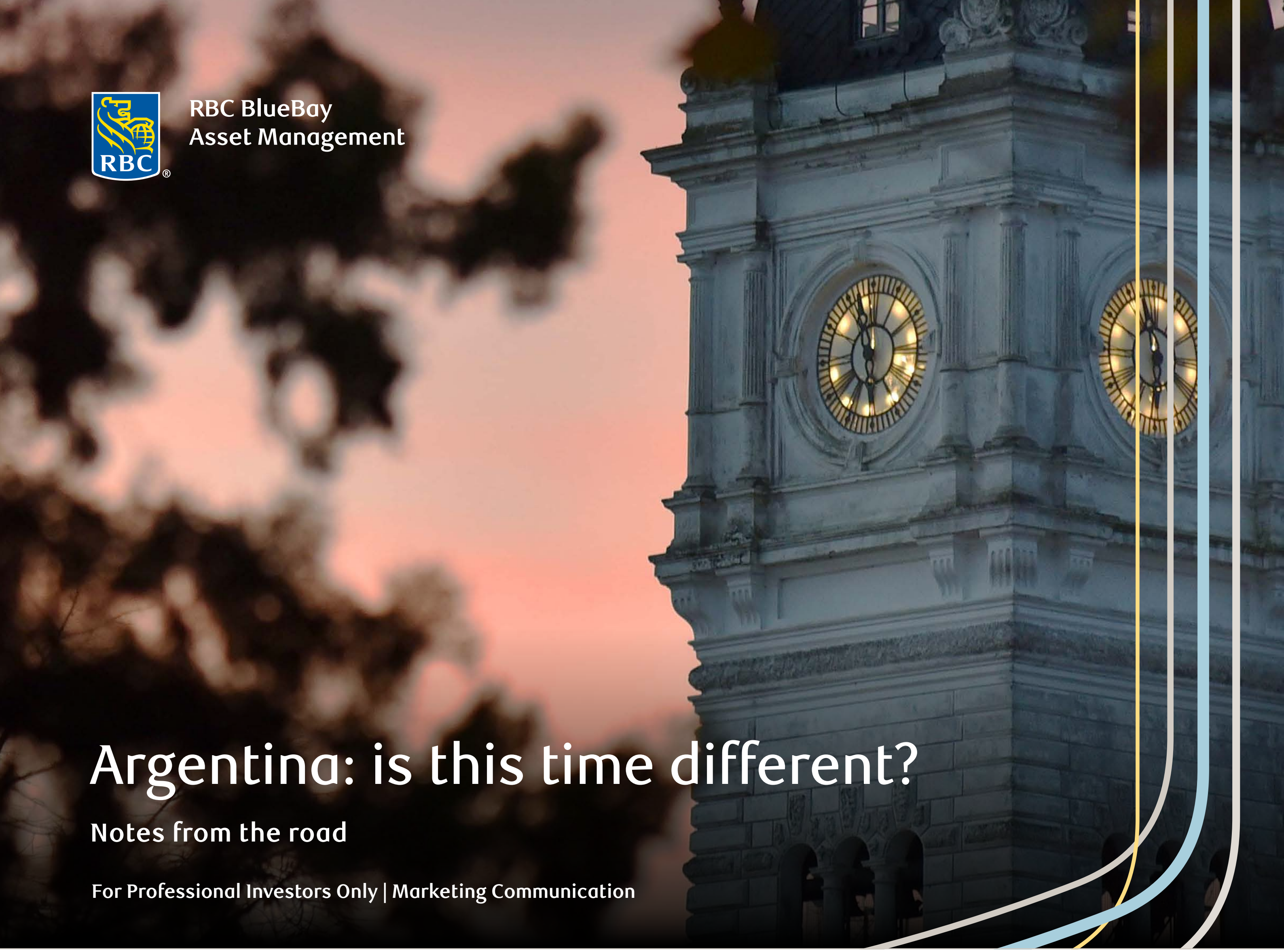

RBC BlueBay Asset Management

Argentina: is this time different?

Notes from the road

For Professional Investors Only | Marketing Communication

Laurence Bensafi
Deputy Head of
Emerging Markets Equities

Published December 2024

> "The Argentine stock market has jumped 100% to become the best performing EM country so far in 2024."

