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Amundi ASSET MANAGEMENT

INVESTMENT TALKS

14 August 2019

Argentina: election surprise amplifies market and political risks

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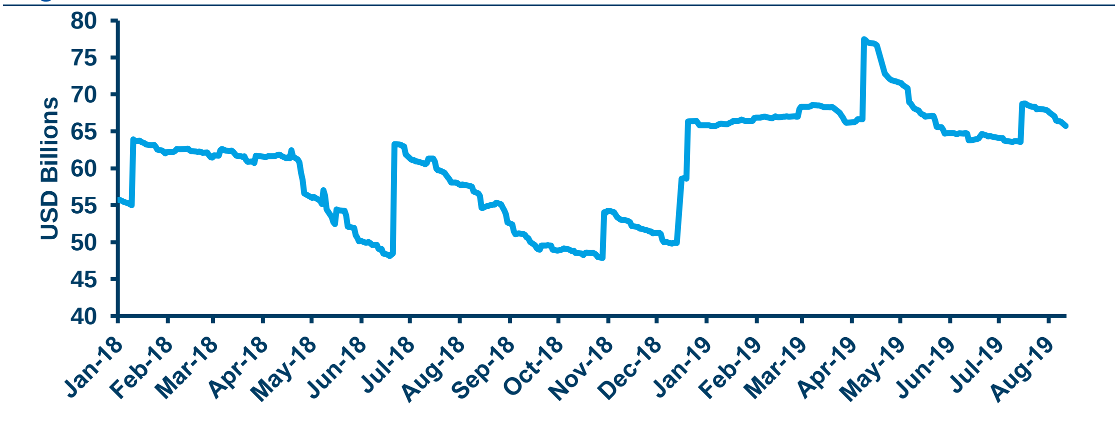
- ***Argentina's primary elections:*** *Opposition candidate Alberto Fernandez won by larger-than-expected margin against President Macri. At this point, markets price in Fernandez's victory in October elections.*
- ***Investment views on Argentina:*** *The primary vote outcome was a negative surprise for the market. Argentine assets collapsed after Macri's defeat. Argentina's stock market index (the Merval index) fell by 48% in USD terms on Monday – the second biggest single day fall of any stock market in the world, ever. Recent events, threatening the reform path and increasing the risk of debt restructuring, should lead investors to reconsider Argentina's investment case. We have become much more cautious on the external debt, while we confirm our conviction that local currency debt is unattractive from a risk/return perspective.*
- ***Contagion effect and implications on EM universe:*** *Overall, we see limited spillover effect on the rest of the EM universe. Argentina is a relatively closed economy, so direct economic impact in the EM region and globally is very limited. Financial contagion should also be limited, as the index-weights of Argentina are quite modest (around 2% of the EMBI Global Index and 0.3% of the MSCI EM Index). A risk reduction occurring in global investors' portfolios as a consequence of a material deterioration (Argentina has been a general long position in the market) should be shared among market participants with limited effects on the EM universe. However, geopolitical risks are elevated globally, leading to an increase in investors' risk aversion. EM assets will not been immune to renewed volatility. The focus will be on asset protection and increased risk management.*

What are your considerations on Argentina's primaries?

Key primary vote in Argentina took place on Sunday, August 11, with the opposition candidate Alberto Fernandez winning by larger-than-expected margin against President Macri. At this point, markets price in Fernandez's victory in October elections. In order to win at the first round, the candidate needs to get 45% of votes outright or more than 40% with a 10% difference to avoid a runoff. The implications for the markets was a large sell-off on all types of Argentine assets. It is worth reminding that a Fernandez victory is likely to imply a debt restructuring, although this may hopefully be an orderly one (some research analysis are now pointing to a 40-60% haircut). Either way, the external debt of Argentina has become unsustainable and with a bit of pickup in growth the current account deficit would get wider.

"Political risk has dramatically increased, as well as the risk of debt restructuring."

Argentina International Reserves in USD



Source: Amundi's elaboration on Bloomberg data. As of 13 August 2019.

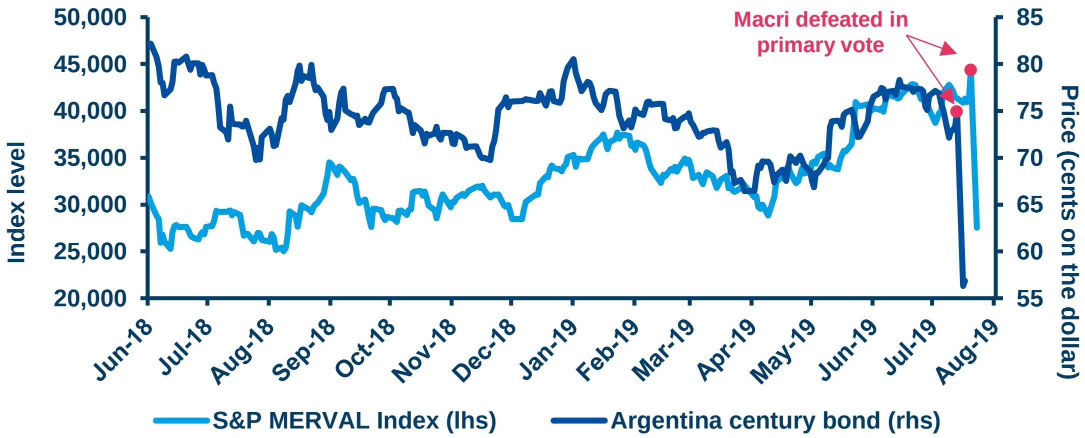
Hence, increasing external funding is needed. In addition, international reserves remain precariously low and are melting down after each IMF disbursement. Since the last disbursement of US$5.4bn on 16 July, US$2bn has already been lost. The IMF disbursements ends this year and in 2020 only debt repayments are planned.

