December 2018

Argentina Trip Notes

As part of our investment process, we travel to portfolio countries to assess current developments and investment opportunities. We visited policy makers in Argentina recently, meeting officials at the Ministry of Finance, the Central Bank (BCRA) and the IMF. We also spoke with representatives of a private gas distribution company, local politicians, political analysts and economists.

Our takeaways from our two days in Buenos Aires are summarized below.

What We Learned

- Growth is beginning to show signs of bottoming. Inflation is falling. The current account adjustment has already been substantial, and fiscal performance is ahead of target. The IMF is pleased with these results.
- Argentina has been satisfying conditions of the country's three-year $57 billion Standby Agreement. According to the Ministry of Finance, the IMF will disburse $7.6 billion by the end of December, increasing cash in fiscal accounts to $9 billion. This development is consistent with the IMF's goal to progressively reduce strains on the balance of payments by lessening vulnerability to pressures on the capital account.
- With support from the IMF and growing local confidence in domestic assets, Argentina has been able to refinance its short term debt. Argentina's financing plan requires reinvestment of roughly 60% of coupons and amortizations of outstanding domestic debt. This "rollover rate" is currently 80-85%, providing a significant cushion for government finances. If the high level of investor participation continues, the government would have the means to accumulate cash reserves, lowering the required rollover rate to 40%, a comfortable margin.
- BCRA is pleased with the response of the economy to the monetary framework established in September, including a 60% floor on the policy lending rate and a commitment to a zero rate of growth of the monetary base through June 2019. An important element of the current IMF program is the replacement of an inflation targeting regime with a stronger and simpler policy, hence the focus on a monetary base target. In response to this change, inflation is declining rapidly; the demand for dollars has turned into a small supply locally. The IMF cautioned that next year adjustments in public sector wages, regulated prices and pensions will be important to monitor, but that the inflation trend appears to be headed lower.
- As part of the IMF program, Argentina has adopted a floating exchange rate regime without intervention as long as the peso remains in a range. The upper and lower bands of the range will adjust on a crawling basis from 3% depreciation currently to 2% beginning in January. The declining rate of crawl is intended to reflect progress in reducing inflation expectations.
- In the event of large moves in the currency, BCRA may conduct limited intervention to assure orderly market conditions and to maintain a more comfortable level of foreign reserves. The Central Bank may sell up to $150 million on a daily basis at the top end of the "no intervention zone" when the peso is weak, but may only buy up to $50 million at the lower end of the band. The asymmetry of this mechanism – the BCRA can sell more US dollars than it can buy – reflects the BCRA's bias in favor of peso strength. At the same time, the allowance to buy US dollars when the peso strengthens is intended to ensure that the economy continues to benefit from a competitive exchange rate.

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- October's 2019 presidential election is the biggest uncertainty for investors in Argentina assets. Continuation of the current reforms is likely to be a binary outcome of the election. In our conversations, local business leaders and politicians expressed confidence that the ruling party Cambiemos and President Mauricio Macri will prevail.

- The case for a Cambiemos victory assumes that the economy improves and that Macri maintains a popularity level of 30-35% despite the economic shock. Argentina's growth rate is expected to climb in 2019 from recessionary levels this year, possibly supporting Macri's cause. Nevertheless, former president Cristina Fernandez de Kirchner remains a key competitor, currently polling at 25-30%. Most pollsters we met believe Macri will benefit from success in implementing the IMF program and in stabilizing the economy. He probably also benefited from successfully hosting the recent meeting of G20 leaders in Buenos Aires. However, an economic downturn or a renewed focus on bribery scandals purportedly involving members of Macri's family may significantly reduce his re-election chances. In that event, pollsters argue that Cambiemos still has a strong alternative: naming one of Argentina's most popular politicians Maria Eugenia Vidal, currently the Governor of the Province of Buenos Aires, as its candidate. Candidates must announce their intentions in June 2019. Until then, markets will have little clarity on the electoral slate.

- One swing factor for the economy is a much better outlook for the 2019 harvest. Following last year's drought, the agricultural sector is expected to add $10 billion directly to the economy from a better harvest and up to $25-30 billion indirectly as economic activity expands. This development could play an important role in Q2 2019 when the soybean and corn harvests coincide with a pickup in political campaigning.

- On Environmental, Social and Governance (ESG) issues, we spoke with the Ministry of Finance, officials in the Province of Buenos Aires and management of a private gas distribution company about the importance of ESG in our investment process. The Ministry of Finance is looking to engage with investors about ESG in Argentina. We took this comment as a positive signal in the current leadership's commitment to improve its policies supporting socially responsible investment criteria.

