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# Argentina Strategy Update: Creative Destruction vs. The Game Clock

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***After the harrowing May to July currency crisis in Argentina, many market players are now endeavoring to evaluate if Argentina is going to claw its way out of this ditch. The question on most investors' lips is: could this "sudden stop" be a harbinger to yet another default chapter in Argentina's tattered economic history or is it a major historic watershed? The short-lived, dead cat bounce in the USD sovereign curve and subsequent selloff this week are powerful evidence that the jury is still out to lunch on Argentina, despite the IMF's bazooka and the energetic assurances coming out of the government's economic team. At this point, we can conclude that the situation is increasingly binary and the final outcome for the country's financial assets will depend on a confluence of tectonic shifts in microeconomic variables, the BCRA's inflation pass-through contention plan, and a full-blown flip in the twin towers deficit paradigm. From our contacts within Cambiemos, we have heard from multiple sources close to the party's leadership that President Macri is absolutely committed to the fiscal adjustment plan negotiated with the IMF, come what may. For this reason, in this report, we are going to turn our attention to how the development of certain microeconomic sectors could advance the government's goal of revolutionizing Argentina's economy, including the oil and gas industry, the automotive manufacturers, agriculture and tourism. As always, we will also provide updated quantitative data on the BCRA's monetary policy and FX regime as the reengineering process underway at Reconquista 266 is absolutely mission critical to underpin the private sector's quest for competitiveness. Inflation remains public enemy No. 1, and while in 2018 it will still run wild, the evolution of prices in 2019-2020 may prove to be the linchpin to Argentina's success or failure. We believe there is room for guarded optimism, but our goal here is not to communicate our unequivocal bullishness on Argentina's fixed income universe; instead, we are intent on presenting a macro construct for research driven investors who want to look beyond the headlines or reactionary research that espouses the herd mentality. Argentina's game clock is running down and only creative destruction can deliver the winning three pointer.***

**After The Notebook Reversal, Argentina Faces An Uphill Climb of 6-9 Months**

The underlying theme of this report is tangentially constructive, but for investors with a strict entry point discipline, we would characterize the next six months as an arduous uphill climb to regain credibility. ***In our review of historical analogues involving structural fiscal and current account adjustments, GDP growth always suffers during at least 4-6 quarters. In an April 2016 World Bank study entitled "Managing Sudden Stops" authored by Barry Eichengreen and Poonam Gupta, the researchers identified 44 sudden stops in 34 countries. These episodes lasted on average of four quarters, and capital outflows in some cases reached almost 6% of GDP over the adjustment period.*** In addition, in this report, we refresh our 66% trading rule for nominal EM currency devaluations, and our sample analogues point to a 9-month period before the 5Y CDS of the affected countries begin to decline in a sustained manner. This suggests that the exit velocity from the crisis may not materialize until February 2019 if this rule of thumb holds true. There is no guarantee that it will. Simplistically, EM debt investors typically favor growth tailwinds over adjustment messiness, and the ugly activity numbers that pop up during a C/A adjustment typically undermine sentiment until a +100bps contraction in the current account deficit is registered. In the following pages of this report, we will delve into the transformational process underway in Argentina that will require time to bootstrap the macroeconomic variables. Without a doubt, the market is a fickle mistress, and there is no guarantee that this makeover will arrive before the market becomes convinced that Cambiemos has run out of time on the game clock.

**Macri's Economic Plan Needs More Time**

**The Macri Government Must Recover Market Access To Allay Concerns**

In today's world, there are only a select group of indebted creditors who can survive an extended closure of their market access. Rolling over debt is what makes the global fixed income markets go around and around. Based on our conversations with clients, there is a back-of-the-envelope estimate making the rounds among the US hedge fund community that assumes Argentina will need to raise US$19bn in the capital markets during 2019, even with the US$11.7bn in disbursements planned from the IMF. In the table below, we can see that the gross financing needs are US$29.44bn, but this does not take into consideration the debt held intra-government. On a rough basis, taking this left-pocket-right-pocket condition under consideration, the hurdle would drop to around US$20bn. On top of this, we would have to add the primary deficit of 1.3% (P$250bn), which converted to dollars at the average estimated exchange rate of 33.25, we arrive at an incremental hole that approximates US$7.5bn. The interest coverage on existing debt is already captured in our amortization of principal and interest provided below. Let's assume that debt costs climb US$1.5bn based on the IMF and bond issues added year-to-date. This assumption places the PSBR (public sector borrowing requirement) at US$29bn. If we subtract the US$11.7bn in fresh IMF funds scheduled for 2019, we can come dangerously close (US$17.3bn) to the market's calculation.

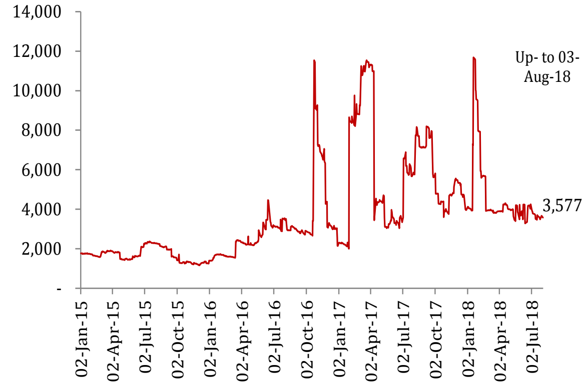
**Our Advice: Focus-In On How Much Cash The Treasury Carries Over To 2019**

In reality, we forcefully recommend that market players should be monitoring the combination of the disbursement funding together with the evolution of stockpiled peso resources that will be carried over into 2019. Time will tell, but we need to test the market's presumption that the entirety of the 2018 disbursement from the IMF (US$21bn) is going to be spent this year, in seven months no less. As of August 3rd, public sector deposits remained large at P$677.6bn (+77.6% ytd) of which P$434.7bn were sitting in time deposits earning BADLAR rates close to 34.5%. If we assume that 80% of this cash is the Treasury's holdings, this represents the whopping sum of US$19.6bn. To this stash, we need to add US$9.6bn in the Treasury's BCRA dollar account and US$3.6bn in the USD account in the public sector banks (some of this is owned by the provinces). On a rough estimate, Dujovne's team is managing around US$28-U$29bn in liquid resources, and we suspect that the Wall Street economists may not be factoring in the pesos that were stored away with the 2018 bond issues. This cash inventory was bolstered by the US$9bn captured by BONTES and DUAL bonds issued since the crisis broke out. The one plug in the model that the market is lacking is the level of LETES rollover.

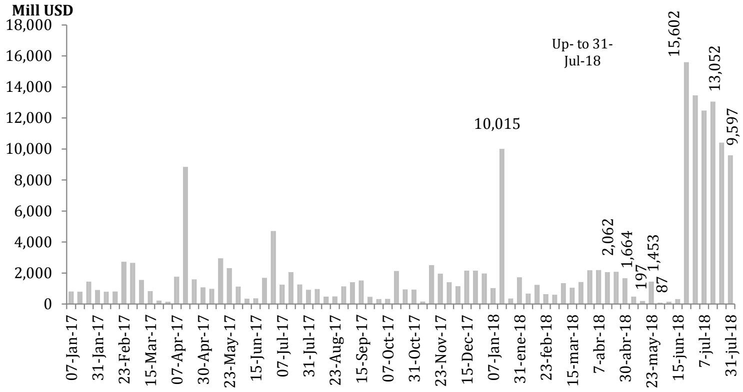
Therefore, the burning question for the financial markets is how much of this cash pile will be carried over into FY19 to chip down the refinancing hurdle that Argentina faces.

| Sovereign Bonds Amortization Schedule | | Jun-18 | Jul-18 | Aug-18 | Sep-18 | Oct-18 | Nov-18 | Dec-18 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Local Currency | Amortization | 476 | 0 | 1,307 | 3,191 | 1,071 | 627 | 3,259 | 6,402 | 8,738 | 3,510 |
| | Interest | 1,148 | 248 | 319 | 1,213 | 1,272 | 247 | 1,117 | 3,780 | 2,703 | 1,791 |
| Foreign Currency | Amortization | 2,559 | 1,706 | 1,806 | 2,057 | 1,556 | 5,527 | 1,106 | 10,956 | 7,012 | 17,791 |
| | Interest | 1,458 | 641 | 13 | 262 | 899 | 1,070 | 1,453 | 8,308 | 7,919 | 7,189 |
| Total | Amortization | 3,035 | 1,706 | 3,113 | 5,248 | 2,627 | 6,155 | 4,365 | 17,357 | 15,750 | 21,301 |
| | Interest | 2,606 | 889 | 332 | 1,474 | 2,172 | 1,317 | 2,570 | 12,088 | 10,622 | 8,981 |
| Total | Local Currency | 1,624 | 248 | 1,625 | 4,403 | 2,344 | 874 | 4,376 | 10,182 | 11,441 | 5,302 |
| | Foreign Currency | 4,018 | 2,347 | 1,819 | 2,319 | 2,455 | 6,598 | 2,559 | 19,264 | 14,932 | 24,980 |
| Total | | **5,642** | **2,595** | **3,445** | **6,722** | **4,799** | **7,472** | **6,935** | **29,446** | **26,373** | **30,282** |

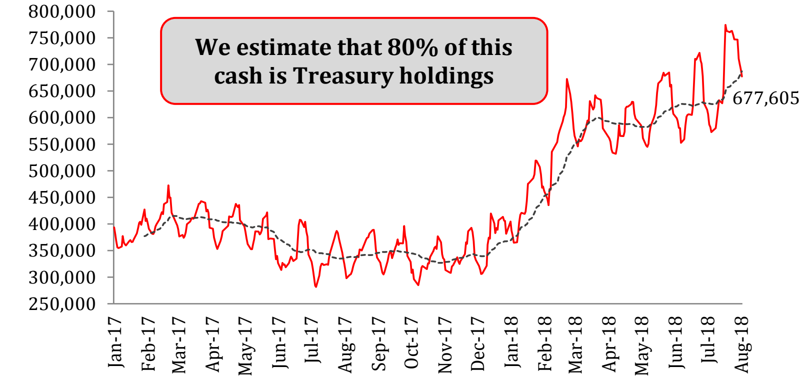
## Public Sector US$ Account




## Caputo's USD in BCRA Account



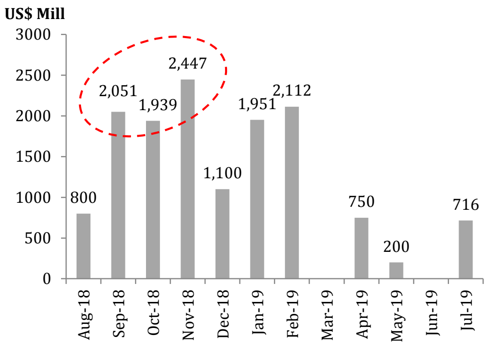

## Public Sector Deposits in ARS



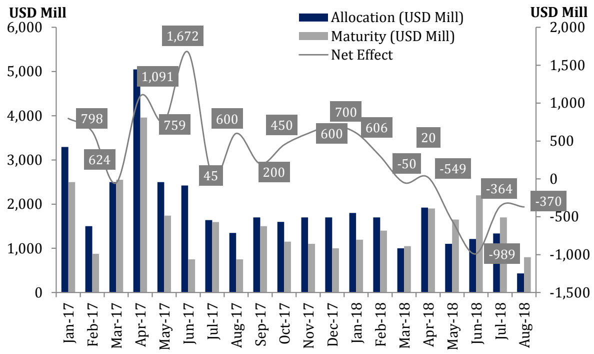

### The US$14.8bn LETES Maturity Schedule Represents The Key Unknown Variable

In one-on-one meetings with the government's economic team, analysts are usually left with the impression that the officials suffer from over-confidence. Post the IMF deal, the economic team has been quoted as saying "the LETES rollover is not a problem, investors will reinvest". In the table below, we can see that this supposition is now being called into question, and the contraction in the LETES stock inevitably will eat into the stockpile of cash that the Treasury has earmarked for other interest and debt amortizations coming down the pike. We believe that the Treasury is committed to shrinking this toxic short-term dollar debt by 20%-25% in order to de-risk the Sword of Damocles that the twice-monthly auctions have started to present, but it is unlikely that the resource planning envisioned a rollover ratio of less than 60%. On August 8th, the Treasury only rolled over US$430m or 54% of the LETES that were maturing, and it had to pay up with a 4.99% interest rate that was the second highest on record for the 182-day security. On August 24th, there is another US$999m in LETES coming due, and in the four months including August, the rollover challenge totals close to US$8.2bn. The rapidly declining appetite for the six-month LETES contrasts with healthy secondary market demand for 1-3 month LETES, which are favored due to the perceived backstop provided by the IMF program. The reticence we are seeing in buying 6-month to 1-year paper is alarming to say the least, and the sentiment spiral could begin to affect the LEBACs rollovers that are much larger in size.

