

BIENVILLE GLOBAL REVIEW

Argentina: The Scioli Factor

August 2015





SUMMARY

Since April, Argentine equities have given back the strong gains posted in Q1. The initial decline was driven by political dynamics, specifically, campaign tactics by Daniel Scioli—the Peronist party’s presidential candidate—that weighed on sentiment. Further declines have been more technically driven, namely, turmoil in emerging markets. Yet the fundamental thesis for Argentina remains intact. A misdiagnosis of campaign rhetoric, in conjunction with a spike in global risk aversion, has left a number of companies uniquely positioned to benefit from Argentina’s political transition trading at depressed valuations only weeks prior to the election.

- Argentine equities rallied strongly in Q1 as Mauricio Macri, perceived as the country’s most market-friendly presidential candidate, gained in the polls. But in April, Daniel Scioli recovered momentum, causing investor enthusiasm to wane.
- In June, investors were dealt a ‘perceptual’ blow. Scioli named Carlos Zannini, a Kirchner insider, to his ticket as potential Vice President. Markets began to question Scioli’s intentions. His subsequent leftist campaign rhetoric exacerbated fears of a continuation of Cristina’s isolationist and antagonistic policies.
- For two primary reasons, we believe these fears are misplaced:
 1. The role of V.P. in Argentina is widely acknowledged as one of minimal importance, and choosing Zannini was a savvy campaign tactic. It ‘bought’ Cristina’s support, ensuring Scioli that he would be the Peronist party’s only candidate.
 2. Although foreign investors remain skeptical, insiders recognize Scioli as a non-ideological, pragmatic leader with a tenuous relationship with Cristina. Scioli will set his own agenda.
- It’s also important to recall that Scioli is a former entrepreneur who entered politics under Carlos Menem, whose government orchestrated the boom of the 1990s and became the darling of the Washington Consensus. Also noteworthy are his track record as Governor of the Province of Buenos Aires and the highly capable technocrats on his team.
- On August 9th Argentina held mandatory open primaries. With the support of the Peronist party, Scioli led with 38% of the vote, outpacing Macri by 7%. But the principal takeaway was that the election in October is still an open race. A potential second round in November could benefit Macri.



SUMMARY

- Since the primaries, Scioli's rhetoric has become more centrist. He recently stated that "investment will be a cornerstone" of his administration. Two preconditions for foreign investment are normalizing the FX regime and settling with the 'holdouts.' Sources suggest both would be addressed early 2016. Like Macri, Scioli will be incentivized to get the economy growing strongly well before the 2017 mid-term election.
- Over the summer, investors have faced a number of negative headlines (e.g. Greece, China, emerging market currency devaluations, etc.). The spike in risk aversion triggering outflows from emerging market funds have weighed on Argentine equities, despite many having little-to-no correlation to global markets.
- In assessing relative value across geographies, it's also noteworthy that Argentina has been in recession. Lack of foreign direct investment, lack of financing, an inability to raise prices due to regulatory capriciousness, high inflation, import/export controls, and a dual FX regime has translated into a disastrous environment for Argentine corporates. Not surprisingly, profitability and valuations are depressed. Regardless of whether Macri or Scioli wins, the operating environment for Argentine companies is set to improve.
- "Politics is like a violin," Juan Peron once remarked. "You hold it with the left, but play with your right." Scioli understands this. His rhetoric has moderated, edging towards the center in attempt to capture the majority of Argentines desirous of moderation and normalization. Both presidential candidates hear their demands. Investors should listen.

THE SCIOLI FACTOR

For much of the past year, Argentine equities had been driven by political dynamics. But stress in emerging markets, leading to devaluations and capital outflows, has contributed to recent declines...

