

BIENVILLE GLOBAL REVIEW

ARGENTINA: PART II IN SIGHT OF POLITICAL REGIME CHANGE

February 2014



SUMMARY

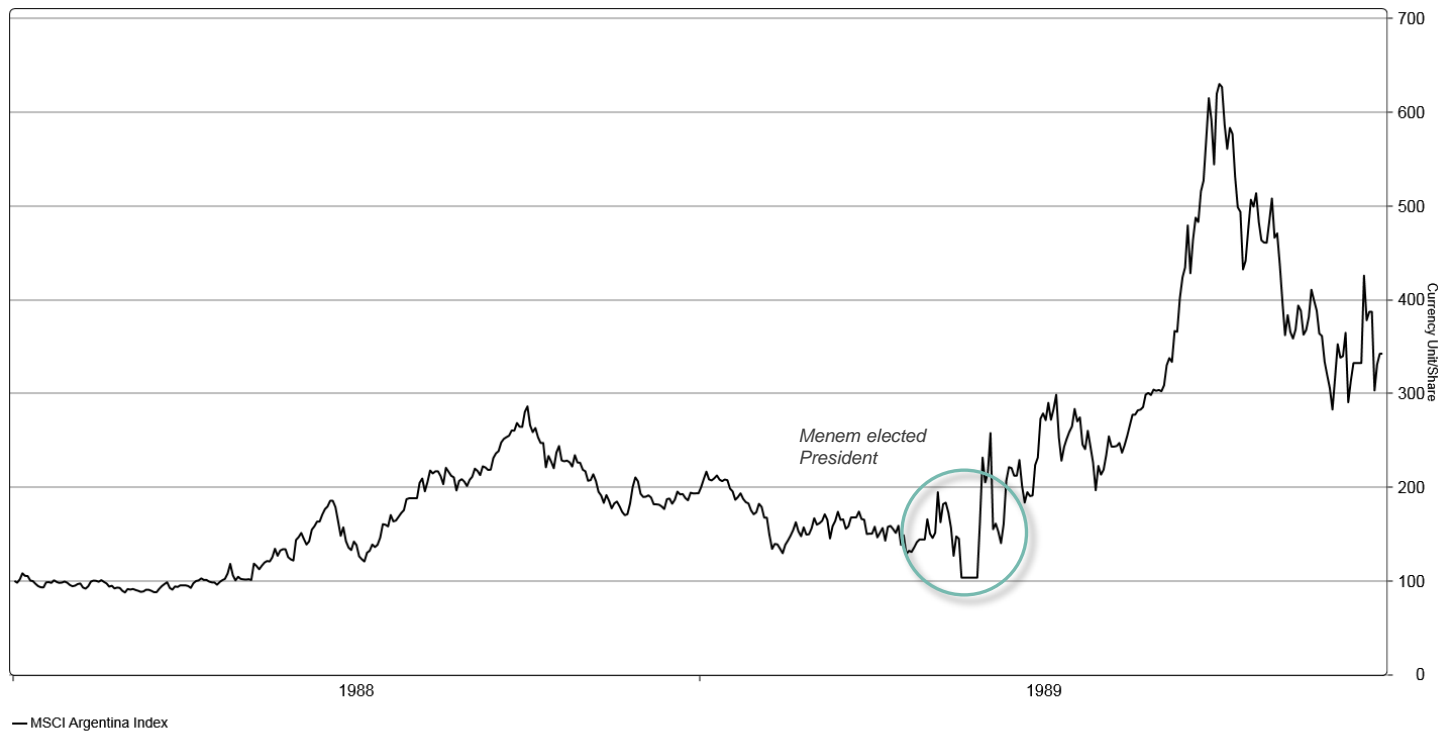
The politics of any given country can have a considerable impact on its real economy. By extension, the 'signaling' of a material policy shift can have a dramatic effect on asset prices. Historically, Latin American countries have been particularly susceptible to large swings in political ideology, oscillating between populist and free market policies. Under the Kirchner administrations of the past decade, Argentina has moved far to the left. The economy is suffering, and relations with the international community are abysmal. Today, Argentines are disenchanted with Kirchnerism, increasing the probability of a more moderate administration in 2015.