## LETE Maturity Profile




## LETE Rollover



**Argentina Is Embarking On A High Stakes Version of Schumpeter's Creative Destruction**

The Austrian economist Joseph Schumpeter (1883-1950) was made famous for his *"creative destruction"* economic theory which effectively describes the chaotic and often-times painful way capitalism generates progress. Inherent to this construct is the free market's continuous progression towards revolution and innovation that inevitably leads to lost jobs, bankrupt companies and vanishing industries. Over time, the society offsets these costs by creating new industries, more advanced products and higher paying employment opportunities. The essence of creative destruction is that you have to tear down in order to build up. We believe that the Macri administration is consciously or unconsciously pushing forward a Schumpeter's gate in an Argentine economy that has been battling against modernization and economic opening ever since Peron empowered the country's labor unions in 1945. We have no doubt that the government's efforts to revolutionize the Argentine private sector will continue to meet with stiff opposition from organized labor, especially the historically powerful truckers' union headed by Hugo Moyano. Cambiemos' economic team is populated with former CEOs and experienced private sector managers who are convinced that Argentina's future depends on fortifying the economic sectors that can generate or attract USD investment, boost exports and engender the creation of associated clusters (suppliers, infrastructure etc) that will help build the capital stock.


**What Are Some Clear Examples Of Creative Destruction Underway?**

For the skeptical bunch out there, we think it is worthwhile to enumerate a few examples of the *creative destruction strategy* that Macri's administration is deploying to revolutionize Argentina's economy. The main problem with this process is that it is lengthy and the vested interests who are suffering the negative consequences of this revolution are not willing to go quietly into the night. Below we list a few examples of the manifold initiatives that have already shown promise (and the injured parties' reaction):

1. **The elimination of import tariffs on notebooks and other home electronics.** For years, Tierra del Fuego has been a huge profit pool for a small group of companies that were importing kits and assembling laptop computers, PCs and televisions under tax-free and tariff protected status. The Macri government assertively reduced the import tariffs on internationally produced notebooks and televisions, which led to dramatic price drops in the domestic market. Overall assembly employment in Tierra del Fuego declined from 19,845 in 2015 to 14,259 in 2017. Total sales from TF factories cascaded down to US$3.2bn in 2017 from US$4.85bn in 2015. On the flip side of this inflicted pain, national notebook sales exploded +60.4% yoy in the first ten months of 2017, and video game console sales surged 52.4%. In a recent move, the Macri government just launched a plan for air conditioners to bolster the plants in Tierra del Fuego through an exchange program for outdated units to swap for newer efficient units. LED TV sales jumped +90% in the first half of 2018, helped by the World Cup but intrinsically made possible by the manufacturing reconversion plan. Meanwhile, cellular firms, Nokia and Xiaomi, are studying new investments in Tierra del Fuego to take advantage of the huge market for handsets. **In this example, the Argentine consumer and companies now have access to cheaper technology, the government cut subsidies channeled to protecting Tierra del Fuego, and the manufacturers have restructured their operations to take on new products.**

2. **The liberalization of fuel prices.** In November of 2017, the Macri government decided to replace a regulated pricing system for domestic fuel prices that was used to control inflation. In a free market mindset, a price liberalization system to match international crude price levels was initiated. While the implementation process was detoured by the huge devaluation in May-July, the government has taken a firm, and controversial, decision to reach import price parity by year-end. ***Already, gasoline prices have been hiked 31% this year (including +7% in the last few days) and additional boosts are coming in October (7%) and November/December (6% each month). This wrenching process is being executed even considering the risks to inflation.*** This polemical economic decision will undoubtedly lead to the failure of many inefficient trucking firms that will be unable to pass on higher costs in a recessionary environment. The truckers union is a sworn enemy of the current administration. Inefficient small-and-medium sized companies (PYMEs) will not survive if their energy costs crush their margins. At the same time, this implicit guarantee of market driven pricing is designed to stimulate further investment in Argentina's oil and gas sector with an emphasis on Vaca Muerta. Global oil majors who can envision obtaining international prices for their crude production are more likely to double down on their bets. Oil investment should have a domino effect on the creation of oil services companies, construction companies for the civil works around the production fields and service companies (caterers, bus companies, electricians, plumbers and housing builders) to accompany the development of new fields. Lastly, higher fuel prices in pesos will significantly boost tax collection, thereby aiding the fiscal adjustment campaign.

3. **The onset of low cost airlines.** The Macri administration has successfully attracted new low cost operators to Argentina's airline industry, a sector that has historically been characterized by a tight oligopoly and price regulation. New players like FlyBondi, Norwegian Air and Andes have spurred an unprecedented price war in domestic airfares in the last six weeks. This new affordable pricing architecture is killing long haul bus companies who have traditionally gouged low-income travelers who needed to visit their families in the interior. Once again, the transportation union is seeing job destruction here, and the bus companies are being forced to restructure to compete. The economic benefits are being seen in a sharp uptick in domestic tourism, and higher investment in regional airports. The Santa Fe, Cordoba, Mendoza and Tucuman airports have been upgraded and passenger traffic domestically is growing around 15%. The jobs lost in the bus industry will be replaced by hotel, restaurant and airport employment that should arise from higher domestic travel activity. Corporate travel to the interior becomes cheaper, and this should facilitate more investment activity.

4. **The forced sale of the Prisma credit card monopoly by the banks.** In order to bring down Argentina's sky-high point-of-sale fees for Primsa, the dominant VISA card player in Argentina, the Macri government mandated the sale of this credit card processor that is jointly owned by 14 Argentine banks. By forcing the divestment of this virtual monopoly, the BCRA has begun a process to bring down POS charges to retailers (see below). While the banks lose a hefty source of easy cash flow, the society benefits from the sharp decline in transaction costs (that eventually spilled over into inflation). In this case, the banks have had to materially reduce credit card promotions and discounts in order to offset the loss of profitability and the sale of the control stake in Prisma, estimated at US$1.5bn. This will pave the way for new entrants and more intense competition in the payments sector. The capital ratios of the top four banks will be bolstered by the profits from the Prisma sale, thereby fortifying the banking system's underlying capitalization level. This is a win-win.

**Lowering POS Rates Cuts Transaction Costs Across Retail Channels**

| Period | Max Interchange Rate | | Max Total Rate | |
|---|---|---|---|---|
| | Debit Card | Credit Card | Debit Card | Credit Card |
| 2017 | 1.00% | 2.00% | 1.20% | 2.50% |
| 2018 | 0.90% | 1.85% | 1.10% | 2.35% |
| 2019 | 0.80% | 1.65% | 1.00% | 2.15% |
| 2020 | 0.70% | 1.50% | 0.90% | 2.00% |
| 2021 + | 0.60% | 1.30% | 0.80% | 1.80% |

**Monetary Targeting: The Proof Is In The Pudding**

When the new BCRA leadership communicated its intention to transition from an inflation-targeting regime to a monetary-targeting program, this announcement came with hardly any technical explanation about how "this time will be different". Moreover, the academic literature on the costs and benefits of monetary targeting is surprisingly sparse. Colombia University's Frederic Mishkin is the most prolific author on monetary targeting, but his key study "*From Monetary Targeting to Inflation Targeting: Lessons from Industrialized Countries*" actually ends up concluding that the inflation targeting recipe is preferable in many countries. Moreover, Mishkin stipulated that a well-designed "*monetary targeting strategy comprises of three elements: 1) reliance on information conveyed by a monetary aggregate to conduct monetary policy, 2) announcement of targets for monetary aggregates, and 3) some accountability mechanism to preclude large and systematic deviations from the monetary targets.*" The BCRA has not delineated any of this requisite detail so far, and we are not sure that it is forthcoming anytime soon. ***If it ain't broke, why explain it?*** Therefore, we need to review the evolution of key monetary variables to pin down what the BCRA is doing and how this activity should impact the ARS and inflation pass-through.

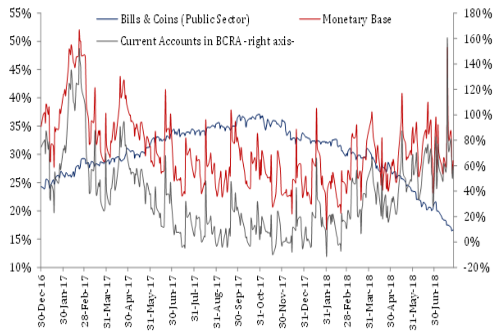
**Observation: The New BCRA Team Has No Qualms About Playing Tough With The Banks**

When we talk to clients about the BCRA's new modus operandi under Toto Caputo, we always begin with a clear differentiation with the Federico Sturzenegger regime. ***Caputo and his sidekick Gustavo Cañonero have shown absolutely no hesitation about exerting their regulatory power over the public and private sector banks in order to achieve their assorted objectives. This tilt contrasts with Federico Sturznegger's kinder-and-gentler handling of the BCRA's relationship with banks that was grounded in his belief that the Central Bank's role included promoting credit penetration in the economy.*** Immediately after sliding into the BCRA's presidential suite, Caputo quickly announced a two-stage hike in reserve requirements of 3% in June and 2% in July, a tool that Sturzenegger only utilized once in June-July 2016, but then reversed. This 500bps squeeze through non-remunerated reserves was augmented by another 300bps after the worrying -5% devaluation of the ARS in the final days of the second quarter that spooked BCRA officials. In the charts below, we demonstrate how the deployment of the blunt force tool of reserve requirements has succeeded in reining in runaway MB expansion, especially in the key sub-set category called "*money in circulation in the hands of the public*" which evidenced a step function drop in its expansion rate from 24.5% in late May to 15.9% currently. Put simply, this policy action was designed to mop up pesos under the theory that you cannot buy dollars if you do not have pesos.

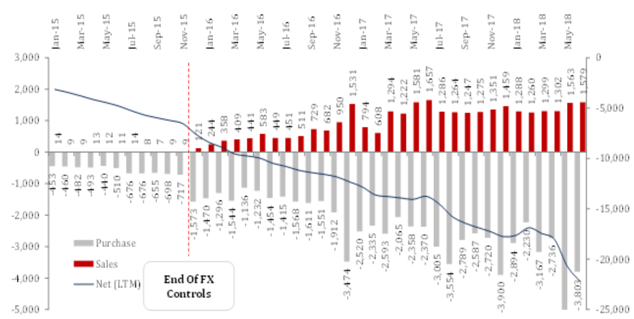
**Monetary Aggregates Converging To Where The BCRA Wants Them To Go**

In the following three charts, we examine three different slices of Argentina's monetary aggregate pizza pie. In the first graph, we can pinpoint that the major progress achieved since March has been evidenced in the significant step function move down in the amount of currency circulating in the hands of the public (transactional cash). This key component of the MB calculation is now only growing at 15.9% yoy vs. LTM CPI inflation of 29.5% (-13.5% in real terms) compared with a nominal growth rate of 25% at the end of April. The rationale behind soaking up transactional currency is to stem the demand for dollars from retail investors who bought a net US$3.44bn in May and a chunky US$2.22bn in June. As we can see, the current annualized expansion rate is materially below the prevailing levels during the first two years of the Macri administration, and we conclude that this is an intentional campaign to control ARS volatility and to quell inflationary pressures.

**Bills & Coins, Bank's Current Accounts & Monetary Base** *(YoY)*



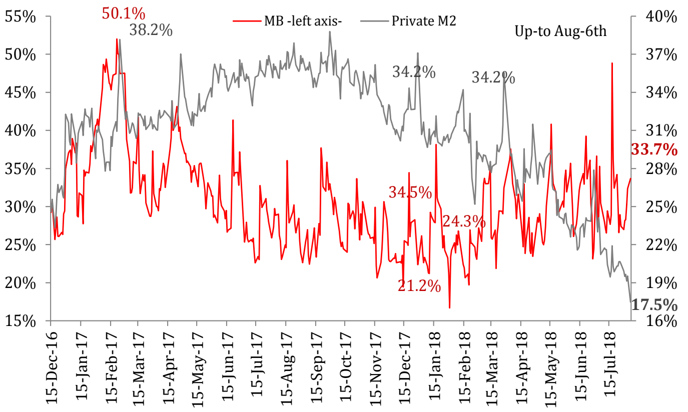

**USD Monthly Purchases** *(Net)*



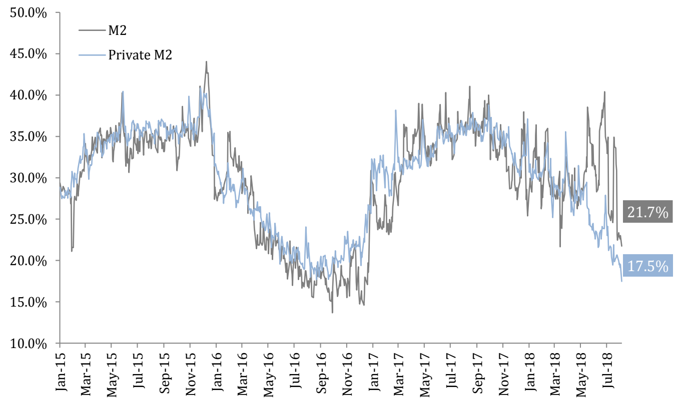
In the second set of pictures, we examine the broad Monetary Base (MB) and the M2 Private monetary indicator. While the MB's expansion rate has indeed been ratcheted down to 33.7%, the freefall in the M2 private's run rate is exposing the deceleration in private sector credit extension and the shrinkage of transactional bills and coins in circulation. Once again, the M2 private's growth rate (17.5%) is at all-time lows for the Macri era. Peso loan growth has only expanded by 0.5% in the last 30-days and by 1.95% in the last sixty days. This two-month growth pace equates to an annualized rate of 12.28% which is much slower than the trailing 46.1% for the LTM.