MSCI Argentina Index



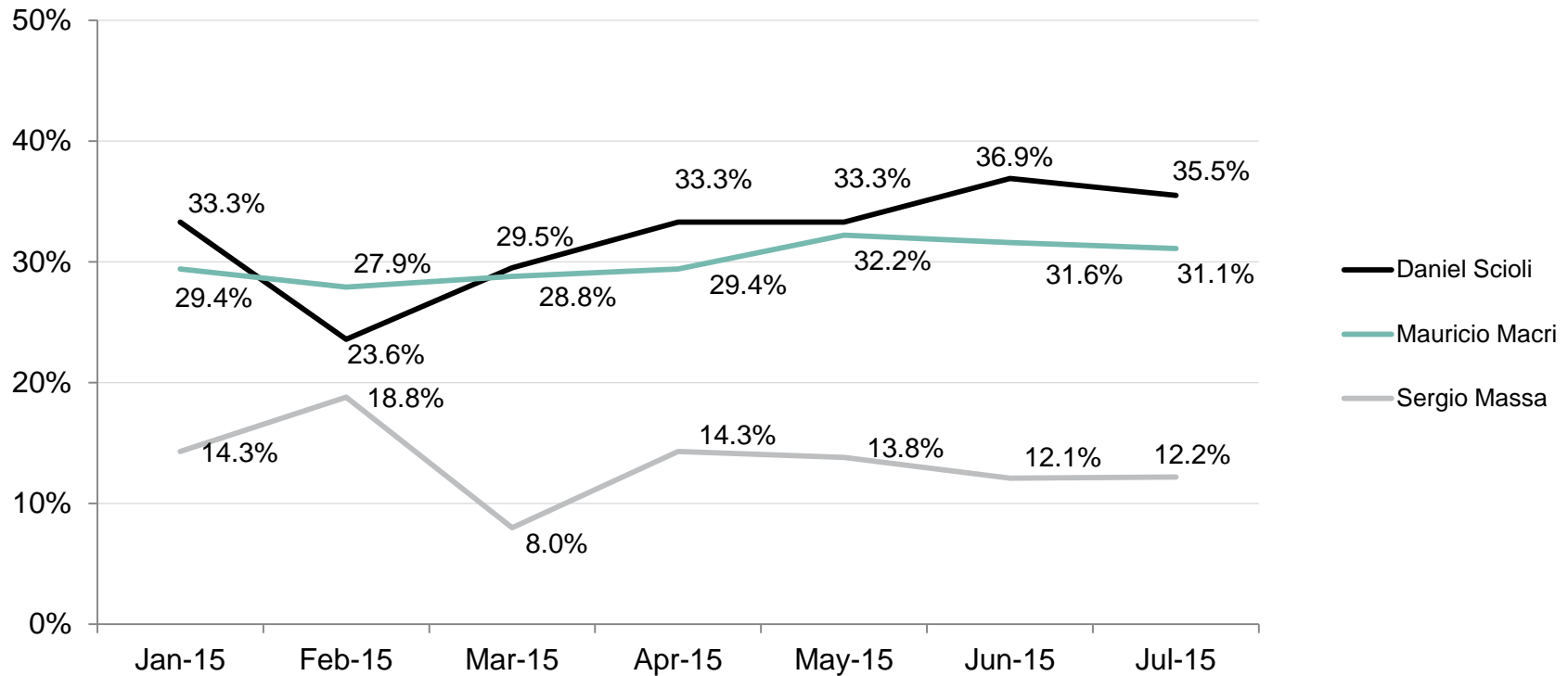
Source: Macrobond



THE SCIOLI FACTOR

What was a three way race for President has now become two. Scioli has gained momentum since February, partly due to his positive image and the improving support of Cristina Kirchner...