- Dramatic shifts in policy can have a dramatic impact on asset prices. Latin America provides numerous examples where political regime change resulted in phenomenal returns for investors, including Argentina (1989 & 1991), Colombia (2002) and Brazil (2002). Argentina could be on the precipice of a similar change
- As discussed in Part I, *Argentina: A Decade of Unorthodox Policies Unraveling*, Kirchnerism has been discredited, as evidenced by the poor performance of the Argentine economy and relative decline among its peers. Not surprisingly, both confidence in the government and the approval rating of Cristina Kircher have plummeted
- The declining popularity of the government, even among Peronists, resulted in a major loss for Cristina in October 2013's legislative elections. Her party failed to achieve the supermajority required to amend the constitution, which would have allowed her to run for a 3rd term
- The recent legislative elections solidified the end of Kirchnerism in 2015. Argentine equities rallied 80%, despite a notable deterioration in the real economy and the likelihood of an incipient balance of payments or currency crisis
- Following defeat, Cristina reshuffled her cabinet, an indirect admission of her administration's ineptitude. The changes were initially well received, but have since proven insufficient. Rather than making the necessary economic adjustments to allow for sustained growth, the government reverted to its disorganized, incrementalist and reactive approach
- Today, there are three leading contenders for president in 2015. All are advocating a significant shift towards more moderate and pragmatic policies
- The most critical issues on the candidates' agenda include: removing capital controls, reducing costly subsidies, instituting an inflation-targeting central bank regime and normalizing relations with the international community. Argentina's imbalances today require a comprehensive reform package. Although the reforms are politically difficult, they are achievable
- Evaluating the policies that the leading candidates advocate, judging the likelihood of their implementation, and understanding the political timeline between now and 2015 will be critical to formulating a holistic investment thesis for Argentina. If there is follow-through on the policy adjustments, Argentina's medium term outlook could be especially bright

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

Dramatic shifts in policy can have dramatic effects on asset prices. In 1989, Argentina was experiencing hyperinflation when the Peronist challenger, Carlos Menem, was elected president. He vowed to pursue more pragmatic policies and slow inflation, catalyzing a 6-month, 500% rally in the equity market in U.S. dollar terms...

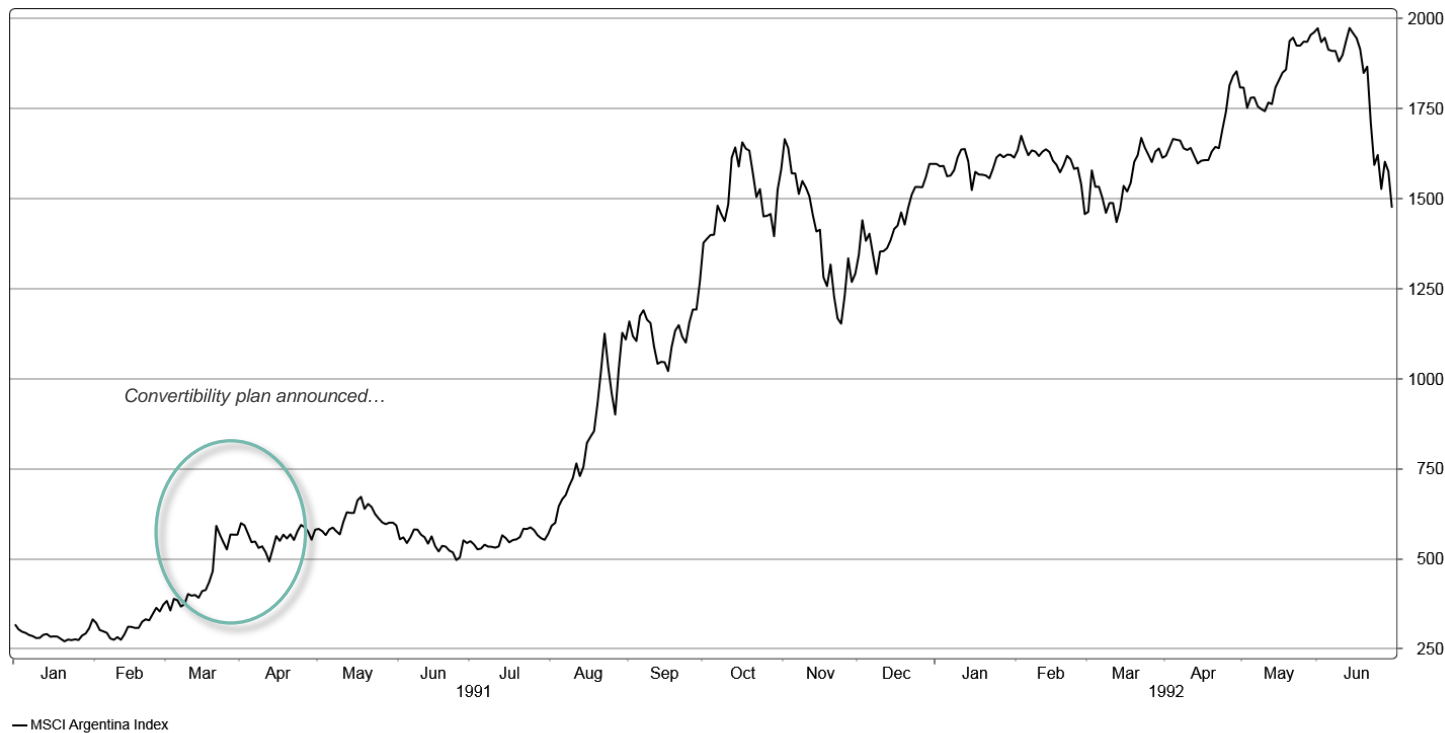
MSCI Argentina (Menem Election)



ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

Following his election, Menem, along with Economy Minister Domingo Cavallo, restored price stability and implemented a number of policies needed to improve the real economy. Equities discounted the improvement and rallied over 600% in U.S. dollar terms...

MSCI Argentina (Post 'Convertibility')



In 1991, the 'convertibility' plan was introduced, pegging the peso to the U.S. dollar at 1:1. Inflation subsequently collapsed...

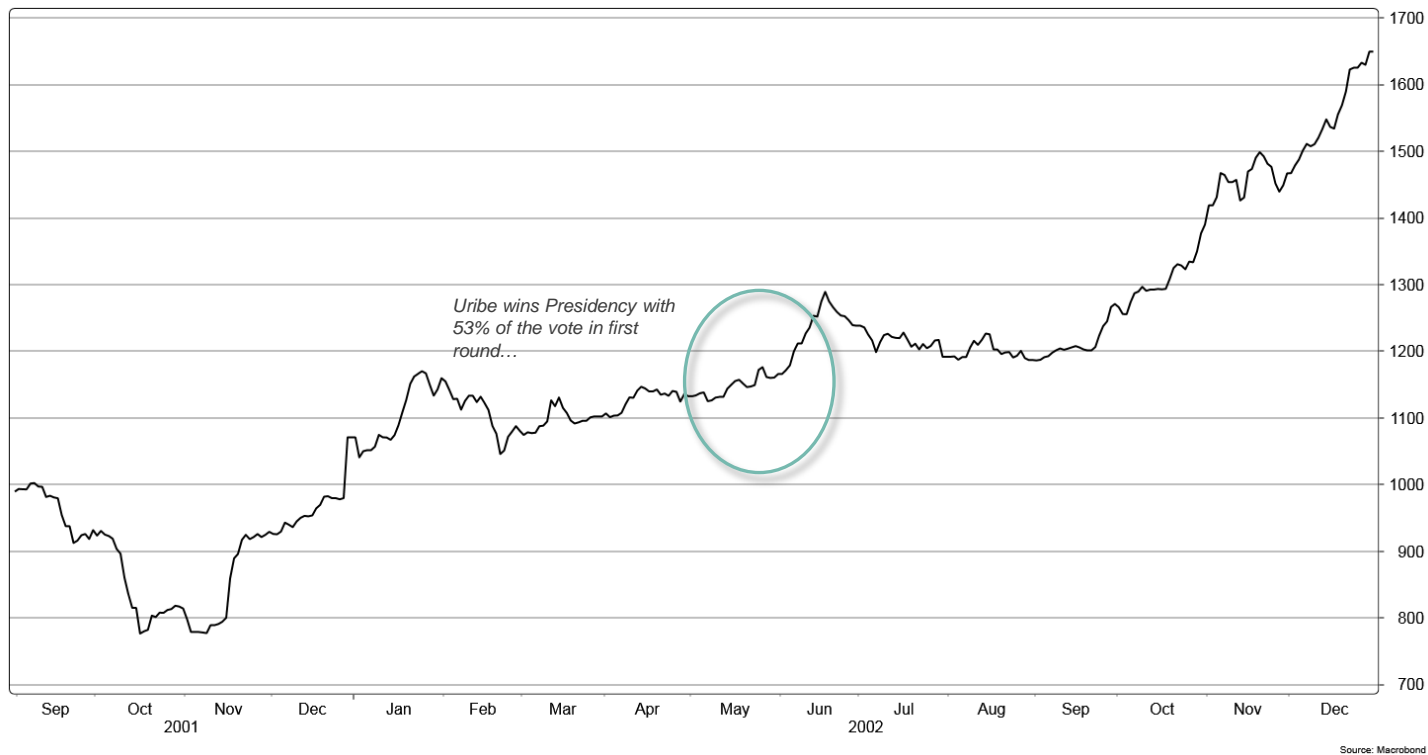
Prior to 'convertibility,' Argentina suffered from hyperinflation. Real wages were in decline, GDP growth was poor, capital investment was deficient and a lack of confidence in both the government and the central bank was pervasive. Although not as extreme today, there are a number of parallels

