RESEARCH

Fixed Income

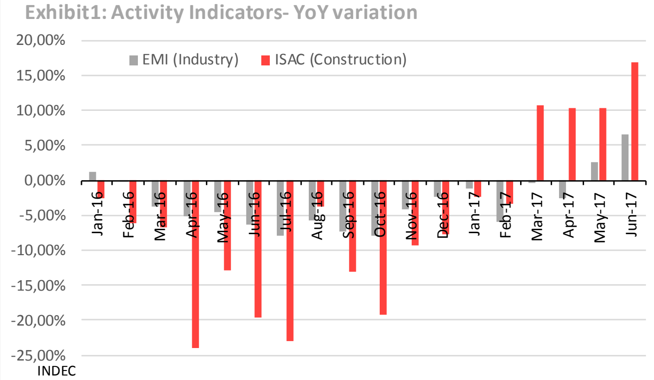
Review Argentina- Fixed Income

Economic Activity- biased results in leading indicators

Latest indicators of economic activity highlight a strong recovery. In Jun17, EMI (industrial index) and ISAC (construction), both reported by the INDEC, recorded a growth rate of 6,6% and 17% YoY respectively (exhibit1). In general terms, different indicators linked to the construction sector reflect a robust expansion, which is mostly attributed to higher public expenditure. On the other hand, industrial activity is still lagging construction activity in terms of growth.

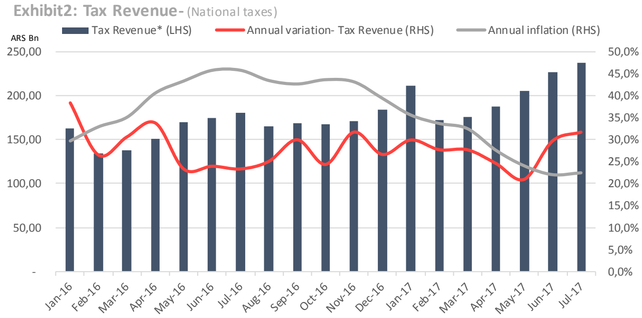
For the 6-month period as of Jun17, the Indec recorded no change in industrial production YoY, while CAME (SMEs) industrial output felt by 3%. Similarly, in 2017 we observe a substantial difference between automobile production reported by ADEFA (car makers) and Indec's figures. The latter states an accumulated annual growth of 6.4% for the six-month period, while the former highlights a slight downturn of 1.8% (220k units in 2017 vs. 224k in 2016). Additionally, it is worth mentioning that INDEC's EMI does not include Crude Oil and Gas production, which declined 8% and 1% YoY in 1H17, deriving in an increase of 39% in Crude Oil imports.

Exhibit1: Activity Indicators- YoY variation



Tax Revenue expanded by 32% YoY in July17, 9% above annual inflation (exhibit2), being VAT and Income Tax the items with the highest growth (35% and 40% respectively). We consider that July's figures are affected by a change in timing of collections compared to 2016 (for example SMEs are allowed to pay VAT in installments) and not by real economic growth. In this way (excluding non-recurring collections from Tax amnesty), tax revenue for Jan17-July17 has expanded YoY by 28%, equal to the annual average inflation. Social security taxes exhibit a growth rate above inflation during the mentioned period, +32%, which we believe is driven by construction activity.

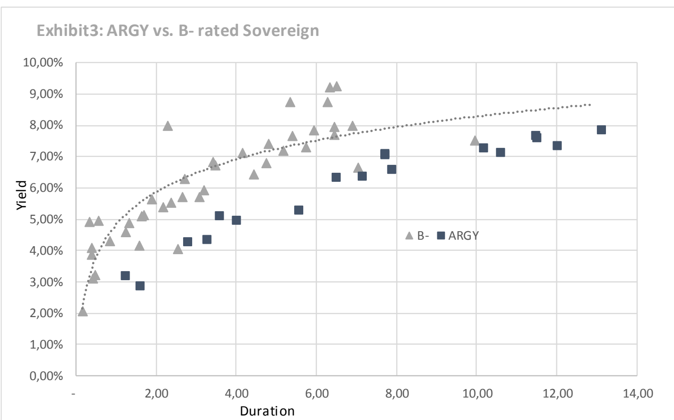
Exhibit2: Tax Revenue- (National taxes)

