

BIENVILLE GLOBAL REVIEW

ARGENTINA: PART I A DECADE OF UNORTHODOX POLICIES UNRAVELING

January 2014





SUMMARY

After 30 years of economic volatility, including a decade of unorthodox policies under two Kirchner administrations, political change is coming in Argentina. In the interim, however, a crisis seems probable. Growth has stalled, inflation is spiraling higher, foreign currency reserves are falling rapidly, and both the official and parallel currency are collapsing. Although politically difficult, the adjustments necessary to resolve the imbalances in Argentina's economy are achievable. Given a new and more pragmatic administration, Argentina's medium-term outlook is positive, suggesting a generational opportunity to buy Argentine assets could soon be approaching.

- The 1980s in Argentina culminated in hyperinflation, followed by Economy Minister Domingo Cavallo's 'convertibility' plan in 1991, which fixed the Argentine peso to the U.S. dollar, reducing inflation from 1,300% to zero
- Along with President Carlos Menem, Cavallo privatized a number of industries and welcomed foreign investors. The economy boomed, and the Argentine stock market soared, rising by over 600% within 18 months
- Over the latter part of the 1990s, budget deficits were modest, but chronic. Foreign-denominated external debt also rose. Before long, the rigid currency regime proved suffocating, and Argentina's inability to service its foreign debt resulted in the country's seminal event over the past 20 years—default and devaluation at the end of 2001
- Default and devaluation resulted in the worst collapse in Argentina's history, wiping out virtually all of the growth achieved in the 1990s. By 2002, income per head was 25% below the level achieved in 1998
- The crisis changed the economic landscape overnight. The Argentine economy went from deflation to inflation, and the devalued peso ultimately resulted in a boost to exports
- The resulting distress from the increase in both unemployment and poverty tore the social fabric of Argentina and opened the door for an unknown Peronist candidate, Nestor Kirchner, to rise from obscurity to be elected President in 2003. Soybean prices soon after rose steadily, and Brazil—Argentina's largest trading partner—began growing strongly. Idled capacity from the depression allowed Argentina to grow without capital investment, at least for a while
- Despite this fortuitous backdrop, Nestor Kirchner supplemented export-led growth with a number of populist policies (e.g., regulation of prices, energy subsidies, direct transfers). And in 2007, he decided not to seek reelection, effectively turning the presidency over to his wife, Cristina Fernandez de Kirchner ("CFK"). Cristina followed Nestor by instituting a number of policies hostile to businesses and foreign investors, further catapulting Argentina to pariah status
- By 2007, Argentina's ability to grow in a noninflationary manner was exhausted. Rather than adjusting the economic model, CFK instead manipulated the inflation statistics. Negative real interest rates incentivized consumption over saving and investment while capital controls in 2011 restricted the free flow of dollars. Not surprisingly, a parallel exchange rate for dollars appeared