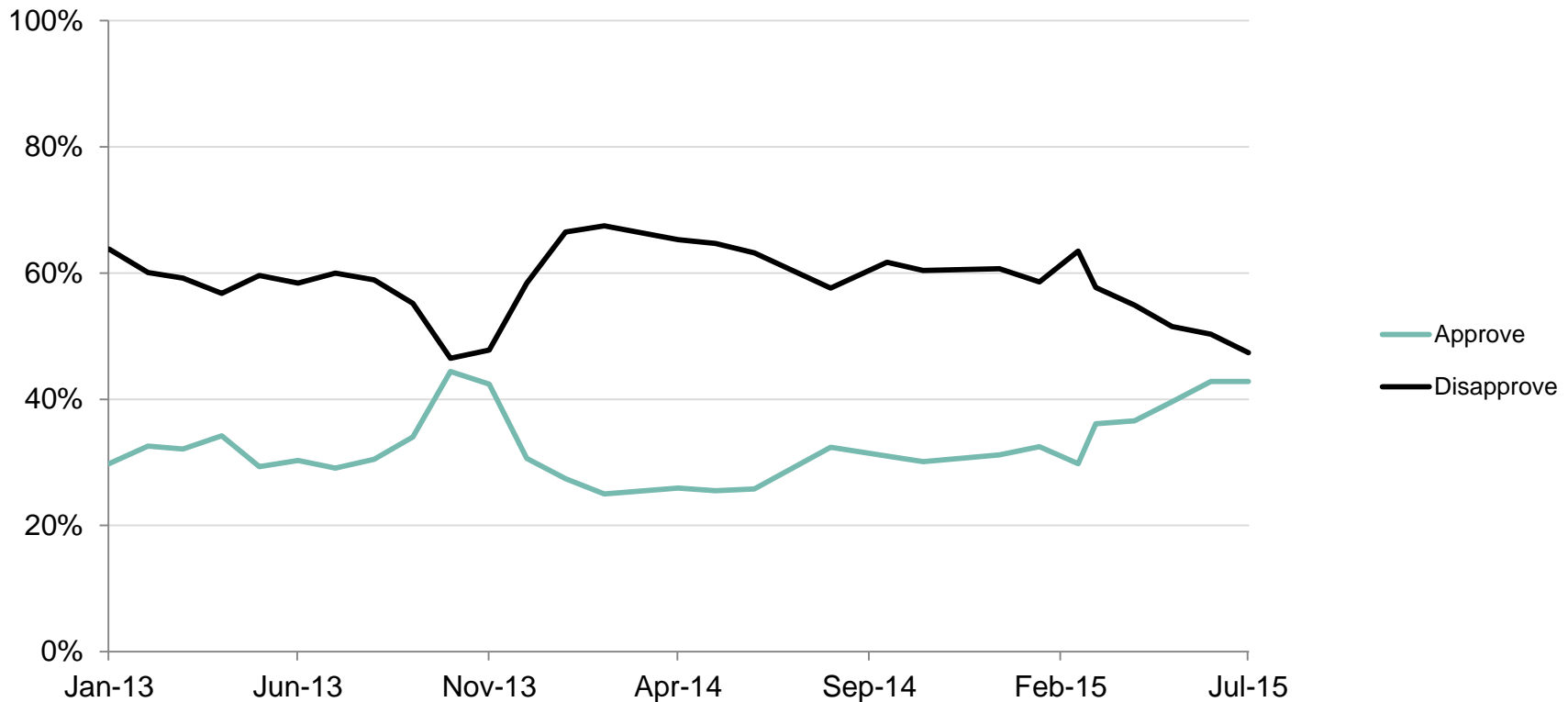
Presidential Vote Intentions



THE SCIOLI FACTOR

Cristina has spent heavily in her final year. Not surprisingly, her approval ratings have bounced, particularly among those benefitting from her administration's largesse. Consolidating her support for Scioli has improved his prospects in October's election...

Cristina Kirchner Approval Ratings



THE SCIOLI FACTOR

Argentina held mandatory primaries on August 9th. As polls had predicted, Scioli was the clear winner. But he failed to gather either 45% of the votes, or 40% of the votes with a 10% margin, which will be necessary in October's first round to avoid a runoff in November. A second round is believed to benefit Macri...