What is your view on Argentine assets in light of the result?

"We have become much more cautious on external debt."

The outcome was a big surprise for us and the market. We expected Alberto Fernandez to perform better than Macri in the primaries, but by no more than 5-7%, in line with some of the polls that predicted the worst outcome for Macri. The 15% gap, however, was a big shock. We view the outcome as very negative and see the likelihood of the incumbent president being re-elected to be very slim. As an indication of how big of a surprise the election was, Argentina's stock market index (the Merval index) fell by 48% in USD terms on Monday – the second biggest single day fall of any stock market in the world, ever.

Argentina's Bond and Stock Market Collapse



Source: Amundi's elaboration on Bloomberg data. As of 13 August 2019.

"Investors should take the opportunity of a possible rebound from distressed level, to further lighten their positions."

Our base case is now for a Fernandez victory in October and a subsequent reversal of the economic reforms carried out by Macri over the past four years. We see a challenging environment ahead for Argentina, with the likelihood of restructuring to be relatively high in the next few years. This event should lead investors to reconsider Argentina's investment case. We have become much more cautious on the external debt, while we confirm our key conviction that local currency debt is unattractive from a risk/return perspective. Current bond prices already reflect a >70% probability of default in the next three years. Historical average recovery values in EM sovereign restructuring scenarios have been close to 60% and many bonds in Argentina are already trading below that level. It is possible that over the next few weeks we hear a more conciliatory tone from Alberto Fernandez in order to avoid a collapse of Argentina's financial system. This could include – albeit not our base case – the appointment of a market-friendly Finance Minister, as well as a verbal commitment for repayment of international debt. Such a scenario should cause a bounce in Argentine assets. Investors should use such a bounce to further reduce exposure as debt dynamics will remain challenging in the absence of extreme budgetary discipline and access to international sources of financing.

Do you see any contagion effect in the EM region or possible implications for the EM debt universe?

"We see limited contagion effect on the rest of the EM region."

Argentina is a closed economy, so direct economic impact in the EM region and globally is very limited. The largest trading partner is Brazil, but financial stress in Argentina is unlikely to produce any material negative impact. The only significant (indirect) impact

"We are now navigating in a more complicated market environment, with increased fragilities. This requires a more cautious risk attitude."

could be on soybean market (already impacted by China-US), which is Brazil's largest export item.

Financial contagion is also limited, as the index-weights of Argentina are quite modest (around 2.0% of the EMBI Global Index and 0.3% of the MSCI EM Index). A risk reduction occurring in global investors' portfolios as a consequence of a material deterioration (Argentina has been a general long position in the market) should be absorbed with limited effects on the EM universe. We are aware that any outflows may create pressures in local markets, however, we have seen big players' capacity to add/double down risk without causing too much stress. Several frontier countries in Africa have a beta[1] similar to Argentina and have been affected (trading back to the beginning of the year levels). Turkey is another high-beta market, but its sensitivity to the market has been lost somewhat given an extreme negative positioning in the market already.

According to our estimates, average cash levels in the investment industry are still relatively healthy and net bond coupon payments over the next quarter could create a natural buffer to face a liquidity shock.

In conclusion, we believe that Argentina remains an idiosyncratic story and we see limited spillover effect on the rest of the EM universe. A key difference with Argentina's market turmoil in 2018 is that central banks have globally turned accommodative now. The Fed has already started an easing cycle, giving EM central banks room to lower interest rates. However, in EM the hit to the sentiment is evident and the market has already been fragile after the shock of 10% additional tariffs on China. As we have seen yesterday after the announcement of President Trump to delay tariffs, risk assets started bouncing back on optimism around the renewal of the China-US trade negotiations in the coming weeks. Geopolitical risk is elevated, leading to an increase in investors' risk aversion and market volatility.

We are now navigating in a more complicated market environment, after a strong year-to-date rally, and EM bond will not be immune. In this phase, therefore, the focus will be on asset protection and increased risk and liquidity management. A stabilization of economic conditions and some relaxation on trade issues could re-open opportunities at higher yield levels. Overall, the asset class remains attractive for investors hunting for yield.

1 Beta – Beta measures an investment's sensitivity (volatility) to market movements in relation to an index. A beta of 1 indicates that the security's price has moved with the market. A beta of less than 1 means that the security has been less volatile than the market. A beta of greater than 1 indicates that the security's price has been more volatile than the market.

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Important Information

Date of First Use: 14 August 2019.

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