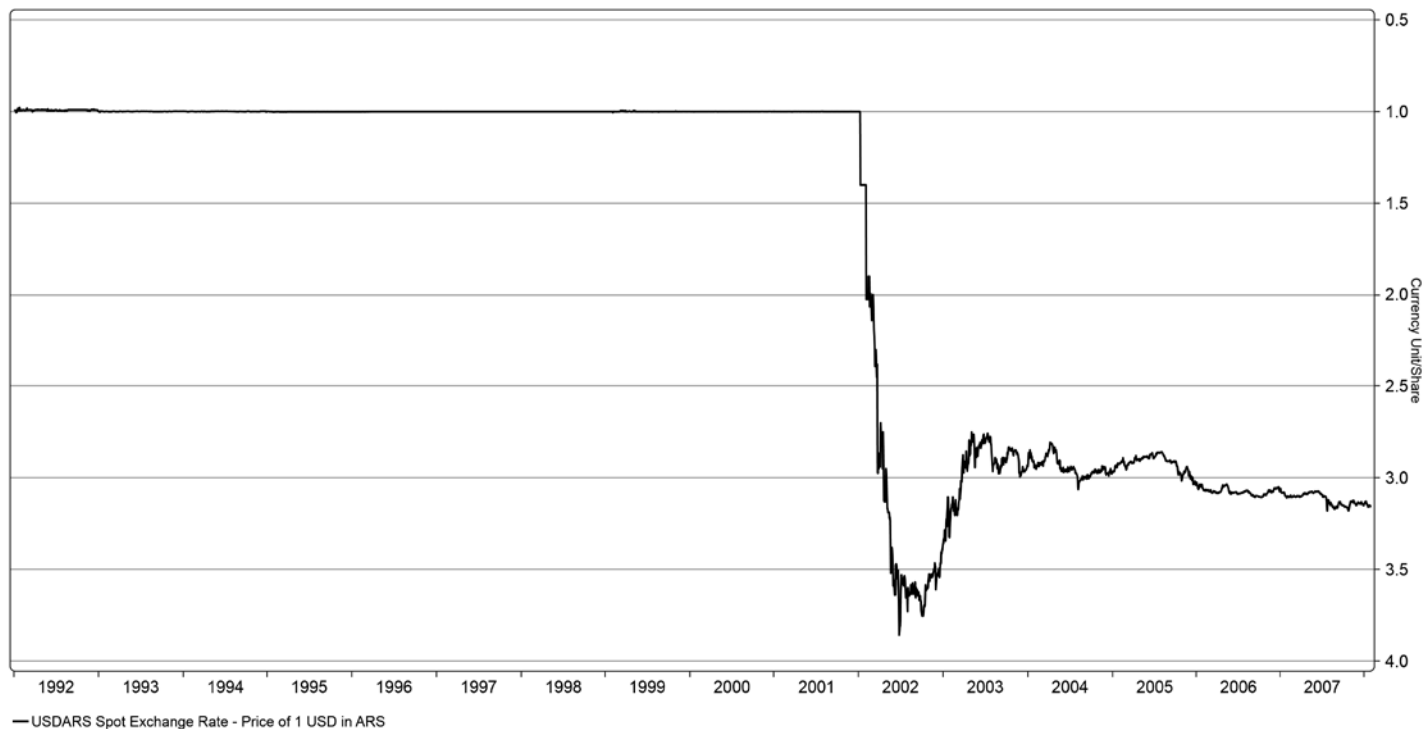
SUMMARY

- Today, growth has stalled, inflation is approaching 30%, real interest rates remain deeply negative, and foreign currency reserves—necessary to import energy and to finance Argentina’s external deficit—are dwindling. Both the official and parallel exchange rates are collapsing and are unlikely to stabilize given the central bank’s financing of government deficits
- Argentina’s primary issue today is its external account. Recently, measures have been taken to slow the decline in reserves, including an increase in taxes on tourism and additional restrictions on imports. These improvised measures will not resolve the structural imbalances leading to the loss in reserves
- With the hope of regaining borrowing capacity in international capital markets, the government recently took measures to improve relations with foreigners. It’s unlikely they will be able to attract enough capital to fund Argentina’s external deficit
- As the rate of inflation rises, real incomes and purchasing power are undermined, reducing consumption, which has been a key source of recent growth. Riots have broken out, resulting in concessions on wage increases that will only exacerbate the government’s fiscal deficit
- Additionally, regulated pricing of energy, which led to overconsumption and years of underinvestment, is resulting in blackouts during the hot summer months in Buenos Aires, infuriating the *Porteños*
- Not surprisingly, Cristina’s popularity has plummeted, resulting in an embarrassing defeat in this past fall’s legislative elections
- The postelection cabinet shake-up serves as an indirect recognition of the failure of the Kirchner model’s unorthodox policies. Since then, the ad hoc adjustments implemented since have been unsuccessful in putting the Argentine economy onto a sustainable path. A full-fledged FX and balance of payments crisis seems imminent
- Argentine equities rose strongly in the latter half of 2013, discounting the end of Kirchnerism. This optimism is understandable, however, it may be short lived given the near-term problems and absence of political will to produce a viable solution
- Despite years of economic mismanagement leading to today’s challenges, the prospects for a post-Kirchner Argentina are promising. The country boasts an educated workforce and the most fertile soil in the world. Recently, the Vaca Muerta was discovered in the Neuquén Province. Argentina now holds the world’s 3rd largest shale gas and 4th largest shale oil deposits
- And although today’s challenges are politically difficult, they are achievable under a more pragmatic administration with a cohesive plan to resolve Argentina’s imbalances
- As these events unfold, uncertainty will be high. Investors may be presented with a generational opportunity to buy Argentine assets

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

The seminal event in Argentina over the past twenty years was the 2001 default and devaluation. Over the 1990s, Argentina accumulated a significant amount of external debt. Unable to print their own currency, as foreign currency reserves dwindled, Argentina's fixed exchange rate proved untenable, leading to the largest sovereign default in history...

Argentine Peso per USD



Source: Macrobond

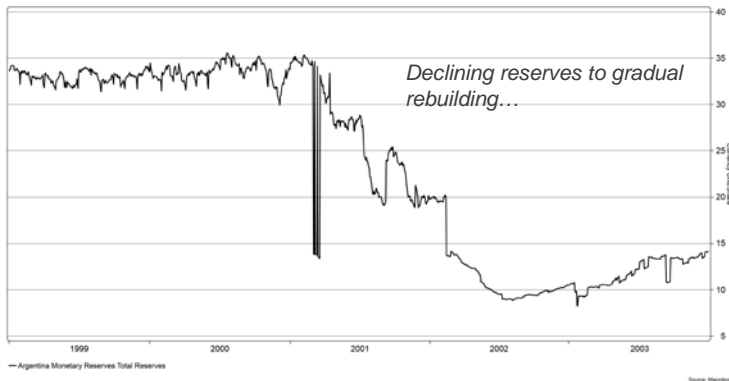
Under the 'convertibility plan' ushered in by Domingo Cavallo in 1991, the Argentine peso was pegged to the USD at a ratio of 1:1

Unlike today, at the time of devaluation, the Argentine economy was largely 'dollarized'—over 70% of deposits and nearly 80% of loans were in dollars. Devaluation was therefore both messy and highly destabilizing

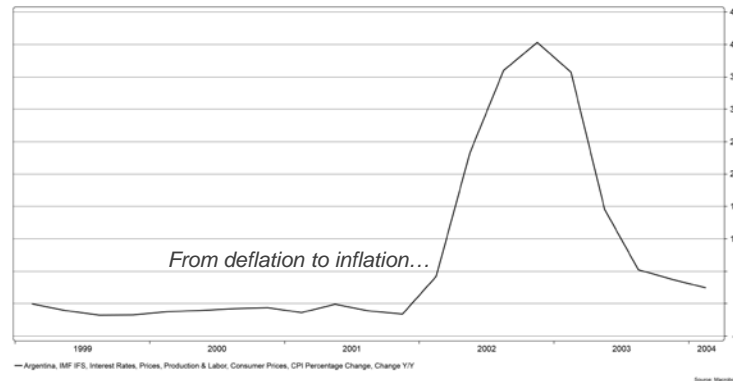
ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

Following default and devaluation, the country's economic picture changed overnight. Fiscal and current account deficits turned into surpluses—boosting international reserves—and the economy moved from deflation to high inflation...

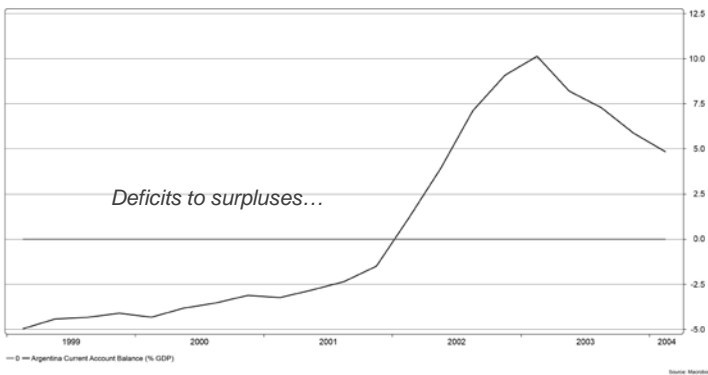
International Reserves



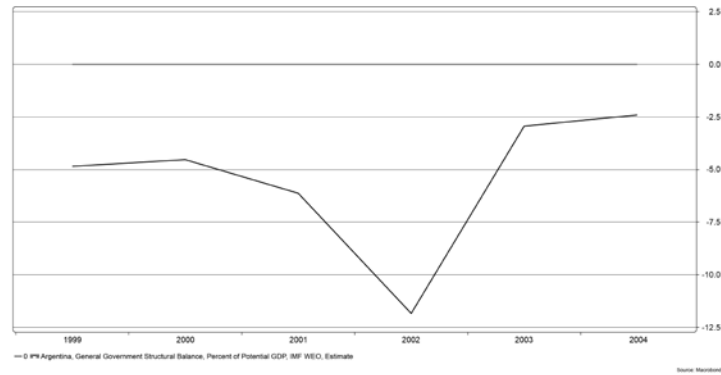
Inflation



Current Account



Structural Budget Deficit



ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

In 2003, Nestor Kirchner, a relatively unknown politician from Santa Cruz was elected President. In 2007, Nestor announced he would not seek reelection, effectively turning the Presidency over to his Peronist wife, Cristina Fernandez de Kirchner...

Nestor Kirchner

(President: May 2003 – Dec 2007; Died: Oct 2010)



Cristina Fernandez de Kirchner

(President: Dec 2007 – Current; Term Ending Dec 2015)



Once in power, Nestor blamed the IMF for Argentina's collapse, suggesting that they were the "promoter and vehicle of policies which provoked poverty and pain in the Argentine people." The government turned inward, shunning the international community