Source: Macrobond

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

In Colombia, equities rallied in late 2001 and early 2002, discounting the victory by Alvaro Uribe, who promised to slash government spending and to take a tough stance against the FARC. Following his election, the rally continued, rising cumulatively by more than 100% as Uribe's more market-friendly policies on energy and trade gained support...

Colombia's IGBC Index – Election of Alvaro Uribe, 2002

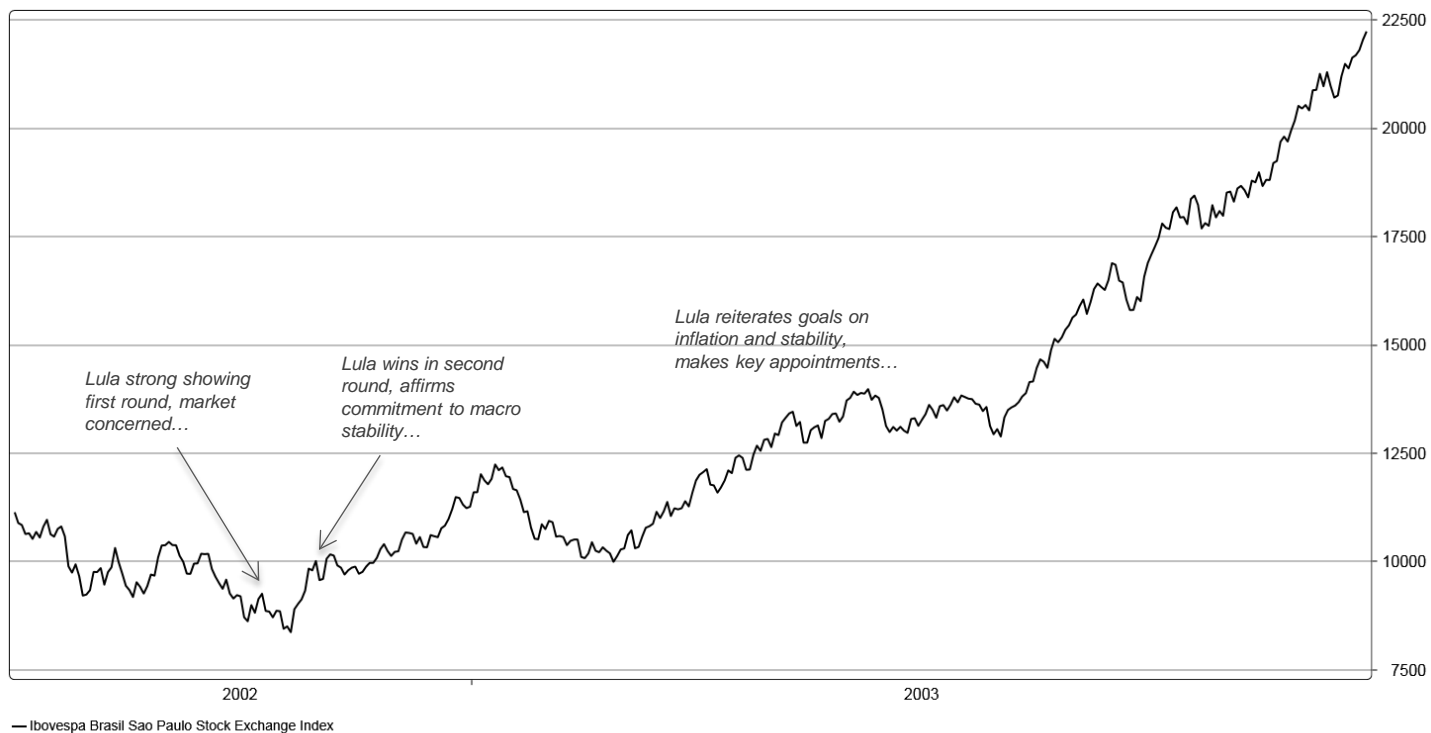


Colombia's rally in 2002 occurred despite poor performance by the emerging markets index, which fell -8% over the year

