ARGENTINA: THE “EMERGING” EMERGING MARKET

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- Despite not being upgraded to emerging market status this year, the outlook for Argentina appears positive.
- President Macri is intent on getting inflation and the fiscal deficit under control.
- While October’s mid-term elections could pose a challenge to the economic reform agenda, opportunities remain for the selective investor.

In June 2017, MSCI decided to keep Argentina’s equity market under review for potential reclassification as an emerging market (from current frontier market status) for another year. In practice, this means that Argentina will not be officially included in the MSCI Emerging Markets index before 2019 at the earliest.

The news came as a disappointment to investors that had previously speculated the market would be upgraded to emerging market status. This was a short-term disappointment and does not change Argentina’s positive outlook, which is based on improving macro fundamentals, led by the reforms and economic agenda of President Mauricio Macri and his Cambiemos party.

Argentina’s capital market is re-emerging after many years of being excluded from international financial markets. In 2001, Argentina experienced one of the worst economic crises in its history, as output fell, inflation picked up and the government defaulted on its debt, exiling Argentina from global debt markets. In 2009, the market was downgraded from emerging markets to frontier markets status due to strict capital controls imposed by the government. As a result, both international debt and equity markets were closed to Argentina and its corporate sector for many years.

RETURNING TO STABILITY

This gloomy picture changed with the election of Mauricio Macri and his Cambiemos party in December 2015. Since taking office, President Macri has surprised many with his rapid implementation of a liberalizing economic agenda. Among his achievements since taking office are removing capital controls and letting the peso rate float in the market; lifting utility tariffs to reduce subsidies and normalize the energy sector; and reaching a settlement with past creditors enabling Argentina’s public and private sector access to international capital markets. Furthermore, medium-term fiscal and inflation targets were introduced and the national statistics agency is being re-built in order to provide credible statistics data. This has helped the equity market reach levels not seen since before the 2009 global financial crisis (see Figure 1).
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Even though the short-term achievements are impressive, the road to stabilization is still long and focused on tackling two of Argentina’s key economic issues – high inflation and its fiscal deficit.

Macri’s government has set itself challenging targets, set out in the table below. There is no official growth target, but the government is aiming for annual GDP growth of 3%-4%.

Exhibit 2: Official government targets

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inflation</strong></td>
<td>No official target*</td>
<td>12-17%</td>
<td>8-12%</td>
<td>5-8%</td>
</tr>
<tr>
<td><strong>Fiscal deficit</strong></td>
<td>4.8%</td>
<td>4.2%</td>
<td>2.2%</td>
<td>2.2%</td>
</tr>
</tbody>
</table>

*In Q4 2016, the central bank’s unofficial target for month-on-month inflation of 1.5% was met.
**Primary deficit targets.
Source: IMF

After many years of double-digit inflation rates, reducing inflation will be challenging. Argentina’s return to international capital market helps as it reduces the government’s need to print money. In April 2016, the government successfully sold $16.5 billion of U.S. dollar bonds to international investors, in its first international bond issue since its 2001 default.
The primary fiscal deficit – the difference between government spending on goods and services and revenue from taxes – reached 1.5% of GDP in the first half of 2017 (source: Reuters). The government is taking a gradual approach to reducing the deficit, which seems to make sense considering it is facing a mid-term election in October 2017. On the expense side, there are expectations for subsidy cuts. Under the proposed 2017 budget, the government plans to lower gas and electricity subsidies by about ½ percent of GDP, to about 1½ percent of GDP (source: IMF). The government has already started a path of reducing electricity subsidies by raising energy tariffs by up to 148% and consumers have been warned to expect more hikes in the coming years (source: Financial Times).

On the revenue side, it is interesting to look at a recent government initiative. A tax amnesty on unregistered funds held abroad has already generated around $10 billion in revenues. Around $116 billion of funds were declared during the amnesty, which closed in March 2017 (source: Reuters). Going forward, it is important to note that government revenues are very much dependent on GDP growth and employment levels: nearly 80% of government revenue comes from income tax, VAT and social security taxes (source: IMF).

ELECTION IN OCTOBER

Achieving the targets for inflation and fiscal deficit will require a lot of political power as unpopular measures, such as raising the price of electricity, need to be implemented. Therefore, the October mid-term election is a risk that investors need to monitor. Although Macri and his party are not expected to improve on their current minority status in Congress, they are expected to increase their number of seats, which will further legitimize the liberal reform agenda and increase his political capital. At the end of June, former president Christina Kirchner, who is strongly opposed to Macri’s reform agenda, announced she will be a candidate for a senate seat by forming a new left-wing party. While this poses a clear risk to Macri’s program of reform, the move may fragment the opposition to the government as other parties are less hostile to the reforms. Politics, therefore, remains a risk investors need to monitor when evaluating Argentina’s commitment and political capacity to achieve its stated inflation and fiscal deficit targets.

THE OPPORTUNITY – A PROLONGED GROWTH CYCLE

Since Macri won the election in 2015, there has been strong demand for Argentine debt and equity assets – there was recently even a successful century bond launched. Crucially, the brighter economic outlook would be based on improved and sustainable economic policies rather than on increasing commodity prices as was the case in the past.

While current benchmark opportunities are limited (see Exhibit 3), there is a strong pipeline of new companies coming to market and off-benchmark opportunities of companies with significant Argentina exposure. Given the strong recent performance shown by Argentinian equities, many companies are fully valued although selective opportunities remain for the active investor.
Exhibit 3: MSCI Argentina index comprises 10 companies (approximately 85% of the Argentine equity universe)

<table>
<thead>
<tr>
<th>Name</th>
<th>Index Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banco Macro B ADR</td>
<td>18.5%</td>
</tr>
<tr>
<td>Grupo Financiero Galicia B ADR</td>
<td>17.3%</td>
</tr>
<tr>
<td>YPF D ADR</td>
<td>17.2%</td>
</tr>
<tr>
<td>Pampa Energia ADR</td>
<td>15.3%</td>
</tr>
<tr>
<td>Telecom Argentina B ADR</td>
<td>8.4%</td>
</tr>
<tr>
<td>Transportadora de Gas B ADR</td>
<td>5.7%</td>
</tr>
<tr>
<td>Globant</td>
<td>5.4%</td>
</tr>
<tr>
<td>Adecoagro</td>
<td>4.3%</td>
</tr>
<tr>
<td>Grupo Clarin B GDR</td>
<td>4.1%</td>
</tr>
<tr>
<td>BBVA Banco Frances ADR</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

Source: MSCI, June 30, 2017. MSCI Argentina Index

Utility and energy stocks are very interesting as Argentina’s reform agenda is dependent on cutting subsidies and increasing tariffs. Therefore, companies here will benefit from the normalization of their sectors. The agriculture sector benefits from the removal of capital controls and the depreciation of the peso that occurred following the liberalization of the FX market (as it is cheaper for these companies to export their goods).

Banks are another area of interest. Though some may argue that current valuations are looking a bit stretched, banks face high growth potential due to the very low credit penetration in the economy. Furthermore, the industry is very fragmented, creating some interesting M&A opportunities.

OUTLOOK

If the current plan succeeds and Argentina is able to achieve its inflation and fiscal deficit targets, we believe there is scope for a prolonged growth cycle. This also takes into account the low base due to 15 years of underinvestment in the country and its lack of access to international capital markets. Given this more positive macro backdrop, we believe that the equity market has further potential to grow. The October elections could provide an upset, meaning investors still need to exercise caution. However, there are reasons for long-term optimism.
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