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Economic crisis and political risk batter Argentina. Way out or opportunity?

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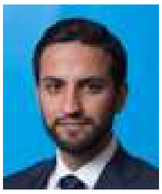

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- ***Argentina's economic situation:*** *The economy is facing severe stagflation. Monetary and fiscal policy are extremely tight, consumer and investor confidence is low, and inflation is proving very sticky amidst wage indexation. Whilst we view the fiscal and monetary mix to be appropriate given Argentina's macro challenges, it is possible that these measures may not be able to stabilise the economy in time for the elections.*
- ***Key elections scheduled in October:*** *The current economic situation is weighing heavily on President Macri's popularity and his re-election chances seem to have taken a turn for the worse. The incumbent's approval ratings have plummeted over the past twelve months and Cristina Kirchner's rejection rates have fallen. The incumbent now polls worse than Kirchner. That said, the political environment remains fluid, especially as the final list of candidates may not be known until June 22nd.*
- ***Investment views on Argentina:*** *Asset prices have reacted very negatively over the past month to the rising chances of Cristina Kirchner returning to power. The direction of travel for Argentina under a Kirchner victory is likely to be one of debt restructuring, price controls and re-imposition of capital controls. We think Argentinian assets are sufficiently discounted for a scenario of Kirchner victory relative to the probability that we attach to such a scenario. As such, we hold on to our hard currency exposure in Argentina.*
- ***Mild contagion effect:*** *Argentina's direct trade and financial linkages with broader EM countries is relatively low. The strongest economic links are with Brazil, where some negative impact could be felt in the event of extreme deterioration. Additionally, some impact on EM is likely to be felt from a portfolio effect: Argentinian assets are well-held by many global asset managers. In case of material deterioration in Argentina's situation they may be forced to reduce overall risk in their portfolios. Beyond that, we view contagion effects to be limited.*
- ***EM bond – key themes and opportunities:*** *After a strong performance in EM assets year-to-date, driven by accommodative central banks, and stabilisation of Chinese data, valuations have become less attractive. Global growth is also yet to pick up meaningfully, and China-US trade war has resurfaced as a risk. We have therefore become more cautious and selective in recent weeks, although we maintain a constructive bias, especially in hard currency debt.*

Before the general elections: where is the Argentine economy right now, how are policymakers dealing with the crisis?

Argentina is in a deep recession and inflation has skyrocketed to close to 5% month-over-month and more than 50% on an annual basis. The Leliq policy rate (seven-day liquidity letters, the assigned benchmark rate in Argentina) has approached 75%. The government and the central bank are doing the right things in terms of trying to reduce the fiscal deficit and also stabilise the exchange rate.

"Argentina's economy is struggling, but the government and the central bank are acting appropriately in terms of trying to reduce the fiscal deficit and stabilise the currency."

The new policy of the central bank to intervene in the FX market by selling US dollars may help to stabilise the Argentine peso, and hence anchor inflation expectations. Nonetheless, the scope and period of the intervention is likely to remain limited since Argentina's reserve adequacy is already weak, and reserves have been declining over the past month. It is possible these measures may not be able to stabilise and turn around the economy in time for the elections, which are scheduled for October 27.

Is the current situation going to change the odds of Macri's re- election?

Stagflation and growing poverty have already impacted President Macri's popularity and his re-election chances negatively. Current surveys suggest roughly 27% of voters intend to vote for him versus 33% for Cristina Kirchner, a significant loss in popularity compared with the situation a few months ago, when Macri was leading the polls against Kirchner. Moreover, according to the latest polls, for the second round, Kirchner leads Macri by 10%.

This said, the elections are scheduled for October and the political situation remains fluid. We see a number of factors that imply a Kirchner victory is far from assured:

