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Argentina: The Turbulent Tango

By Eric Fine, Portfolio Manager, and the Active Emerging Markets Debt Team

Portfolio Manager Eric Fine recently returned from Argentina, where he met with a range of government and private sector officials. Here is the latest view from the investment team on Argentina.

- Argentine sovereign bonds look set to enter a turbulent period, as the government readies its initial proposal to external bondholders. The IMF's conclusion that Argentine debt is "unsustainable", and must involve "a meaningful contribution from private creditors", makes it look even more likely, in our view, that the government's first proposal will be "tough".
- In fact, as a result of this potential turbulence, we reduced our exposure to Argentina significantly (we closed the Government of Argentina 6.875% 22-APR 2021, which was approximately 4.5% of our overall portfolio as of January 31st, 2020). This turbulence may create buying opportunities and it might also lead to self-fulfilling deterioration if debt negotiations bog down.
- Not much has really changed, though, and we continue to think private creditors have the stronger negotiation position. A default to external creditors would be an economic, and thus political, disaster for Argentina, so a voluntary restructuring remains the most likely eventual outcome.
- The good economic news is that Argentina's central bank reserves have stabilized, the merchandise trade account surplus has grown and inflation was less than expected in January. The bad economic news is that government fiscal policy will be lax and structural reform looks non-existent.
- There remain many attractive corporate and provincial bonds in Argentina, despite risks to the sovereign bonds. The upside (see table below) from Argentine bonds looks extremely high … the highest it has looked since we first ran these tables in August 2019.
- Although COVID-19 is dominating market attention, Argentina is clearly an uncorrelated asset price. Top-down situations such as the virus rarely drive our positioning and this is especially the case with Argentina. We wake up in the morning thinking about negotiation and fundamental developments, not the virus, when thinking about Argentina.

Argentine sovereign bonds look set to enter a turbulent period, as the government readies its initial proposal to external bondholders. The IMF's conclusion that Argentine debt at current levels is "unsustainable", and must involve "a meaningful contribution from private creditors", makes it look even more likely, in our view, that the government's first proposal will be "tough". The government official in charge of debt negotiations, moreover, has never engaged in any before and doesn't seem to be leveraging expertise in that sphere, making mistakes likely. Nonetheless, our view remains largely unchanged. We still think most negotiation power remains with creditors—the government and IMF understand that an involuntary restructuring would be far more devastating to the government's standing and the economy, than would a negotiated settlement. The policy stance of the new government is arguably better than expected compared to just after elections. There's little fiscal restraint and a very state-centered economic framework. As we note above, we think there's real risk of a tough initial stance from the government. But, we're not sure long-term economic policy is that relevant, as all future paths must go through the current "stage", which we think is the debt negotiation stage. All we've done is reduce exposure tactically, to reduce downside risks, and create the chance of buying back some bonds at lower levels.

The basic setup remains: the key game is debt negotiations and creditors have the upper hand

In all meetings, the basic line of the newly-elected government remained the same as it was—that they were focused on a quick and cooperative restructuring or reprofiling of Argentina's foreign-law debt, in our opinion. This makes sense given the devastation the country and many current officials experienced during Argentina's previous defaults and this experience is specifically referenced by officials. Even the IMF, we believe, understands the need for cooperation with private sector creditors if they want the Argentine economic program to succeed.

The country's new Minister of Economy, Martin Guzman, though, is making tougher noises and appears to be taking personal charge of debt negotiations. He is framed as a "protégé" of Nobel Laureate Joe Stiglitz and wrote papers on debt sustainability. As we noted in our other Argentina-related writing, his academic work points to the importance of speedy defaults, with an emphasis on extending payments and preserving much of principal payments, in order to restart financing access. That all sounds fine. He has also never conducted a debt negotiation and seems to be centralizing all negotiation efforts on himself, despite this lack of experience (i.e., he hasn't assigned an experienced negotiator to conduct the actual negotiations). We emphasize this because our experience with debt negotiations is that they are inherently fragile and small mistakes can quickly lead to unforeseen and undesirable results.

In fact, it looks like a mistake was made in Guzman's first gambit, one that reinforces our view that creditors have the upper hand. The Province of Buenos Aires (PBA) had coupons and some principal on a New York-law bond due on January 26. Guzman took control of the initial negotiations and sent a consent solicitation to bondholders in which payments would be postponed, with nothing in return for creditors. He did this with little apparent formal discussion with bondholder groups. Creditors rejected this "offer". The PBA eventually offered some principal prepayment as a sweetener to creditors in a third consent solicitation, and more creditors agreed, but not enough to change bond terms. Just before the end of the grace period on payments, the PBA relented and paid everything that was due.

