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Argentina Economics and Strategy

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The new elephant in the room

- **The Peso debt problem is not going away**
- **FX stability hangs by a thread**
- **What is needed to muddle through in 1Q?**
- **Next ARS debt auctions and drought impact are key to watch**

Argentine Sovereign bonds have massively outperformed Provincial notes and most of its EM peers since the outset of December (Table 1). True, other distressed credits (i.e. Ecuador and El Salvador) have also profited from the recovery in global risk appetite. Under this light, the rebound in Argentine bond valuations seems more related to a broader re-pricing of risk that is unwinding the excessive punishment undergone by the riskier names during the sell-off. While we hold a NEUTRAL and OW positions on Argentina Sovereign in our baseline and aggressive model portfolios (see 2023 Year Ahead Outlook: "Lingering challenges" 16 December 2022), we see substantial downside risks and potential volatility in the near term. Skyrocketing ARS-denominated Treasury and central bank debt has become the new elephant in the room. The build-up of local currency short-term liabilities is a serious threat to financial stability and to international reserves that could undermine the country's capacity to repay its external debt. The music could stop if domestic investors decide not to continue taking on government debt, a scenario that does not seem materially distant despite expectations of regime change after the October presidential election. We think that, as with Ecuador and El Salvador, the valuation of Argentine global bonds had probably dipped below reasonable estimates of recovery values. We calculate recovery for Argentine EXD bonds at 35 cents on the dollar, so some upside would be left considering current levels of 31 cents. Nevertheless, the Peso debt problem could become a catalyst for renewed pessimism.

Table 1. Total return of Sovereign and Provincial bonds vs benchmark

	07-Dec to 11-Jan
ARG 2035 USD	**19.2%**
ARG 2046 USD	**18.9%**
ARG 2030 USD	**17.3%**
Sovereign	**17.1%**
ARG 2038 USD	**16.0%**
ARG 2029 PDI USD	**15.7%**
ARG 2041 USD	**14.8%**
PBA	12.6%
Neuquén	8.8%
Entre Ríos	7.5%
Salta	6.4%
Mendoza	6.3%
Santa Fe	5.2%
Córdoba	5.2%
Tierra del Fuego	4.9%
Chubut	4.1%
Jujuy	3.9%
BA City	3.7%
La Rioja	3.3%
Chaco	2.7%
Río Negro	2.0%
JPM USD EM Sov. Bond ETF	**-0.2%**

Source: BancTrust & Co. based on Bloomberg.

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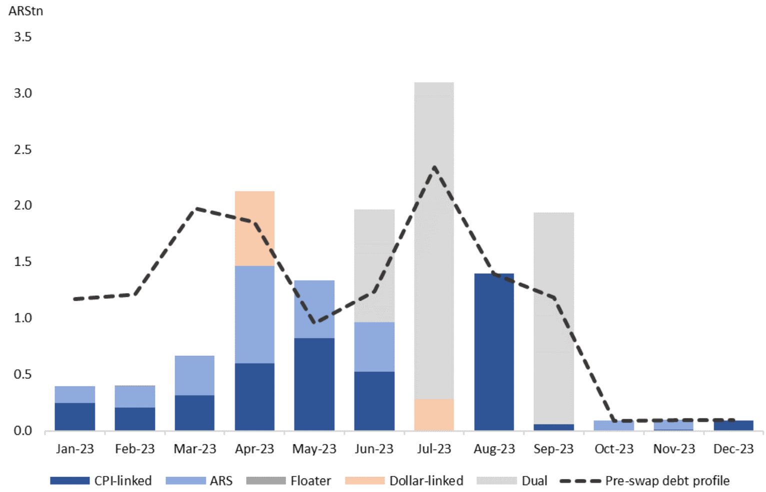
The Peso debt problem is not going away. On 3 January the Treasury swapped 67% of its ARS4.3tn debt due in 1Q23. However, this apparent success hides some major weaknesses. Predictably, public sector agencies exchanged 100% of their holdings, including the central bank (BCRA). In the last months of 2022, BCRA had resumed heavy purchasing of Treasury securities in the secondary market, to compensate for the growing fatigue in the private sector's demand for Treasury debt. Private sector participation in the January swap stood below 50%, with tenders mostly stemming from creditors subject to state regulation (i.e. commercial banks). The residual size of ARS maturities in 1Q dropped to ARS1.5tn (1.3% of GDP), which nevertheless remains large enough to potentially trigger a new bout of FX pressures with modest roll-over. Beyond 1Q, the LMO did not involve a meaningful extension of maturities either. The post-swap ARS debt profile shows a steep increase in June, July and September 2023 (see Chart 1). Therefore, we estimate the updated ARS debt servicing schedule in 2Q and 3Q at ARS5.4bn (4.6% of GDP) and ARS6.4tn (5.5% of GDP), respectively. Appetite for ARS debt can certainly take a dive in 3Q in tandem with the build-up of electoral tensions. The mounting roll-over risks have also been recently flagged by S&P, describing the exchange as a distressed transaction and noting "pronounced macroeconomic vulnerabilities and very limited ability to extend maturity and place paper in the local market".