- One possibility is that Macri could withdraw his candidacy in favour of Buenos Aires Governor Maria Vidal (also Cambiemos), whose is leading Macri by 10% in the polls;
- Formation of consensus amongst Peronists around Roberto Lavagna, a former Finance Minister and market friendly figure, could boost Lavagna's chances of making it to the second round, in which case his chances of beating either Macri or Kirchner in the second round is very high;
- A third factor is the large number of undecided voters, which could change over time as the elections near; and
- Lastly, a turnaround of the economy and a stabilisation of the exchange rate and inflation would favour Macri.
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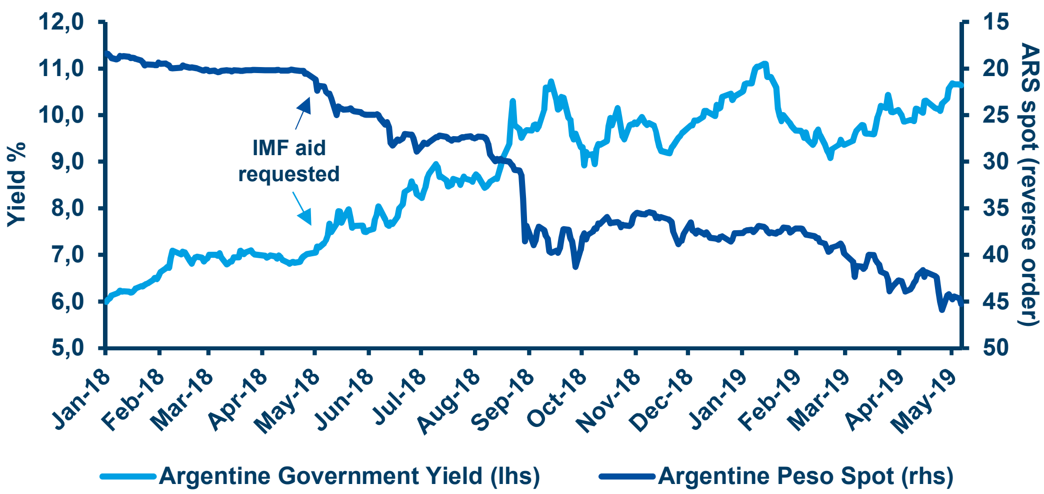
"The current economic situation is weighing heavily on President Macri's popularity, while increasing the chances of Cristina Kirchner coming back to power."

How could the election outcome affect Argentine assets?

Asset prices have reacted very negatively over the past month to the rising chance of Cristina Kirchner returning to power, as it is perceived by the market as a return of debt restructuring, price controls and capital controls. We think such a scenario is more likely to be avoided under either a Cambiemos (incumbent) or moderate Peronist Presidency. Given the extremely stagflationary dynamics in Argentina's macroeconomy at this juncture, President Macri's re-election prospects have become increasingly unlikely. Despite this, Kirchner's victory is far from assured, and this is an upside risk for Argentina. However, we acknowledge that the downside risks remain just as potent, especially around the economy and the prospects for an improvement in the stagflationary environment. At this juncture, we think Argentine assets are sufficiently discounted for the scenario of a Kirchner's victory, relative to the probability that we attach to such a scenario. As such, we have maintained our preference for external debt in Argentina, but for the first time this year we see some value in the currency, although we stay alert to a currency run that may occur in a short period of time.

"Argentine assets have been heavily discounted for political risk and, as such, we remain positive on external debt and start to see some value in the ARS."