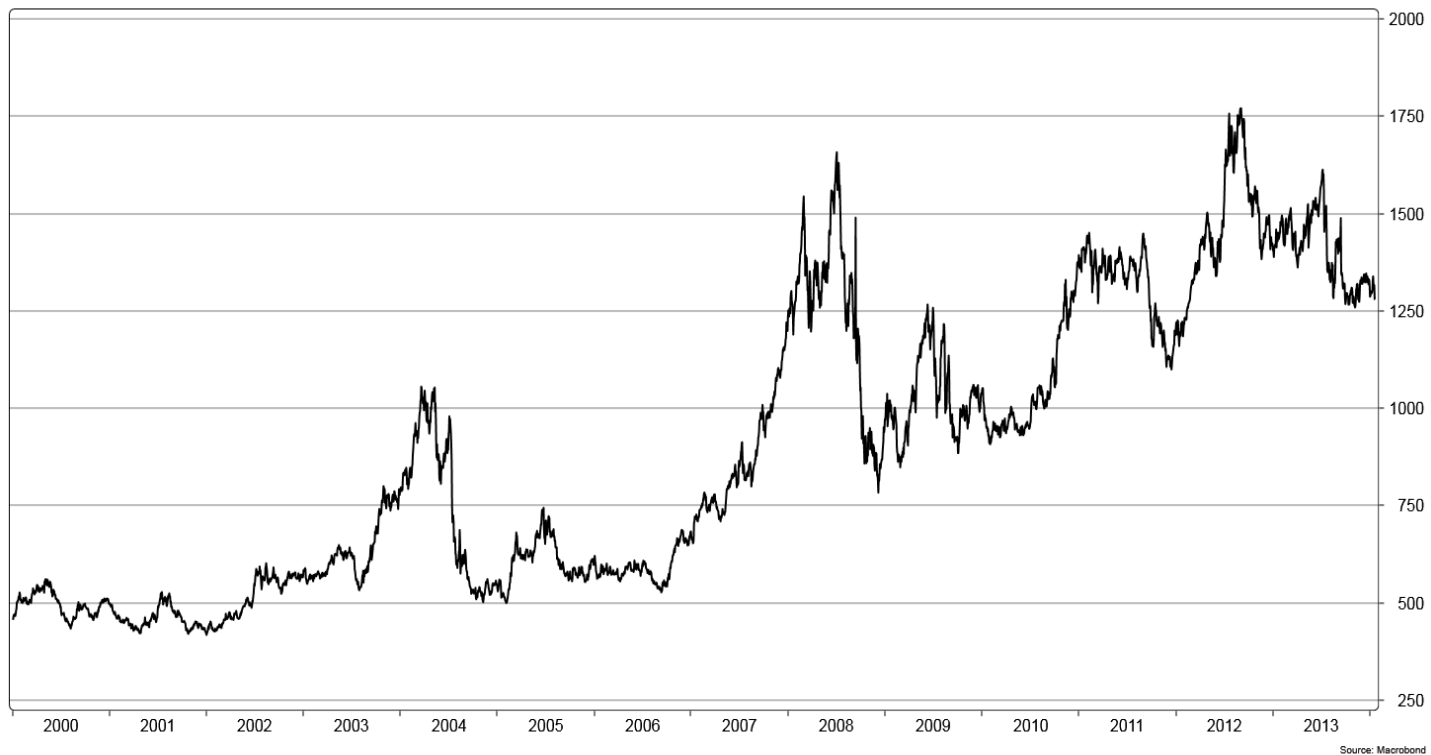
Lacking an external scapegoat for her failed policies, CFK will not have the same luxury

Both Kirchners have practiced policies of a weak currency, fiscal stimulus, and price and export controls

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

As soybean prices tripled, Argentina's exports boomed, benefitting the Kirchners and masking the inherent flaws in their policies...

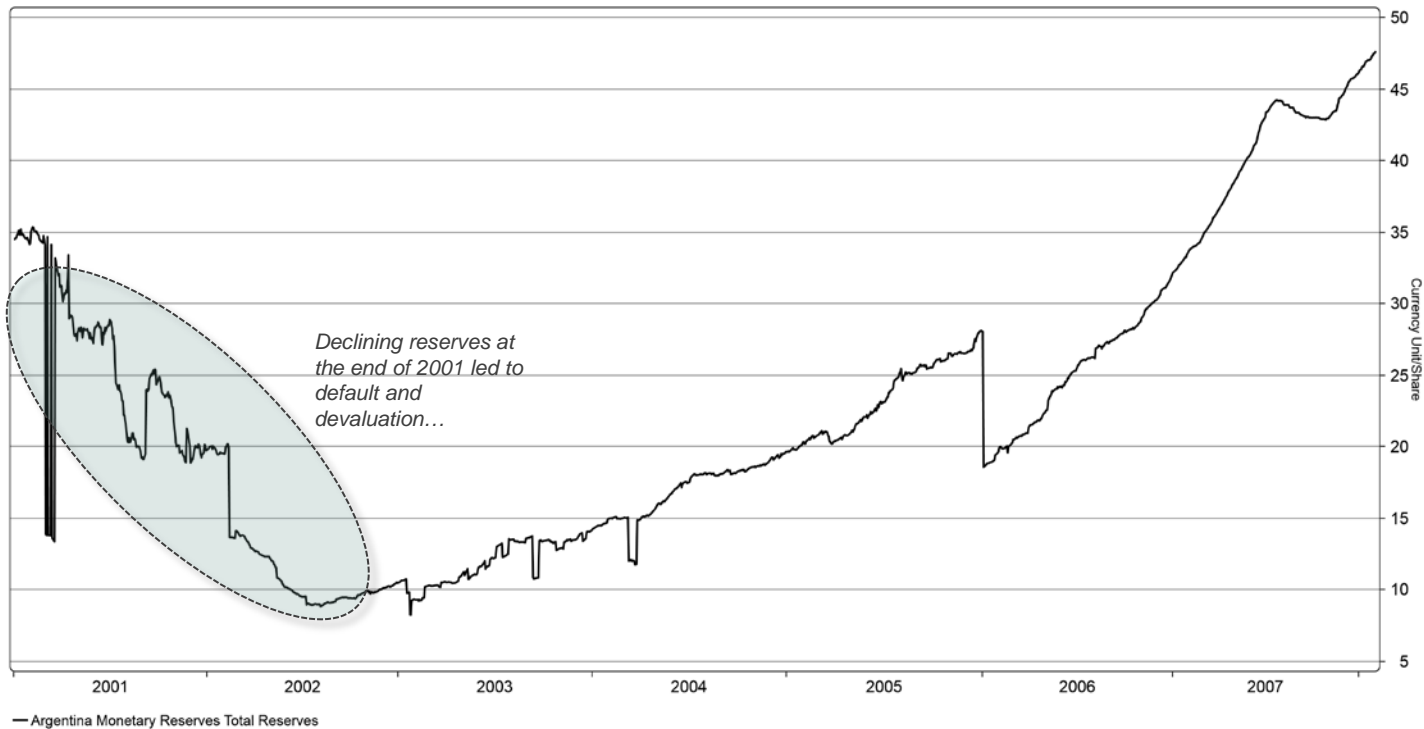
Soybean



ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

Booming exports helped to rebuild international reserves, improving Argentina's external position...

