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Argentina's looming make-or-break election

By Angelo Katsoras

Introduction

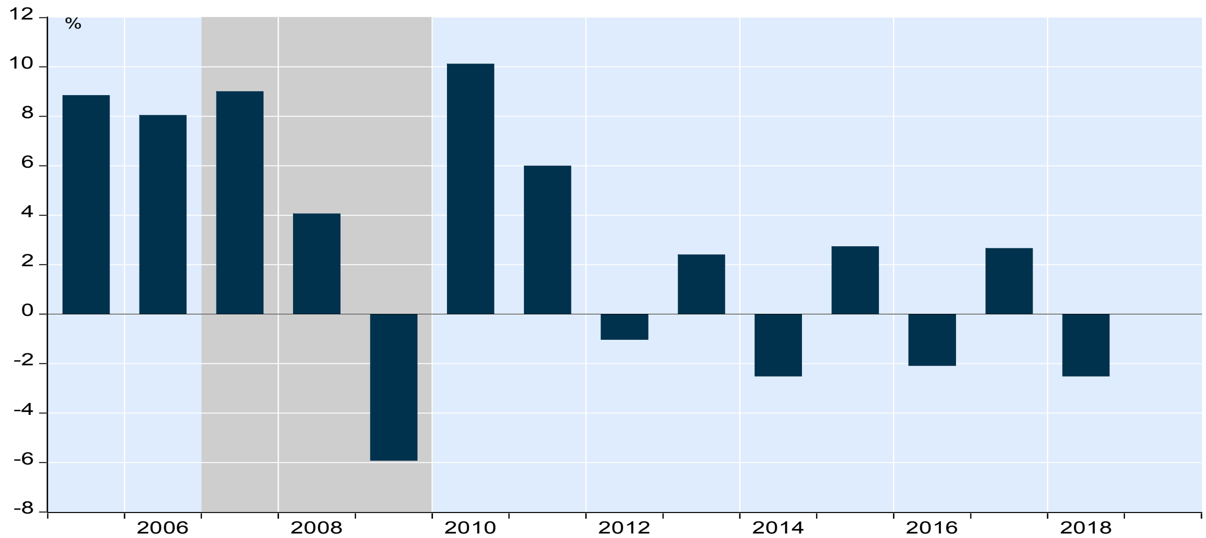
When President Mauricio Macri was elected in 2015 after eight years of far-left Cristina Fernandez de Kirchner at the helm of Argentina (from 2007 to 2015), hopes were high that the country would finally break its seemingly never-ending economic boom and bust cycle. Today, Argentina finds itself instead in the midst of its fifth recession in 15 years. The upcoming two-round elections (October 27 and November 24) have raised fears of even further economic turbulence.

Argentina's dashed economic hopes

Soon after Macri came to power, investors were encouraged by his rapid moves to reform the economy. These included ending most currency/price controls, implementing austerity measures, and negotiating a legal settlement with creditors over Argentina's 2001 debt default. This enthusiasm translated into $9.75 billion in orders for a $2.75-billion 100-year bond offering in U.S. dollars. The economy also finally appeared to be heading in the right direction, expanding nearly 3% in 2017.

By 2018, however, deficit spending, rising inflation and a slowing economy rekindled investor concerns. The fact that the hoped for significant increase in exports failed to materialize owing in part to a drought that hurt agriculture production did not help matters. The economy slid back into recession in 2018 (-2.5% GDP growth) and is expected to shrink another 1.2% in 2019.[1]

Argentina seems unable to break its economic boom and bust cycle
GDP annual growth rate (Constant $)