This was a failed gambit for many reasons which underlined creditors' strengths. First, the fact that bonds were eventually paid shows that the logic of a cooperative stance makes sense—at the final hour, the PBA decided that the cost of a hard default was far higher than staying current on bonds while negotiating a settlement. Second, Guzman does not work for the government of PBA. Because the market looked to PBA behavior as hinting at Federal behavior, it appears as if Guzman was "playing tough" using someone else's gun—using the creditworthiness of PBA as the weapon that he was never able to fire. In our conversations, we have this sense. In addition, moreover, we believe that the PBA now understands that its creditworthiness (which is arguably better than the sovereign's) should not be played with. Third, the negotiation ploy meant zero payments relief and

still-weakened creditworthiness, so all loss, no gain. Fourth, it might be that this risk of default got President Alberto Fernandez to interfere, further undermining Guzman's credibility. Anyway, hopefully all of the above repercussions give a sense of how fragile and game-theoretic a sovereign debt negotiation can be.

Now, this failure does not mean lessons that have been learned, in our view. Our sense is that Guzman is still centralizing all decisions. In addition, because of his weaker negotiation position, he could try to "strengthen" his stance by making a tough offer on Federal debt. He is saying as much publicly. This also seems to be behind his strategy, we believe, in working with the IMF to get both hints at a future IMF lending program, but also their declaration that private creditors should take a hit. We do not view the IMF statement as really amounting to anything, as a deal still with bondholders needs to be negotiated. It should not sway creditors, in our view. Anyway, we would not be surprised at a tough initial offer, perhaps adding a haircut of 40% +/- to the currently media-discussed term-out of maturities by three years, a grace-period on coupons for three years and a 15% principal haircut. Such a deal would be very positive for bondholders, by the way, so if such a proposal is coming we do not understand the tough bluster, thus our view that a tough initial offer may be coming.

At the end of the day, under foreign-law bond clauses, 75% of each issue and 80% of all bondholders need to agree—this will force Argentina to work with bondholders. Moreover, bondholders will use their ownership of particular issues (for example, a very short-dated bond) to be subject to better treatment than other issues (for example, a very long-dated bond). This is a bit complicated by a clause that says a deal must be "uniformly applicable"; we will not go into the nuances here, but we believe it raises legal complexity and perhaps makes bond-by-bond deals less likely.

As a result, likely negotiation outcomes may make many bonds continue to look cheap

Below, we go through some of the negotiation outcome scenarios we have used in past reports. The bottom line remains—there are a lot of NPV-positive outcomes, still. The table's upsides across representative bond tenors, and across restructuring scenarios, should speak for themselves. The front-end bonds still look best to us.

Exhibit A – Total Return Upside Across Tenors and Negotiation Outcomes

		Expected Return by Bond		
Scenario	Probability	Arg 21	Arg 26	Arg 46
No Restrucuring	0%	122%	131%	119%
Uruguay 2003*	15%	122%	131%	119%
Trial Balloon 1`	**50%**	**99%**	**76%**	**9%**
Ukraine 2015^	20%	84%	94%	78%
40% haircut	10%	26%	19%	-8%
Argentina 2001~	5%	-33%	-27%	-32%
Expected Value		85%	77%	36%

All scenarios assume an 11% exit yield

*Maturity extension with preference for front end debt similar to Uruguay's 2003 restructuring

`2 year principal extension, 50% permanent cut in coupons

^20% principal haircut and 4 year maturity extension similar to Ukraine's 2015 restructuring

~65% haircut, 3 year delay in payments, no PDI

Source: Jeffries, VanEck

There is not a lot of foreign-law debt coming due in 2020, reinforcing near-term bullish case

Another key point to keep in mind is that there is not much foreign-law U.S. dollar-denominated debt coming due in 2020. As the table below shows, the big U.S. dollar payments are for local-law debt. The government is talking up the idea that local-law debt will be treated identically to foreign-law debt (the bonds we have tended to view as representing buying opportunities). However, local-law debt can be restructured via presidential decree, which has happened for earlier maturities, actually. When push comes to shove, we expect the government to use their flexibility on local-law debt if needed.

This becomes important for game-theoretic reasons. If you do not have anything to default on, why would you default? What this means to us is that waiting it out is a practical strategy. Of course, one should "bob and weave" according to the ebb and flow of negotiations. But, the sovereign faces no serious foreign-law amortizations until October's 400 million principal payment on a Swiss franc-denominated bond. Our point is that as the months wear on, if the government's stance remains largely intact (i.e., play tough, but make sure you get a voluntary deal), we see a chance that even that payment is made in full (assuming a deal is closer, but not signed at that stage).

Exhibit B– Argentina Merchandise Trade Balance

2020 USD Payments Due

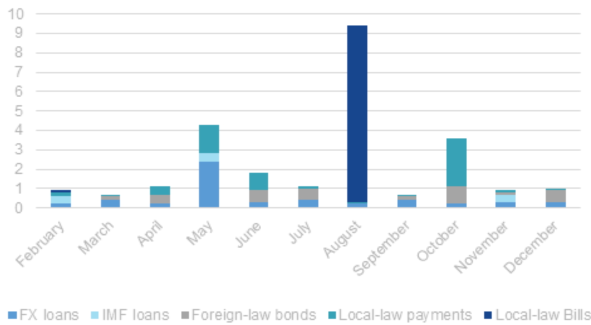
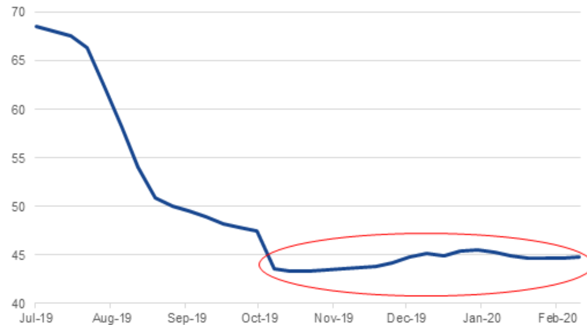