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In Brazil, the equity market declined in mid-2002 prior to the October Presidential election. Polling data predicted the eventual victory by the former labor leader, Lula da Silva, which investors feared could end the era of low inflation and budget surpluses. However, after Lula affirmed his commitment to the stable macro framework in place, the Bovespa index doubled...

Brazil's Bovespa Index – Election of Lula Da Silva, 2002



Market participants were initially worried that the more left-wing candidate would reject the low inflation and fiscal stability adopted in Brazil in the late 1990s...

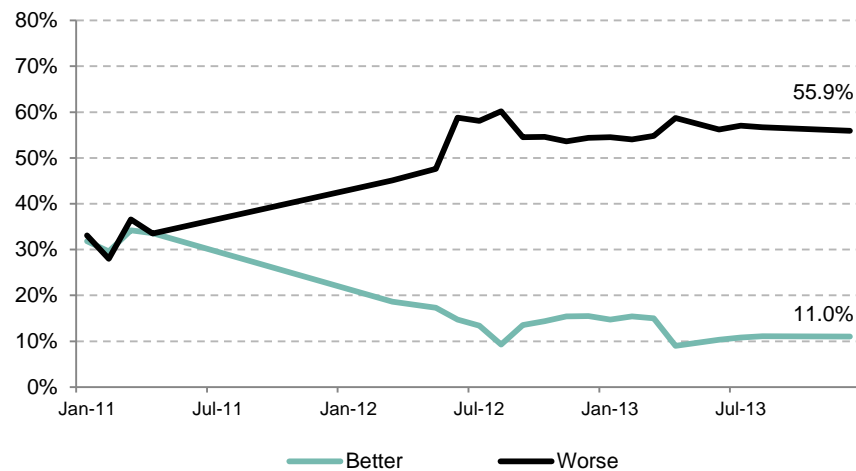
However, Lula proved to be an economic moderate and made several key appointments in order to show his dedication to stability. As the market gained confidence in Lula's team, equities continued to rally

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

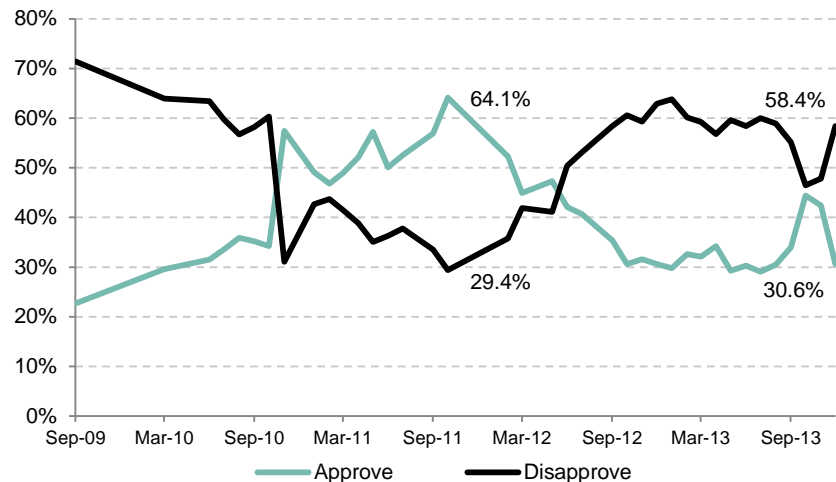
Today in Argentina, Kirchnerism is being debunked, increasing the probability of a significant political regime change. The tailwind of rising commodity prices and an undervalued currency that initially benefited the Kirchners has dissipated, and the ineptitude of Cristina's administration is now apparent...

- Excessive fiscal spending financed by the central bank has led to high inflation and a decline in real incomes. Not surprisingly, confidence in the economy and Cristina's government has collapsed. As expectations for the economy to worsen have nearly doubled, Cristina's approval rating has fallen by half

Expectations - Economy



Approval Rating – National Government



ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

Cristina's declining popularity led to her party's loss in the October 2013 legislative elections. As a result, the Frente para la Victoria (the FPV party) fell short of attaining a two-thirds majority. Such a supermajority would have allowed the FPV to amend the constitution, permitting Cristina Kirchner to run for a third term as President...