Despite being one of the most interesting countries in emerging markets ("EM"), Argentina is not currently part of our universe as defined by the index provider, MSCI. Given political and economic instability, the country's stock market has been included and excluded several times over the past 15 years, and since 2021, Argentina is a standalone country with capital controls still in place today.

However, since President Javier Milei was elected almost a year ago and his subsequent progress in fixing the country, the Argentine stock market has jumped 100% to become the best performing EM country so far in 2024[1]. It is no wonder then that investors have shown renewed interest. We therefore decided to visit the country to form our own opinion on the sustainability of the rally and look for potential opportunities for our portfolios.

When Milei, labelled as an ultraliberal, ultraconservative, far-right populist, shocked the world by winning the presidential elections in October 2023, he took over a country with no international reserves, an overvalued FX with a 100% gap between the official rate and informal rate, inflation of close to 200%, a fiscal deficit of more than 4%, and no access to international debt markets[2]. Argentina has defaulted nine times on its sovereign debt in the past, and the 10th time was around the corner. In other words, the country was bankrupt, and it was difficult to forecast a turnaround.

1 MSCI Argentina Index in USD.
2 Bloomberg.

Argentina is quite different from other Latin America countries. The population of 47 million is predominantly (97%) of Spanish and Italian descent, created by strong European immigration from the end of the 19th century. Indeed, the elegant tree-lined streets of Buenos Aires have a European feel. Around 1900, Argentina was one of the richest countries in the world, its GDP per capita was high, comparable to countries such as Germany, France, and Canada. In 1913, Argentina's GDP per capita was approximately 70% of the UK's and higher than Italy's or Japan's[3]. The country's wealth came from exports of beef, grain, and wool, thanks to its fertile lands (the Pampas) and advanced agricultural techniques. Argentina took on an increasingly significant role in the global economy during this period, moving from 0.1% of global GDP in 1870 to 2.4% by 1913[4]. By the end of the Second World War, Argentina had one of the largest rail networks in the world, exceeding 47,000 kilometers. However, Argentina declined throughout the 20th century due to factors such as political instability, protectionist policies, economic mismanagement, and global shifts in trade and industry.

Milei won elections as the population became frustrated with the situation and were ready to try something different. Expectations were low and scepticism high due to Milei's unusual appearance, attitude, and methods of communicating (for instance, the hair, the chainsaw, and the rock concerts).

"When Milei was given the mandate to turn around the country, his commitment was to bring the deficit and money printing down to zero. Less than a year later, he has already delivered the first phase of his stabilisation plan."

However, there is a possibility that he has been underestimated; he is a sharp economist, surrounded by an excellent economic team, which have so far proven to be very pragmatic and focused on the most pressing matters. The most provocative election campaign promises, such as shutting down the central bank or dollarising the economy haven't happened (yet).

"No hay plata", translated as "there is no money", is the phrase many locals repeated to us when we enquired about how President Milei has managed to remain so popular, despite slashing government expenses and bringing the percentage of population in poverty to 50%.

Tree-lined streets of Buenos Aires.

When Milei was given the mandate to turn around the country, his commitment was to bring the deficit and money printing down to zero. Less than a year later, he has already delivered the first phase of his stabilisation plan through devaluation and dilution.

Firstly, the Argentine peso devalued by 100% in one day in December 2023, causing inflation to shoot up to 25.5% that month[5]. Then in the first quarter of 2024, government expenditures were cut by 35%, most notably retirement benefits, capital expenditures, and subsidies, as well as operating expenses. Dilution helped to almost immediately bring the primary fiscal deficit to surplus for the first time in 15 years[6].

Through several mechanisms to restructure government debt, money printing stopped, and the sharp economic contraction saw monthly inflation fall quite rapidly to 2.7% in October 2024, the lowest level in three years. The central bank has started to lower interest rates, while economic activity seems to have troughed, with the potential for 2025 GDP to grow more than 5% from a low base in 2024. Finally, external accounts have improved, with a current account surplus forecasted in 2024 and further improvement expected in the next two years due to strong growth in the production of oil and gas[7].

