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Political Consolidation before Fiscal Consolidation

By David Austerweil, Deputy Portfolio Manager

Deputy Portfolio Manager David Austerweil visited Argentina the week of May 9 and met with key policy makers in the public sector along with private sector analysts. Here are some of his key takeaways:

- The Mauricio Macri government must now turn its focus to generating growth in order to manufacture a victory in next year's mid-term elections. If it is unable to win, questions of governability and political continuity could limit future foreign direct investment (FDI) and key private sector reforms.
- There are no major growth drivers in the near term: real personal incomes are declining due to subsidy reductions and this could limit consumption growth; FDI and private sector investment are being crowded out by high real interest rates and concerns over the longevity of Macri's administration; and infrastructure investment spending may come too slowly due to a lack of shovel-ready projects.
- We feel the central bank demonstrates an admirable commitment to rebuilding its credibility and should be successful in bringing inflation down, despite the need to finance the treasury for 2% of GDP due to the slow pace of fiscal adjustment. An overvalued exchange rate can help.
- After almost four years of being very overweight Argentina, we are reducing exposure in our portfolios. We plan to focus on high-carry positions in short-dated provincial bonds and local market debt that could benefit from a successful disinflation of the economy and exchange rate stability.

Since the Macri administration took office, Argentina has exceeded almost every analyst's expectations in solving the legacy distortions in the economy left by Cristina Kirchner's (former president) administration: lifting the Cepo Cambiario (draconian foreign exchange controls restricting the purchase of USD) and freely floating the exchange rate, resolving the default by settling with holdouts and regaining market access by issuing $16.5B in government bonds, and reducing subsidies for utilities mainly in electricity and gas. The government also presented targets for a fiscal and monetary adjustment that gradually brings down the primary balance from 4.8% of GDP in 2016 to zero by 2019 and inflation to the low single digits by 2019 down from over 30%. Until INDEC (National Statistics and Censuses Institute) begins publishing inflation statistics (expected in June) there is no official measure of inflation at the national level. During meetings, the government referred to the slow pace of adjustment as a possible solution to maintain the governability of Macri's administration while it remains a minority government. In the October 2017 legislative elections, Macri will have a chance to gain a majority in congress and so now he must focus on winning.

While the initial concerns over governability were valid ones (no Argentine president from outside the Peronist party has ever completed a full term), the slow pace of adjustment risks undermining popular support as further subsidy reductions and expenditure cuts could be required in 2017 and 2018. Next year's subsidy reductions will boost inflation again for unsuspecting voters and risk labeling Macri as the president of perpetual adjustment. Additionally, a majority of next year's 1.5% fiscal adjustment is expected to come from growth of tax revenues which will only be feasible if the government's FY2017 expected growth estimate of above 3% is met. If it is not, we believe future subsidy reductions will need to be even larger (further increasing inflation) or expenditure cuts more dramatic (at the expense of public sector jobs). Since the entire adjustment plan hinges on strong real economic growth and because the government needs congress to implement its reform plans, the government appears to be shifting its focus to growing the real economy before next October's mid-term elections. The likely result of any fiscal slippage would be even more sovereign external debt issuance, making current prices less attractive.

We believe the outlook for local rates is more compelling, even with the slower fiscal adjustment making it necessary for the central bank to partially finance the government deficit in 2016 and 2017. While the central bank's policy rate of 36.75% is most likely inconsistent with the above 3% real GDP growth in 2017, as high rates depress economic activity and crowd out the private sector, it is consistent with a strong disinflation, making next year's target of 25% inflation feasible and the resulting 11.75% future real interest rates very attractive. The central bank expressed discomfort with the overvaluation of the Argentine Peso (ARS), but it was unwilling to entertain a large rate cutting cycle that could jeopardize disinflation in the near term, and was almost ideologically opposed to purchasing U.S. dollars to accumulate reserves. Without the central bank intervening, the ARS should remain strong against the USD for the next few months due to seasonal grain exports, large portfolio inflows to local fixed income, a stronger Brazilian Real and the potential for a tax amnesty for Argentine offshore savings by year end. Expected returns for unhedged local rates look very compelling and any sell-off in ARS would be an opportunity to increase our position.

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