**Argentina's MB, M2 and M2 Private Reflect New Monetary Targeting Tactics**

**MB Vs Private M2** *(YoY)*

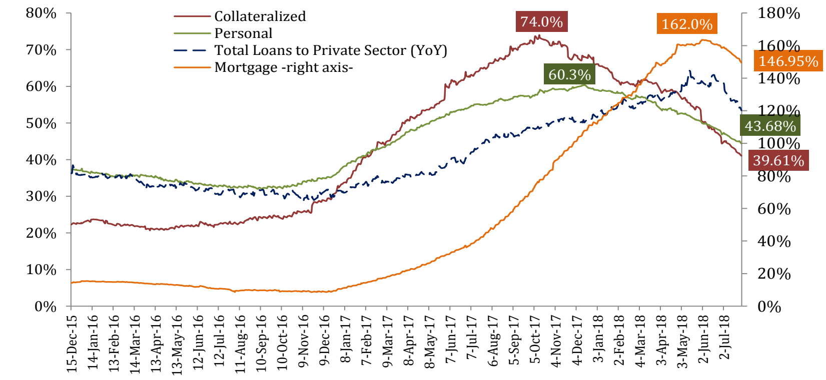



**M2 & Private M2** *(YoY)*




In the final chart in this series, we graphically demonstrate the marked slowdown in credit extension with the steepest ski slopes seen in collateralized credit sliding from 74.0% yoy in October 2017 (right before the mid-term elections) to 39.6% (Aug-2nd) and personal loans downshifting from a 60.3% pace in December 2017 to 43.7% recently. From an inflation fighting perspective, this pull-back in the red hot, loan growth momentum removes some of the inflationary aggregate demand push that complicated the BCRA's disinflation program during 2017.

**YoY Loan Growth Rates** *(Mortgages, Car Loans & Personal Loans)*




**Groundhog Day: The Next Chapter In The LEBACs Maturity Mountain Vigil**

Just like Bill Murray's recurring encounter with the irritating Ned Ryerson character in the *Groundhog Day* movie, Argentina's market participants will once again begin chattering about the ostensibly worrisome August 15th LEBACs auction where P$528.8bn in securities are set to mature. As we continuously like to remind Nervous Nellies, the rollover hurdle is a moving target that is a work-in-progress for the BCRA trading desk. As we can see, the BCRA has been toiling to chip down the August 15th maturity mountain with the total amount of bonds maturing down to P$528.7bn on August 2nd from P$609.4bn on July 23rd. The lion's share of this contraction has been achieved by shifting LEBAC holders from the August 15th to the September 19th maturity in order diminish the "perceived risk" to the ARS if the rollover ratio is below 75%. From our contacts with BCRA officials, we have learned that the monetary authority is actively working with market players to further reduce the size of the August 15th maturity amount in order to reduce the angst and currency preoccupation that accompanies this monthly ritual.

**The LEBACs Monthly Auction Vigil: As Irritating As Ned Ryerson**


**LEBAC Maturity Evolution From July 23-to- August 6**

23-Jul-18

| Lebac Auctions | Maturity | |
|---|---|---|
| 15-Ago-18 | 609,374 | 65.1% |
| 19-Sep-18 | 179,331 | 19.1% |
| 17-Oct-18 | 111,059 | 11.9% |
| 21-Nov-18 | 33,192 | 3.5% |
| 19-Dec-18 | 3,529 | 0.4% |
| **Total** | **936,485** | |

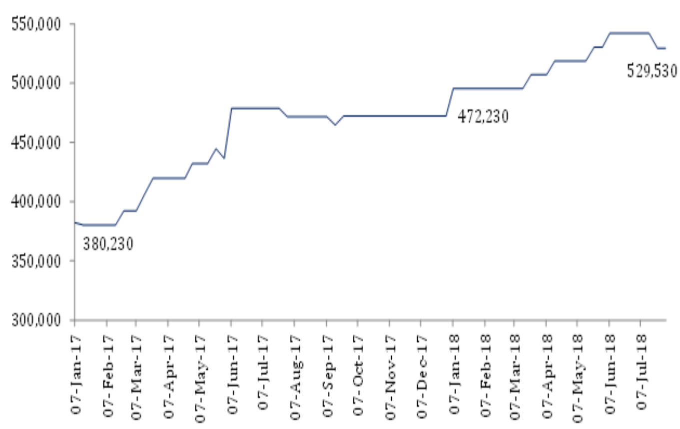
07-Aug-18

| Lebac Auctions | Maturity | |
|---|---|---|
| 15-Ago-18 | 528,774 | 54.3% |
| 19-Sep-18 | 275,479 | 28.3% |
| 17-Oct-18 | 124,163 | 12.7% |
| 21-Nov-18 | 42,408 | 4.4% |
| 19-Dec-18 | 3,529 | 0.4% |
| **Total** | **974,352** | |

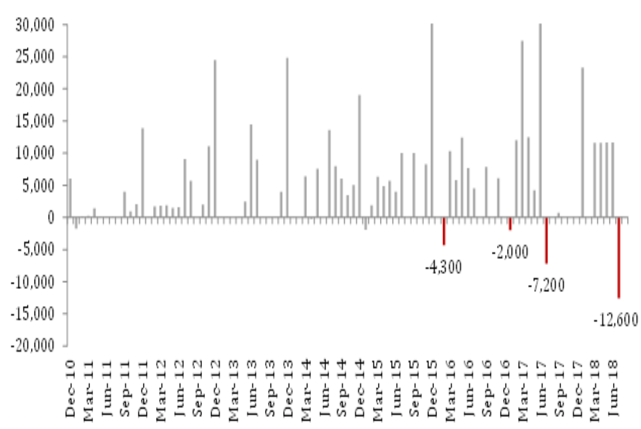
**Unwind Of Automatic Transfers Balance Is New Path To Shrink LEBAC Stock**

A highly esoteric, technical wrinkle in the relationship between the BCRA and Treasury has emerged in the last two weeks, and this alteration is linked to the IMF's insistence on improving the BCRA's balance sheet as an integral target within the overall financial program for Argentina. For the time being, the Attorney General has not given the legal authorization to the Treasury to cancel the Non-transferrable notes (IOUs) due to the difficulty in valuing this asset. Instead, two weeks ago, the Treasury paid back P$12.6bn of the *Adelantos Transitorios* stock (Temporary Transfers) that came due for renewal, and this transfer of pesos to the Central Bank effectively shrinks the monetary base by the same amount. Indirectly, this allows the Central Bank to allocate fewer LEBACs in the upcoming auction, thereby shrinking the outstanding amount of these securities. In the remaining months of 2018, the BCRA's AT balance will face another P$90bn in maturities that the Treasury could, at its discretion, repay to the monetary authority. The AT stock today totals P$528.8bn. ***However, we would caution that this use of funds will compete with Argentina's debt rollover requirements, and the government may choose to sit on its cash reserves in order to ensure its ability to meet its commitments that also include the primary deficit.*** Our understanding is that the IMF is pushing the government to make progress on the rehabilitation of the BCRA balance sheet, and by year-end, we believe that the government will pass this test if the LEBACs stock is reduced from P$963bn to P$750bn or less, and the balance of temporary transfers could potentially be cut by P$50bn to P$90bn within this ~200bn-210bn shrinkage in the LEBACs mountain.

**Adelantos Transitorios In The Summary Account Of The BCRA**




**Monthly Evolution of Transitory Transfers**



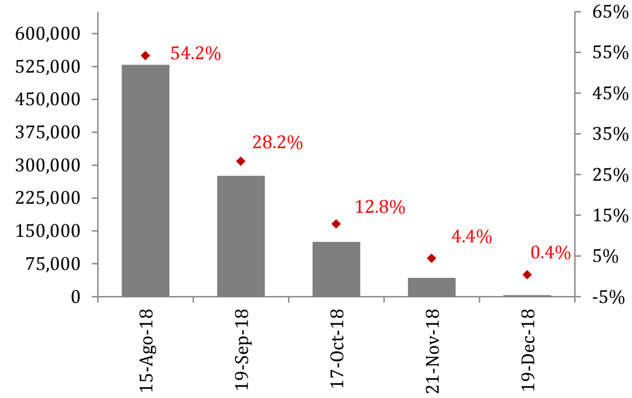
**IMF Memorandum Calls For Reduction Of Stock of US$3.125bn Per Quarter**

Based on the IMF memorandum, the multilateral lender is demanding that Argentina trim the stock of BCRA financing to the Treasury. This stipulation is laid out in the Memorandum of Understanding with the Argentine government. Below we provide an excerpt from this document to highlight the magnitude of the unwind, which appears to symbolize an unexpectedly large source of "Crowding Out" that will compete with the Treasury's other outsized refinancing (rollover) and deficit funding needs in the next three years. In particular, the next twelve months plan for this Treasury liability cancellation represents a whopping US$12.5bn that is not included in most economists' estimates of Argentina's capital needs.

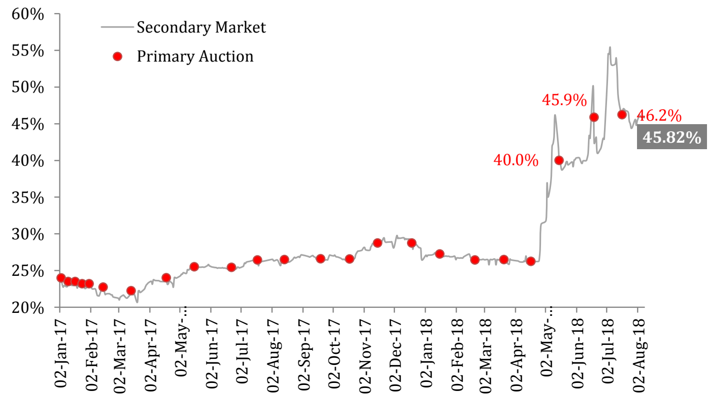
*Ceiling on Central Bank Credit to the Government*

37. Definitions. Central bank (BCRA) credit to the government is defined as the sum of the stock of government securities held by the BCRA (line Títulos Públicos in the summary account of the BCRA, as published on its web site), and overdraft transfers from the BCRA to the Federal Government (line Adelantos Transitorios in the summary account of the BCRA, as published on its web site). Starting in July 2018, the stock of central bank credit to the government shall decrease by the peso equivalent of **US$ 3.125 billion per quarter until end-June 2019, and then per semester until end-April 2021. By end-May 2021, the total decrease will correspond to US$ 25 billion**. This decrease in the claim shall reflect cash payments of this amount in pesos by the Treasury to the BCRA; variation in the value of the claim due to changes in exchange rates or accounting practices are exclude

**Lebac Maturity Profile** *(Up-to Aug-8th)*




**Lebac Rate Secondary Market**
*(Implicit rate level on a 35d Lebac)*



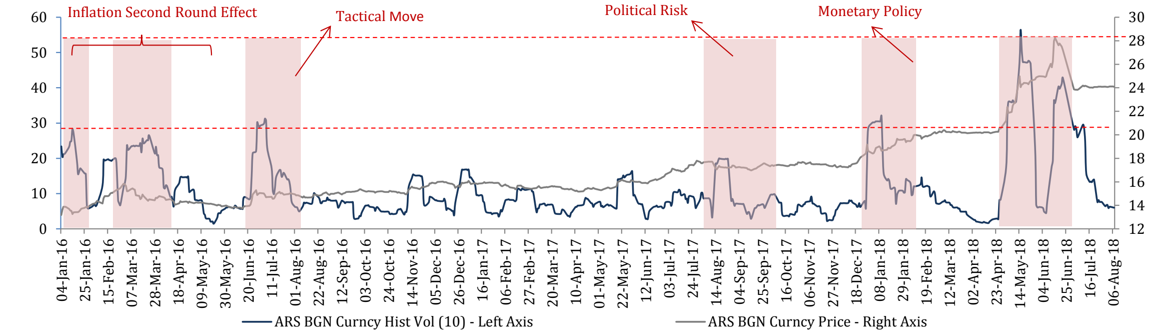

**ARS Trading Toolkit: Caputo's Tricky Balancing Act**

After the horrendous losses inflicted on Argentina's carry trade investor universe in May through early July, the sky-high YTMs and inflation break evens currently offered by Argentina's BADLAR+ and CPI Linker bonds are being looked at like a delicious chocolate cake that might have been dipped in arsenic. The Argentine peso is the figurative poison, and few investors trust the relative stability and volatility calm that Toto Caputo has achieved since taking over the helm of the BCRA. From our chats with people inside the BCRA, we detect a desire to extend the run of ARS stability for a good while longer even if the tradeoff is for the peso to lose some of its REER competitiveness gains from each monthly CPI print, including June's nasty 3.7% reading. Inflation spillover has obliterated the competitive tailwinds created by all of the devaluations since 2011 as prices stampeded higher in the six-to-nine months following the ARS's extra-large depreciation episodes. This time around, the Macri team has the IMF technocrats breathing down their necks to meet the 1.3% fiscal target for 2019, and an inflation spiral above and beyond the REM consensus level of 31.8% for 2018 would likely trigger undesirably large wage adjustments and social security indexation in 2019. In a nut shell, it could detonate a grenade in the Economy Ministry's fiscal adjustment plan.