Argentina's bond yield and Argentine Peso spot rate

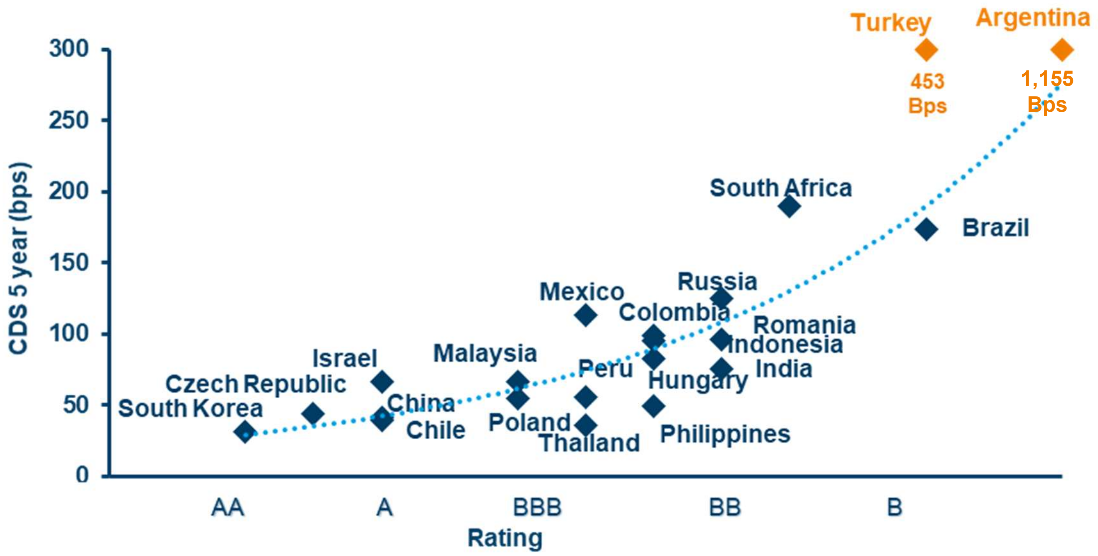


Source: Bloomberg, Amundi. Data as of 8 May 2019. Argentine Government Yield: J.P. Morgan EMBIG Diversified Argentina Sovereign Yield

Do you see any potential risk of contagion among emerging markets should Argentina's crisis worsen?

We doubt that there will be significant contagion from Argentina to other emerging market assets. Argentina is an idiosyncratic story with an unfortunate past of hyperinflation and default, and a population with a memory of these ill-fated economic episodes. Argentina's direct trade and financial linkages with broader EM countries is relatively low. The strongest economic links are with Brazil, where some negative impact could be felt in the event of extreme deterioration. Additionally, some impact on EM is likely to be felt from a portfolio effect: Argentinian assets are well-held by many global asset managers. In case of material deterioration in Argentina's situation they may be forced to reduce overall risk in their portfolios. Beyond that, we view contagion effects to be limited.

Emerging markets CDS levels vs. rating



Source: Bloomberg, Amundi. Data as of 30 April 2019. Turkey and Argentina are out of y-axis scale. CDS 5Y bps are 453 and 1,155, respectively

What are the key themes in EM bond markets for the coming months?

The key driver of returns for EM bonds this year has been carry and spread tightening. Market participants are now starting to draw parallels between the current juncture and the pattern of events in 2018, which put pressure on EM debt. The assumption of upward growth re-synchronisation is showing signs of faltering, with the US potentially being able to surprise to the upside again, leaving behind the rest of the world. The USD continues to be stronger than consensus expected and negative idiosyncratic developments in Turkey and Argentina have affected sentiment for the rest of the asset class. The comparison with last year is fair, but we see notable differences with last year's situation: in the absence of the fiscal stimulus that was delivered via tax cuts in the US in December 2017, the US economy is unlikely to be able to decouple from the rest of the world. In addition, we see starting valuation points as much cheaper than in 2018, while growth expectations are already very depressed compared to the buoyancy of early last year. Finally, the Fed is a long way away from resuming policy hikes at this juncture – unlike 12 months ago. That's the positive narrative. On the other hand, we have to consider the less attractive valuations in absolute terms, and the fact that the US-China trade dispute is still far from being solved. There has been a sort of market complacency on a possible resolution, and after the strong rally, we may see some volatility return to the market again. We have therefore become

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"In this phase, we have a tilt towards hard currency over local currency, mainly supported on a risk-adjusted basis."

Where do you see the opportunities in EM bonds?

Most of the spread compression is behind us, and we expect a mild widening of the spread on EM debt (EMBI), to around 380 in the next 12 months. Therefore, we believe investors should continue to favour the asset class mainly for carry reasons. At the moment, we prefer hard currency over local currency on a risk-adjusted basis (as FX is very volatile). The observed strength in oil prices has been another beneficial factor for hard currency debt as there are a large number of EM countries whose fiscal deficits benefit significantly from higher oil prices and thereby have lower external borrowing needs. Countries such as Ecuador, Azerbaijan, Nigeria and the states of the Gulf Cooperation Council (GCC) are among the biggest beneficiaries of higher oil prices on the external debt side.

Within EM local debt, we are more cautious and prefer rates to FX. We remain positive on the prospects of pension reform in Brazil. Elsewhere, we are less constructive on Indonesian credit, rates and FX following President Jokowi's decisive victory as we now see most of the good news to be priced in. We remain cautious on low yielding currencies in Asia exposed to China growth.

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