Chart 1. 2023 ARS debt profile post 3 January exchange



Source: BancTrust & Co. based on Economics Ministry and BCRA.

FX stability hangs by a thread insofar as the government does not anchor demand for ARS-denominated assets, which is being eroded by inconsistent macroeconomic policies. The official multilateral real exchange rate is currently trading close to April 2018 (Chart 2), before the ARS selloff that motivated the bailout request to the IMF. In addition, amidst rumours of government intervention, the Blue Chip Swap (BCS) rate seems also below fair value considering its close correlation with broad monetary aggregates (Chart 3). In spite of this, the authorities have been blatantly clear in that they will strive to uphold the current policy framework in the run-up to the August primaries and November presidential elections. In our view, **the necessary (but unpopular) remedial measures, such as a realignment of the official USD-ARS, can be delayed to the extent that the following five conditions are met**, namely: i) the Treasury can rollover its debt; ii) depositors do not run against banks; iii) new hard currency loans become available; iv) inflation keeps slowing down and v) fiscal profligacy is off the table. These conditions are closely intertwined and feed each other, working as in a series circuit. We assign a large probability to at least one of the components in the circuit failing before August, which is why our current base scenario foresees a c20% real depreciation of the official exchange rate in 2023 (see Lingering challenges).

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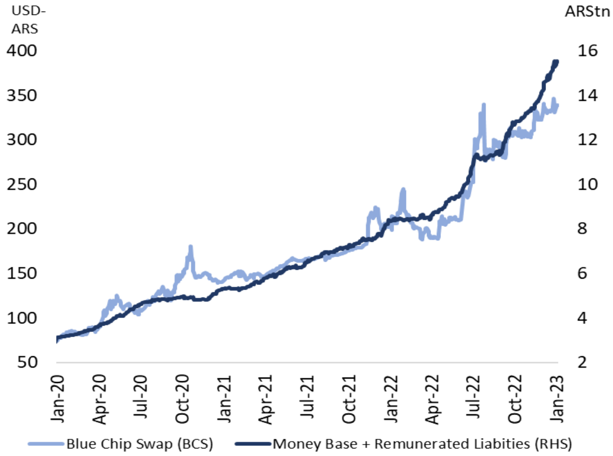
Chart 2. Official multilateral exchange rate

Source: BancTrust & Co. based on Argentina's Central Bank (BCRA).

Chart 3. Blue Chip Swap (BCS) vs Monetary aggregates



Source: BancTrust & Co. based on Bloomberg and Argentina's Central Bank (BCRA).

Table 2. The 1Q monetary puzzle

		Base money (ARStn)
1	**Dec-22 (obs.)**	**4,782**
2	**BM Drivers**	**2,518**
	BCRA's bond purchases	145
	Interest on RLs	1,932
	Primary deficit financing	441
	FX interventions	0
3	**Change in RLs**	1,660
4	**Mar-23 (4 = 1 + 2 - 3)**	**5,640**
	Memo items:	
	Nominal % chg.	*17.9%*
	1Q exp. inflation	*16.0%*
	Real % chg.	*1.7%*

Source: BancTrust & Co. based on Argentina's Central Bank and INDEC.

