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Argentina Fixed Income Strategy

3 March 2023

Provincial fundamentals take the front seat

- **FX protection loses value …**
- **… With fiscal fundamentals back on the front burner**
- **BA City, Chaco, Entre Ríos and Salta are our new top picks**
- **Playing the "electoral trade" with PBA bonds could disappoint**

Relative spreads of the FX-Hedged subset of provinces vs the EMBIG narrowed compared to the non-FX-Hedged group since our last recommendation[1]. However, the incremental value of the FX protection now seems visibly weaker. In our view, the FX hedge is now fully priced in. Not only FX protection would no longer deliver excess returns, but it could have also led to somewhat rich valuations. In this context, we now focus on those credits with supportive fundamentals, whose solvency would not wane in the event of material depreciation of the Peso. Resilience to a weaker currency could now take the front seat in terms of investors' preferences, in our view. While most provinces portray healthy fiscal metrics, **we find BA City, Chaco, Entre Ríos and Salta as the most attractive from the point of view of risk-reward.** Finally, **we do not like Province of Buenos Aires (PBA)** bonds due to the high probability of Kirchnerism retaining power in this jurisdiction.

Chart 1. Sovereign, Provincial, FX Hedged and Non-FX Hedged relative spreads (vs. EMBIG)

Source: BancTrust & Co. based on Bloomberg.

Spread compression of FX-hedged provincial bonds loses steam. Since the publication of Argentina Fixed Income Strategy: "FX Hedge remains the defining trait of provincial returns", 29 September 2022, relative spreads of those provinces featuring an implicit FX protection declined by 346bps compared to 316bps of the non-FX-Hedged sample. Importantly, the value of the hedge seems to have taken a dive in the last few weeks, judging by the fact that this 30bps difference had peaked at 250bps on 23 January (Chart 1). Given their higher YTM and MD, a weighted total return measure of the non-FX-Hedged bonds beat the notes with FX protection by 5.6ppt. Our top

[1] We split provinces into two subsets based on their holdings of Eurodollar deposits and the guarantee on their bonds. The "FX Hedged" group comprised BA City, Chubut, Mendoza, Neuquén and Tierra del Fuego. The "Non-FX hedged" consisted of Buenos Aires, Córdoba, Santa Fe, Entre Ríos, Salta, Chaco, La Rioja, Jujuy and Río Negro. (see Argentina Fixed Income Strategy: "FX outlook splits the waters of Provincial credits" 16 May).

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picks also delivered a moderate excess performance thanks to the inclusion of La Rioja and Salta (Table 1), although they were undoubtedly dragged by the FX-Hedged. Noteworthy, the large outstanding amount of PBA bonds heavily swayed the weighted average, so disparities are less pronounced when considering the simple average. In any case, we think that FX protection mitigated risks at the same time it offered handsome returns. Nevertheless, this trade is clearly showing signs of exhaustion, probably because the hedge was too expensive as several of these credits seem well-equipped to weather the negative fallout of a cheaper ARS.

Table 1. Total return of Provincial credits and benchmarks since 29 September 2022

	Total Return 29-Sep-22 to 01-Mar-23
Mendoza	27.7%
Jujuy	26.6%
La Rioja	25.0%
Entre Ríos	24.8%
PBA	24.1%
Salta	23.4%
Córdoba	21.5%
Chaco	21.2%
Neuquén	20.3%
Chubut	18.6%
Santa Fe	17.2%
Tierra del Fuego	13.2%
BA City	9.0%
Río Negro	9.0%

Weighted Average	
FX-Hedged Weighted Avg.	16.9%
Non Fx-Hedged Weighted Avg.	22.5%
Top Picks Weighted Avg.	17.2%
Provincial Weighted Avg.	20.8%

Simple Average	
FX-Hedged Simple Avg.	17.8%
Non Fx-Hedged Simple Avg.	21.4%
Top Picks Simple Avg.	19.7%
Provincial Simple Avg.	20.1%

JPM USD EM Sov. Bond ETF	8.9%

Source: BancTrust & Co. based on Bloomberg and own calculations.

FX protection is priced in and could have led to somewhat rich valuations. We note that the federal government would gain nothing by restricting provincial access to the official USD-ARS. A provincial default would be a negative headline that could deteriorate expectations and fuel private agents' dollar demand. This is exactly what the authorities would seek to avoid in an elections year. Also, FX-denominated debt servicing for the provinces in the remainder of 2023 amounts to USD1.3bn (0.2% of GDP).

