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Argentina: Will They or Won’t They?

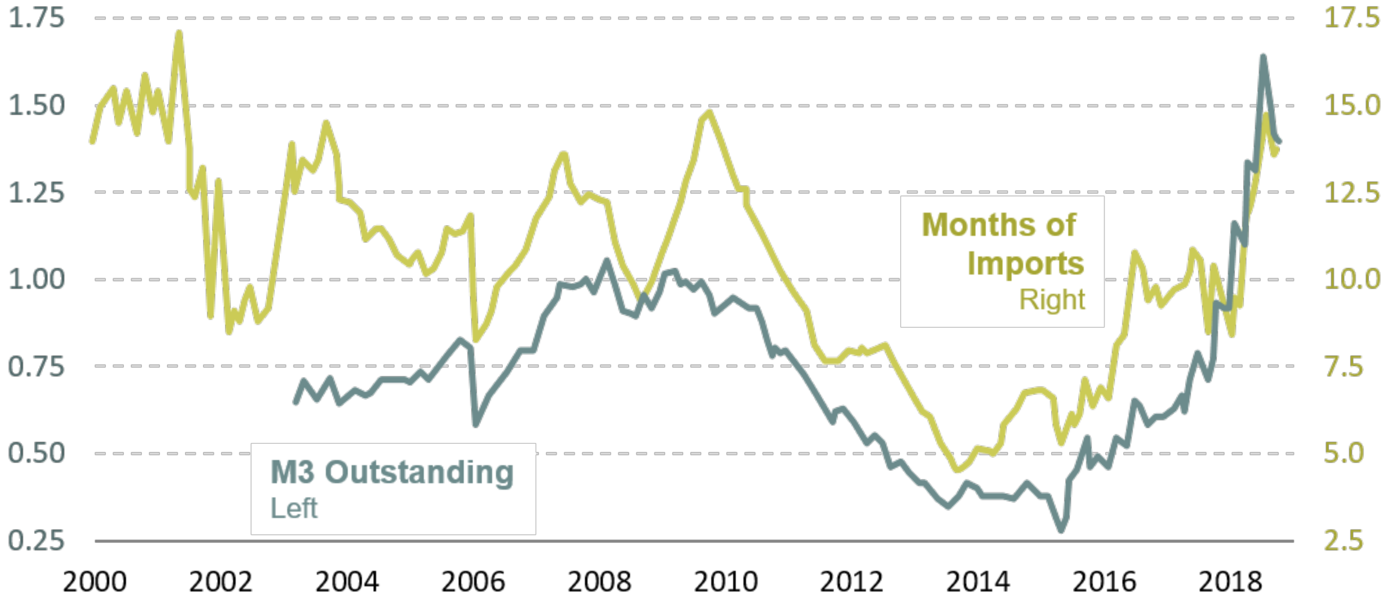
Back in June 2017, we expressed optimism that Argentina could overcome its history of frequent defaults. The key we highlighted was the country’s need to overcome “original sin.” They didn’t. A belabored fiscal consolidation, a bungled monetary policy, and a bias to issue cheap dollar debt instead led to high inflation, a recession, and debt default concerns. Unfortunately, the alternative to Macri would mean a likely return to the Kirchner-ist approach to macroeconomic management of the 2000s that culminated in a technical default in 2014.

Risk premia in early August had already adjusted to reflect heightened political uncertainty with 2027 dollar bonds issued at a 6.875% coupon in 2017 trading above 12%. It was supposed to be a closely fought election, but the results of the August 11th primary shocked markets with Macri’s challenger receiving 15 percentage points more of the vote. In the ensuing days, the exchange rate gapped higher from 45 to 60. Most of Argentina’s debt is denominated in hard currency, so the peso’s move fed into debt sustainability concerns. Fears of a credit event have spiked with default assumptions in dollar bonds rising from 20% to approximately 75%.

Should bond markets be pricing in default as a nearly sure thing? Yes and no. For one, market fears can be self-fulfilling as otherwise solvent borrowers lose the ability to roll over their debt. Fortunately for Argentina, the next lumpy debt maturity is not until 2021 when $4.5 billion of principal comes due. In the meantime, coupon payments and T-bill rollovers will be challenging, but the central bank does have over $60 billion in gross reserves. For context, this is equivalent to 1.4x the money supply and 13 months of imports (see Chart 1).