Argentina: Congress Post-October 2013 Election

Lower House	Seats Prior to Election	Net Gain	Seats Post Election	Percentage
FPV+ Allies	135	0	135	53%
Opposition	22	0	122	47%
Total	257		257	100%

Instead of cementing the two-thirds majority necessary to amend the Constitution, the FPV and its allies actually lost seats in the Senate and gained no seats in the House...

This defeat marked the beginning of the end for Kirchnerism

Upper House	Seats Prior to Election	Net Gain	Seats Post Election	Percentage
FPV+ Allies	38	-4	34	47%
Opposition	34	4	38	53%
Total	72		72	100%

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

Most stunning was the ruling FPV party's rout in Buenos Aires province, the political epicenter of Argentina. The FPV lost the August 2013 primaries by 5% to Sergio Massa's new party, the Frente Renovador (the FR). But Massa was able to build on his momentum over the fall, defeating Cristina Kirchner's candidate by nearly 12% in October's legislative elections...

Performance in Province of Buenos Aires, Lower House

Candidate	Percentage in Primary	Percentage in Election	Difference	Seats Held
FR, Sergio Massa	34.9%	43.9%	9.0%	16
FPV, Martin Insurrealde (i.e., CFK's Candidate)	29.6%	32.2%	-2.6%	12
Other Candidates	29.4%	23.9%	-5.5%	7

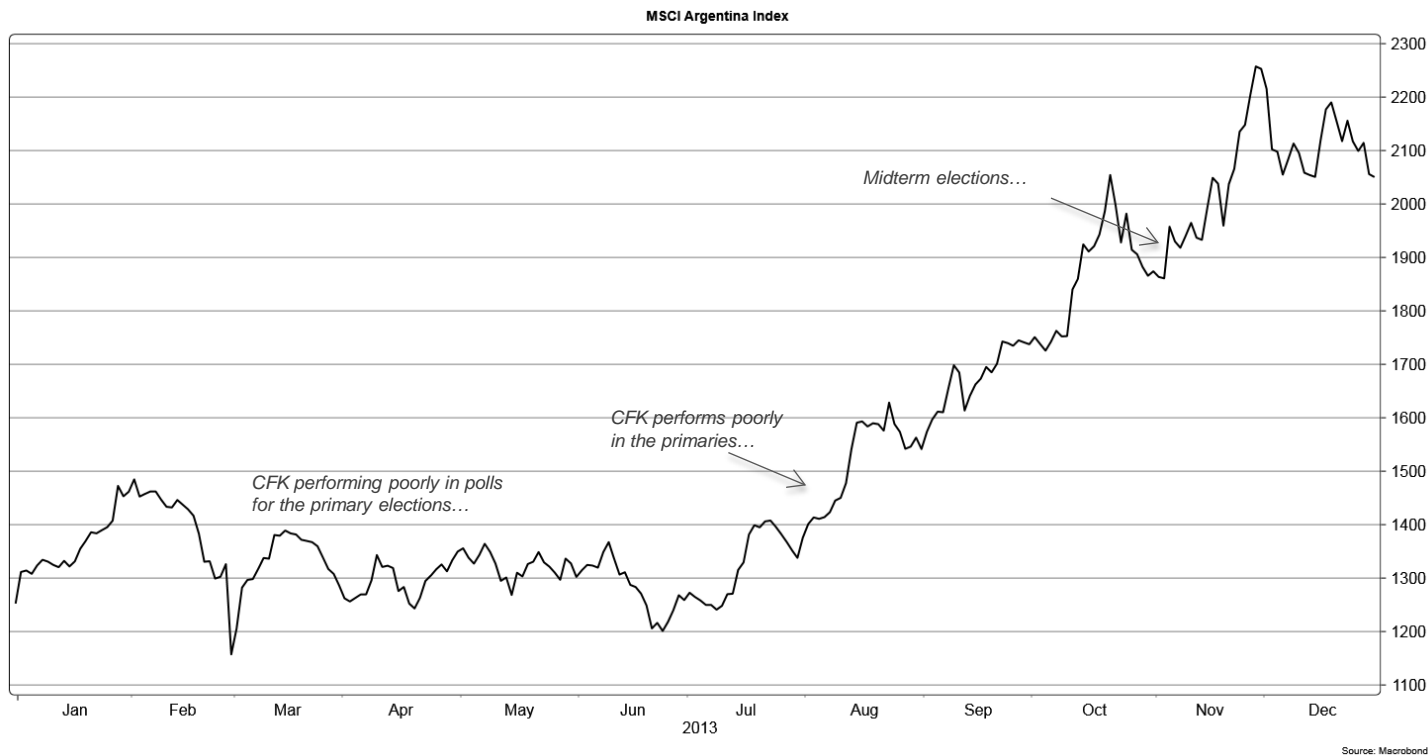
Buenos Aires province is the most important in the country and controls 40% of all votes. The defeat was a major strategic defeat for Cristina and her allies