**Stemming Pass-through Inevitably Requires Low FX Volatility**

The positive externalities to pinning the ARS in a tight range include: (1) the quelling of inflation pass-through (which is vital for next year's social security expenditure indexation), (2) the pacification of animal spirits among the local investment community; and (3) the buttressing of public opinion in a country where the variation of the dollar is top of-mind every single day. It goes without saying that the utilization of nosebleed interest rates and beefed up reserve requirements could be considered “cheating” the textbook standard definition of a “freely floating exchange”, but Argentina is trying to pull out of a currency crisis, and four weeks of consistency is simply not enough for the BCRA to uncork the champagne bottle. **While we do not doubt the BCRA’s commitment to dampening ARS volatility, we have seen this intervention tactic before, and the deviation from a freely floated FX regime is a highly risky proposition when Argentina’s peers (Russian ruble, Turkish Lira etc) are devaluing in true free floating manner.**

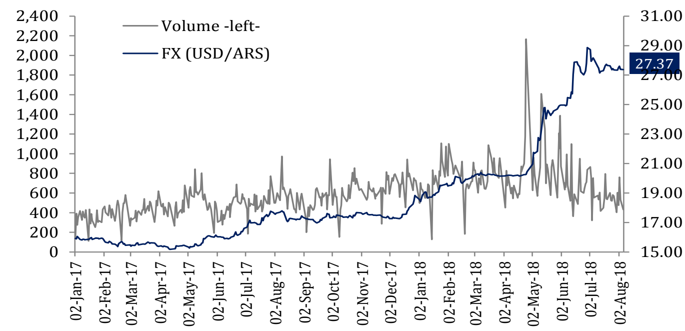
**Caputo’s BCRA Is Clamping Down on Volatility To Stem Pass-through**




| | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 4.14 | 3.97 | 3.32 | 3.39 | 4.19 | 3.08 | 2.05 | 0.20 | 1.15 | 2.36 | 1.62 | 1.20 | 1.59 | 2.07 | 2.37 | 2.66 | 1.43 | 1.19 | 1.73 | 1.40 | 1.90 | 1.51 | 1.38 | 3.14 | 1.76 | 2.42 | 2.34 | 2.74 | 2.08 | 3.74 |
| CABA | | | | SL | INDEC INFLATION | | | | | | | | | | | | | | | | | | | | | | | | |

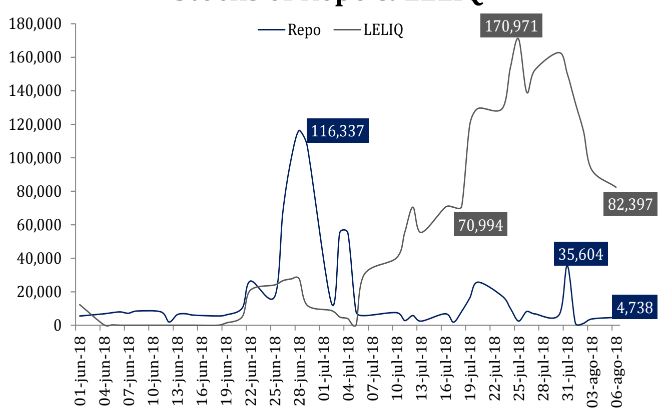
If we look at the cocktail that the Central Bank is using to keep the ARS under control in this crucial phase of inflation risk post the devaluation, we can observe that it combines the utilization of elevated CALL and REPO1 overnight rates with the hoovering up of peso liquidity through more Draconian reserve requirements. The added wrinkle to this combination in recent weeks has been Caputo’s willingness to use Dollar Futures sales in the AE market to intervene tactically during the trading sessions when the ARS slides on low volume. In the two charts below, we provide the evolution of the CALL/REPO1 rates and the volume in the MULC dollar market in order to demonstrate how the Central Bank is cooling the USD fever after the outbreak in May-July.

**MAE FX Daily Volume**

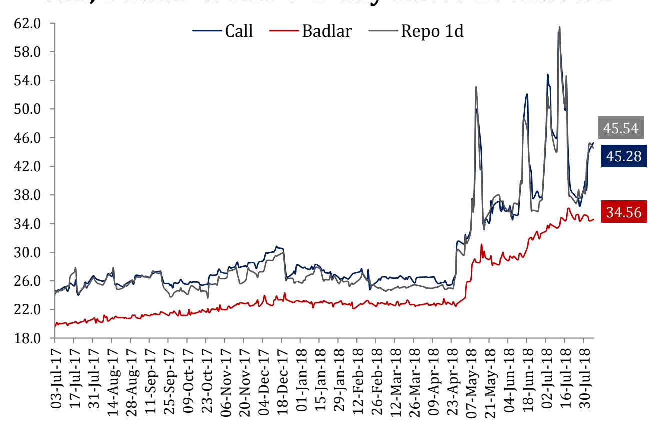



**MULC daily volumes fell to US$549.4m from US$691.4m in first half of June**

**Stocks of Repo & LELIQ**




**Call, Badlar & REPO 1-day Rates Lockdown**

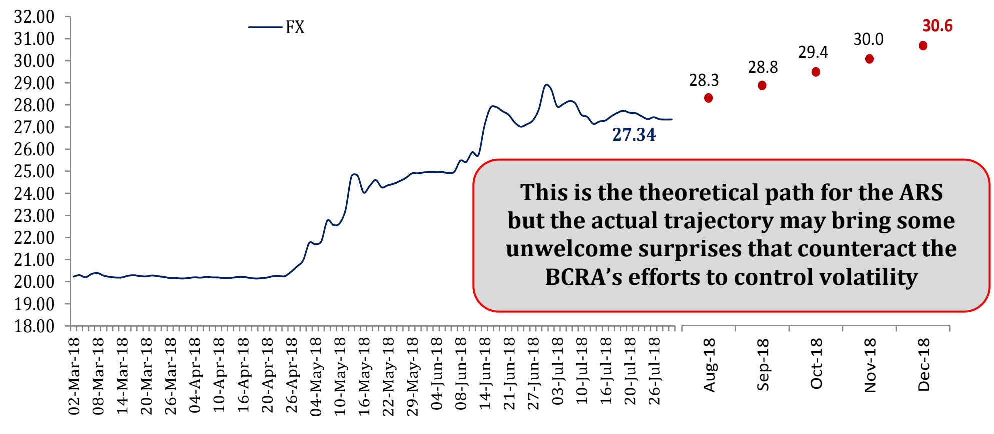


**Shift To LELIQ As Monetary Policy Benchmark Was Inevitable**
In previous Balanz Capital research pieces, we anticipated the BCRA's decision to switch from the 7-day REPO facility to the LELIQ as the monetary policy benchmark rate. The LELIQs have a 7-day term, and it is an instrument that is only available to the banks. The 7-day REPO never gained much popularity among the banking system due to differing opinions on the applicability of taxes, but the LELIQ is non-taxable. The most important conclusion from the move to the LELIQ is that this instrument is a vital tool in the BCRA's monetary absorption activities, and the latest move in the Central bank corridor effectively increased the remuneration on the LELIQ from 37% to 40%. As we can see in the chart above, the LELIQ plays a starring role in the monthly swings in the systemic effective minimum balances movements. These balances are built in the second half of each month and then are released in the first part of the subsequent month. By hiking the LELIQ to 40%, the Central Bank gains a tighter grip on the pesos that may be released by a low rollover ratio in the upcoming LEBACs auction. This is a technically sound move.

**What Is Our Roadmap For The ARS Into Year-end?**
Our current view is that the Caputo-led Central Bank is energetically attempting to quell inflation pass-through that is coming from the ARS's May to July devaluation. This renewed effort to "pin the currency" in a stable, low volatility band resembles behavior seen under Federico Sturzenegger's tenure. There are powerful fiscal motivations behind this short-term strategy as the 2019 budget targets could be compromised by an uncontrolled move in CPI in the last five months of the year. The Pension benefits adjustment for September was just announced at 6.68%, and follows an 11.4% bump that was spread out over March and June. Despite the strong arguments in favor of this tactical pause, it is an unstable equilibrium, and we would urge valed against complacency given the flurry of administered price adjustments that are being pushed through from here until December. ARS devaluation sooner or later follows inflation, and CPI control is taking a back seat to fiscal consolidation in 2018 with the blessing from the IMF.

Irrespective of this trench warfare, which is being waged increasingly with MAE dollar futures interventions, ***the 2018 IMF program is fundamentally inflationary.*** In the Egyptian and Ukrainian IMF programs, the technocrats on 19th Street DC have decided that energy subsidies are the most effective fiscal adjustment tool available. Fuel prices, which have been hiked 31% ytd, are going to jump an additional 7% in October, 6% in November and 6% in December. Electricity and gas prices are being increased 25%-30%. As a result, we think that the ARS, after this profitable pause for carry trade investors, is going to follow headline inflation but not in a straight-line. Given the heavy fiscal expenditure that falls in late November and particularly in December, we would recommend bolstering Rofex and NDF hedges to ride out an inevitable adjustment in that time frame. Caputo would be ill-advised to repeat the errors of the previous BCRA administration by allowing inflation to erase the competitiveness gains delivered by the recent devaluation, but our suspicion is that the Central Bank will stick with a hard line until they have cleared the September 19th LEBACs auction. The ARS may not be tamed so easily if EM stress comes back with a vengeance.

## Projection of The Exchange Rate By Inflation



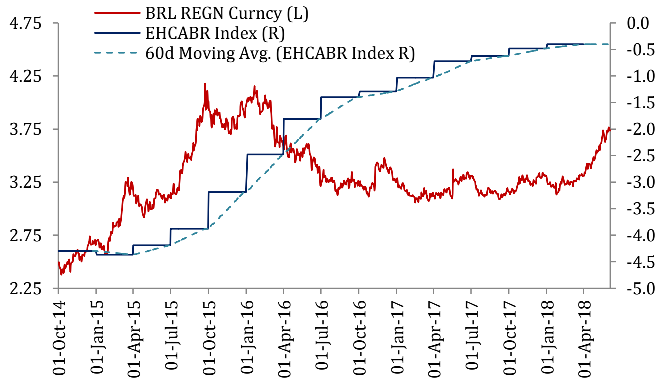

| | FX (MoM, EoP) | Variation | Inflation % LTM |
|---|---|---|---|
| Jan-18 | 19.7 | 1.8% | 25.0% |
| Feb-18 | 20.1 | 2.4% | 25.4% |
| Mar-18 | 20.1 | 2.3% | 25.4% |
| Apr-18 | 20.7 | 2.7% | 25.5% |
| May-18 | 24.9 | 2.1% | 26.3% |
| Jun-18 | 28.9 | 3.7% | 29.5% |
| Jul-18 | 27.6 | 2.7% | 30.7% |
| Aug-18 | 28.3 | 2.3% | 31.9% |
| Sep-18 | 28.8 | 2.0% | 32.0% |
| Oct-18 | 29.4 | 2.1% | 32.7% |
| Nov-18 | 30.0 | 2.0% | 33.6% |
| Dec-18 | 30.6 | 2.0% | 32.1% |

**Is Argentina Heading Towards Becoming The Newest Member of 66% Rule Club?**

In our June 5th, Balanz strategy report entitled ***Go Big or Go Home***, we presented the theory of the **66% rule for nominal devaluations and current account deficit swings** in Emerging Markets. Below, we provide the examples we cited from Mexico and Brazil in 2014-2016 that we highlighted in that report to reinforce the validity of this trader's dictum. For a few days, when the ARS spurted to 28.85, it appeared that our short-term devaluation target was being blown away. Since then, the peso has grinded back to the 27.35-27.60 therapeutic range, and the first condition in the trading rule is being met. However, in order for this trading rule to be applicable, the second condition (requiring a swing in the Current Account deficit in the next six to twelve months) needs to be analyzed with the utmost care. Only with a convincing and lasting contraction in this external account measure can investors feel more confident that the peso's relative stability is something more than a flash in the pan. In the following paragraphs, we will spotlight some of the key high frequency data series that offer some clues to the emerging signs of a structural swing in some of Argentina's key disequilibrium.

