



Argentina: Position for the upturn

Introduction

Upside surprises – lackluster market response. Argentina's FX and fixed income markets have had a muted response to the recent upside surprises in both domestic activity and better-than-expected primary results / electoral polls since the PASO. Rather than a sign of market skepticism we find this consistent with the new stage of the cycle the economy finds itself in, where the growth is accelerating but amid a very gradual improvement in fiscal accounts, a widening current account deficit and persistent inflation.

Asset selection becomes more important. The improvement in growth outlook is more clearly reflected in the 40%+ returns in equity markets and outperformance of Argentina's external debt. Meanwhile, inflation inertia and the still high pace of issuance have underpinned the lackluster performance of the peso and local fixed income in recent months. The gradual improvement in macro conditions we foresee slows re-pricing and highlights the importance of relative value at this stage in the business cycle.

In this report, we review recent macro developments and outlook, and discuss how to position for this stage in the cycle.

Politics and policy mix support (tactical) carry in local markets and duration in hard currency

The October mid-term elections will likely confirm the expected gains by Macri's coalition. The race in the key (and normally a leading indicator) BA province shows the incumbent's candidate leading by almost 5 points. Also, the main Cambiemos leaders still enjoy favorable ratings – especially Governor Vidal (near historical highs) – while Cristina Kirchner's rejection rate is on the rise. Local polls also suggest – despite limitations – that Cambiemos may win in the province of Buenos Aires, the city of Buenos Aires, Cordoba, Mendoza and Santa Fe – the five largest electoral districts. The government would still lack majority in congress but such an outcome would fragment the opposition further and increase the government's leverage with governors and thus legislators.

This is essential to pass various reforms (especially tax, co-participation, and de-regulation), keep growth momentum sustainable, and pave the way to reelection. The administration has revealed its preference for a gradual policy rebalancing and growth recovery, but

the incumbents would still need the economic momentum to continue with the reforms needed to eventually balance the budget and stabilize external indebtedness after all. These are the pre-conditions for another round of re-pricing – eventually.

Where do policies point to in terms of asset allocation? The political and policy mix means elevated primary deficits (likely to post 3.2% in 2018 and 3.8% without one-off revenues) and still a slight positive impulse vs. 2017 – when the primary deficit is likely reaching 5% without extraordinary measures. This combined with investment growth – concentrated in public and (less so) private consumption (at 4.1%) – and rising real wages (over 3% up in real terms) point to excess absorption.

Therefore, we expect price pressures to remain concentrated in non-tradables, which means further real currency appreciation pressures. According to our fundamental-based valuation framework the ARS is about 15% overvalued and this will probably increase in the coming quarters. An economy running hot to secure political support and an overvalued currency are consistent with a widening current account deficit.

Funding this wider gap and fighting inflation will require high – and possibly temporarily higher – real rates for long. The central bank suggested that real rates of 4% are consistent with disinflation. Persistent inflation and the increase in 2018 inflation expectations to 15.8% (vs. 14% of early Q2) suggest that policy rates may have to increase a little further still before easing could resume early next year

What could be the market implications?

Local rates: Focus on “safer” carry

In our view, the need to fund widening current account deficits and anchor disinflation will support additional (mild) real peso appreciation. We expect the peso to depreciate in nominal terms but to lag inflation and forwards. In other words, without fiscal tightening monetary policy (including the exchange rate) will continue to bear the brunt of disinflation. We target the USD/ARS at 18.0 at the end of 2017 and 19.8 at the end of 2018 vs. forwards of 18.3 and 21.0, respectively. With the forwards likely overestimating the pace of ARS depreciation the backdrop is supportive of carry oriented positions.

Monetizing carry will not be straightforward, however. It is important to bear in mind that – in contrast with