Massa has used this victory to propel himself onto the national stage to be a major force in the upcoming presidential election of 2015

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

The Argentine equity market traded in a range for much of 2013. But as polls began to predict the defeat of CFK in the primaries and legislative elections in October—removing the prospect of a 3rd term—equities rallied over 80% (in U.S. dollar terms). The Argentine market was one of 2013's top performers, despite a considerable deterioration in the underlying economy and the reality of experiencing another two years of Cristina...

MSCI Argentina Index



The MSCI Argentina index ended the year 64% higher in U.S. dollar terms

Given the poor economic data, the market responded almost entirely to political factors, illustrating the politicization of the equity market

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

In recognition of her defeat, Cristina has recently announced changes within her cabinet. The changes were initially received positively. But that optimism has now faded. Instead, the Kirchner administration has continued its incrementalist approach, reacting to circumstances, rather than introducing substantive reforms necessary to address Argentina's fundamental imbalances...

Cabinet Changes (Following October's Elections)

- **Appointed Jorge Capitanich as Cabinet Chief**
 - ✓ Initially received positively. Capitanich seemed more pragmatic, inspiring hope in Argentina's near-term future. However, it's now clear that Capitanich has been usurped by Kicillof, the new, leftist Economy Minister
- **Appointed Carlos Fabrega as President of the Central Bank**
 - ✓ Received positively, and justifiably so. Fabrega, an economic moderate, has made a number of positive changes, including the necessary step-devaluation of the peso in late January and an increase in policy interest rates (such that real interest rates are now less negative). His ability to fully normalize monetary policy is limited however
- **Removed Guillermo Moreno, Secretary of Domestic Trade**
 - ✓ Received positively, and justifiably so. Moreno has long been a controversial figure of Cristina's administration, often using rhetorical threats to accomplish his goals, and even showing up in meetings carrying a gun
- **Replaced Economy Minister Hernan Lorenzino with Axel Kicillof**
 - × Moving Lorenzino to focus solely on resolving international creditor issues (e.g., Paris Club, World Bank, 'Holdouts') was received positively. But replacing him with Kicillof, a known Marxist and the intellectual inspiration behind Argentina's nationalizations, was a net negative
 - × At the time, it was believed Kicillof would answer to Capitanich, who would mitigate Kicillof's potential harm. Despite his incompetence, it now appears Kicillof has the upper hand on Capitanich

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

There are currently three leading candidates for President in 2015. Most important, all appear to represent a significant shift towards more pragmatic policies and recognize the importance of normalizing relations with the international community...



Sergio Massa

National Deputy, Buenos Aires

- Former Mayor of Tigre, Chief of Staff to CFK before resigning
- Leader of FR party
- Relationship with CFK: Estranged



Daniel Scioli

Governor, Province of Buenos Aires

- Former VP of Nestor Kirchner
- Prominent member of Peronist party, powerful among Governors
- Relationship with CFK: Complicated, possibly viewed as "too close"



Mauricio Macri

Mayor, City of Buenos Aires

- Leader of PRO party
- Former prominent businessman (owner of Boca Juniors, etc.)
- Relationship with CFK: Long-time rival and outspoken critic of the Kirchners

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

Despite their different political affiliations and relationship to Kirchnerism, the three candidates have similar views on the major issues...