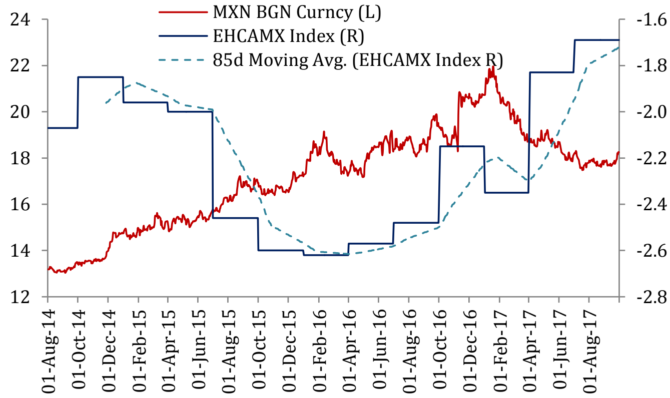
**BRL 2014-2016 Deval Swung C/A Brazil**

*(Oct-14 to Jun-18)*




**Bigtime MXN 2014-2017 Deval Swung C/A Deficit**

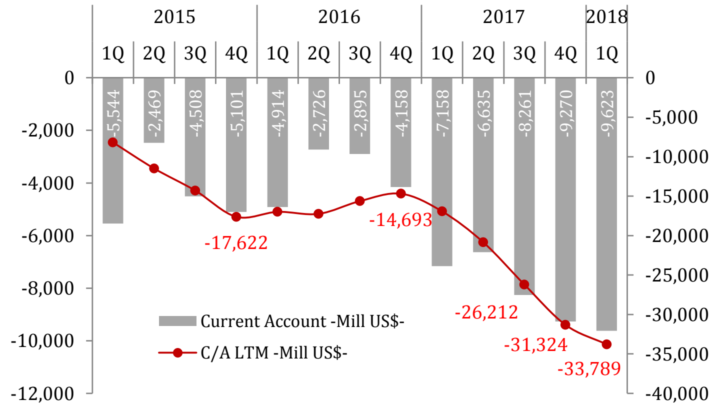
*(Aug-14 to Sep-17)*

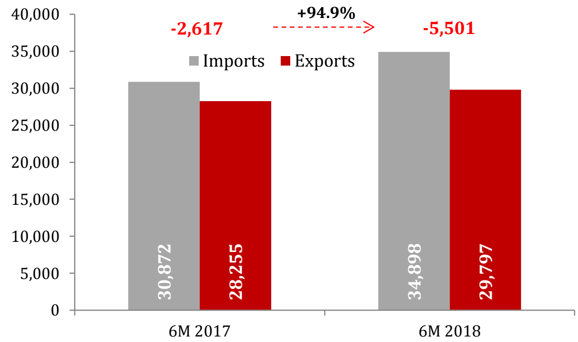



## Let The Current Account Swing Begin In Key Shortfall Generators

In the minds of EM debt investors, Argentina's road to convalescence, and then onwards to eventual recovery, is not simply a function of a brutal fiscal adjustment plan being executed under the tutelage of IMF technocrats. Argentina's vulnerability matrix is inextricably linked to the uncomfortably large current account deficit and the paucity of competitive industries that can generate dollars for the capital account on a sustainable basis. At the heart of Argentina's current account conundrum is a ***cultural predisposition towards consumption*** of externally produced goods like cars and motorcycles, an obsession with international ***shop-vacations***, and an energy deficit that is inexplicable to the uninitiated given the vast oil and gas resources sitting below ground in *Vaca Muerta*. Over the past three years, we have been shouting from the rooftops about Argentina's massive tourism deficit that is the most extreme symbol of the previously overvalued currency. The strong peso fueled the flames of Argentina's most entrenched consumption patterns while it incentivized the country's citizens to use bank and credit card financing to fill their luggage with cheap goods in Miami, London, NY and a wide array of other international destinations. Accordingly, the hidden upside from the painful May-June crash in the ARS is that it hammers aggregate demand to such an extent that conspicuous consumption craters, and the economy's handful of competitive industries can ramp up to generate the dollars that the economy needs to bolster growth. *Make no mistake: President Macri's team has embarked on an old-style IMF game plan to transition the economy from a consumption driven growth model to an investment fueled recovery program.*

**Argentina's C/A & Trade Deficits: Starting From Deep Dark Hole**




**C/A Swing Green Shoots, Body Blow Blip Or The Beginning of Something Durable**

For any market participant who has spent a considerable amount of time in Argentina, the following gallery of ostensibly encouraging inflection points in the country's main current account deficit numbers may look like a transitory battery drain in the country's consumptive Energizer Bunny. While Argentina's legendary penchant for international travel and shopping vacations lend credence to this cynicism regarding the sustainability of these green shoots, we would argue that there are major overlooked shifts in certain variables that support a less dire evaluation. In the following series of charts and tables, we will shine a light on the key C/A factors that we believe international investors should be tracking with sharp attention, because a C/A improvement that is ephemeral only sets the table for future FX weakness down the road. By definition, in Argentina's investment case, the contraction in the current account must become structural.

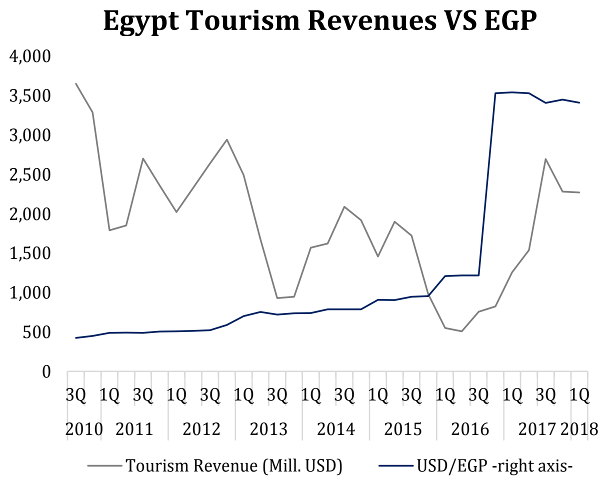
**Is The Swing In Consumption A Battery Drain Or Something Lasting?**

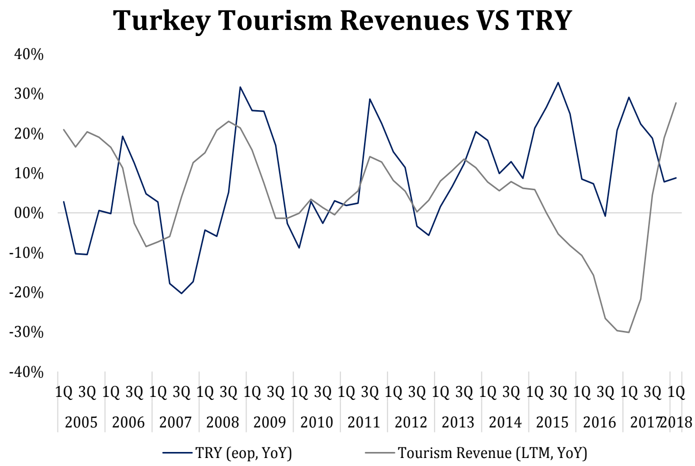

## Tackling The Outlandish Tourism Deficit

A major hot button for our Balanz Research team over the last two years has been Argentina's enormous tourism deficit that hit a LTM record of -US$10.89bn in May 2018, only to pull back to -US$10.6bn in June after the major devaluation of the ARS in May/June. Contrary to prevailing wisdom, the majority of this potent USD dollar outflow is linked to credit card purchases for goods and services abroad more than the simple purchase of international airline tickets. Argentines go abroad to have fun, but also to acquire products that cannot be bought affordably in the local economy. In our view, the reversal of this gaping hole in Argentina's current account (representing 1/3 of the overall gap) can be achieved through a battery of initiatives that: (1) strangle credit to tourists through macro-prudential measures, (2) promote of affordable domestic tourism for Argentine residents and international visitors; (3) end peso overvaluation that makes international shop-vacations so attractive.

**Egypt & Turkey's Tourism Revivals: Devaluation Acts As A Magnet For Frugal Tourists**

In the following paragraphs, we discuss some of the structural changes that can help Argentina's tourism balance. In the overall analysis, if we can point to one single determinant of success, a cheap currency has to be at the top of the list. Below, we provide two case studies of tourism revivals following significant devaluations that took place in Egypt and Turkey. After a major devaluation of the Egyptian pound that was supported by an IMF program (sound familiar?), Egypt's balance of payments for tourism has improved bigtime. It jumped to US$2.27bn (80.7%) in 1Q18 after surging +176.4% in 4Q17. Similarly, in Turkey, in the last three months, the yoy growth in tourist arrivals has bulged by 29.2%, 27.3% and 28.3%, respectively. It will be interesting to see if Argentina can replicate this success, but this another area where maintaining a competitive currency is absolutely vital.

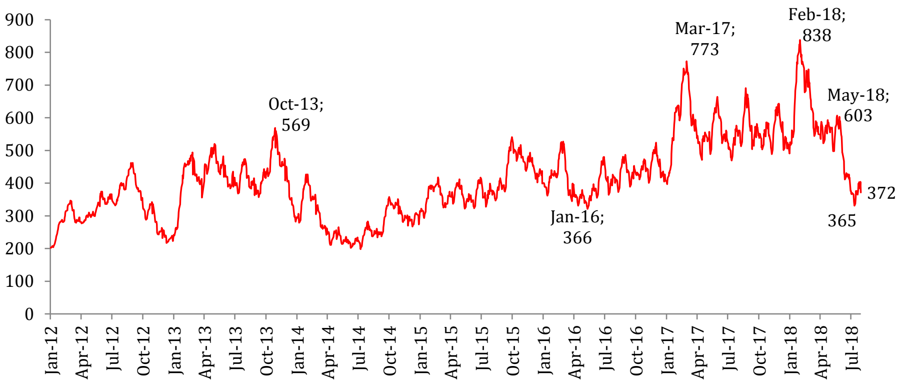



**Freefall Credit In USD Card Loans Foreshadows Sharp Contraction In Tourism Deficit**

In the chart below, we show the evolution of USD denominated credit card loans. Since February 3rd when this loan category ballooned to US$838m, the balance has contracted a stunning -55.6%. Since the May currency run on the peso, the overall balance has dropped -38.3%, bringing the yoy slide to -33.8%. In our view, this data series has a high correlation with international travel purchases, and the steep recent pullback is the first sign that the combination of tighter monetary policy and a weaker currency are working in Argentina's favor.

**USD Credit Card Loans In USD**



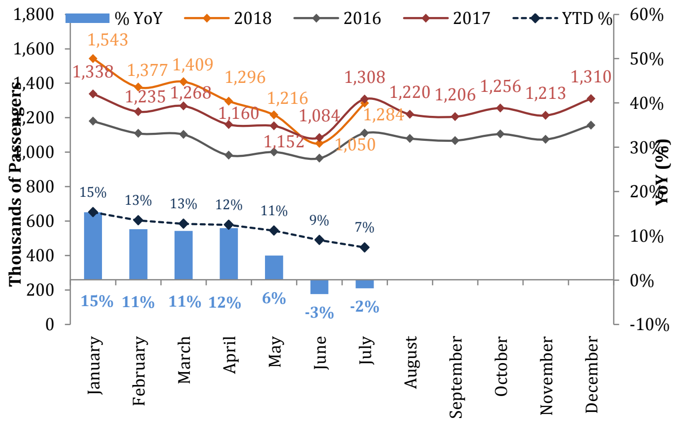

**Shopping Trips To Chile & Paraguay In Retreat**

The freshest data points revealing the impact of the ARS devaluation from 20.25 to 27.35 are encouraging, but they are far from conclusive. In June, the first month after the peso slide, the tourism deficit contracted an impressive -29.3%. In 2016-2017, Argentina's neighbor Chile became a magnet for Argentines who cross the frontier to buy inexpensive clothes and home electronics. The Macri administration's decision to lower import duties on notebooks and flat panel TVs took some of the wind out of this border crossing tourism, but the devaluation appears to be even more effective in curbing this behavior. In March, the number of Argentine tourists fell -5.3% yoy (258,597), in April it collapsed -19.7% (201,716) and in May it fell by -5.94% (138,018). In the first five months of 2018, the number of Argentine tourists in Chile dropped -19.2% yoy. The same phenomenon of border shopping trips took hold in Paraguay. Between 2010 and 2014, the average number of Argentine tourists in Paraguay ranged from 210,000 to 310,000. In 2015, this number surged to 848,000, and in 2016, it swelled to 932,000. Paraguayan newspapers have been reporting a -30% freefall in sales to Argentines in recent months, and in April, the number of individuals entering Paraguay via bridges fell a whopping -74% yoy.

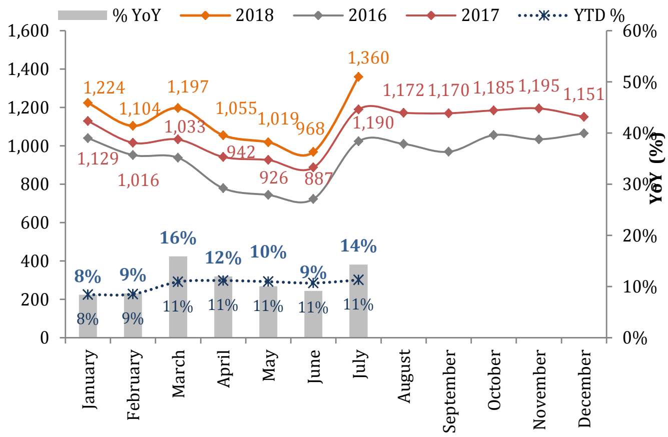
### Argentina Is A Great Place For Tourism, Affordability Is The Key

It may come as a surprise to many people that Argentina receives more tourists (6.7m) than Brazil (6.5m) and Chile (6.4m). In 2017, Argentina's incoming tourism hit a record with 21 million hotel visits and 13 million passengers on domestic flights. In the first five months of 2018, the number of international arrivals climbed 5.9% yoy. One of the Macri administration's main strategies for growth is to develop the Argentine tourism industry by making air travel much more affordable. By inviting new entrants like FlyBondi and Norwegian Air into the market for air travel, his administration has revolutionized the business and incumbents like Aerolineas Argentinas and LATAM have wisely slashed prices for domestic travel. AA just announced a domestic promotion for P$499 per leg for certain destinations in the country, and they sold 9,000 tickets in the first 12 hours. LATAM sold 11,000 tickets under a similar promotion, and new player FlyBondi booked 16,000 tickets in 24 hours. During the winter holidays, ski destination Bariloche received 35 flights per day, an all-time record, and hotels and ski slopes were booked solid.