Primary Poll Vote Intentions

	FPV (Scioli)	Cambiamos (Macri)	UNA (Massa)	Difference (Scioli-Macri)
Poliarquia	37.6	30.7	18.1	6.9
Management & Fit	35.3	30.5	18.1	4.8
Giacobbe & Associates	36.1	32.3	18.1	3.8
IPSOS	35.9	29.1	22.0	6.8
CEOP	38.0	30.5	17.3	7.5
OPSM	38.1	31.1	18.4	7.0
<i>Polling Average</i>	<i>36.8</i>	<i>30.7</i>	<i>18.7</i>	<i>6.1</i>
Actual Result	37.9	30.6	20.5	7.3

Interestingly, Cambiamos—the party of 'Change'—performed better than expected in the Province of Buenos Aires' gubernatorial primaries.

THE SCIOLI FACTOR

Scioli's rise has weighed on the freely-traded 'blue chip swap' exchange rate, which fell from 12 pesos to 13.7 pesos to the dollar. The 'prospect of change' is needed to stabilize the FX. The currency market will not tolerate the perpetuation of Kirchnerism. Ultimately, the two rates need to converge towards the 'blue chip swap' rate where much of the economy already transacts...

Peso: Official Rate vs. Parallel FX Rate



The wide gap between the two rates will continue to put pressure on reserves, demanding that the next administration address the macro imbalances early in their term.

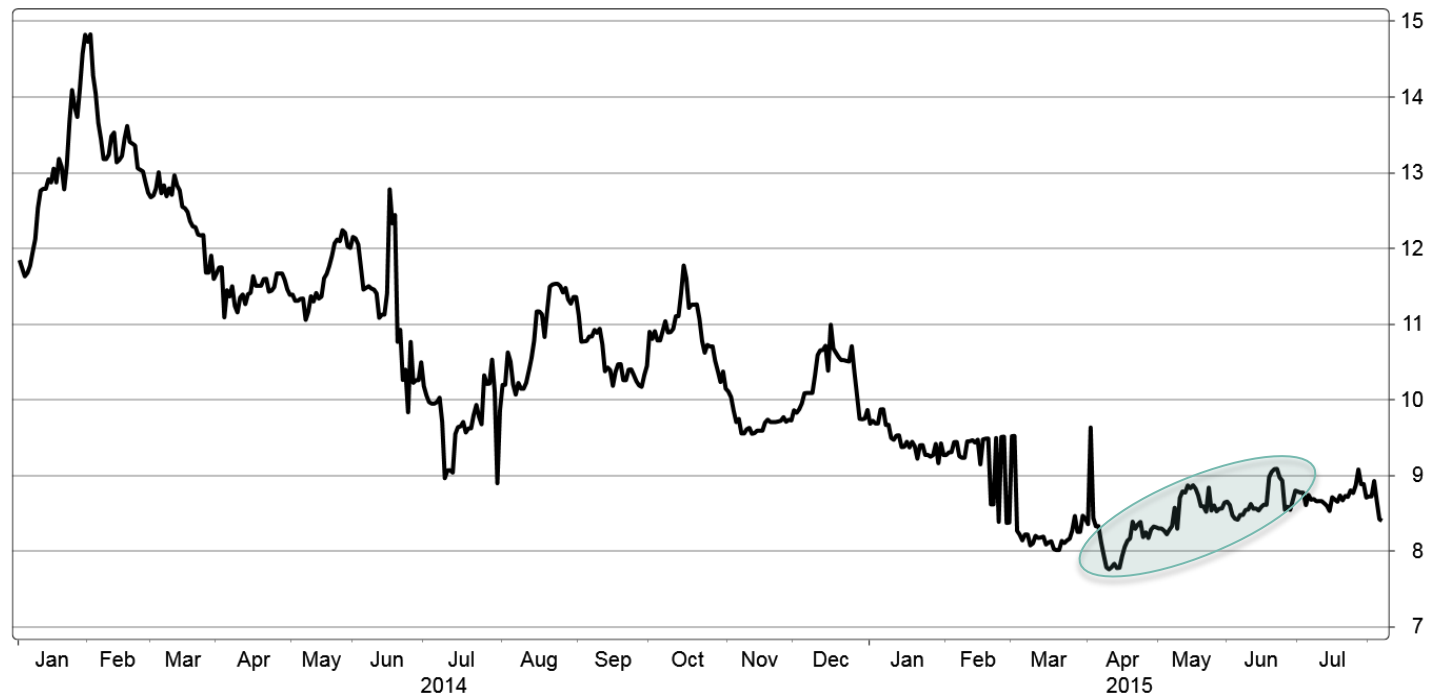
Without a comprehensive fiscal and monetary plan, a flight from pesos will arise from fear of future devaluations, draining reserves in the process.