What is needed to muddle through in 1Q? We look to inflation having moderated further in December as a result of an unexpected monetary squeeze by end-22, the impact of price controls and a slower pace of USD-ARS appreciation. We forecast inflation in 1Q at around 5%m-o-m, down from an average of 6.8% in 3Q 2022 (Chart 4). The end-22 monetary squeeze coupled with the reinstatement of the differential FX scheme for soybeans exporters gave another huge fillip to BCRA's short-term debt or remunerated liabilities (RL) that in December surged 6.6% in real terms. The impressive growth of RLs has been one of the main drivers behind the marked increase of ARS deposits in the last few months. However, RLs are already doubling the monetary base, getting very close to the peak of the hyperinflation period (Chart 5). The latter implies that RLs are approaching a level that could be dangerous to financial stability, so in 1Q we see them rising in tandem with inflation, at most. Based on this, and our calculation of base money demand, we conclude that BCRA has little leeway to engineer a monetary expansion to purchase either Treasury debt or dollars from the market. As shown in Table 1, financing the primary deficit (ARS441bn) and interest on RLs (ARS1,932bn) will use up almost all the available space as regards to money-printing. According to our figures, **the Treasury will need to rollover at least 90% of its 1Q ARS maturities**, the rest being bought by the central bank in the secondary market (ARS145bn). In addition, we estimate that **authorities would need to secure at least USD1.6bn in fresh external funding** to comply with the net international reserves (NIR) accumulation target agreed with IMF for 1Q (USD5.5bn relative to the value taken

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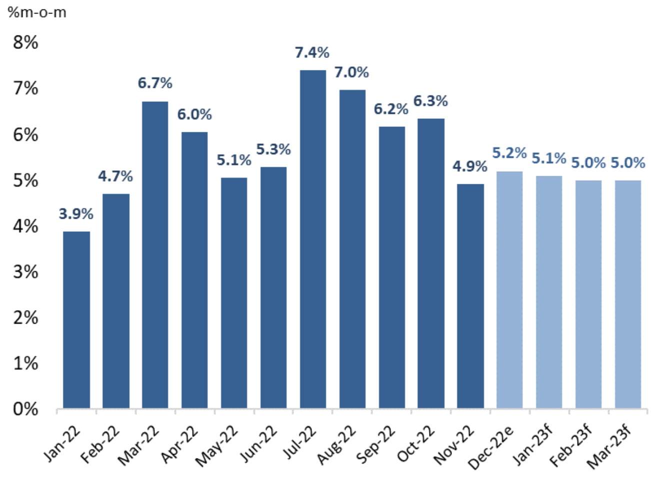
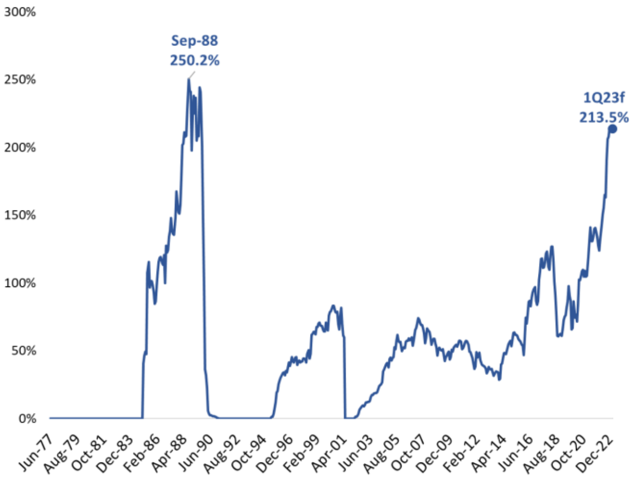
on by NIRs when the programme kicked off). This would compensate the settlement of USD1bn in Eurobond coupons in January and other payments to multilateral institutions. The final box that needs to be ticked is that of fiscal prudence. We have assumed a primary deficit in line with IMF targets and that the electoral fiscal push would start later in the year.