Significance of What We Learned

- Argentina's economic recovery plan is going as planned. A key factor supporting our current long positioning in Argentina is the improvement in the country's creditworthiness driven by the IMF program. Our recent trip confirmed continued positive direction of change toward more conservative fiscal and monetary policy making.

- We returned from Buenos Aires with a more positive view on Argentina's economic performance but expect political uncertainty ahead of the October 2019 presidential elections. While the Cambiemos party and President Macri appear well-positioned to win, the impact of the election on future performance of the economy, in our view, is binary.

- Nevertheless, we see a realistic path for positive long-term developments in which economic growth picks up, inflation declines, real wages increase and political continuity allows the IMF program to play out as designed.

Investment Conclusions

- Risk premiums remain high in Argentina assets as investors continue to price in the uncertainty of the October presidential election. We believe that President Macri has strong support from his followers and is likely to be re-elected.

- As the BCRA has managed to outperform its zero monetary base growth target, we believe financial stabilization will continue. Falling inflation expectations and stabilization of the exchange rate may allow the BCRA to cautiously adjust policy going forward and allow for further declines in interest rates. But we believe that BCRA recognizes that this process will take time and will err on the side of ARS strength in the near term. Therefore, we see a short-term opportunity to increase exposure to the peso and to short-dated local bonds.

- Sovereign credit also remains attractively priced, in our view, given the ongoing improvement in Argentina's fiscal and monetary policies and financing support from the IMF.

- We believe the political uncertainty ahead creates an opportunity to generate potentially significant excess returns from Argentina assets in 2019.

Argentina

12/10/2018

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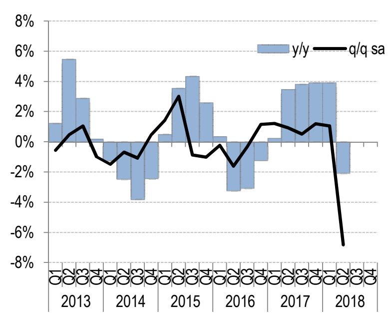
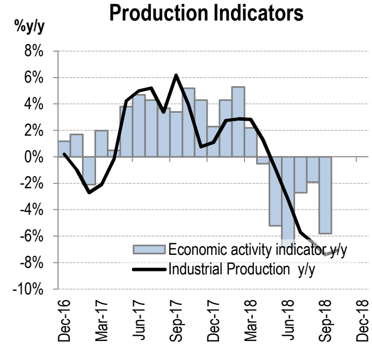
	2011	2012	2013	2014	2015	2016	2017	2018(f)	2019(f)
Real GDP Growth (%)	6.0	-1.0	2.4	-2.5	2.7	-1.8	2.9	*-2.8 **	*-0.9 **
Investment (% of GDP)	17.2	15.9	16.3	16.0	15.6	14.6	14.8	...	...
Nominal GDP ($bn)	530	581	613	566	644	554	637	...	...
GDP per capita ($)	12,836	13,918	14,526	13,265	14,936	12,717	14,446	...	...
Population (mn)	41.3	41.7	42.2	42.7	43.1	43.6	44.1	...	...
CPI Inflation, official (%)	9.5	10.8	10.9	23.9	28.4	37.9	24.8	*48.0 **	*25.0 **
Exchange Rate, avg (Peso/$)	4.14	4.55	5.48	8.13	9.27	14.78	16.56	...	...
Fiscal Balance (% of GDP)	-2.7	-3.0	-3.3	-4.3	-6.0	-6.6	-6.7	*-5.4*	*-2.6*
Public Debt, Gross (% of GDP)	37.5	38.9	41.7	43.6	55.1	55.0	57.6	*62.7*	*58.2*
External Debt (% of GDP)	30	27	25	28	26	33	37	...	...
External Debt ($bn)	156	156	155	159	167	181	235	...	...
International Reserves ($bn)	46	43	31	31	26	39	55	...	...
Credit, to private sector (% of GDP)	13.5	14.7	15.2	13.5	14.1	13.3	15.5	...	...
Exports (% of GDP)	15.7	13.8	12.4	12.1	8.8	10.4	9.2	...	...
Imports (% of GDP)	13.4	11.2	11.6	11.1	8.9	9.6	10.0	...	...
Current Account Balance (% of GDP)	-1.0	-0.4	-2.1	-1.6	-2.7	-2.6	-4.9	*-3.8 **	*-1.6 **
Foreign Direct Investment (% of GDP)	2.0	2.6	1.6	0.9	1.8	0.6	1.8	...	...