Source: Macrobond

THE SCIOLI FACTOR

Yields on Argentina's debt had fallen during 2014 and Q1 of 2015. But as Scioli took the lead yields crept back up to 9%. Investors began to question whether Scioli would settle. We believe these fears are misplaced...

Argentina Discount Bonds, Yield to Maturity



Recently, Axel Kiciloff, Cristina's Economy Minister, even acknowledged that Argentina needs to settle in order to obtain access to financing

— Argentine Republic Government International Bond, Mid Yield To Maturity

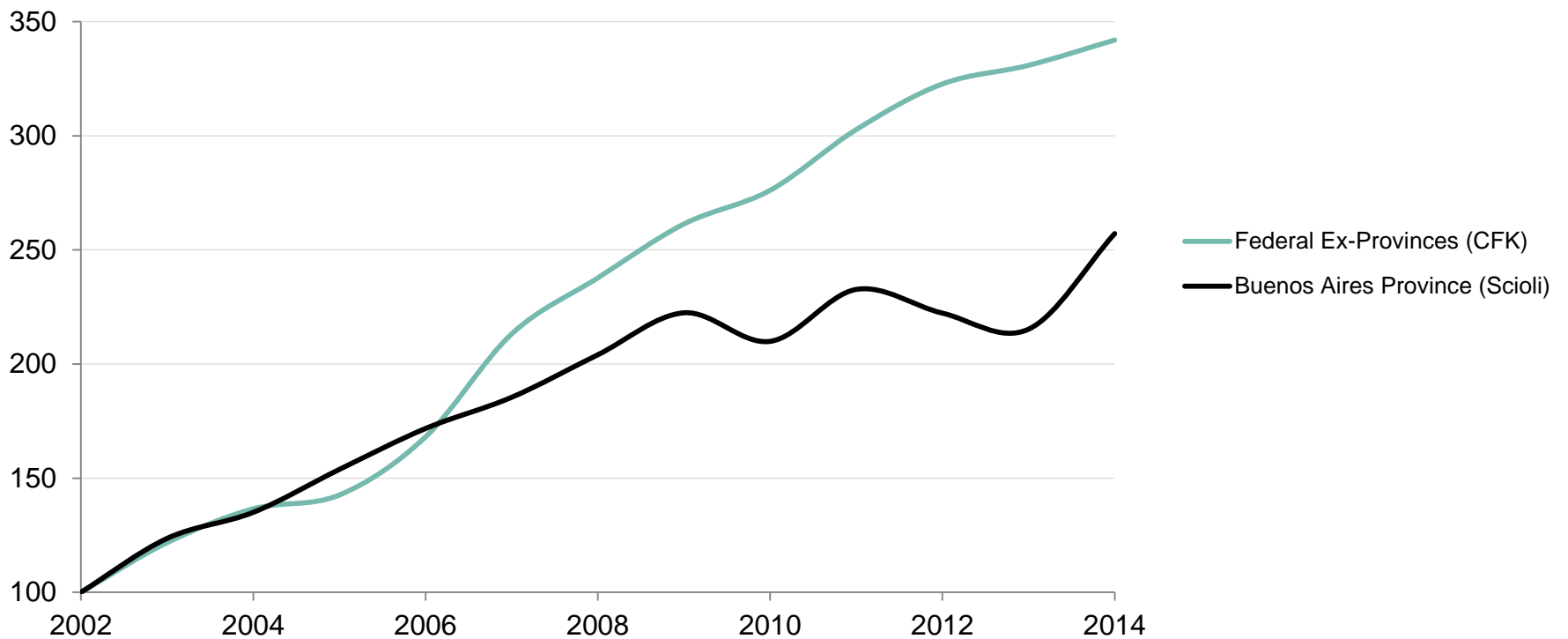
Source: Macrobond



THE SCIOLI FACTOR

Investors have seemingly prejudged a potential Scioli administration by his campaign rhetoric, rather than his actual track record as Governor of the Province of Buenos Aires, which has received scant attention by newer observers of Argentina. In terms of government spending, Scioli was more disciplined than President Kirchner...