Chart 4. Monthly inflation



Source: BancTrust & Co. based on INDEC and own estimates.

Chart 5. Remunerated liabilities as % of money base



Source: BancTrust & Co. based on Argentina's Central Bank.

Next ARS debt auctions will be key… We think the government has a reasonable chance of securing a roll-over ratio of at least 90% in 1Q provided they showcase the dollars in the reserves. The transitory slowdown of inflation would also help to support short-term FX stability. In this vein, we could see appetite for fixed rate notes vs CPI linkers, to profit from what could possibly be the last episode in the ongoing carry trade season. On 18 January, the Treasury will conduct the first ARS debt auction of the year seeking to refinance cARS300bn of debt due two days later, most of which is in private hands. The outcome of this and the 27 January auctions will be key to assess whether the Treasury will be able to meet the rollover rate threshold. On the bright side, fiscal needs are usually low in January, so initially authorities will only need to raise funds to cover debt servicing. Hence, inasmuch as rollover rates approach 90%, the latter will provide some room to limit direct monetary financing in the first month of the year.

… As well as the final impact of the drought. Besides market financing, the government will also need some luck to navigate this challenging 1Q. On 30 December 2022, the Rosario Grain Exchange (BCR) estimated that dollar settlements from agricultural exports will fall by USD10.7bn to USD33.3bn in 2023 mainly on the back of the current drought. Although higher relative to the 2015-20 period (Chart 6), 1Q agricultural dollar sales would be the lowest in the last 5 years excluding 2020, due to the frontloading of exports triggered by the FX benefit for soybean exporters last December. A deepening of the dry season in the coming weeks could fuel expectations of a larger dollar gap, prompting a readjustment of the parallel FX. Against this backdrop, news of additional external lending will be critical to bolster FX stability and mitigate any setback triggered by the worsening of weather conditions. On 8 January, BCRA Governor Miguel Pesce announced that CNY35bn (cUSD5bn) of the Chinese currency swap could be used to settle bilateral trade invoices with China, although we think that this would fall short of significantly easing the external constraint. On the one hand, if the previous forecasts materialise, the China loan would account for less than half the foregone hard currency inflows. On a further and important note, with a maturity of less than a year, tapping this credit line will imply increasing short-term liabilities. NIRs are defined as gross international reserves minus short-term BCRA liabilities, so borrowing from the swap to meet FX

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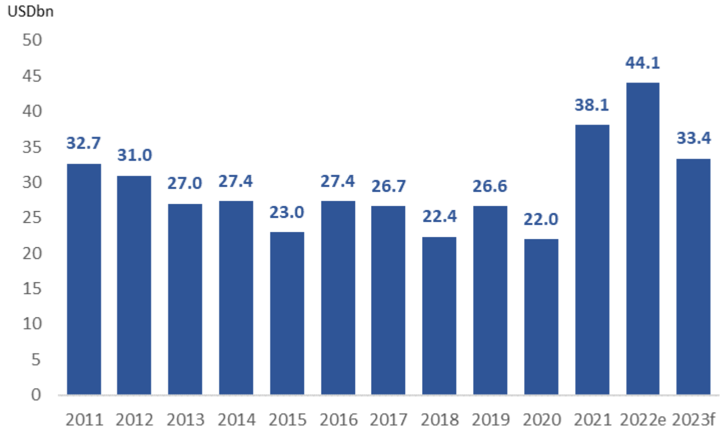
payments would mean missing the NIR target agreed with the IMF. Such negative headlines could stimulate dollar demand and magnify pressures in the parallel FX markets. Consequently, unless authorities can negotiate increasing the maturity of the loan to exceed one year, costs of activating the swap could exceed benefits.

Chart 6. Dollar settlements from agricultural exports



Source: BancTrust & Co. based on Rosario Grain Exchange (BCR).

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