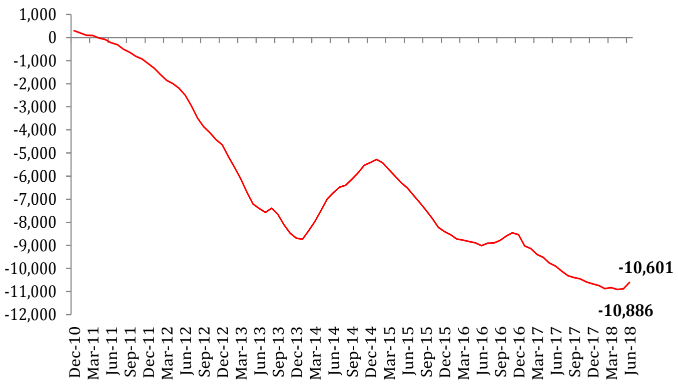
**International Tourism** *(Up – to June)*



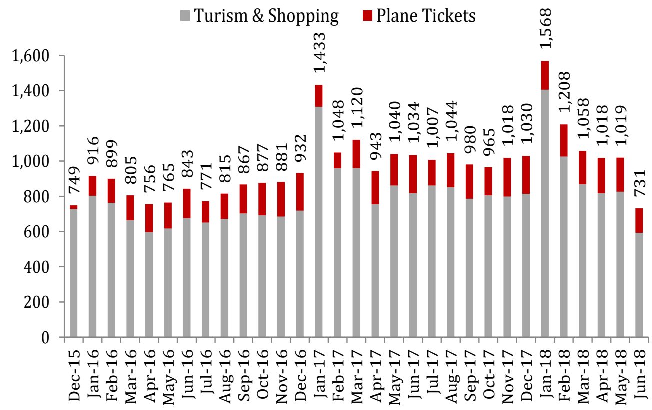

**Domestic Airline Traffic** *(Up to June)*




**Net Tourism Account** *(LTM, Mill. USD)*




**Tourism Account Outflows** *(Mill. US$)*



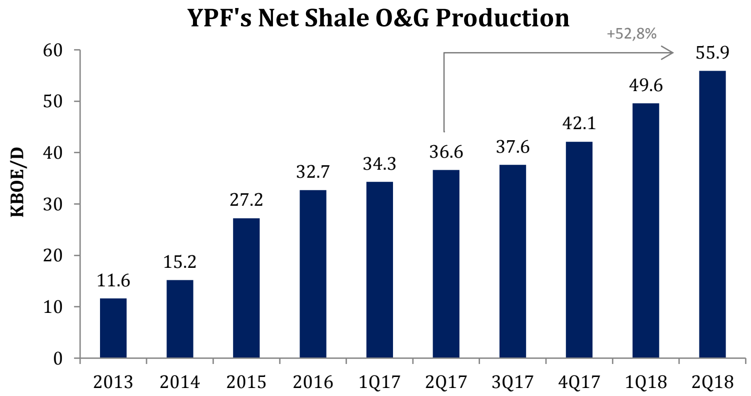

## Argentina's Oil & Gas Revival

### Vaca Muerta Is For Real: The Gas Market May Be In Surplus By 2H19

The long-term potential represented by the massive *Vaca Muerta* shale oil and gas deposit has never been disputed, but the output from this massive basin in recent years has barely been able to offset the rapid decline rates in Argentina's historically significant conventional oil and gas fields. Here are few data points on gas and crude production in the first half of the year. Please pay close attention to the figures related to non-conventional fields as these are primarily situated in the Vaca Muerta area.

- In June, the total production of gas jumped +8.2% yoy with 132.2m m3 produced. This was the best month for gas output since August 2010, almost eight years ago. In 1H18, overall natural gas production climbed +4.6% yoy.

- Crude oil production improved +5% yoy in June, lifting the cumulative boost in output for the first six months to 1.9% yoy.
- Non-conventional gas production jumped +34% in the 1H18, and this type of field now represents more than 33% of the total gas produced in Argentina. Unconventional crude production accounts for 12% of the overall oil production, and this segment surged +36% yoy in 1H18.
- YPF's non-conventional crude oil production soared +55.3% in the recently released 2Q18 numbers (see the growth trend below).




In previous Balanz research reports, we have commented on Tecpetrol's Fortin de Piedra natural gas field as a leading case for the renaissance of Vaca Muerta. This US$2.3bn project is already delivering close to 8m m3 per day, and it is on track to produce 14m-15m m3 by May 2019. The next two major operations set to ramp up production are located in two blocks in the Aguada Pichana area. In July 2017, the Aguada Pichana concession was split into Aguada Pichana West and Aguada Pichana East, and concession right granted for the next 35 years (until 2052). Wintershall maintained its 27.3 percent share in the original development located in the Aguada Pichana East block (operator is Total 27.3%, YPF 27.3%, PAE 18.1%) and now also holds 22.5% percent share for the new Vaca Muerta shale gas developments of the same block (operator is Total 41.0%, YPF 22.5%, PAE 14.0%). The partners in the East block are investing US$1.15bn. Below are some of the highlights.

- **330+ wells drilled in this block, extending over 721 km².**
- **300 wells producing natural gas**
- **In 2017, 7.1 million standard cubic meters of gas were produced daily in the block.**
- This joint venture also started a shale gas pilot project back in 2014:
    i. **12 horizontal wells spudded** to verify presence of natural gas in the Vaca Muerta formation.
    ii. Promising results from 10 of the 12 pilot wells led to the launching of shale gas development (20 wells) in 2017. The first of these wells came on production in December 2017.

Some experts believe that the Aguada Pichana fields will be producing 12m m3 per day by mid-2019, and they have the potential eventually supply one-third of the total gas demand in Argentina.

### Aguada Pichana East's Production Rose +8.3% In June

| Concession | Company | Jan-18 | Feb-18 | Mar-18 | Apr-18 | May-18 | Jun-18 |
|---|---|---|---|---|---|---|---|
| AGUADA PICHANA ESTE | TOTAL AUSTRAL S.A. | 6.9 | 7.0 | 7.4 | 7.0 | 7.2 | 7.4 |
| AGUADA PICHANA OESTE | PAN AMERICAN ENERGY (SUCURSAL ARGENTINA) LLC | - | - | - | 0.0 | 0.3 | 0.8 |
| **Total** | **Total** | **6.9** | **7.0** | **7.4** | **7.0** | **7.5** | **8.2** |
| **YoY Total Production** | **YoY Total Production** | **-12.3%** | **-12.5%** | **21.3%** | **-12.6%** | **-3.3%** | **8.3%** |

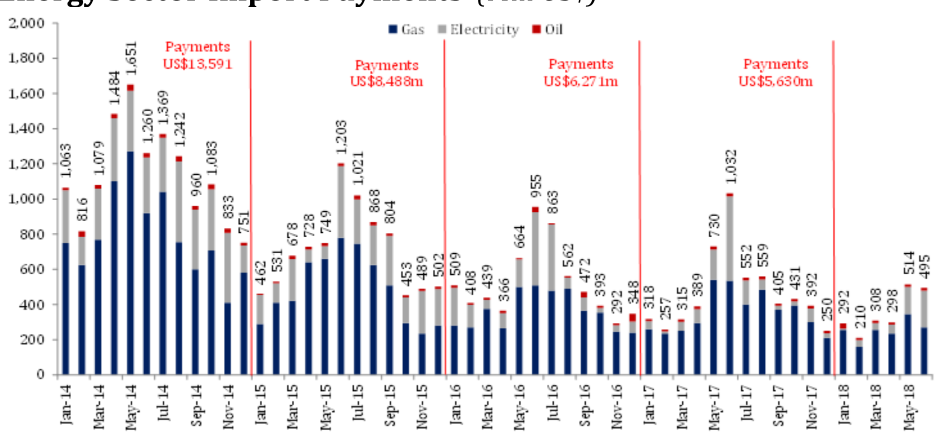
### Odelval Is Boosting Neuquen Liquids Capacity Ahead Of Crude Oil Output Growth

In Argentina's oil and gas industry, there is a little-known pipeline company called Oleoductos de Valle. The company is owned 30% by YPF and 70% by a group of crude oil producers in the Province of Neuquén. Currently, the company transports 30% of the crude produced in Argentina and 100% of the oil extracted in the Neuquén Basin. Overall, this company delivers 70% of the fossil fuel liquids that are carried to the refineries in Bahia Blanca and Luján de Cuyo. At present, Oldelval is working at a 50% capacity utilization rate (150,955 bbl/day of transportation) vs. its overall transportation capability of 264,172 bbl/day. The company is already making upgrades to its network in order to boost its effective capacity by 50% in 2019, and it is negotiating with a handful of producers to develop firm contracts in order to finance additional expansion by 2020, when the unconventional oil fields are projected outstrip its installed capacity. Oldelval is evaluating a new pipeline to take oil produced in the Northeast part of Vaca Muerta where areas like Bajo del Choique, Águila Mora, and Rincón de las Cenizas are located. **With this infrastructure upgrade, Vaca Muerta's producers can export their production either from Bahia Blanca or potentially out of the Buenos Aires port. The existence of this alternative market for the crude, above and beyond the demand from local refineries, helps mitigate the risk arising from price regulation. We believe that this is a positive underpin for the oil and gas investment outlook.**

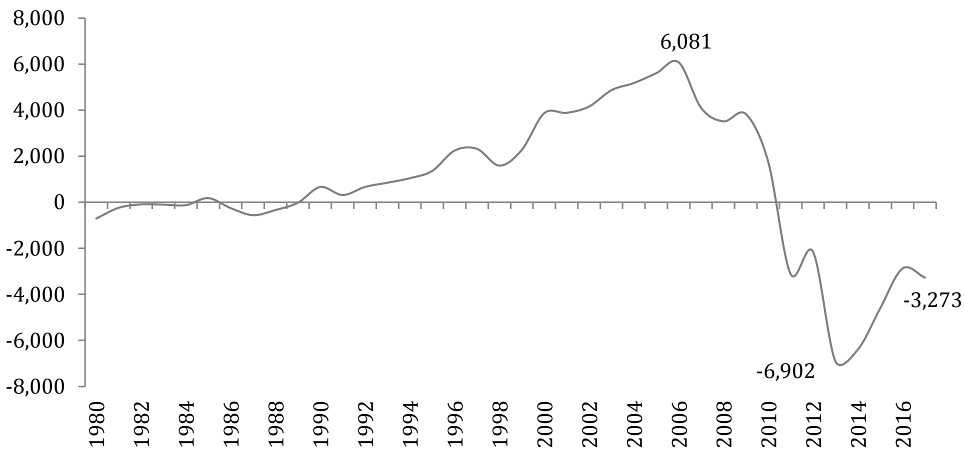
**Energy Sector Import Data & Energy Trade Balance Highlight Inflection Point**

In the two charts below, we show how the high frequency data on energy imports are blinking a green light in terms of this gap's contribution to the Current Account Deficit. In June, the energy sector imports fell -52%, and in the first six months of the year, they declined an impressive -30.4%. In dollar terms, this reversal has saved the country US$1bn vs. the first six months of 2017. In the second chart, we reveal how Argentina's energy import bill (gas, electricity and oil derivatives) on a LTM basis has improved from –US$7.00bn in 2013 to -US$3.27bn in the last twelve months. It is important to point out that Argentina enjoyed a US$6bn surplus in this category in 2007, and Vaca Muerta has the potential to restore the energy trade balance to surplus in the next 3-5 years. Moreover, the 8,000 MW of new electricity generation capacity may also add momentum to this swing.

**Energy Sector Import Payments** *(Mill US$)*



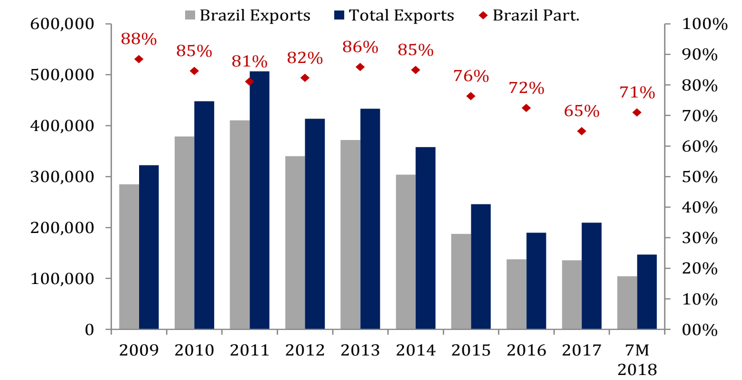

**Energy Sector Trade Balance LTM***(Mill. USD)*



## Argentina's Automotive Sector Is Exporting Once Again

Argentina's vehicle trade balance went from bad to worse in the first two years of President Macri's administration. Brazil's two-year depression crushed demand for Argentina's SUV and truck production, and a mountain of economy cars stacked up in the neighboring country's ports found their way into Argentina's suddenly revitalized market. In the 2009-2013 time frame, Brazil absorbed 70%-88% of the Argentina's vehicle exports. In 2011, Argentina exported a whopping 506,715 units, a number that dwindled to 190,008 in 2016 and only rebounded slightly in 2017 to 209,587 units sold abroad. In 2017, Brazil's market share of vehicle exports had cascaded down to 64.8% or 135,900 units. In order for a rebound in Argentina's automotive export complex to gain strength, the industry needed a more competitive exchange rate, a materially more buoyant Brazilian consumer, and new models destined for international markets. This trifecta of factors appears to moving in Argentina's favor.