Primary Spending, in Real Terms (Rebased to 100)

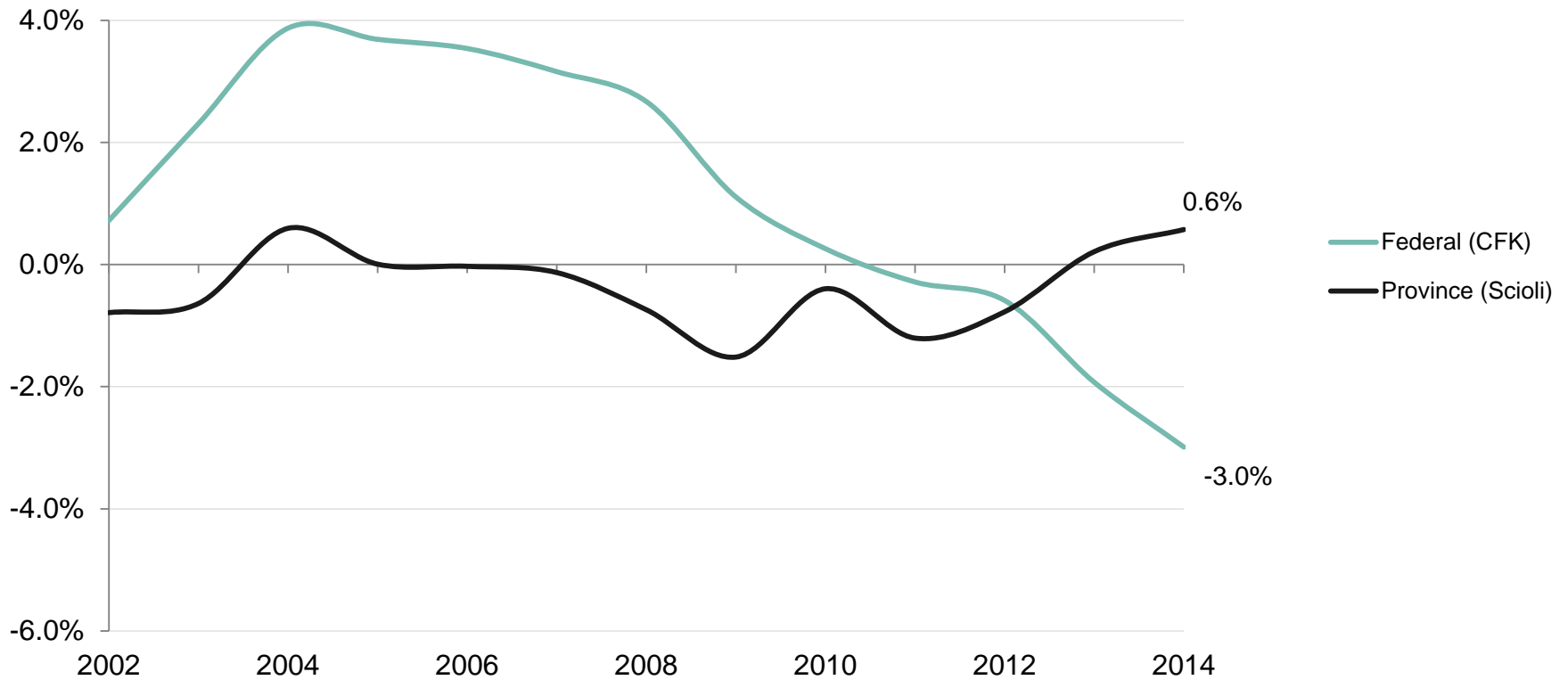




THE SCIOLI FACTOR

Scioli has also maintained a primary budget balance in the province while the national government has run persistent deficits since Cristina's reelection in 2011...