International Reserves, USD (in billions)



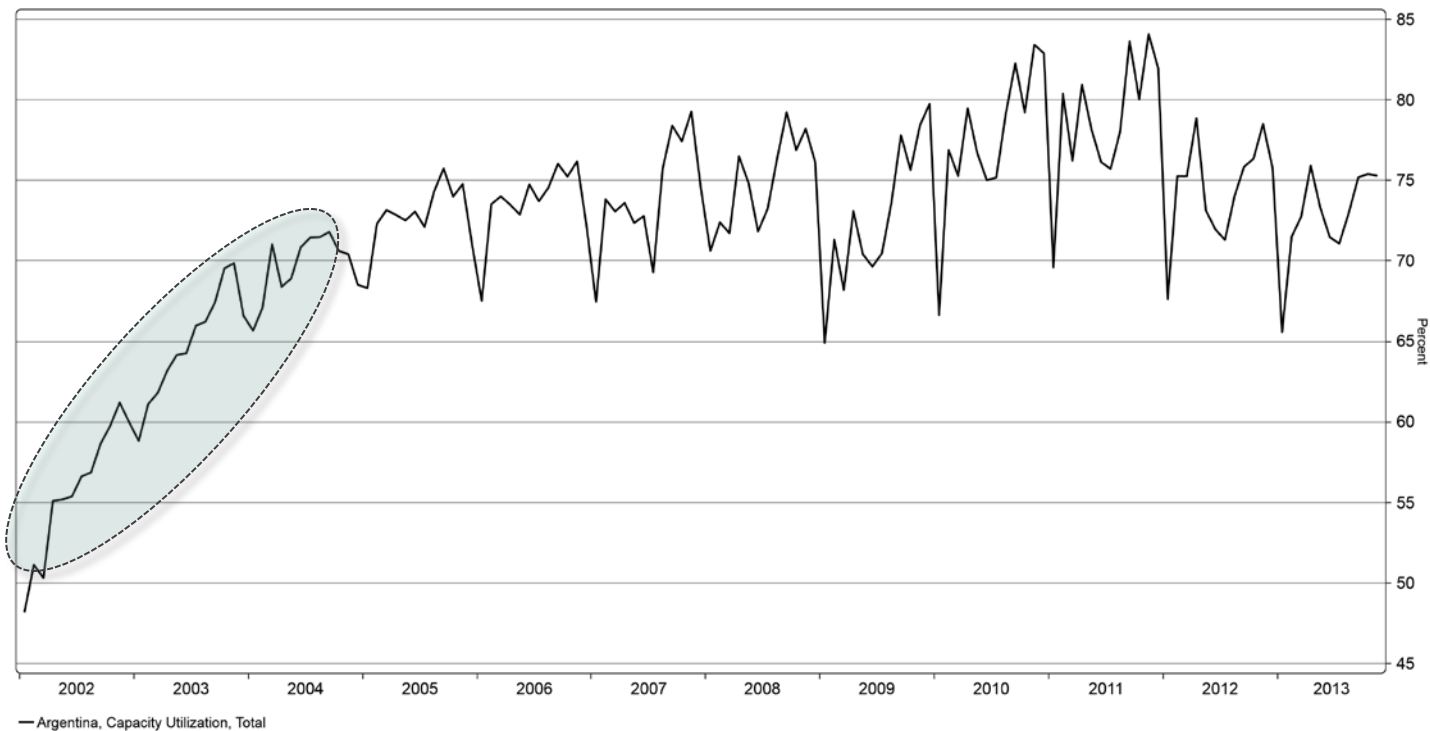
Not surprisingly, given their history of crises, Argentines are intensely aware of the level of international reserves and their importance to the economy

Source: Macrobond

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

Low capacity utilization allowed Argentina to grow for several years without capital investment. However, by 2005, the latent capacity idled in the depression had been fully absorbed...

Capacity Utilization



Source: Macrobond

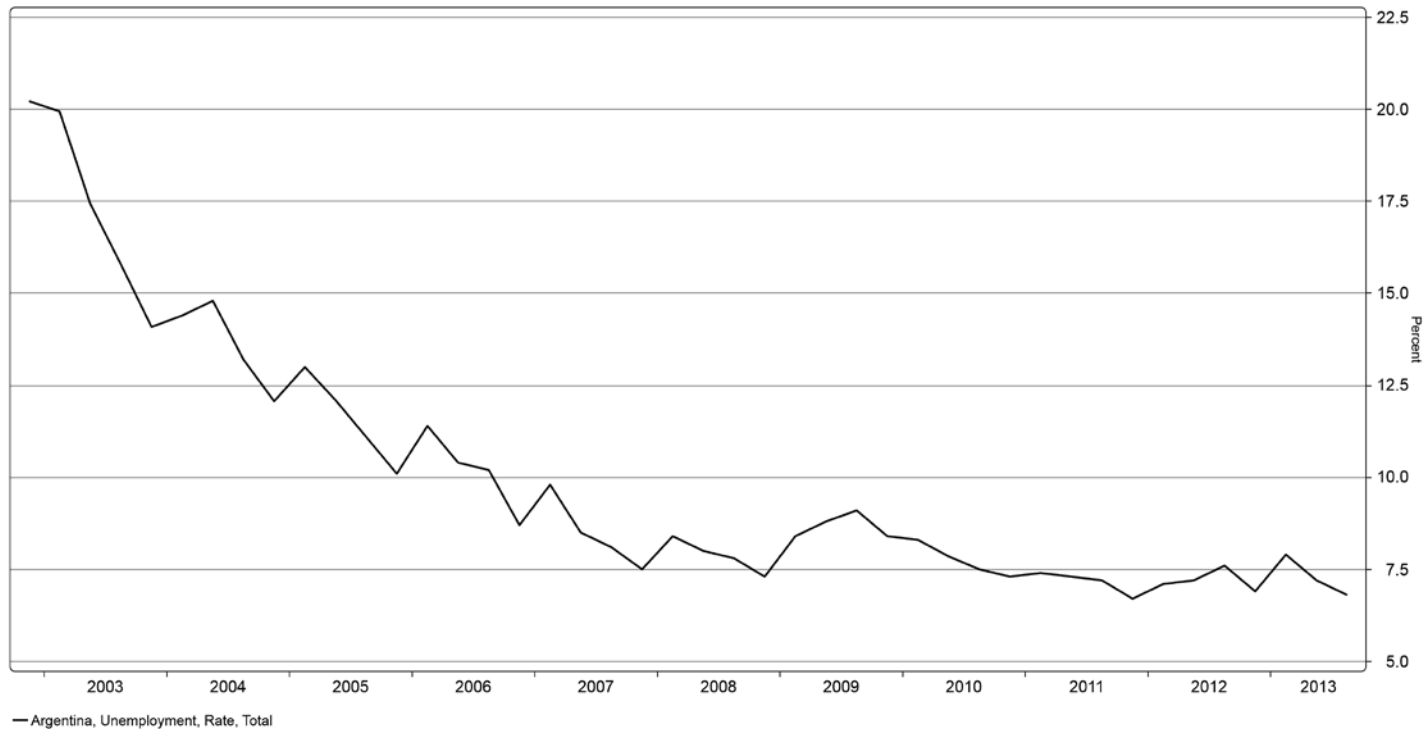
By 2005, inflation began to tick up, as did salaries and the prices of raw materials. Yet the central bank kept real interest rates negative, encouraging spending over saving for capital investment

As idle capacity was eventually brought back online, bottlenecks eventually appeared. Nestor Kirchner's response was to intimidate producers with 'voluntary' price freezes, in addition to outright price controls and export bans, including beef, to keep domestic prices down

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

With unemployment high, wage pressures were minimal in the post-default era...

