Aegon Asset Management

ARGENTINA

By Phil Torres, Global Co-head of Emerging Markets &
Alan Buss, Senior Sovereign Research Analyst

The Argentine peso hit another record low, in nominal terms, to close out the month of April. In order to counteract the decline and stabilize the currency, Argentina pushed short-term rates above 70%—again. With the further decline of its currency and economy, the odds of Argentina defaulting rose. Although the country has suffered recurring economic crises most of the last century, there are some encouraging positive developments that may, if given time, right the course.

Brief background

In 2018, Argentina's credit had a foreign exchange (FX) liquidity crisis related to fiscal deficits that could no longer be funded. As a result, Argentina entered an International Monetary Fund (IMF) 36-month Stand-By Arrangement (SBA) aimed to solve both the short- and medium-term liquidity needs so the country could pursue very difficult fiscal adjustments through 2020. Thus far, it has received more than $38 billion in support to date, out of its $57 billion program.

Foreseen complications

The country's leadership, particularly President Mauricio Macri, who is highly market friendly and a known IMF ally, was instrumental in securing the IMF's rapid and easy involvement. The upcoming presidential election in October may change the course Macri has set out for the country. Macri has poor polling results largely related to the country's economic distress. His opponent for the election is expected to be former President Cristina Fernández de Kirchner (CFK), the anti-market, anti-IMF social democrat.

Further complicating matters politically and economically for Macri is the accelerating inflation rate— rising from 25.6% this time last year to currently 54%. Argentines are accustomed to high inflation and rapidly transition from the domestic peso to the US dollar (dollarization) to protect wealth from inflation and political fears. However, this dollarization wave risks a vicious cycle unless it is offset by central bank intervention or real-sector inflows.

Near term pivot points

FX:

Negative. Inflation persistence is historically extreme in Argentina due to indexation and historical experience. To date, the Central Bank's efforts have failed to counter the inflation trend and the inflation rate continues to rise in spite of the Central Bank's new and highly conservative approach it adopted late last year—targeting a zero nominal base money growth and sticking to strict FX intervention bands. It may need to constrict monetary policy even further to gain control of the value of its currency. This extremely constrictive monetary policy would likely further restrict economic growth and strain Macri's re-election chances further.

Positive. The current account deficit has closed sharply and may be in surplus, the result of a large soybean harvest and collapsing consumer imports. Earlier this year, central bank foreign exchange reserves increased from Central Bank dollar buying (part of the official IMF agreed intervention policy) when the FX was at the stronger side of the official intervention band. These factors suggest the currency may be undervalued and available to a real rally if locals' dollarization can be reversed. A sustained currency rally could be a source of a virtuous cycle for the country and its asset values. Additionally, net FX reserves, including an untapped currency swap with China, are roughly $40 billion USD in the context of an economy that has already dollarized by close to 90%.

Fiscal:

Negative. The fiscal deficit is programmed, per the IMF agreement, to be funded primarily by the IMF and the remainder (roughly 30% of total needs) with short-term T-bills (Letes). The IMF agreement assumed a roughly 60% private sector average annual roll-over rate through 2019. If the roll-over rate comes in much lower than the 60% average for the year, the government may print pesos, take from FX reserves, or default without further IMF support. In April, the total rollover rate (public and private sector) fell from near 100% in early 2019 to 67%, suggesting the private sector roll-over rate was meaningfully below 60%.

Positive. To date, budgetary adjustments have succeeded. Year on year change in fiscal spending for 2018 was -9% and 2019 is expected to be -11%—difficult belt tightening during an election year. Consequently, the government met their 2018 primary deficit target and are on track to achieve a balanced primary budget balance by the end of 2019. These notable achievements put them modestly ahead of the IMF's goal of a primary fiscal surplus in 2020. As mentioned, the IMF prescribed roll-over rate for the Letes is 60%; however, the local authorities recently (April 2019) announced Treasury balances are at historically high levels and suggest average roll-over rates can comfortably be as low as 40%.