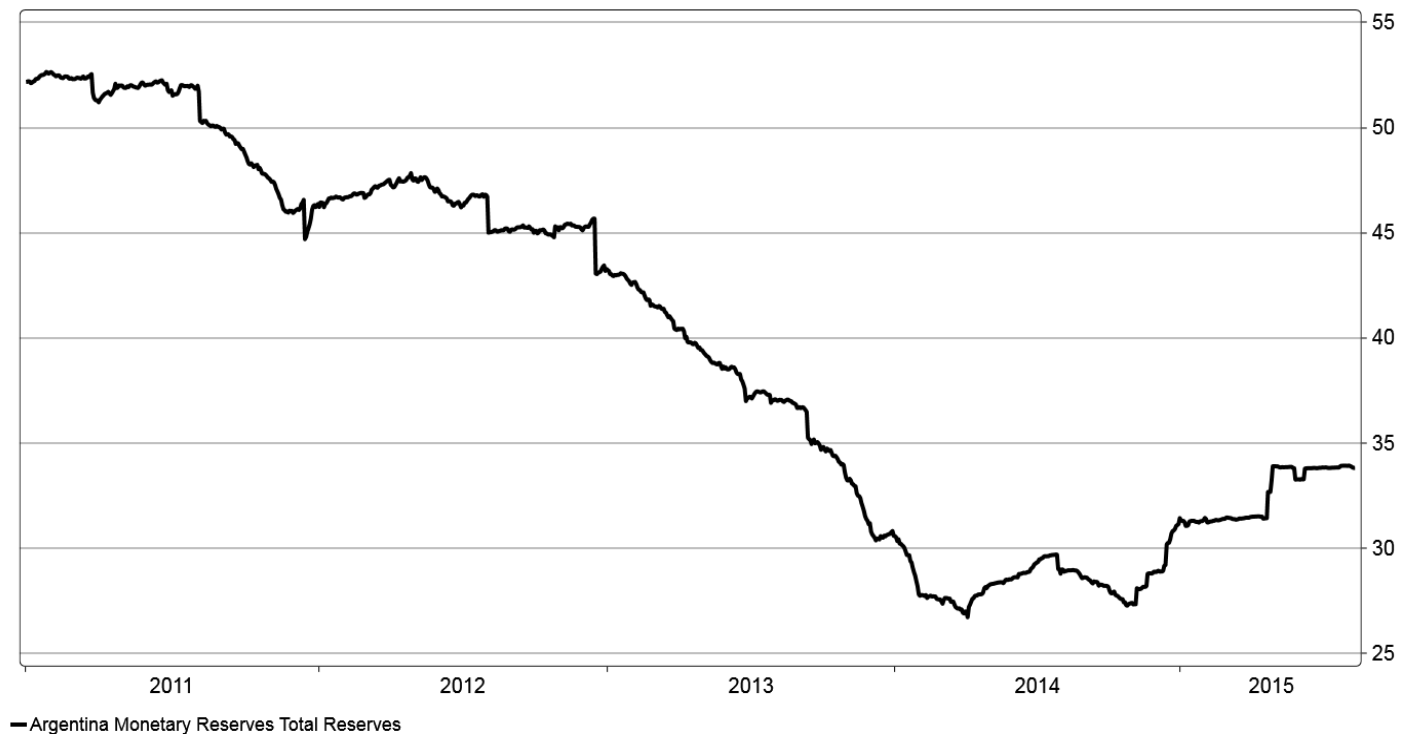
Primary Balance (% of GDP)



THE SCIOLI FACTOR

Argentina's reserves fell during 2014 before the Kirchner administration took several one-time measures to stem the decline. Scioli claims that he wants to be "the president of investment." Investment requires financing. Given today's level of reserves, a deal with the 'holdouts' is a prerequisite. It will allow Argentina to borrow internationally and remove a barrier to FDI...