Unemployment



Source: Macrobond

Recently a series of rebellions and riots broke out in Cordoba, in addition to other cities, resulting in wage increases in the range of 50 to 100% (far in excess of expectations of around 15%)

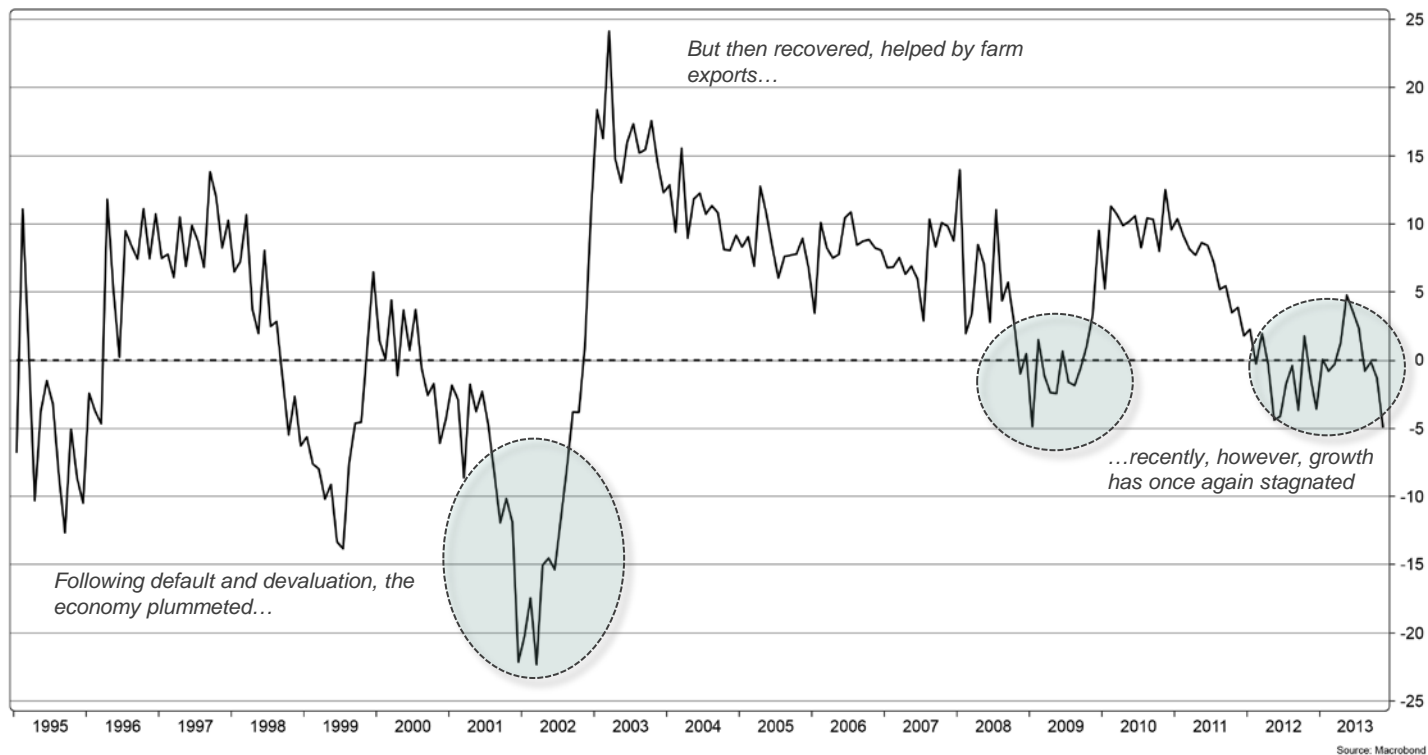
Now, unions are likely to demand wage increases of at least 30%

The dramatic wage increases are adding to inflationary pressures at a time when the currency is depreciating rapidly

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

Industrial production illustrates the volatility of the Argentine economy. After a deep recession following the default, the economy rebounded as a cheap peso improved the competitiveness of Argentina's exports. The economy remained strong until the global financial crisis. However, growth has recently stalled as the model's limits have been reached...

Industrial Production



Margaret Thatcher once commented that "the problem with Socialism is that eventually you run out of other people's money."



ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

Despite the temporary tailwinds that existed immediately after default and devaluation, the Kirchners resorted to a variety of antibusiness measures. These politically-driven policies were inspired by short-term priorities and implemented in a discretionary, rather than systematic manner, which created confusion and undermined confidence...