### Vehicle Exports To Brazil

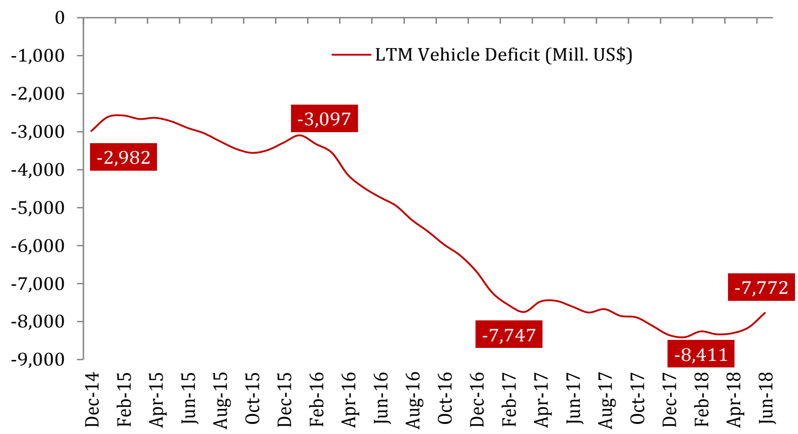



| | Brazil Exports | Total Exports | Brazil Part. |
|---|---|---|---|
| 2009 | 285,089 | 322,495 | 88.4% |
| 2010 | 378,865 | 447,953 | 84.6% |
| 2011 | 410,677 | 506,715 | 81.0% |
| 2012 | 340,165 | 413,472 | 82.3% |
| 2013 | 371,961 | 433,295 | 85.8% |
| 2014 | 303,786 | 357,847 | 84.9% |
| 2015 | 187,545 | 245,725 | 76.3% |
| 2016 | 137,649 | 190,008 | 72.4% |
| 2017 | 135,900 | 209,587 | 64.8% |
| 7M 2018 | 104,263 | 146,933 | 71.0% |

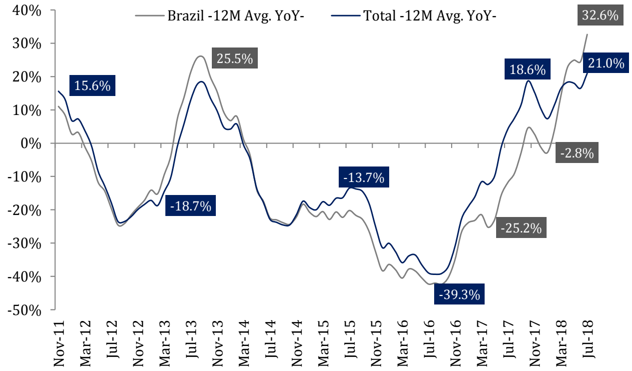
### June Vehicle Exports Surged +74%- Toyota Predicts +68% (US$3bn) In 2018

In most EM countries facing a suddent stop, a current account reversal involves a step function move in the trade balance. In Argentina's case, the Brazilian depression and a lack of competitiveness due to a dearth of investment during the Kirchner era conspired to create a vehicle's deficit that ballooned to US$8.4bn at its peak in February. In order to fix this problem, Argentina needs to boost exports and reduce imports, and these two variables depend on the REER of the ARS. In June, we witnessed the first sign that this deficit could swing violently as vehicle imports plummeted -35.8% and exports jumped +74.7%. In the last two months, dealer sales of vehicles declined -18.5% in June and -17.5% in July. In 2017, the automotive market totaled 883k vehicles, and Brazilian automakers exported 534,970 units to Argentina. *An 18% drop in imports would be equivalent to 96k units. If we assume an average unit cost of US$17,500, this would translate into a drop in imports of –US$1.7bn. YTD unit exports have climbed 42k, they may expand by 100,000 in 2018. At US$20,000 per unit (more SUVs and light trucks), the swing in exports could climb to US$2bn. These numbers could be even higher as Toyota is projecting export revenues from Argentina of US$3.0bn (105,000 units), an increase of 68% vs. 2017.*

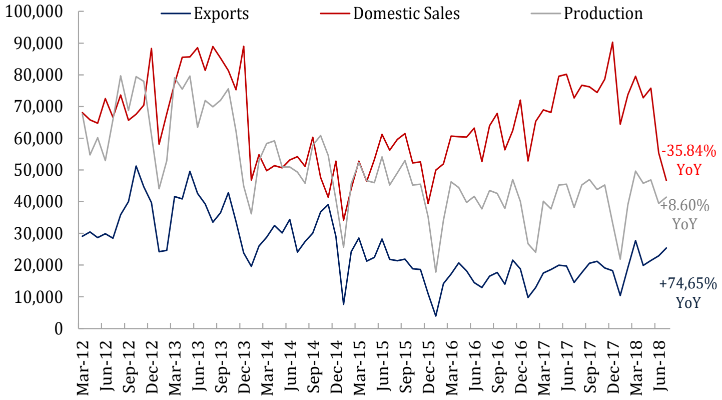
### LTM Vehicle Trade Balance *(Mill. US$)*



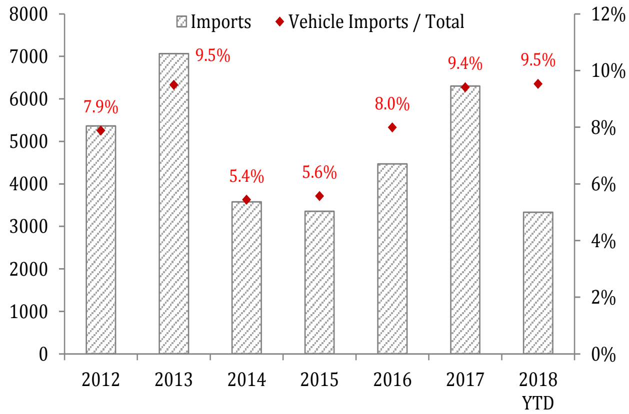
## Brazil & Total Exports *(Chg. % YoY)*



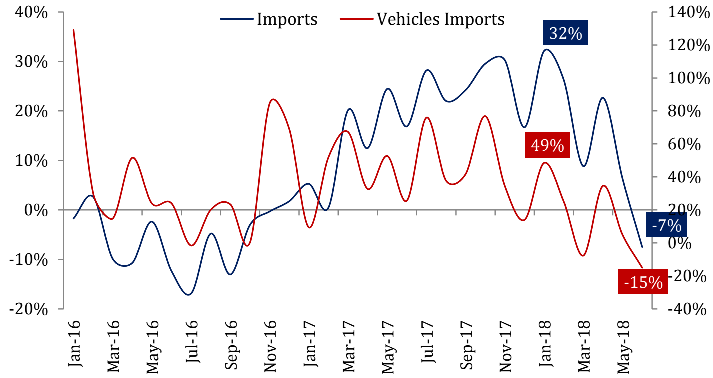

## Argentina's Domestic Sales, Exports & Output *(YoY)*




## Vehicle Imports As A % Of Total



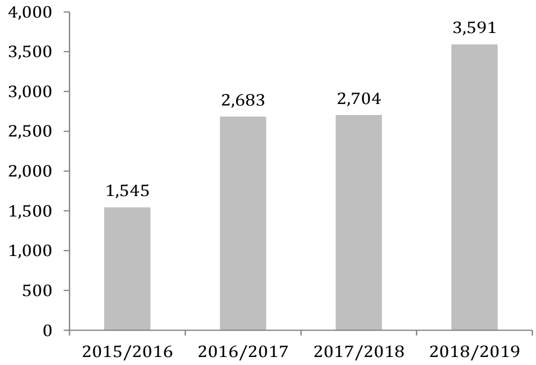

## Total Imports vs Vehicle Imports *(YoY)*




### Macri's Administration Is Betting On A Major Agricultural Rebound In 2019

Cambiemos' economic team is betting on a stunning rebound in soybean production in 2019 after a drought-stricken 2018 campaign that saw output collapse from 57.6m tons to 37m tons. The most recent USDA report predicted that Argentina will come roaring back with 56 million tons, but the Macri administration's decision to continue cutting export retention taxes could stimulate an even higher level of planting. Argentina's agriculture community is expecting record wheat production of 20m tons in 2019 (+10% yoy) with a price supported by lower yields in Ukraine and Russia. Overall, the Argentine Grain market is expecting the GDP contribution from the wheat cluster to reach US$3.6bn vs. US$2.7bn in 2017/2018. Wheat exports to Brazil should climb from 2.5m tons in 2018 to 5m tons next year. Overall, the Macri administration is anticipating a yoy swing in dollar exports of US$7bn to US$8bn, a number that would dramatically improve the trade deficit in 2019.

## GDP of Wheat Sector *(US$ Mill.)*

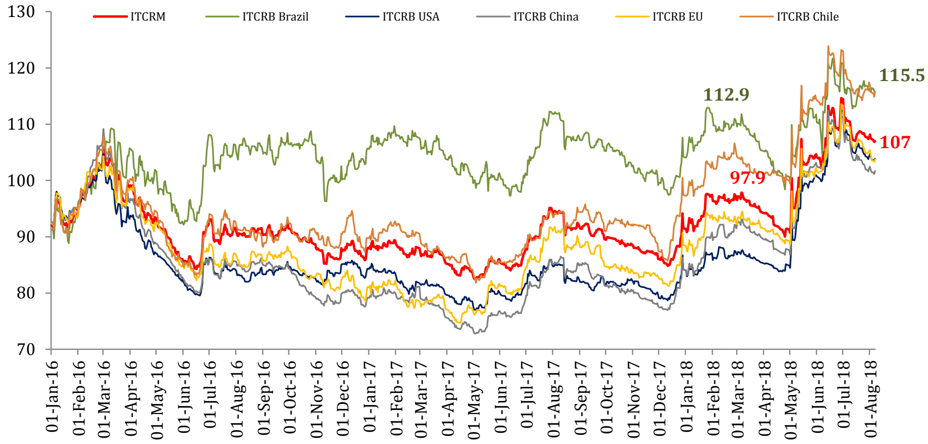



## Wheat Tax Contribution By Category *(US$ Mill.)*

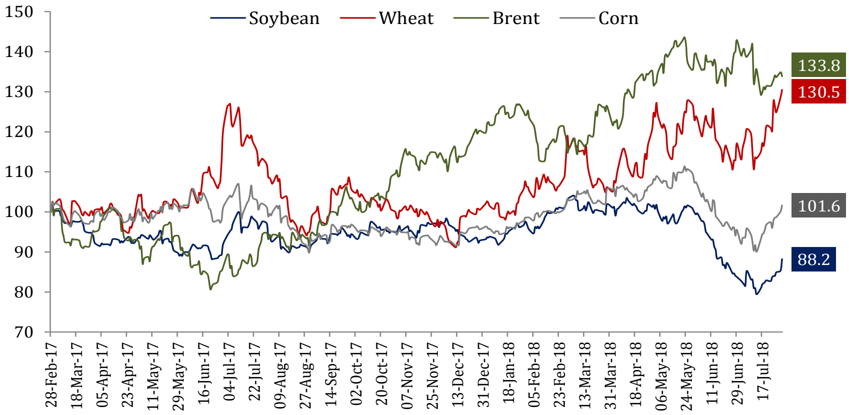
| Taxes | 2015/16 | 2018/19 | % YoY Chg |
|---|---|---|---|
| Export Duties | 254 | 0 | -100% |
| Land Taxes | 43 | 80 | 85% |
| Diesel Oil Tax | 8 | 13 | 63% |
| Stamp Tax | 5 | 15 | 201% |
| Tax on Debits & Credits | 33 | 67 | 102% |
| Income Taxes | 150 | 426 | 184% |
| Social Contributions | 41 | 76 | 86% |
| Gross Income | 28 | 50 | 77% |
| **Total Tax Collection** | **562** | **726** | **29%** |

**REER & Terms-of-Trade May Help Export Competitiveness**
In our final series of charts, we provide the update charts for REER and the recent price evolutions of key grain exports vs. Brent crude oil prices. The recent bounce in grain prices after the China trade war downdraft helps buttress the 2019 Argentina export recovery story. While Argentina is not a major importer of crude oil, diesel fuel is a major cost input for Argentina's grain exporters so its trajectory is important to watch. Clearly, the current pause in the ARS may serve to undermine the favorable picture for the REER that was achieved with the May-June devaluation. As a result, the BCRA may need to weaken the peso in the first half of 2019 in order to ensure the export story plays out.

**Real Effective Exchange Rates (USD/ARS)** *(Up- to Aug-08)*




**Prices: Soybean, Wheat, Brent & Corn**




| | MoM | Ytd | Last Price USD |
|---|---|---|---|
| Soybean | 4.9% | -6.0% | 893.75 |
| Wheat | 16.6% | 33.6% | 570.00 |
| Brent | -8.1% | 8.3% | 72.30 |
| Corn | 9.4% | 6.0% | 371.25 |

**Base 100 = Feb-17*

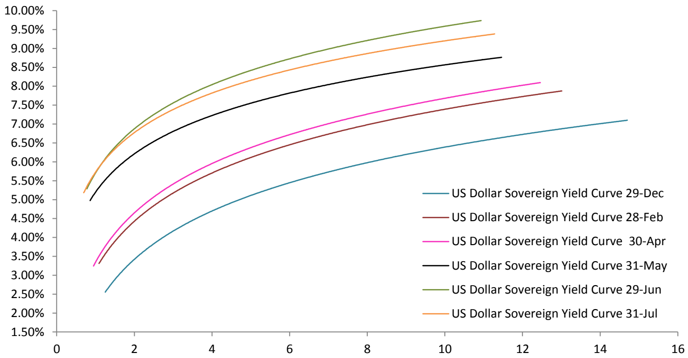
## Investment Section: Argentina Is Back In The Distressed Category

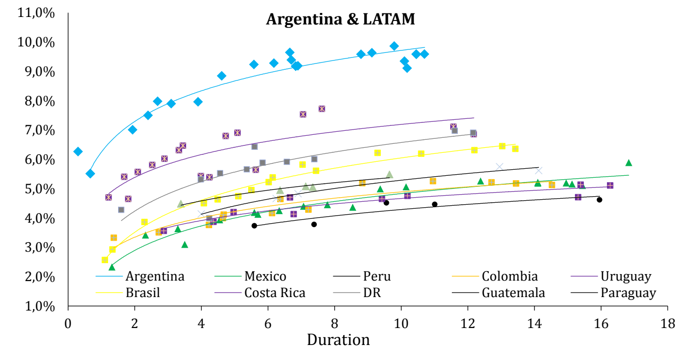
On May 24th we issued the report entitled ***Balanz Capital 214: Argentina Strategy Report: Winter Is Coming***, that laid out the material challenges facing Argentina in its imminent betrothal with the IMF. This list included debt rollover hurdles, the combined threat of recession on tax collection growth and the concomitant effects of recession on the government's fiscal consolidation efforts. For good measure, we reinforced the intractable problem represented by the *country's unique legacy of inflation pass-through.* The historic U$50bn bazooka from the IMF along with the MSCI's inclusion of Argentina in its Emerging Market Index on June 20th ushered in much needed fresh air and relief after weeks of ARS volatility. However, the market could only take a short, deep breath as this combo of ostensibly good news proved insufficient to close a Pandora's Box of fiscal challenges in the wake of Fed rate hikes and balance sheet reduction.