Advocated Policies of Major Candidates

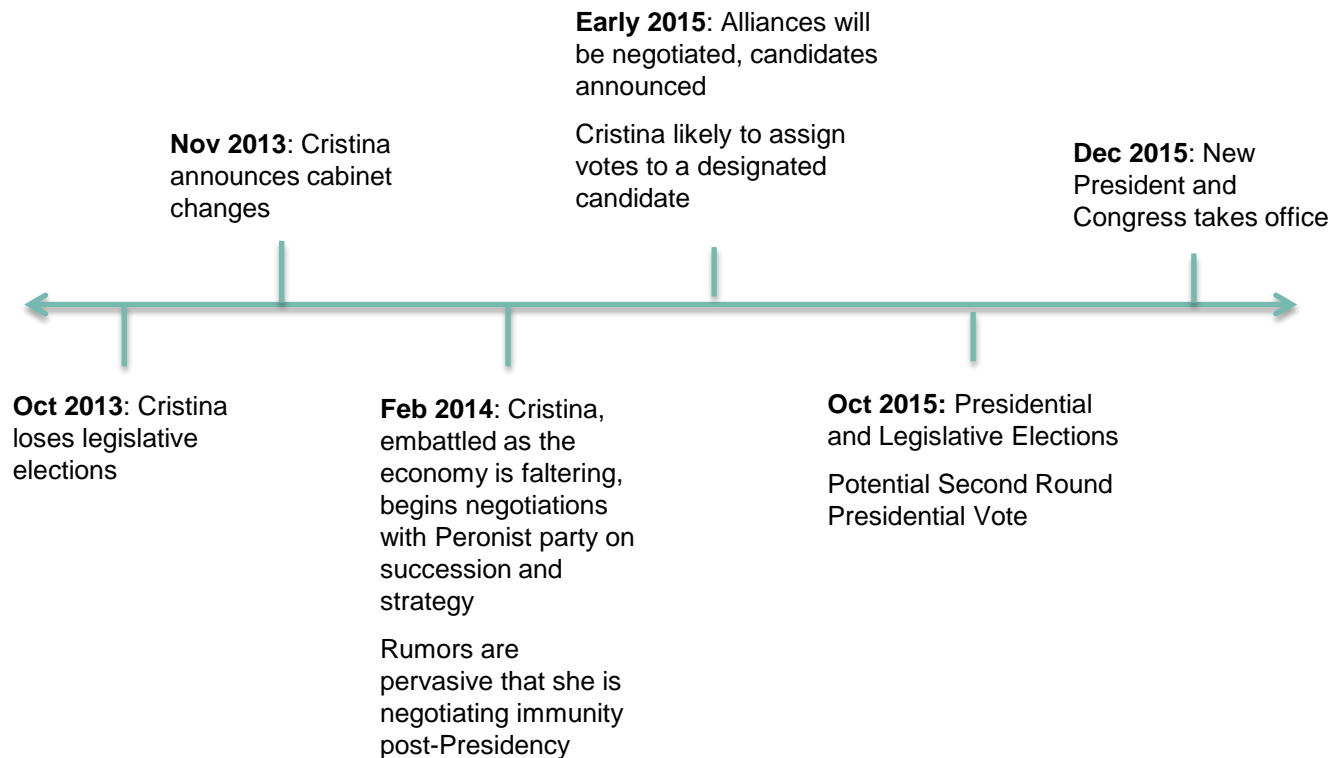
Policy	Daniel Scioli Governor, Province of Buenos Aires	Sergio Massa National Deputy, Buenos Aires	Mauricio Macri Mayor, City of Buenos Aires
Remove capital controls	✓	✓	✓
Stabilize inflation in single digits	✓	✓	✓
Institute inflation-targeting regime at the Central Bank	✓	✓	✓
Allow positive real interest rates	✓	✓	✓
Attract foreign investment	✓	✓	✓
Privatize state-owned assets	x	x	✓
Curtail / eliminate energy subsidies	✓	✓	✓
Increase electricity tariffs	x	✓	✓
Create new infrastructure concessions	✓	✓	✓
Settle with 'Holdout' creditors	✓	✓	✓

Equally important, these views are shared by opposition and minor parties, making major reform likely in the initial years after Kirchnerism

ARGENTINA: IN SIGHT OF POLITICAL REGIME CHANGE

Understanding the policies that candidates advocate, the likelihood of their implementation, and the political timeline between now and the Presidential election in 2015 will be critical to the development of an investment thesis...

Political Timeline (through 2015)



In the near future, CFK will need to decide who will succeed her, likely in exchange for her immunity after her exit

However, should her popularity continue to decline, so will her leverage and influence on the outcome

Also important to monitor is the jockeying between the various opposition candidates to see who can build the strongest alliance. Historically, a divided opposition has allowed a Peronist candidate to win



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