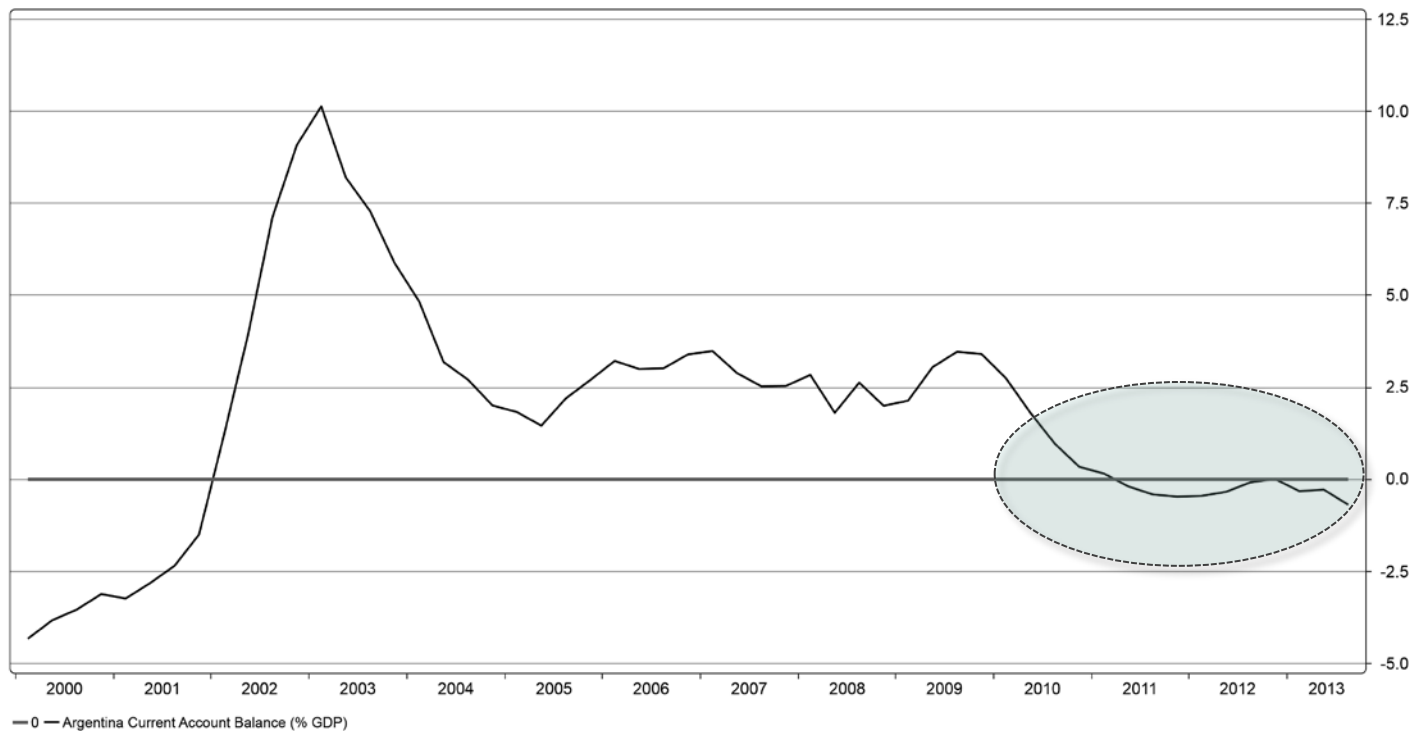
Anti-business Measures

1. **Capital Controls** - in 2007, the government introduced steep capital controls on foreign investors. In 2011, the government restricted Argentines' access to dollar bank accounts and to free movement of dollars out of the country
 2. **Import Bans** - in order to stop the outflow of dollars, the government introduced restrictions on a host of imported items
 3. **Media Law** - forced the disposition of assets by the largest media company, Grupo Clarin (an outspoken opponent of CFK)
 4. **Nationalization of YPF** - in 2012, the government expropriated 51% of the largest oil company, YPF, from Repsol, a Spanish company. In late 2013, as part of a desire to restore relations with the international community in order to attract foreign capital, Argentina finally settled with Repsol
 5. **Nationalizing Railways** - over the past few years, the government has nationalized dozens of passenger and cargo rail lines
 6. **Nationalizing the Pension System** - in November 2008, the national private pension system (with assets valued at approximately \$30 billion at the time) was seized, resulting in a number of board positions for the government on a variety of public companies. Shortly after, the Argentina stock market fell 30%, and approximately \$4 billion fled the country
- Additionally, other issues, such as failing to settle with the 'holdout' creditors and frequent reports of corruption within the government, have consistently undermined confidence

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After moving strongly from deficit to surplus, Argentina's current account has turned negative, resulting in fewer dollars entering the country...

Argentina's Current Account (% of GDP)

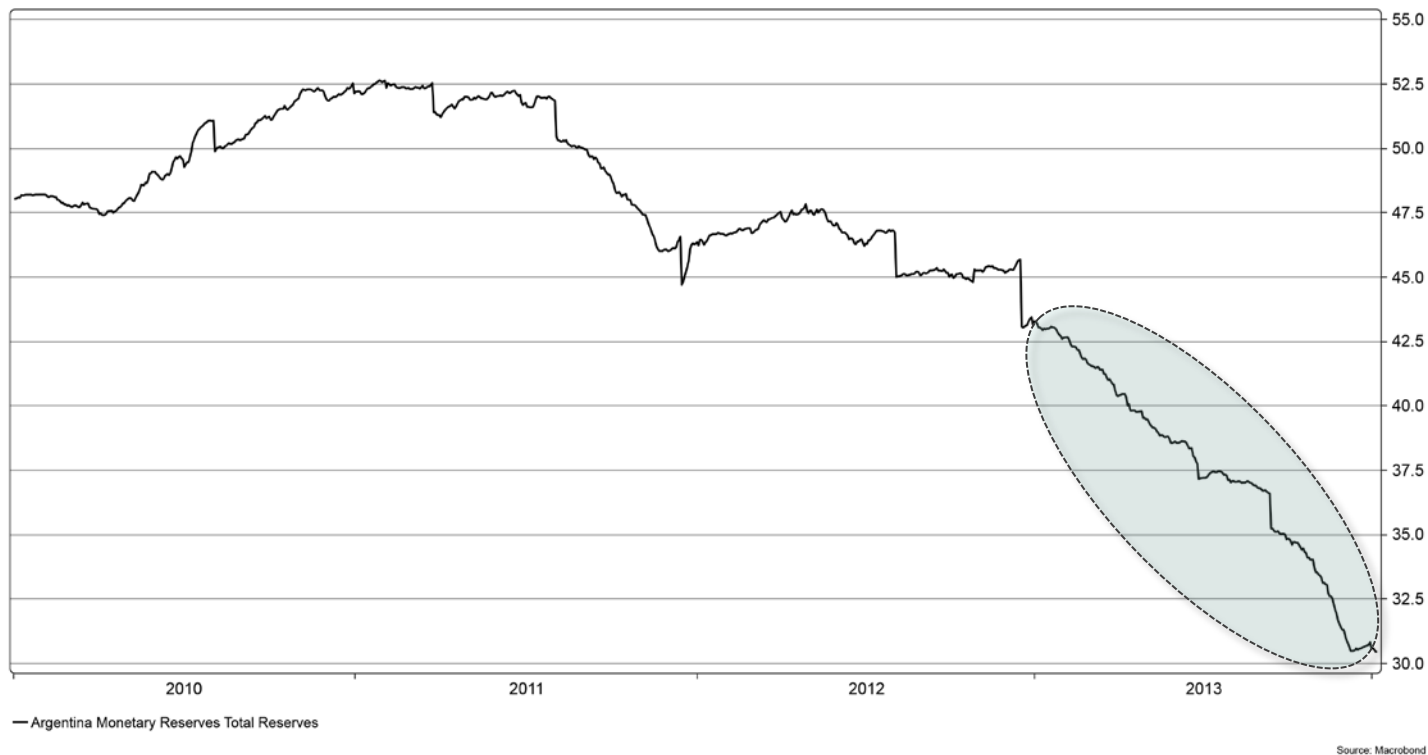


Source: Macrobond

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

In 2013, Argentina lost nearly \$13 billion of reserves. In January 2014, the decline has continued, falling below the psychologically important level of \$30 billion, increasing the possibility of a foreign exchange and balance of payments crisis. This leaves CFK to choose between several unpalatable options: simply accept a further fall in reserves, attempt to borrow funds in global markets, reinforce FX restrictions or impose multiple exchange rates...

International Reserves, in USD



At the current pace of loss, reserves are likely to run out by mid-2015...

...therefore, slowing the rate of reserve loss has become a key goal for the government, which recently implemented a host of measures that have proven to be unsuccessful

Without a coherent adjustment strategy, Argentina is unlikely to attract capital inflows sufficient to rebuild reserves, yet estimates suggest that Argentina will need to attract \$8 billion in 2014 in order to keep reserves above \$30b

For reference, \$30 billion of reserves represents ~4 months of imports

In terms of foreign currency-denominated debt, fortunately for CFK, no significant payments are due until 2015, shortly before her departure

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

As reserves dwindle, the official and unofficial currency has weakened. In 2013, the peso depreciated by 32.2%, up from 14.2% in 2012. But recently, the rate of peso depreciation has accelerated, falling by 6.2% in December alone, an annualized rate of over 100%. The Blue Swap rate has now reached 11.0, representing a 40% dispersion from the official rate...