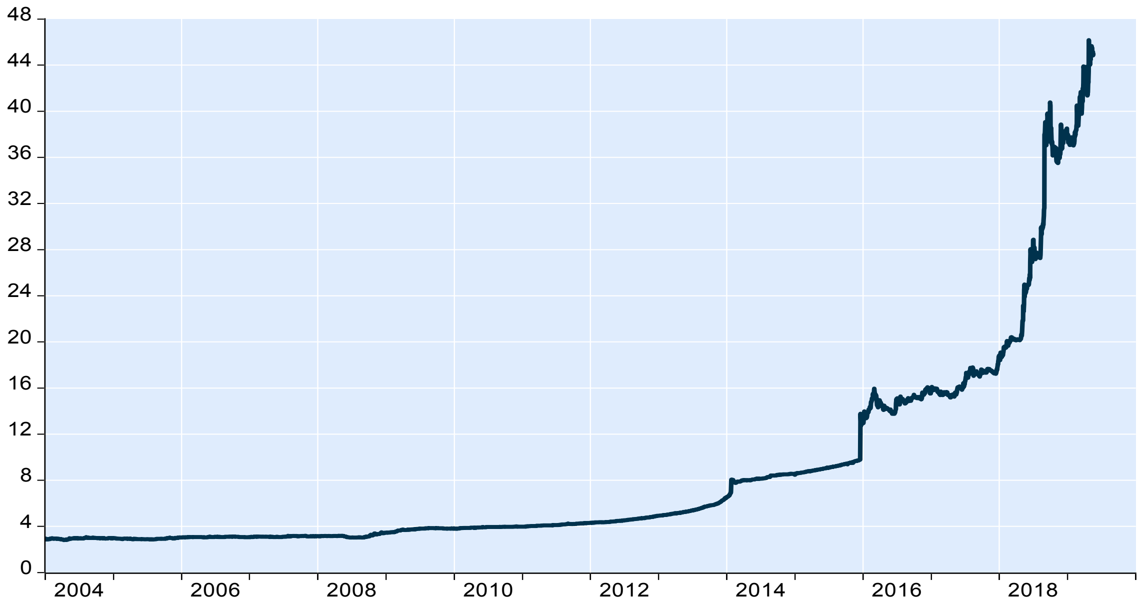


NBF Economics and Strategy (data via Refinitiv)

While the removal of various subsidies and currency controls were necessary to relieve pressure on public finances, the short-term impact has been to push year-over-year inflation to 54.7% in March, up from 25.4% a year earlier. The situation worsened when the United States raised interest rates in 2018 and money started flowing out of Argentina and other riskier emerging markets. In an effort to stabilize the country's plunging currency, Argentina's central bank raised its key interest rate from 45% last August to 72% today. Despite this, the peso, which lost over 50% of its value in 2018, has sunk another 20% so far this year.

[1] "Mauricio Macri freezes prices," The Economist, April 19, 2019

World: Sharp depreciation of Argentina's peso
Argentine peso per U.S. dollar



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High levels of external sovereign debt yet another looming risk

Argentina's public debt went from 58% of GDP in 2017 to 86% in 2018 (the equivalent of US$332 billion as of December 2018). More worrisome is the fact that the percentage of debt denominated in foreign currencies rose from 68% in 2017 to 78% in 2018. With only $72 billion in foreign reserves, there is little room for further policy errors.[2] The higher perceived risk means that two years after investors rushed to purchase dollar-denominated bonds maturing in 100 years, the bonds are now trading at about 67 cents on the dollar.

Starting in 2020, Argentina's foreign debt will enter a more challenging phase. About $26 billion in dollar-denominated debt in 2020 and 2021 will need to be renewed.[3]

Government trying to cushion economic blow with various measures

- The government negotiated a $56.3-billion bailout package from the IMF last October. The deal requires Argentina to make deeper spending cuts and increase taxes.
- Despite campaigning against price controls, Macri recently imposed them on 60 mostly food items until October, the eve of the election.
- The central bank announced that it would intervene more actively on the currency market to defend the peso. It also has permission to use IMF loans to support the peso.

The jury is still out on whether these measures are enough to stem the economic bleeding.