3 What Happened to Argentina? - The New York Times.
4 Migration and trade during the belle epoque in Argentina (1870-1913).
5 Argentina devalues peso, cuts spending to treat fiscal deficit 'addiction' | Reuters.
6 Banco Galicia, based on Ministry of Economy and INDEC, September 2024.
7 Phase 2 of Argentina's Stabilisation Plan: still time in a race against time.

So far, Milei remains quite popular as the population has welcomed the drop in inflation and recovery in economic growth, but the biggest short-term risk flagged during our meetings are the mid-term legislative elections next year. These will be key for Milei to increase his party's representation, as currently he doesn't have a majority in the lower house to pass reforms. The previous pro-business reformist, President Macri, failed to convince the population that his project would eventually improve the standard of life for Argentinians, causing him to lose power in 2019, two years after being elected.

The coming months will be crucial for the country. The economic situation is still very fragile, with negative foreign exchange reserves and a high level of debt that needs to be repaid in 2025. Capital controls are still in place; their removal is key to attracting significant investment and flows into the country but there is no clarity on timing. One positive comes from the RIGI law, passed in July 2024, which stimulates foreign private investment in the country. Already several have been approved this year primarily focusing on two key sectors: energy and mining. Combined with recent investments in oil and gas, exports could double by 2030, a game changer for the country.

Visit to an agricultural company's headquarters.

"One positive comes from the RIGI law, passed in July 2024, which stimulates foreign private investment in the country."

Even if Milei remains in power after October 2025, he will face many challenges over the next few years. For example, within infrastructure, education and health care, the government will need to resume spending at some point in order to support the structural reforms needed to develop the manufacturing industry, attract foreign investment, and lower the country's dependence on soft and hard commodities. If the economic growth expected over the coming years is insufficient to lift a large portion of the population out of poverty, we could see Argentina revert to old patterns. Finally, the country remains very dependent on external factors, such as commodity prices.

Investment opportunities

During our three days in Argentina, we met with the management teams of large listed corporates, held discussions with economists, and spoke informally with taxi drivers and other locals. From these conversations, we felt growing hope that maybe this time will be different. The CFO of one of the largest companies in the country told us that he didn't vote for Milei a year ago but, considering the changes Milei has made so far, he will happily vote for him next year.

Compared to other EM countries, we could feel the European influence when speaking with management and we were impressed with the quality of management we met. Indeed, we spoke to two of the largest private banks in the country and, despite operating in a very volatile and difficult environment, they have remained profitable over the past few years. We were reminded that Argentina remains one of the countries with the lowest banking penetration levels in the world. According to Bank Galicia, the ratio of loans to GDP is only 9% in Argentina, compared to 37% in Mexico and 99% in Chile. Therefore, the potential for growth is large and the bank has considerable liquidity that it is ready to deploy.

Driving around the beautiful city of Buenos Aires and speaking to impressive management teams, it is easy to get carried away. However, many investors have been burned in the past and we remain cautious, as uncertainties and risks are high. The next twelve months will be crucial for the country. However, we also acknowledge that progress has been made and this has only partly been reflected in the stock market as valuations remain below long-term and regional averages.

One potential way to gain more prudent exposure is through Latin American companies with operations in Argentina. For instance, many food and clothing retailers based in Chile and Brazil have stores in Argentina; meanwhile the market tends to assign zero value to these operations partly due to capital controls, meaning it is very difficult to take profits out of Argentina.

As we leave Buenos Aires, we share the optimism of the population and hope that indeed this time will be different for Argentina.

Author

Laurence Bensafi CFA

Portfolio Manager and Deputy Head of Emerging Markets Equities

Laurence is managing director, and a portfolio manager and deputy head on the Emerging Markets Equities team at RBC Global Asset Management (UK) Limited. Prior to joining the firm in 2013, she headed the Emerging Markets team of a leading U.K. asset manager. In this role, Laurence was responsible for managing Asian and global emerging market income strategies, and developing quantitative stock selection and environmental analysis models. She began her career in the investment industry 1998 as a quantitative analyst at a major financial services company, where she supported European and global equity portfolio management by developing quantitative models to assist in the portfolio construction and security selection process.

Published December 2024

RE/0174/12/24

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