Exhibit D– Argentina Reserves Stabilized

Argentina's International Reserves, bn USD

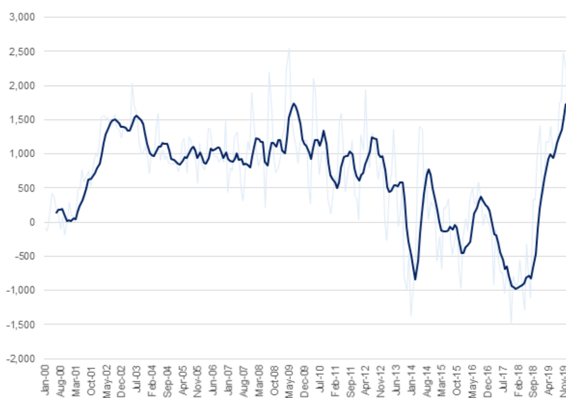


Reserves have stabilized and policy is largely better than expected, despite serious deficiencies

At this stage of the game, we are not too focused on long-term economic policy and really only care about the kind of deal bondholders will get and whether economic policy will generate U.S. dollars to meet the deal, which so far looks hopeful. As a result of economic collapse, import demand has collapsed. So, the country's merchandise trade balance looks much improved. In addition, capital controls are keeping the capital account from undermining this strength—the U.S. dollars are being kept in, with government in charge of who gets access.

As a result, as long as a basic bias to preserve reserves is in place, we see a pretty good setup for the market reaction, when and if a deal is finally agreed.

Exhibit C – Argentina Merchandise Trade Balance, mn USD



Policy generally looks lackluster—there should be a steep credit curve

Policy—especially fiscal—looks weak, in our view, under the current government. We think weak policy is being viewed too simplistically as "bad" for Argentine bonds, rather than as meaning "bad, eventually". Our case has never been that Argentine policy is on a good footing, only that policy was not going to be as bad as priced by the market. So, what we write below detailing policy deficiencies should be seen in that context. We continue to think that risks are more than priced, not that policy improvements are underpriced.

The fiscal effort is unclear, in our opinion. On the one hand, the new government is orthodox in that it understands the need to reduce borrowing one way or another. In particular, it wants to limit monetization, as this would quickly feed inflation and inflation expectations and raise domestic borrowing costs. On the other hand, the IMF seems to be supportive of a more limited fiscal effort. Announcements of progress toward a deal occurred after the country implied it would only reach a primary fiscal balance by 2023.

And, the initial fiscal outturn is mixed to worrisome—December results were good, January results look very bad. The December outturn was viewed as emblematic of the new Fernandez administration's fiscal stance. The fact that December's results allowed the country to achieve a 0.44% primary deficit—well within the 0.5% agreed with the IMF—was hopeful. But in January, we saw a big deterioration, with many speculating that the profligacy is a tactic designed to soften up creditors in negotiations. January revenue dropped by around 40%, spending was

up 51%, and this was the first time in two years the country saw faster spending growth than revenue growth. Still, though, as we note above, this is "atmospheric" at best and bondholders may use their rights, officials' legitimate fears of collapse in the event of hard default, and to the extent fundamentals are in focus, it is only the level of reserves.

The only "gem" from policymakers is their stated intention to exploit fully the Vaca Meurte shale deposit. The government's new law to enable foreign investment and the ring-fencing of U.S. dollar proceeds via offshore trusts is winding its way through the legislature. On this front, we got two distinct stories. The government's line is that the law is complete and addresses all key issues any foreign investor would need to invest. In speaking with industry analysts, though, there are misgivings about the worth of the legislation. At the minimum, all agree that a good law and bad treatment of bondholders would make the law worthless. Good treatment of bondholders and a bad law would make the law mixed. A narrow conclusion from this is that it is another example of how important bondholder negotiations are to the Argentine government.

A broader conclusion is that this policy uncertainty should mean a steeper credit curve. If, at the end of the day, economic policy results in breathing space from a debt deal, but no real change in government spending behavior and structural policy, we will risk re-igniting debt-sustainability issues. We note this point because we see few in the market paying attention to this basic logic. All investors seem to have one unitary "exit yield" that they use for all bonds, injecting no or low premia for longer-dated bonds. We think this approach is wrong and continue to have opinions across the curve of maturities. The shorter maturities benefit from all of the positive arguments made above (progress with the IMF, not-as-bad initial policy, an eventual bond restructuring agreement) without suffering from one of the key negative arguments above (weak or highly uncertain long-term economic policy).

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