We now focus on those credits with good solvency indicators, capable of absorbing the costs of the higher debt services arising from a weaker currency. Given that we are expecting a c20% real devaluation of the official USD-ARS in 2023 (see 2023 Year Ahead Outlook: "Lingering challenges", 16 December 2022), we aim to capitalise on potential spread compression of those credits that in spite of modest FX savings have outstanding fiscal metrics. The regime change story would also bode positively for these names given the prevailing expectations of an opposition victory in the 2023 elections.

We update our estimates from the previous report (see FX Hedge remains the defining trait of provincial returns), when we had assessed the FX exposure of each province under the 20% real depreciation scenario. We include 2024 in our calculations and conduct a stress test by which the gap between the official and parallel USD-ARS is eliminated by end-2023 (consistent with and 85% real devaluation).

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Table 2. Fiscal metrics under different FX scenarios

	Baseline		Stress-Test		LTM (3Q22)			
Province	FX Mkt. Debt Service as % of Revenue*	Debt / Revenue (2023)	FX Mkt. Debt Service as % of Revenue*	Debt / Revenue (2023)	Primary Balance / Revenue	Debt / Revenue	10Y Primary Balance / Revenue	SoT**
BA City	0.8%	39.2%	1.0%	58.6%	17.8%	37.3%	-1.5%	550
Santa Fe	1.2%	13.9%	1.3%	20.9%	1.5%	12.8%	-1.6%	685
Chaco	1.4%	22.8%	2.1%	33.4%	3.3%	24.1%	-0.7%	2435
PBA	1.7%	56.6%	2.5%	86.6%	1.9%	47.3%	-0.5%	2252
Entre Ríos	2.5%	33.1%	3.5%	50.0%	7.0%	30.1%	-1.7%	1372
Tierra del Fuego	2.8%	20.2%	3.6%	30.4%	1.1%	19.0%	-3.7%	611
Neuquén	3.1%	41.5%	4.2%	63.0%	2.7%	36.3%	-3.1%	980
Salta	3.1%	27.2%	4.0%	40.4%	8.0%	26.4%	1.3%	1252
Río Negro	3.5%	38.9%	5.0%	57.5%	2.9%	38.9%	-3.2%	2286
Mendoza	3.6%	35.7%	4.5%	52.0%	12.5%	38.2%	0.0%	811
La Rioja	3.7%	34.8%	5.4%	52.8%	4.2%	30.6%	0.0%	2615
Jujuy	4.2%	71.4%	5.2%	107.3%	13.0%	66.2%	-7.6%	1762
Córdoba	4.5%	48.3%	5.7%	74.2%	11.8%	39.6%	2.8%	1159
Chubut	5.7%	59.6%	7.6%	89.4%	7.6%	55.7%	-4.4%	779
14 Provinces Simple Avg.	3.0%	38.8%	4.0%	58.3%	6.8%	35.9%	-1.7%	

*Average of 2023-2024, excluding YTD payments

** Excludes Santa Fe 23s and Neuquén royalties-backed bond

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

As a result, **we have rebalanced our top-picks list** to capture the impact on valuations of a superior fiscal track record.

We start analysing the traditionally stronger credits comprised of **BA City**, **Santa Fe** and **Tierra del Fuego**. We now drop Tierra del Fuego from our top picks list due to the elevated cost of FX protection, but **we stick to BA City** due to its healthy fiscal position and decent liquidity. Within this "lower-beta" group, investors with a higher tolerance for risk might wish to consider **Santa Fe 27s**, as we look to a narrowing spread difference vis à vis these other two names as fiscal fundamentals start to weigh more in investors' preferences.

Chubut, Neuquén and Mendoza also seem to be trading rich due to their expensive FX hedge. In the past, despite relying on FX protection, we have dismissed Chubut for its subpar fiscal figures. On the other hand, while we had previously favoured Mendoza, we think it is now trading expensive relative to peers with similar fiscal metrics. As for **Neuquén**, its non-royalty-backed bond also appears to have priced in the strong linkage of this province's revenue base to the FX due to oil and gas output.

We continue to like **Salta** and we add **Entre Ríos** to our top picks. We have always praised Salta for its fiscal strengths, even when we were assigning more value to the FX hedge. The case for Salta is currently more compelling given that the FX hedge is less of a positive, while fundamentals are broadly in line with those of Mendoza and Neuquén. We prefer Salta to Entre Ríos due to the latter's high structural deficit in pensions, which could become a drag on fiscal accounts if inflation cools. Nevertheless, fiscal dynamics in the short term should remain supportive for Entre Ríos that could also leverage in the regime change story, with polls pointing to a defeat of Peronism in the gubernatorial elections.

Córdoba's bonds seem fairly priced. Despite showing an above-average fiscal track record, the province is exposed to real FX depreciation risks in the short term. Also, its spread differential with Salta and Entre Ríos appears to be aligned with the historical evidence.