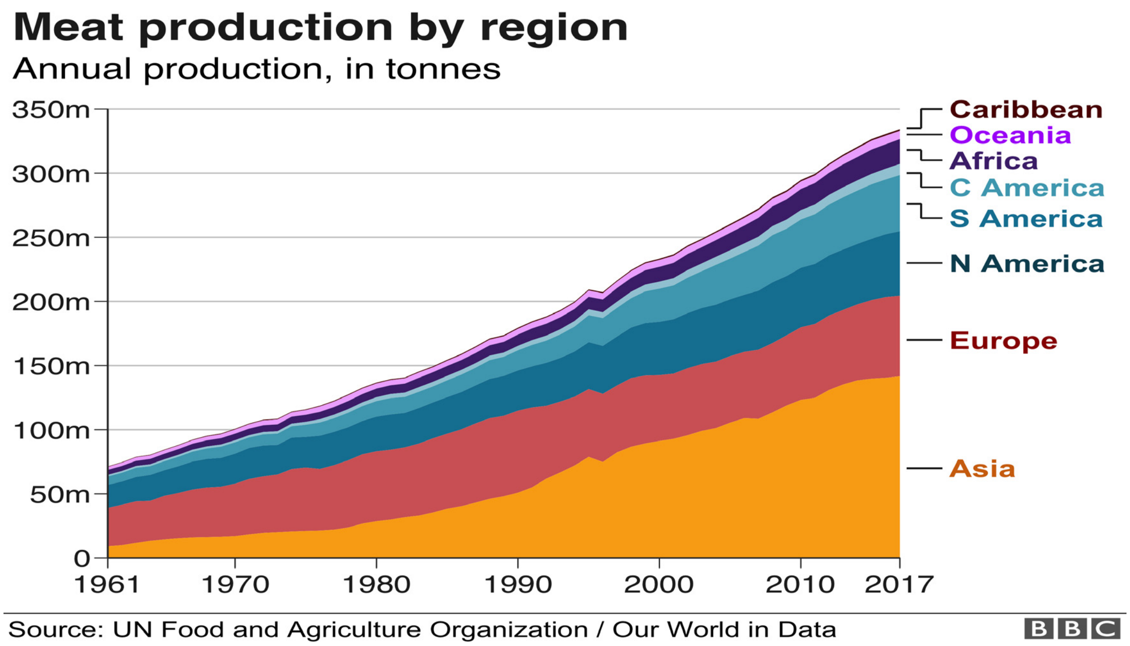
As goes agriculture, so goes Argentina

Argentina is counting on its agriculture sector—which accounts for just over half of its exports—to help pull the country out of the recession. Argentina is one of the world's major exporters of soybeans, corn, wheat, and meat. Its agricultural production is expected to rebound strongly this year after the 2018 crop was battered by drought. The government estimates its soy harvest at 55.9 million tonnes this season, up from a drought-reduced 37.78 million tonnes the year before.[4]

[2] IMF, April 2019
[3] "In the Upcoming Presidential Election, Argentina's Business Environment Is on the Line," Stratfor, May 10, 2019
[4] "Argentina touts its soymeal in China, seeking import approval," Reuters, April 24, 2019

Long-term global food demand trends work in Argentina's favour

Increasing global demand for meat and eggs requires more and more corn and soybeans to feed growing numbers of cows, chicken and pigs. Global meat production has increased nearly fivefold from 70 million metric tons in the early 1960s to 330 million metric tons in 2017, while the global population only slightly more than doubled over this period.[5] Typically, the richer a country is, the more meat its citizens consume.

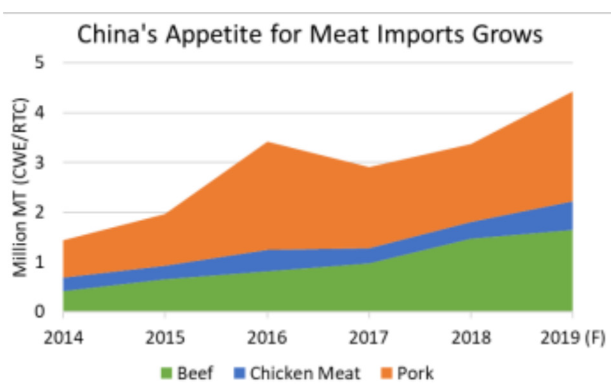


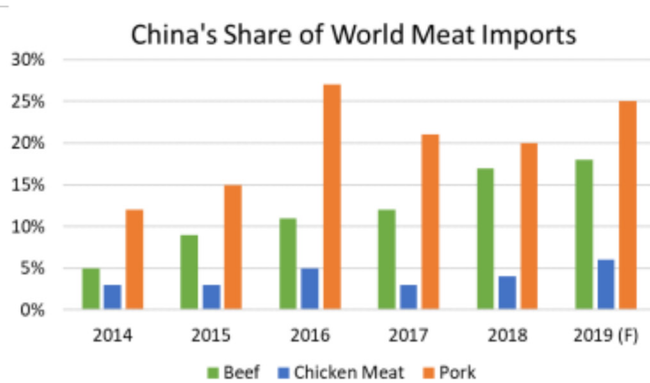
Source: "Which countries eat the most meat?" BBC, February 4, 2019

China's pigs hit by African swine fever: Does this spell opportunity for Argentina's agriculturep sector?