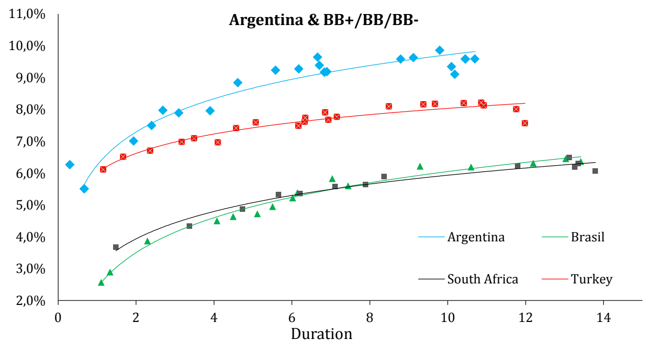
Over two months later, we can hang our hat only on nascent and fragile signs of improvement, seedlings strewn about on rocky macro and micro terrain. The investment community's bar for credibility has been set much higher, and Argentina's 10Y yield vs. Brazil's 10Y has gapped to 357bps, a level than relegates Argentina's debt universe back into distressed territory. In the following pages, we dispense a few ideas for investors contemplating taking on more risk exposure in the Argentine fixed-income universe. Present conditions are less than ideal for stand-alone recommendations as the country risk blowout is eliminating differentiation. At these moments, we recall the Latin adage, *fortuna fortibus favet—fortune favors the bold.* It is going to be a long winter, but everything has a price in financial markets. We invite our friends from the distressed community to come back to Buenos Aires to evaluate what is on sale.

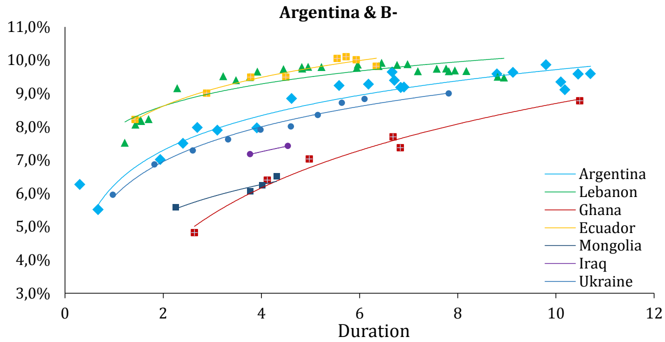
**Argentina's Sovereign Curve**

Argentina is once again trading back in its old neighborhood of distressed territory. Yield curves have been shifting upwards since the euphoric compression that came on the back of Cambiemos's midterm election win in October of 2017, and we see little respite in the short-term. The sovereign USD curve continues to sit well above its LATAM and EM Peers who continue to have their own challenges with volatility—Brazil, South Africa, and Turkey. Among credit rating peers (B-) Argentina continues to underperform, sitting above Ukraine and just below Lebanon and Ecuador.




**The YTM Blowout Has Created Carry High Enough To Protect Capital Against Further Blowout**

We expect that Argentina's sovereign curve will continue searching for a new valuation level on the basis of the IMF plan's uncertainties and the assorted exogenous risk pressures linked to QE unwinds and FED monetary policy. Accordingly, we decided to develop a total return matrix over a one-year time frame to estimate what total returns Argentine bonds of differing durations would deliver at discrete levels of YTM, either in the negative or positive direction. As Argentina's yields explode to the upside, fund managers may either be looking for defensive plays to ride out the storm and outperform. Meanwhile, emboldened risk takers may be looking to identify the securities with the highest upside optionality if sentiment improves significantly.

The chart below shows a total return sensitivity chart with 50-300bp yield swings in each direction. Under a maximum +300bps incremental hit to YTM, the bonds that stay in the green on a total return basis for a one-year term are the Global 2019, Bonar 2020, Global 2021 and the Global 2022. All of these bonds are trading at the wides against EM Peers. Moreover, they are sitting above pre-April 2016 levels when Argentina officially exited default after 15 years. While the Bonar 2024 missed the cut, yielding a total return of -2.09% should the 300bps body blow materialize, it offers relative value against EM peers and adjacent duration peers on either side of the sovereign curve.

On the basis of this number crunching, we can make the following conclusions:

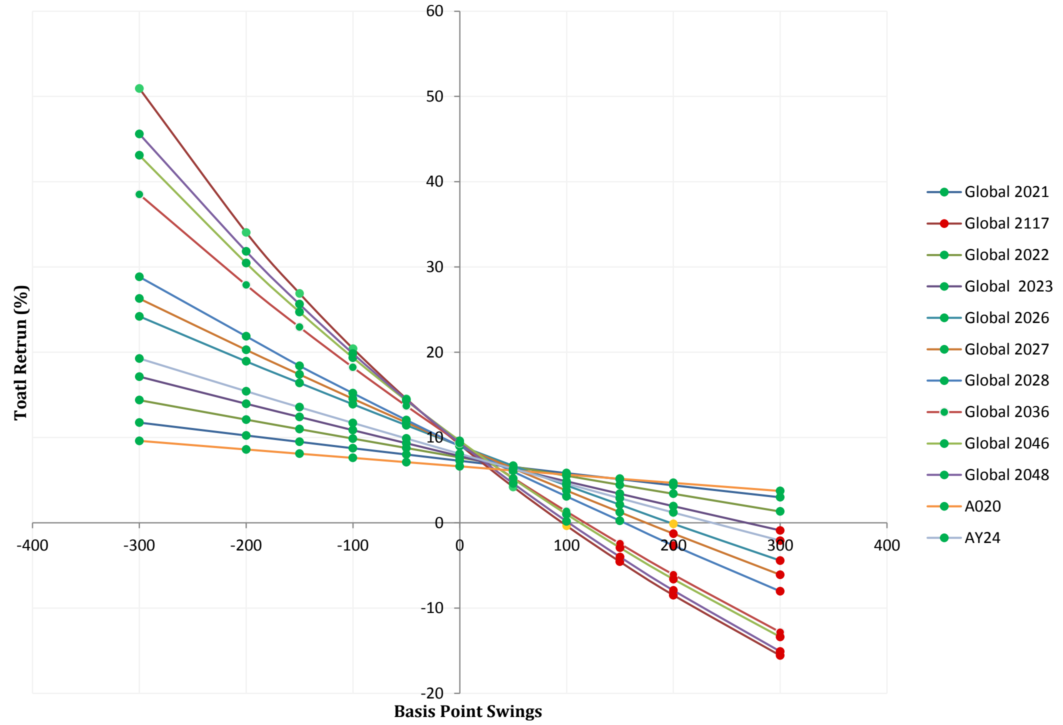
- In the event of a further +50bps widening in YTMs that is limited to that level, all of the Argentine sovereign bonds would have positive total returns.
- Under a +100bps YTM expansion, all of the bonds, exception the Centurion 2117 offer positive 1-year total returns.
- Under a +150bps spike in YTMs across the curve, the Global 2036, Global 2048 and Global 2117 would suffer TR losses.
- With an extreme +300bps move in YTMs, the AO20, the Global 2021 and the Global 2022 would ride through the storm with a small gain after 12-months. The short durations and relatively high coupons for these bonds (AO20-8%, Global 2021-6.875%  Global 2022-5,625%) explain this defensive nature.

Interestingly, this quantitative analysis reinforces the age-old convexity theory. The Centurion would lose -15.6% if bond yields blow out 300bps, but this same bond would produce a total return of +50.9% in the event that yields compress the same 300bps. This analysis tells us that the Centurion 2117 will become the weathervane for Argentina's sovereign curve.

**Total Return Bond**

| | | A020 | Global 2021 | Global 2022 | Global 2023 | AY24 | Global 2026 | Global 2027 | Global 2028 | Global 2036 | Global 2046 | Global 2048 | Global 2117 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 300 | 3.73 | 2.99 | 1.32 | -0.89 | -2.09 | -4.43 | -6.09 | -8.03 | -12.83 | -13.38 | -15.09 | -15.57 |
| | 200 | 4.68 | 4.39 | 3.4 | 1.95 | 1.2 | -0.13 | -1.27 | -2.66 | -6.08 | -6.61 | -7.93 | -8.49 |
| B | 150 | 5.16 | 5.11 | 4.45 | 3.4 | 2.88 | 2.12 | 1.24 | 0.24 | -2.45 | -2.92 | -4 | -4.57 |
| A | 100 | 5.65 | 5.82 | 5.52 | 4.86 | 4.59 | 4.38 | 3.78 | 3.09 | 1.32 | 1 | 0.17 | -0.35 |
| S | 50 | 6.13 | 6.55 | 6.59 | 6.33 | 6.33 | 6.68 | 6.38 | 6 | 5.26 | 5.17 | 4.62 | 4.21 |
| I | 0 | 6.62 | 7.27 | 7.67 | 7.82 | 8.09 | 9.04 | 9.04 | 8.99 | 9.38 | 9.61 | 9.36 | 9.16 |
| S | -50 | 7.11 | 8.01 | 8.77 | 9.33 | 9.89 | 11.44 | 11.76 | 12.05 | 13.7 | 14.33 | 14.43 | 14.54 |
| | -100 | 7.61 | 8.74 | 9.87 | 10.86 | 11.71 | 13.9 | 14.54 | 15.19 | 18.22 | 19.36 | 19.84 | 20.43 |
| | -150 | 8.1 | 9.49 | 10.98 | 12.41 | 13.55 | 16.4 | 17.39 | 18.4 | 22.94 | 24.72 | 25.63 | 26.9 |
| | -200 | 8.6 | 10.24 | 12.1 | 13.96 | 15.43 | 18.93 | 20.28 | 21.87 | 27.89 | 30.45 | 31.83 | 34.05 |
| | -300 | 9.61 | 11.75 | 14.38 | 17.14 | 19.27 | 24.21 | 26.29 | 28.84 | 38.51 | 43.09 | 45.6 | 50.94 |

## Stress Test Sensitivity Plot For 1-Year Total Return On Argentina's Curve

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## Sub-Sovereign Universe: CABA 2021 Stands Out As Value & Defensiveness

In the sub-sovereign universe, it is important to remember that yield compression often comes on the back of sovereign performance. Given the present context, we prefer short duration buy and hold credits with bullet proof stand-alone credit credentials. Under these conditions, we would watch the City of Buenos Aires's 2021 bonds. This US$500m issue currently trades at a YTM of 7.72% with a duration of 1.36 years and a healthy 8.95% coupon that translates into a CY of 8.79%. As the most outstanding credit in Argentina's governmental universe, we sustain that this could be an attractive buy and hold option for aggressive investors who take comfort in CABA's rock solid fiscal condition and attractive debt dynamics.

| Technical Data: City of Buenos Aires 2021 (BUEAIR 21) | | YTM | Nominal Yield (Sem.) | Clean Price | Dirty Price | Variation % in Price |
|---|---|---|---|---|---|---|
| Issue Currency | US$ | 4.72% | 4.67% | 106.15 | 110.48 | 4.03% |
| Date of Issue | 19-Feb-15 | 5.22% | 5.16% | 105.42 | 109.74 | 3.33% |
| Maturity | 19-Feb-21 | 5.72% | 5.64% | 104.69 | 109.01 | 2.65% |
| Amount Outstanding (MM) | USD 500 | 6.22% | 6.13% | 103.97 | 108.30 | 1.97% |
| Coupon | 8.950% | 6.72% | 6.61% | 103.26 | 107.59 | 1.31% |
| Freq. Coupon. payment | Sem. | 7.22% | 7.10% | 102.56 | 106.89 | 0.65% |
| Amortization | Sinkable | *7.72%* | *7.58%* | *101.87* | *106.20* | *0.00%* |
| Next Payment | 19-Aug-2018 | 8.22% | 8.06% | 101.19 | 105.52 | -0.64% |
| Clean Price | 101.87 | 8.72% | 8.54% | 100.52 | 104.85 | -1.27% |
| Acc. Interest | 4.33 | 9.22% | 9.02% | 99.86 | 104.19 | -1.90% |
| Mod. Dur | 1.36 | 9.72% | 9.50% | 99.21 | 103.53 | -2.51% |
| YTM | 7.72% | | | | | |
| Nominal Rate | 7.58% | | | | | |
| Law | ENG | | | | | |
| ISIN | XS1191130753 | | | | | |

Specified Denominations: U.S.$200,000 and integral multiples of U.S.$1,000 in excess thereof