Finally, we look into the group of provincial issuers featuring lower liquidity and higher spreads, namely **Chaco, La**

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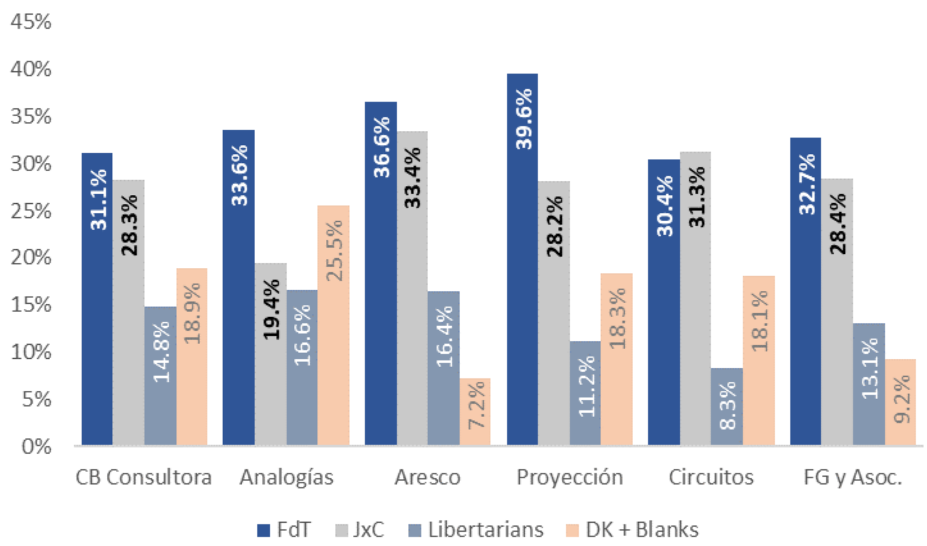
Rioja, Jujuy and Río Negro. Jujuy's bonds have outperformed in recent months, which in our view could be related to the lithium story. However, Jujuy shows one of the most worrying medium-term fiscal metrics of all provinces. We also flag similar fundamental weaknesses in Rio Negro. In this vein, we exclude both provinces from our top picks. On the other hand, La Rioja is still lagging in terms of spread compression relative to Chaco and the Sovereign, with yields notoriously exceeding the traditional difference versus these two. This being said, we now lean towards Chaco given that it is much more resilient to devaluation of the currency relative to La Rioja, so we think that the spread difference could be warranted. As a caveat, these four credits are highly illiquid, which could be detrimental to our recommendations.

Province of Buenos Aires portrays decent fiscal accounts, while BUENOS 27A at first sight seems well-positioned to profit from the electoral trade, given its higher liquidity, larger discount to par value, and longer duration relative to most of the other notes in the provincial space. Moreover, PBA also relies on substantial Eurodollar deposits to account for this year's FX debt payments while its FX market debt service in terms of revenues is below average. Despite these advantages compared to its peers, we highlight major sources of risk that make us wary of gaining exposure.

Investors should hold back from playing the "electoral trade" with PBA bonds. The main risk is that Kirchnerism remains competitive enough to attain a victory in this year's gubernatorial elections. This is mostly a result of the absence of a run-off in the province. Thus, on the back of the fragmentation of the opposition, Axel Kicillof has a real chance of winning a second four-year term as governor of the province next October (see Chart 2).

Chart 2. Latest polls on PBA 2023 elections



BancTrust & Co. based on several media outlets.

A scenario in which the national election is won by *Juntos por el Cambio* (JxC) and the PBA is retained by *Frente de Todos* (FdT) could affect PBA's creditworthiness. Under this scenario, Kirchnerism would take the province as its stronghold, which would likely result in policy slippage. In this vein, the potential JxC-led national government would have low incentives to financially support the province beyond legal mandates. Moreover, Kirchnerism could use PBA's sizeable resources in a bid to regain nationwide political influence.

As shown in Chart 3, the average spread over Treasury of PBA bonds has replicated the sovereign's (considering a simple average of spreads from all bonds for a more accurate comparison in terms of modified duration) but with

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lower volatility. In our view, this correlation could come to an end as we get closer to the elections on the back of the Kirchnerist threat in PBA. In this vein, the differential could revert and PBA might start trading lower versus the sovereign.

Chart 3. PBA and Sovereign bonds spreads

BancTrust & Co. based on Bloomberg.

Therefore, we would not choose PBA as a credit to capture an electoral rally as the aforementioned risks could affect its performance in the run-up to the ballot and could also lead to higher spreads in the longer run. To avoid this scenario, JxC would have to work on an ad-hoc coalition with libertarian candidates in PBA, something that still seems a distant possibility.

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