A deadly swine disease has infected pigs in China and elsewhere in Asia. The United States Department of Agriculture (USDA) estimates that hog production in China alone will decline by 134 million heads this year, which is equal to the entire annual U.S. output of pigs. This will force China to import more pork and other types of meat. **The USDA estimates that China will import 41% more pork, 70% more chicken, and 15% more beef in 2019.**[6]

While livestock feed prices (i.e., soybeans) have fallen significantly due to reduced demand from China, demand for feed will transfer from China to major meat-exporting countries over the longer term. A shift in consumption in China and other Asian countries away from pork to beef would eventually further increase demand for livestock feed. Beef production requires about three times as much animal feed as pork production does.[7]





Source: "Livestock and Poultry: World Markets and Trade," USDA, April 9, 2019

[5] "Which countries eat the most meat ?," BBC, Feb 4, 2019
[6] "Livestock and Poultry: World Markets and Trade," USDA, April 9, 2019
[7] "Global meat-eating is on the rise, bringing surprising benefits," The Economist, May 2, 2019

Argentina is the world's fifth largest exporter of beef and ninth largest exporter of chicken[8] and has recently signed a deal allowing it to begin exporting pork to China. This will add to China's already growing demand for meat imports from Argentina. From January to July 2018, China doubled its purchases of Argentine beef to 96,500 metric tons.[9] Farm products accounted for 86% of Argentina's $3.48 billion in exports to China in 2018.[10] Meanwhile, U.S. pork currently faces tariffs of 62% in China, which includes 50% punitive tariffs owing to trade disputes between the two countries.[11]

Argentina's promising shale oil sector

Argentina is home to the world's second largest shale gas reserves and fourth largest deposits of shale oil. Unfortunately, more than a decade of costly state intervention has hobbled this sector.

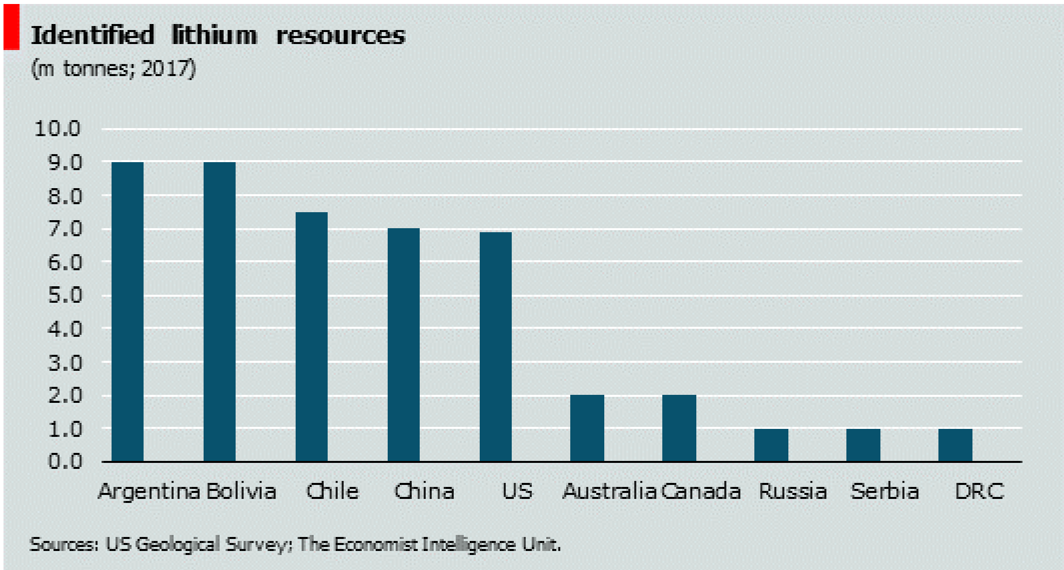
But there are indications of a turnaround. The government estimates that oil production has the potential to increase from 250,000 barrels per day presently to over a million by 2024.[12] However, many private-sector analysts consider this target overambitious.