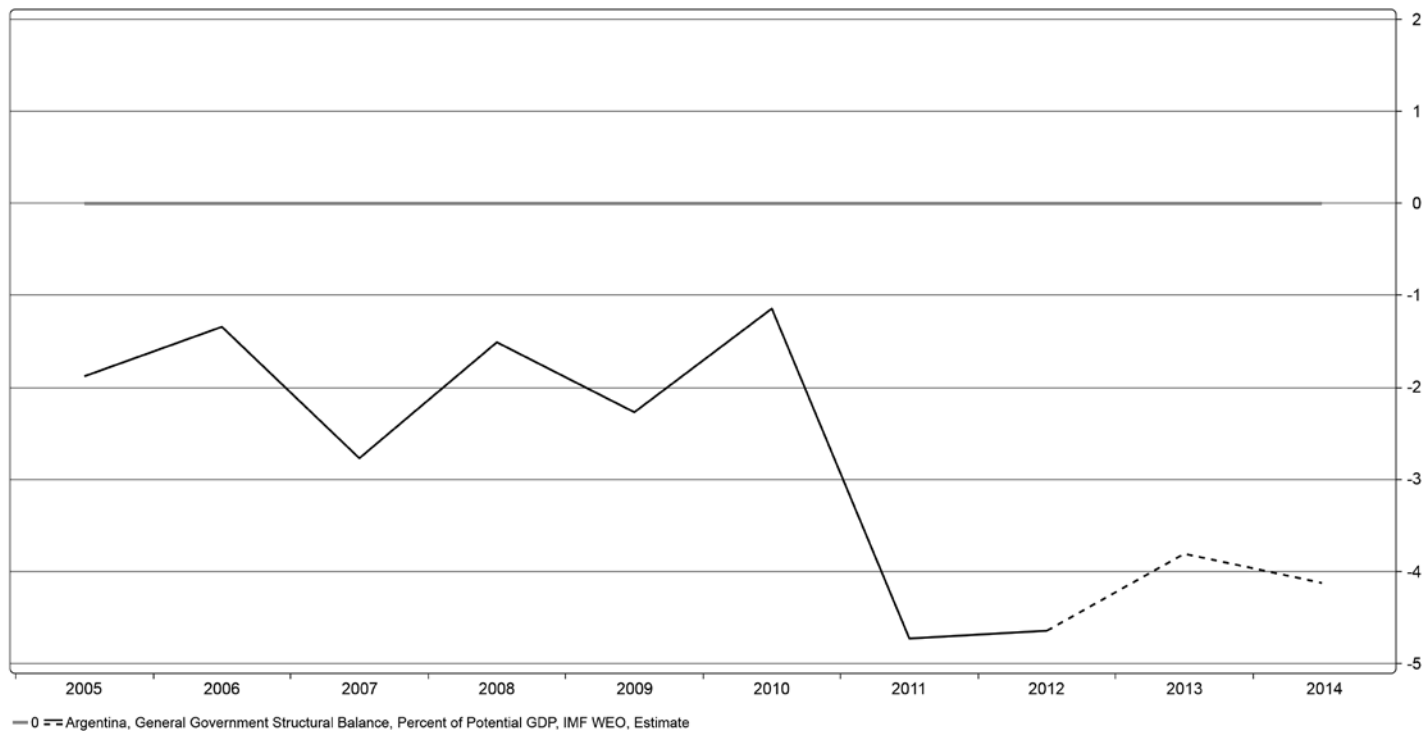
Argentina Pesos per USD – Official vs. Unofficial Rate



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The structural budget deficit has been financed by the central bank, which prints money necessary to cover the government's shortfall. Inflation has inevitably spiked...

Structural Budget Balance (% of GDP)

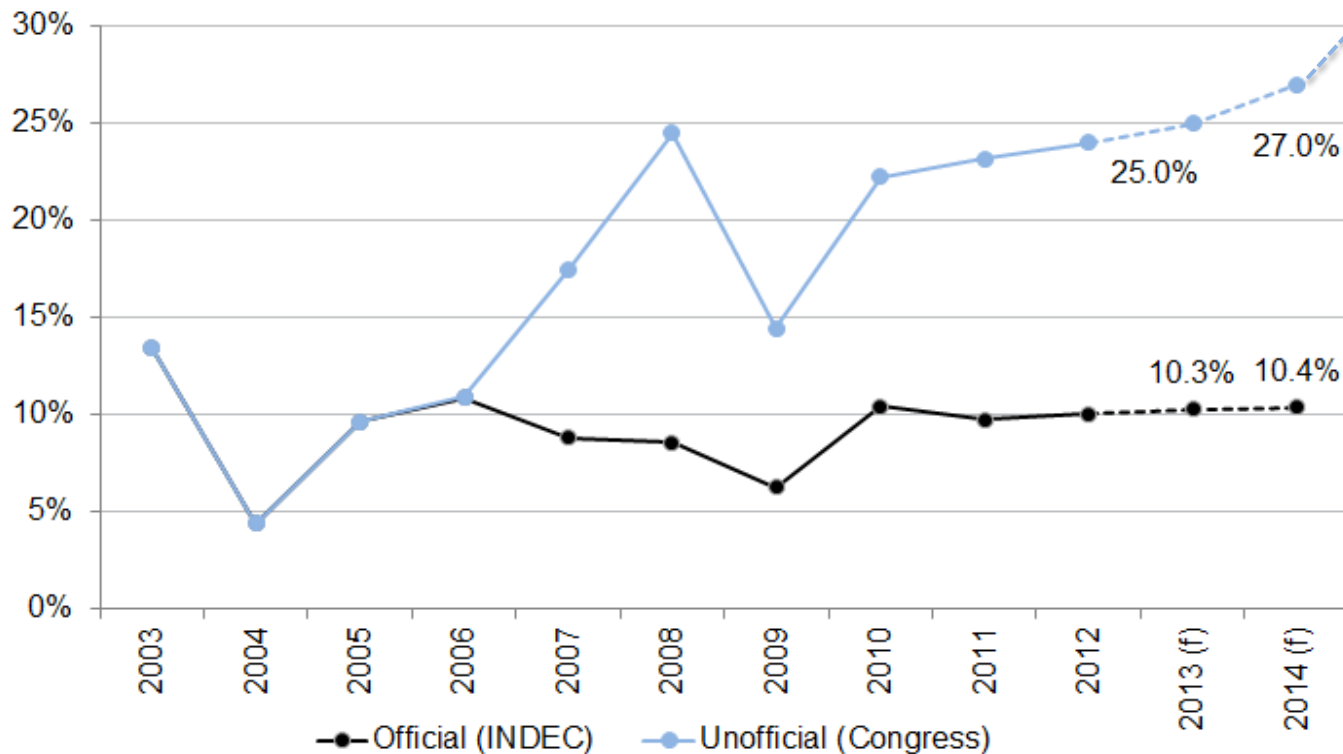


Source: Macrobond

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

As monetization of deficits has accelerated, so has inflation. In 2007, the government began manipulating the inflation statistics, which have diverged at an increasing rate. Options to reduce inflation are politically untenable for Cristina and without a 'nominal anchor,' inflation expectations could become unhinged, potentially leading to additional price controls...

Inflation (YoY) – Official vs. Unofficial



As inflation accelerated in the early 2000s, rather than changing policies, the Argentine government opted to change the inflation numbers

In January 2007, the head of the consumer prices section of the National Statistics and Census Institute (INDEC) was fired. Five days later the methodology was changed, and the government statistics began diverging from private economists'