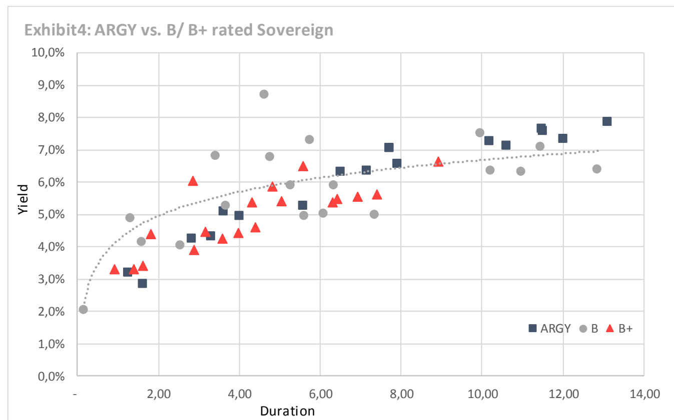


Election's outcome and the impact on Sov bonds- Peer analysis approach.

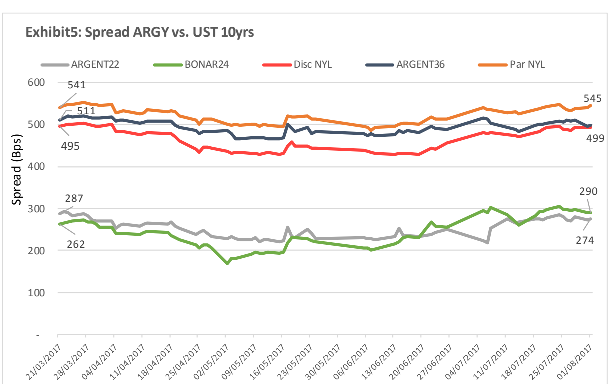
Since May17, political uncertainty has surged, and affected yields of ARGY bonds (See exhibit5). Under a peer analysis approach, we estimate that a negative outcome for the incumbent government in the upcoming legislative elections (in Both August (primary) and October) may widen spreads by approximately 100bps, while a positive outcome may tighten yields by 50bps.

Under a stunning victory of the opposition (former President Cristina Fernandez de Kirchner), we estimate that Argentina risk perception may match that of B- rated countries, and therefore, ARGY can widen by 100-110bps (see exhibit3). In a positive scenario for the Macri's administration, Argentina's yields could converge close to B+ and B rated countries, with the long end compressing by 50-60bps on average (see exhibit4). We observe that the short end of the ARGY curve (duration <4yrs), trade as B+ rated countries, and may experience limited upside in a favorable scenario.



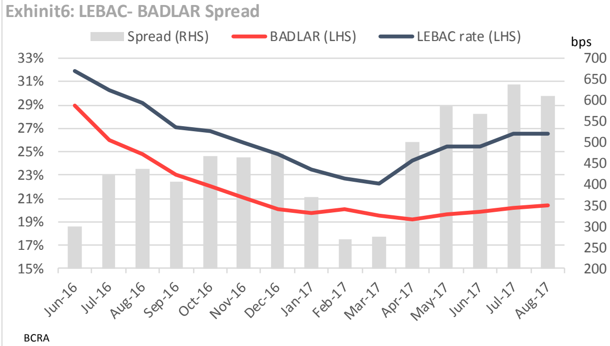


Moreover, a positive outcome for the ruling government, will revert yields to the minimum levels reached in May17, right before the confirmation of Fernandez de Kirchner to run in the elections. Exhibit5 shows the spread of different sovereign bonds over 10yrs UST. Currently, G-spreads are back to March17's levels (with the exception of Bonar24, which trades 28bps above), and since May17, spreads have widened by 53bps.