Source: Haver Analytics, IMF, IMF WEO Forecast
*/ Stone Harbor Forecast

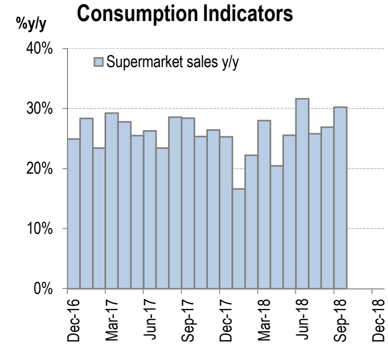
GDP Growth



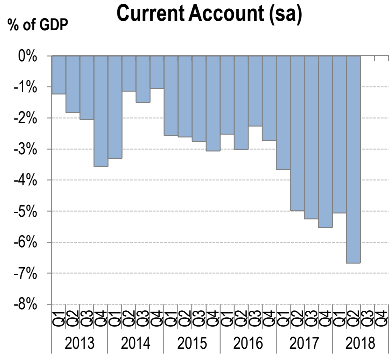
Production Indicators



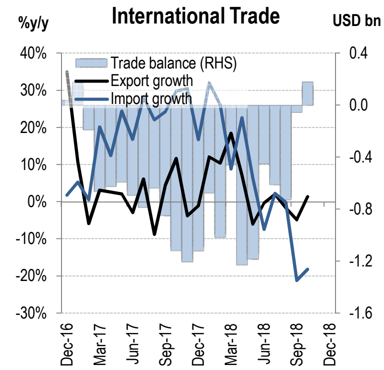
Consumption Indicators



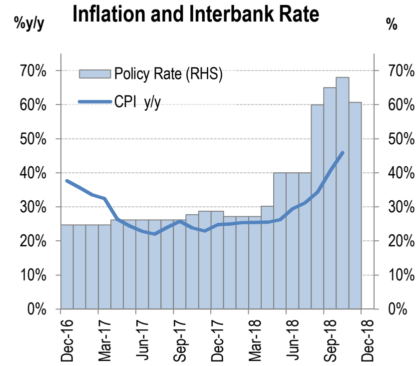
Current Account (sa)



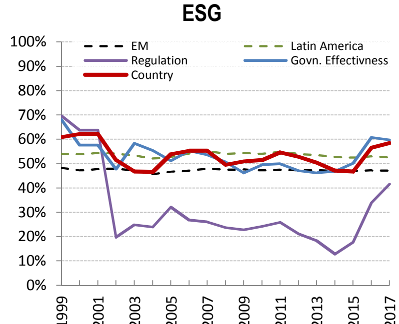
International Trade



Inflation and Interbank Rate



ESG



Sources for ESG data: Yale Center for Environmental Law & Policy and Center for International Earth Science Information Network (CIESIN) at Columbia University, in collaboration with the World Economic Forum and others, CATO Institute, Fraser Institute, Friedrich Nauman Foundation, Worldwide Governance Indicators: World Bank, Brookings Institution, and Natural Resource Governance Institute, Transparency International. You should not assume that any investments in regions identified or described were or will be profitable. Investing entails risks, including possible loss of principal. For illustrative purposes only.

Stone Harbor Investment Partners

- Institutional fixed income investment firm focused on credit risk strategies and asset allocation.
- 100% employee-owned
- Many team members have been together for nearly 30 years
- Offices in New York, Chicago, London, Singapore and Melbourne.
- Total assets under management: USD 29.35 billion as of 30 September 2018

Emerging Markets Debt management team, many of whom have worked together for nearly 30 years spanning a variety of market events and stages, have established a lengthy track record managing portfolios in emerging sovereign and corporate debt markets denominated in developed and local currencies. As a dedicated portfolio management team they are able to supplement intensive credit work with extensive travel to visit with decision makers in emerging markets. The 14 member portfolio management team averages over 20 years of investment experience. Resources include:

- 12 Portfolio Managers
- 4 Dedicated Emerging Markets Corporate Credit Specialists
- 9 Global Credit Industry Analysts
- 2 Economists (both developed and emerging markets)
- 11 Quantitative and Risk Analysts
- 2 Dedicated Emerging Markets Desk Analysts

Indices referred to herein are broad-based securities market indices. Broad-based securities indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds. Investments cannot be made directly in an index.

Index Definitions

The J.P. Morgan EMBI Global Diversified (EMBI Global Diversified) limits the weights of those index countries with larger debt stocks by only including specified portions of these countries' eligible current face amounts outstanding. The countries covered in the EMBI Global Diversified are identical to those covered by the EMBI Global.

The J.P. Morgan GBI-EM Global Diversified consists of regularly traded, liquid fixed-rate, domestic currency government bonds to which international investors can gain exposure. The weightings among the countries are more evenly distributed within this index.

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Multi-Sector Credit	Investment Grade	Global High Yield	Emerging Markets

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