Chart 1: Gross Reserve Ratios

As of 8/1/2019



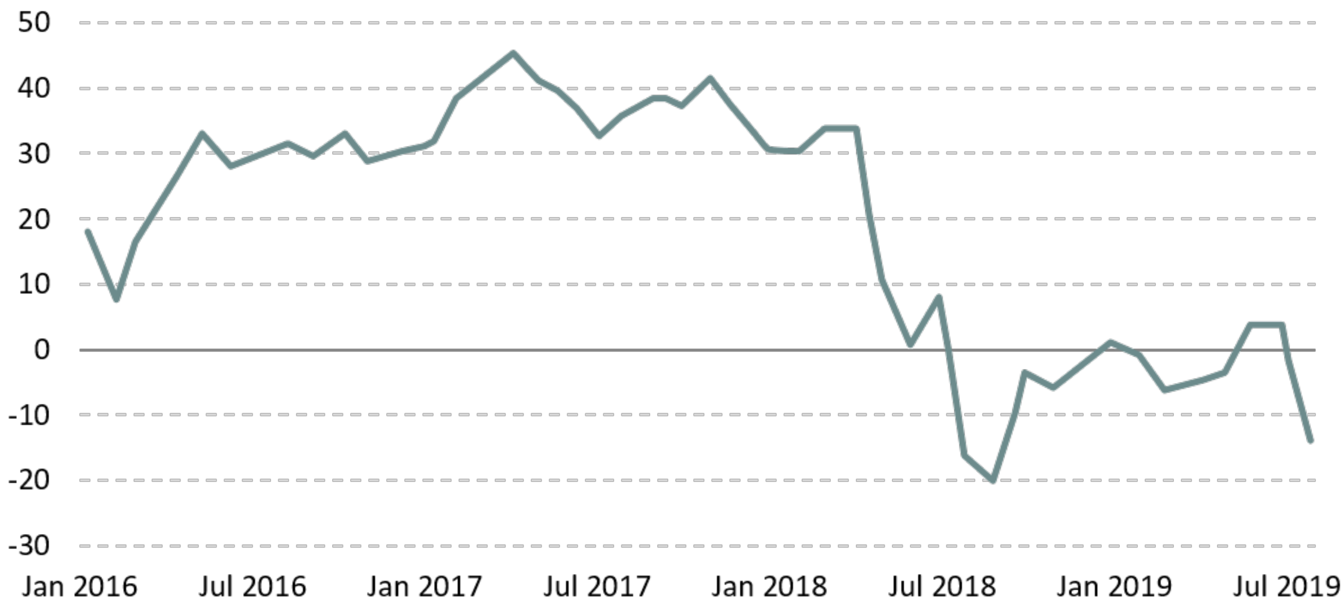
Source: Haver Analytics

The next tranche of International Monetary Fund (IMF) money is set for mid-September, but with gross debt to gross domestic product (GDP) now over 100% due to the peso's devaluation, it is unclear Argentina will meet the IMF's criteria that borrowers must demonstrate to sustain their debt. It helps that about a third of the debt is held by other public sector entities so net debt is closer to 65%. Regardless, Argentina might need to access additional sources of liquidity such as a swap line with a foreign central bank.

Exchange rate dynamics will be key going forward. The devaluation that was supposed to take place gradually over a year took place in a single day. By some of our estimates, the peso is once again trading on the cheap side of valuations (Chart 2).

Chart 2: Purchasing Power Parity*

% Over/Undervaluation, As of 8/1/2019



**Positive numbers indicates overvaluation relative to PPP*

Source: Brandywine Global

There is a chance that the current foreign exchange level discourages further dollarization by locals and quickly improves current account dynamics in the near term. Political pronunciations also bear watching. Both candidates have expressed a willingness to continue servicing the debt, but given Argentina's history, markets are right to remain skeptical.

Dollar bonds now trade under 50 cents on the dollar which implies a downside of about 15 cents in a default scenario and an upside of over 50 cents if principal is paid back. A default or a "friendly restructuring" cannot be ruled out at this point, but the risk-reward has become more intriguing.

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