BADLAR: Still at low levels amid declining fixed term bank deposits

In Apr17 the Central bank increased 30d Lebac rate by 200Bps, and additionally two more hikes have taken place since then. In this way, Lebac rate rose from 22.25% in March17 to 26.50% in July's auction, while Badlar rate modestly increased 60bps (see exhibit6). The spread between Lebac rate and Badlar stands at 638bps, considerably higher than the average of 380bps for Jun16- Mar17. In previous reports we expected a fast spread compression, but this did not occur even though fixed term bank deposits have tumble in real terms.



Exhinit6: LEBAC- BADLAR Spread

In july17, the annual decline of fixed term bank deposits (in real terms) has accelerated, reaching 4% (see exhibit7 and 8). We expect this trend to continue in the next months, but do not foresee a rise in Badlar rate as the bulk of total Bank deposits are inelastic to rate variations, and therefore Banks do not have enough incentives to increase rates.

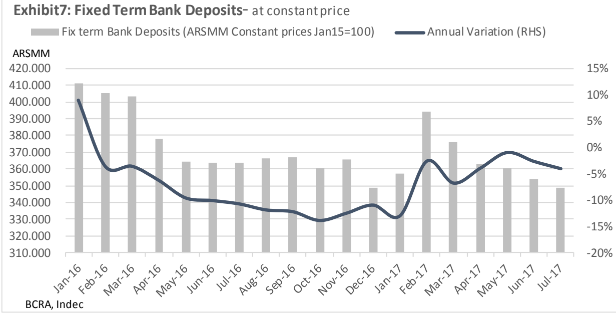


Exhibit7: Fixed Term Bank Deposits- at constant price

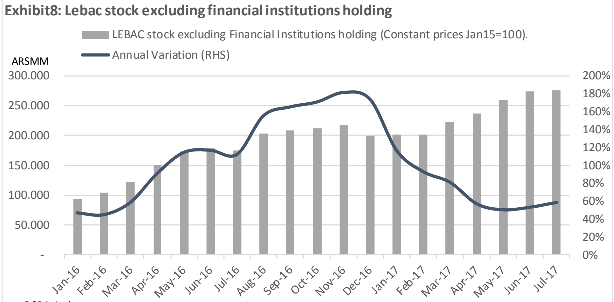


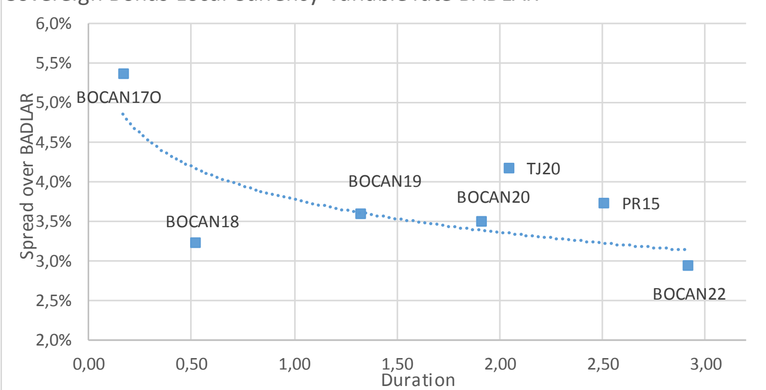
Exhibit8: Lebac stock excluding financial institutions holding