The elimination of the twin current account and budget deficits goes a long way in reducing the country's vulnerabilities. If fiscal targets are met and the currency is stable or stronger in real terms, the country's debt/GDP ratio should be on a clear downward trajectory.

Exhibit 1: Argentina 5-year credit default swap (CDS) implied probability of default

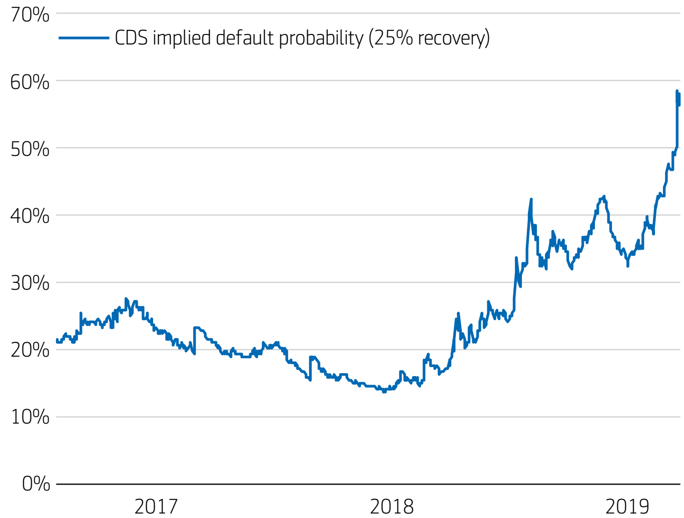
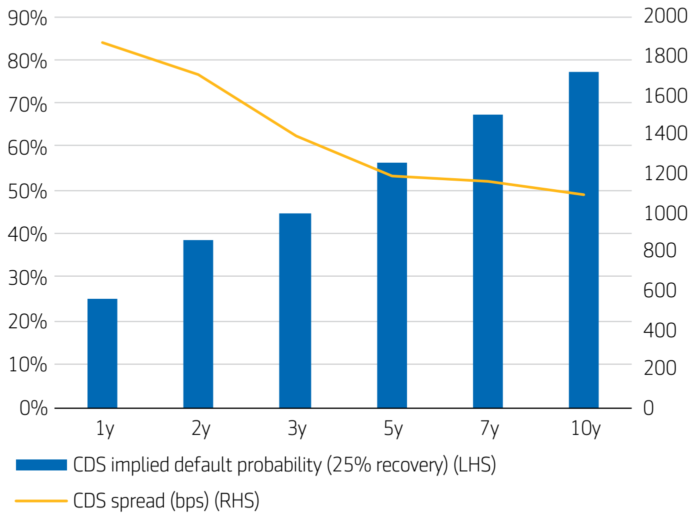


Exhibit 2: Argentina CDS implied probability of default



Source Exhibits 1 & 2: Bloomberg. As of April 19, 2019.

Where we stand on Argentina

We think the probability of default is far lower than currently implied by market pricing. However, the country is a high-risk case (Exhibits 1 & 2). We are concerned about the market either anticipating or reacting to a CFK win, and closing financing options in spite of improving fiscal balances. Both CFK-related and other opposition leadership all speak positively of the IMF deal. However, we worry the market or the IMF won't fund CFK in a manner consistent with the current IMF SBA.

We infer, extracted from 5-year credit default swap (CDS) prices, that the market roughly projects CFK to have a 40% chance of election versus 30% each for Macri or a moderate Peronist coalition. Our estimates of where credit spreads trade under the various scenarios should be taken with a large "grain of salt"—especially a CFK victory. However, these estimates offer us an opportunity to compare what we think the market has priced-in compared to what we think as the more likely scenario. We think the implied 40% odds of a CFK victory are too high; however, those odds are in line with two recent polls by consulting firms Insomnia and Elypsis (Exhibit 3).

