings, such as dollarisation, but appears to lack the political structures to emerge victorious on election day. Perhaps most surprisingly, however, the current government's economic team also argues for exactly the same adjustment, suggesting that the Peronist mainstream is set to break ranks with the Kirchnerist left.

External Debt Service



Source: RBC BlueBay and IMF.

Asymmetric outlook for sovereign bonds

With bonds trading at less than 30 cents on the dollar, the value proposition in sovereign debt remains that we see upside in all but a worst-case scenario. Prices could settle below 20 cents on the dollar in the event of a Venezuela-style rejection of international financial relations or imposition of international sanctions. The political environment in Argentina may be febrile at times but we do not see the conditions for such an outcome. The institutional framework remains much more robust than in Venezuela, and the consensus around the normalisation of the country's relationships with the outside world is only growing. The alternative outcome of yet another restructuring of sovereign debt to buy more time for adjustment under the next government seems to offer modest upside from these depressed levels, while our base case of a successful fiscal adjustment would push prices back closer to 50 cents on the dollar.

RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **rbcgam.com**