Recommendations

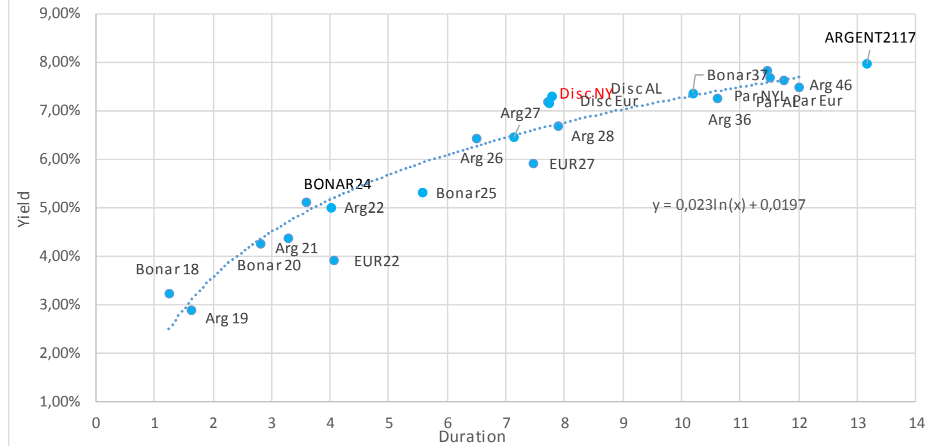
In the coming week, volatility will continue in the ARGY curves, as August elections approach. We estimate that demand will be concentrated in the most liquid bonds, Globales and probably Discounts usd in the case investors forecast a positive outcome for the national government and BONAR24 for more conservative investors shortening duration. In this sense, although BONAR24 compressed 20bps in the last week and has reached our target price, it may exhibit further upside. Additionally, since May 15th, Sovereign bonds yields widened by 42bps, higher than the 30bps for provincial bonds, and 24bps of corporate bonds. Therefore, we still expect further price correction in these last two curves.

In the ARS curve, we do not observe any attractiveness in: i) Badlar curve, as a result of the behavior of the underlying rate, ii) the fixed rate bonds (BOTES), due to the strong negative carry against Lebacs and BOPOMO. Performance of CER adjusted bonds will mainly depend on the election's outcome. Although the elections will track the trend, some price upside is expected in as inflation will remain high in the next months and as bonds are underpriced compared to historic yields. In this way, for investors that bet for a positive outcome for Macri's party, we mainly recommend TC20.

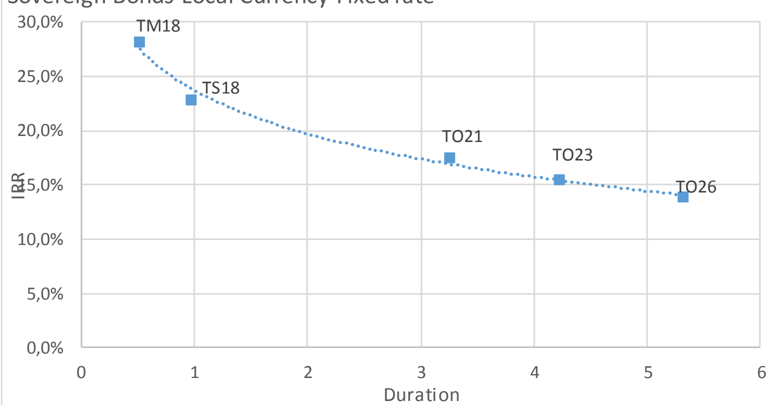
RESEARCH
Fixed Income



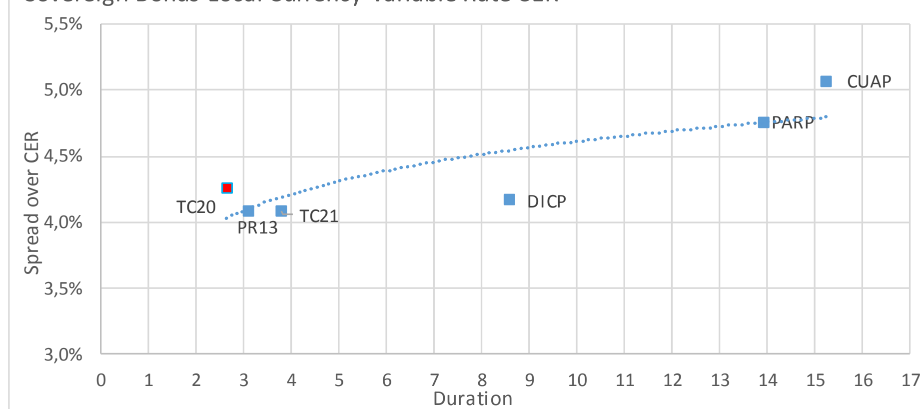
Sovereign Bonds Local Currency Variable rate BADLAR



Argentina Sovereign Bonds- Foreign Currency



Sovereign Bonds Local Currency Fixed rate



Sovereign Bonds Local Currency Variable Rate CER