Exhibit 3: Market implied pricing of election odds vs. AAM estimates of election odds

Market implied Pricing of Election Odds

	Odds of winning election	Default Risk	Risk Premia	Final Spread	Implied Return
Macri	30%	350	200	550	26%
CFK	40%	1500	500	2000	-22%
Other	30%	550	150	700	19%
Current Market				1175	0%

AAM Estimates of Election odds

	Odds of winning election	Default Risk	Risk Premia	Final Spread	Implied Return
Macri	50%	350	200	550	26%
CFK	20%	1500	500	2000	-22%
Other	30%	550	150	700	19%
Expected Market				885	11%

*Returns are estimates without coupon and an instantaneous credit spread change to a 5yr CDS. Depending on the timing of the spread change returns would be very different than estimates above.

Argentina has a high portion of its debt denominated in foreign currency and—given the extreme sensitivity and interaction between politics, inflation, nominal currency value, and debt sustainability—the country exists in a series of unstable equilibriums that change rapidly under virtuous or vicious cycles. Argentina is presently experiencing a vicious cycle change. We expect any new equilibrium point to be led by currency stability further stabilized with related slow successes in inflation and politics. The latter two will likely require many months before any stability can truly be expected.

As a consequence of the wide range of election outcomes and our view that any stabilization will be led by central bank success with the currency, we think that very short duration peso denominated bonds should outperform USD bonds in the near term. Further, given that Argentina is no stranger to rapid inflation and sovereign default, many companies have designed their balance sheets and operations to be as immune as possible to sovereign difficulties. Consequently, we think high quality Argentine USD denominated corporate credits have a higher probability of surviving a sovereign default and have become cheaper along with the sovereign. We think our outlook represents a somewhat more sanguine view of the Argentine complex than is currently priced-in which, if implemented with the instruments described above, has the potential to offer modestly improved asymmetry to the wide range of possible outcomes.

Disclosure

Past performance is not indicative of future results. This material is to be used for institutional investors and not for any other purpose. This communication is being provided for informational purposes in connection with the marketing and advertising of products and services. This material contains current opinions of the manager and such opinions are subject to change without notice. Aegon AM US is under no obligation, expressed or implied, to update the material contained herein. This material contains general information only on investment matters; it should not be considered a comprehensive statement on any matter and should not be relied upon as such. If there is any conflict between the enclosed information and Aegon AM US' ADV, the Form ADV controls. The information contained does not take into account any investor's investment objectives, particular needs, or financial situation. Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to you. The value of any investment may fluctuate. Investors should consult their investment professional prior to making an investment decision. Aegon AM US is not undertaking to provide impartial investment advice or give advice in a fiduciary capacity for purposes of any applicable federal or state law or regulation. By receiving this communication, you agree with the intended purpose described above.

Results for certain charts and graphs are included for illustrative purposes only and should not be relied upon to assist or inform the making of any investment decisions.

Specific sectors mentioned do not represent all sectors in which Aegon AM US seeks investments. It should not be assumed that investments of securities in these sectors were or will be profitable.

This document contains "forward-looking statements" which are based on to the firm's beliefs, as well as on a number of assumptions concerning future events based on information currently available. These statements involve certain risks, uncertainties and assumptions which are difficult to predict. Consequently, such statements cannot be guarantees of future performance and actual outcomes and returns may differ materially from statements set forth herein. In addition, this material contains information regarding market outlook, rates of return, market indicators and other statistical information that is not intended and should not be considered an indication of the results of any Aegon AM US-managed portfolio.

Aegon Asset Management US is a US-based SEC registered investment adviser and is also registered as a Commodity Trading Advisor (CTA) with the Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA). Aegon Asset Management US is part of Aegon Asset Management, the global investment management brand of the Aegon Group.

Recipient shall not distribute, publish, sell, license or otherwise create derivative works using any of the content of this report without the prior written consent of Aegon USA Investment Management, LLC, 6300 C Street SW, Cedar Rapids, IA 52499.