Argentina: International Reserves (\$, billions)



Source: Macrobond

Argentina has several billion dollars of debt payment coming due in October, in addition to a current account deficit.

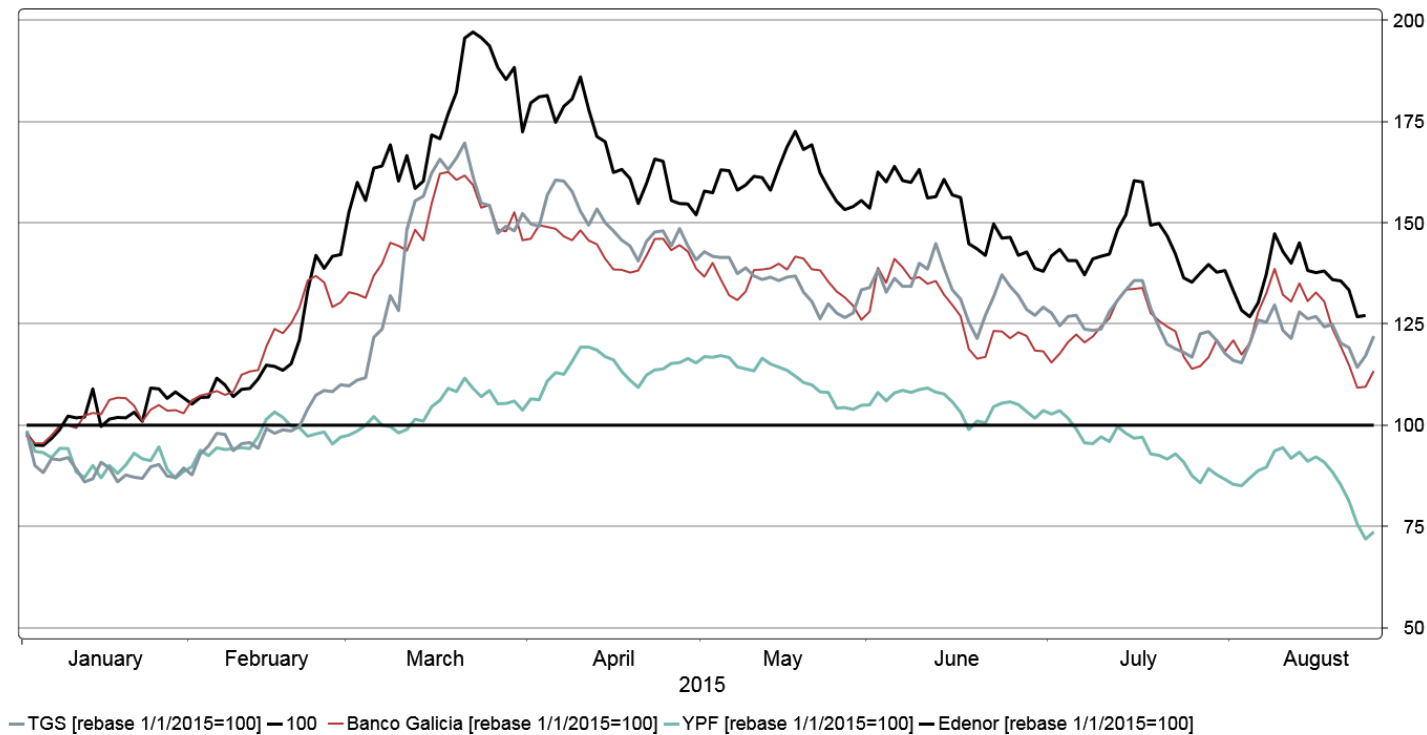
Restoring access to international credit and dollars will be critical for the next administration



THE SCIOLI FACTOR

In contrast to YPF, Argentina's largest oil company, many other domestically-oriented companies are more levered to reform. Utilities, telecom and gas transportation companies have experienced a great deal of volatility, but remain highly geared to policy normalization, allowing them to recapture previous pricing power and profitability...

Select Argentine Equities (January 1, /2015 = 100)



Source: Macrobond



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