Argentina's state-controlled oil company, YPF, has promised to invest $1.5 billion in shale oil production this year. Exxon Mobil Corp., for its part, plans to spend $800 million annually over the next few years.

Argentina: the potential Saudi Arabia of lithium

Argentina is tied with Bolivia for the world's largest proven lithium reserves. In terms of production, however, Australia is number one, followed by Chile and then Argentina.[13] Demand for lithium is expected to soar from 300,000 tons per year in 2018 to 850,000 tons in 2025, according to estimates from Bloomberg NEF.

The Economist Intelligence Unit estimates that Argentina is in the early stages of a lithium boom. Two mines are currently in production and more than 60 projects are in development.



Source: "Argentina's lithium boom," The Economist Intelligence Unit, November 2018

[8] "Livestock and Poultry: World Markets and Trade," USDA, April 9, 2019
[9] "ARGENTINA 2018 BEEF EXPORTS TO DOUBLE ON HIGH CHINESE DEMAND," Reuters, August 28, 2019
[10] "Argentina approved to export pork to China," Reuters, April 30, 2019
[11] "Argentina Approved to Export Pork to China; U.S. Pork Trade Suffers," Farm's Journal, April 30, 2019
[12] "Argentina sees steady growth in light crude exports from Vaca Muerta," S&P, April 2019
[13] "Argentina's lithium boom," The Economist Intelligence Unit, November 2018

Argentina's make-or-break elections

Not long ago, most investors believed that President Macri's reelection was virtually a sure thing. However, with six months to go until the election, his popularity has taken a tumble as the economy suffers the second recession of his presidency.

It was also widely believed up until recently that his main adversary for the presidency would be arch-rival and former President Cristina Fernandez de Kirchner (CFK). **A mid-April survey by local polling firm Isonomia showed CFK beating Macri 45% to 36% (with 20% undecided) in a hypothetical second-round run-off ballot. Other more recent polls show the two virtually tied.** Despite facing charges of corruption (being a senator protects her from conviction), CFK remains popular among lower-income voters who benefited from generous welfare spending during her time in office.

In a surprise move last Saturday, CFK announced that she would not be running for president. Instead, she will run for vice-president alongside Alberto Fernandez. He was the chief of staff for former President Nestor Kirchner, CFK's late husband, and served her in the same position for a few months in 2007. **She is hoping that running alongside someone perceived to be more moderate will improve her odds of victory. Many fear, however, she would be the real power behind the throne.**

While the economy has struggled under Macri, many investors worry it would deteriorate even further if the Fernandez-CFK ticket won the election. They also feel Argentina is still suffering the consequences of the interventionist policies CFK implemented while in power. These include price controls and forced nationalizations. Her eight years in power were also marked by four recessions.

Investment conclusion: President Macri in electoral race against time

Macri's chances of winning re-election hinge on his administration being able to stabilize the peso and bring down inflation at least a few months before the vote. If the Fernandez-CFK ticket is ahead of him in the polls by late August however (two-round elections scheduled for October 27 and November 24), his reform efforts risk being sapped by investors and Argentinians looking to pull their capital out of the country.

On the positive side, there are signs the recession has bottomed out:

- The combination of a cheaper currency and tight money policy has resulted in Argentina going from a trade deficit of $554 million in March 2017 to a trade surplus of $1.18 billion last March.[14]
- Agricultural production seems set to increase significantly from last year's drought-induced lows. Agricultural exports will benefit from a weak currency and growing demand for meat imports from China and other Asian countries. This in turn should increase the supply of U.S. dollars and ease downward pressure on the peso.

Investors should be asking two questions. First, will these factors allow the peso to recover in value and inflation to decline significantly? Second, if so, will this occur in time to tip the election in Macri's favour?

[14] "Argentina is on the brink," Financial Times, April 25, 2018

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