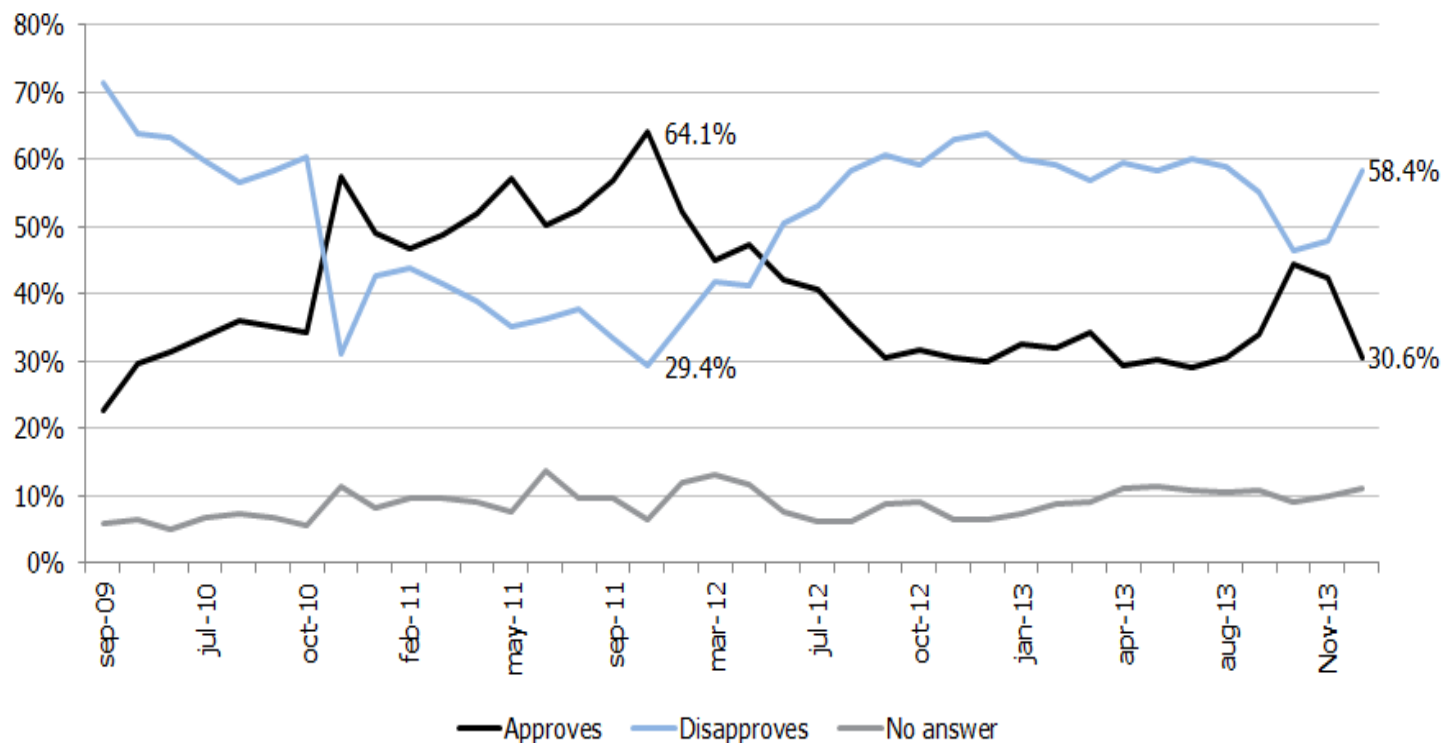
At 30%, Argentina's inflation rate is only surpassed by Iran and Venezuela. Admitting to significantly higher levels of inflation will automatically increase poverty statistics, undermining the supposed merit of CFK's policies

However, at the demand of the IMF, a new inflation index is being constructed and expected to be introduced early in '14

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

Given the failing economy, it's no surprise that CFK's approval rating has fallen by half. This is despite significant subsidies to lower social classes that generally garner political support...

CFK's Approval Rating

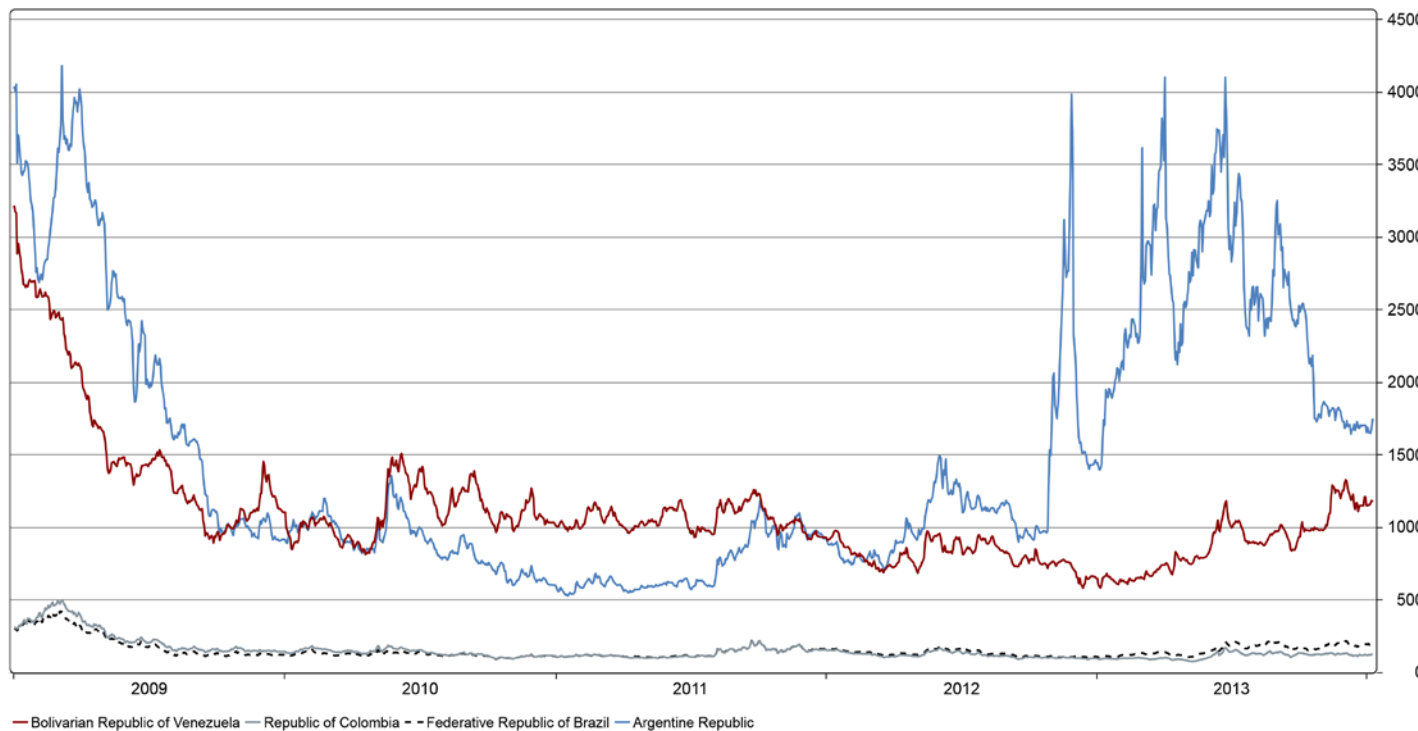


CFK's conspicuous absence over the past month has only exacerbated the collapse in confidence, reducing hope that the government can deliver a sustainable solution

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

In terms of credit spreads, Argentina trades wider than Venezuela and far wider than countries with more orthodox policies, such as Brazil and Columbia, leaving room for ample improvement once a new administration assumes control of the government...

CDS Spreads, Latin American (in basis points)



Understandably, long considered a pariah—in part due to Argentina's highly publicized fight with creditor holdouts—the perceived 'country risk' has kept many investors away from Argentina, leaving global institutional investors underweight

Source: Macrobond

ARGENTINA: A DECADE OF UNORTHODOX POLICIES UNRAVELING

Prior to 2013, Argentine equities had underperformed the rest of Latin America by a considerable margin. But over the second half of 2013, equities began discounting the end of Kirchnerism and rallied substantially. The optimism could be a bit premature as painful adjustments are necessary. Nonetheless, there will likely soon be a generational opportunity to buy Argentine assets...

MSCI Latin America vs. MSCI Argentina



Source: Macrobond



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