LATIN AMERICA

Argentina Emerges

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While Argentina's economy has faced some challenges of late, some good news came this month for investors when index provider MSCI announced the country would be upgraded to emerging-market status. Franklin Templeton Emerging Markets Equity's Santiago Petri—who is based in Argentina—weighs in on the situation there.

Inclusion of Argentina into MSCI's Emerging Markets (EM) Index came as a bit of a surprise to some market observers given its recent struggles—including a sharp selloff in its currency and a US$50 billion bailout from the International Monetary Fund (IMF).

MSCI stated that the decision came on the heels of international institutional investor confidence in the country's ability to maintain current equity market accessibility conditions, which is an important factor of MSCI's classification framework. However, MSCI noted that in light of recent events impacting Argentina's foreign exchange situation, it would review its reclassification decision should authorities there introduce any sort of market accessibility restrictions, such as capital or foreign exchange controls.

Notwithstanding any changes, the emerging-market upgrade is set to become effective beginning in mid-2019. Accordingly, Argentinian stocks will be added to MSCI's Emerging Markets Index.

This isn't Argentina's first foray into the emerging-market universe—the country had been downgraded from emerging-market to frontier-market status in 2009.

The decision is likely to attract capital flows from both active and passive investors that follow not only the MSCI Emerging Markets benchmark, but also the MSCI Latin America benchmark. It is estimated that approximately US 1.5-$1.9 trillion in assets under management (AUM) are tracking the MSCI EM Index, representing a significant pool of potential foreign flows into the country.[1]

Depending on the country weighting assigned to Argentina, which some estimate would be between 0.4%-0.5% of the index, this could imply between US $1.5-$1.9 billion of passive inflows and up to US $1.6 billion of inflows from actively managed strategies.[2]

However, if Argentina is assigned a weighting by MSCI in the lower range of estimates, there is also the potential that the current estimated exposure to Argentina from active managers of approximately 0.4% will not be increased significantly.

Reasons for Cautious Optimism

President Mauricio Macri’s administration, which came to power in late 2015, had to deal with several complex issues, such as an oversized government sector, which at the national and sub-national level comprised 42% of gross domestic product (GDP)—almost double that of 26% of GDP in 2002—combined with a dual exchange rate regime supported by capital controls. At the same time, the federal government was still in default with some of its creditors, limiting its access to the international capital markets.

The Argentinian economy was seen as over-regulated and faced several constraints in key segments such as in the energy industry. The country, which was a net-exporter of oil and gas a decade ago, had to rely on expensive imports to supply its domestic needs. As a consequence of these impairments, per-capita income had barely grown since 2011 and the economy was in stagflation.

President Macri’s team was able to swiftly solve many of these constraints, liberalizing capital controls, reestablishing the relationship with its creditors and implementing market-based rules to normalize over-regulated segments like the energy industry. At the same time, the government undertook an ambitious reconstruction program in infrastructure to support domestic economic activity until a proper market-based economy could recover by itself. It is worth mentioning that transparency would be one of the distinctive features of Macri´s government, enabling it to achieve sensible savings in public works when compared with previous governments.

Given other pending issues, such as the size of government and its fiscal deficit, Macri undertook a more gradual adjustment process. The delicate economic situation combined with a minority position in Congress made Macri opt on a strategy of relying on international capital markets to finance a transition that would reduce the relative size of government, with economic growth over time. This strategy was not exempt from risks.

After successful mid-term elections, the government launched a moderate package of reforms that sought to balance the fiscal needs with social tolerance. Still, the program relied on external financing.

In our view, two politically driven events began to undermine market’s confidence on the sustainability of policies: a) the central bank was suggested to re-calibrate its restrictive monetary policy at a time when the economy was having a very acceptable rate of growth; and b) members of the ruling governmental coalition had objections on the pace of utility rates adjustments, which was one of the most clear fiscal adjustment policies the Macri administration undertook. This, combined with a more negative international environment and a tightening of 10-year interest rates, in addition to the implementation of a new tax on financial income, triggered a run on the Argentinian peso. There was also a flight from both fixed income and equities. The end result was an IMF request for a financial assistance package.

The meaningful assistance package under a Stand-by Agreement for US $50 billion (1,100% the quota of Argentina) revealed the international support to the normalization of the Macri government’s market-oriented policies. Nevertheless, the Argentine government has also committed to an ambitious fiscal normalization path, which is not exempt of implementation challenges, particularly in an electoral year. Argentina holds presidential elections in 2019.

The government’s committed policies reinforce and accelerate what the Macri administration has been implementing since it took office. The government has pledged a balanced budget by 2020. We are confident that President Macri will be successful in striking agreements with the more constructive opposition parties, since it is also in their interest that rational policies prevail, at risk of losing themselves ground to more radical opposition alternatives.

The financial stress resulted in the revision of some of the normalization policies, such as the liberalization of energy generation prices, which were deregulated late last year. We believe that this is consistent with the extraordinary event that afflicted the financial variables, but we are confident that the government will resume its market-oriented approach, as soon as the variables are contained.

Argentina has also committed to allow its central bank to focus primarily on the management of its monetary policy. It has appointed valuable talent who will likely continue to build upon the policies their also proficient outgoing staff have implemented.

We think Argentina has significant potential to capitalize on both its physical and human capital, which will allow it to regain a leading regional role the country enjoyed in the past.

Market Liquidity

Argentina's equity market is still small compared to its emerging-market peers, so there has been some concern about a potential large increase in investor flows.

It is true that the Argentine market could be considered as having lower turnover than other countries currently classified as emerging markets. However, this can be explained in part by the fact that the market has been inaccessible to international investors for a considerable period of time.

At first, MSCI will include only NYSE-listed American depositary receipts (ADRs) of Argentinian companies in its emerging-markets index. MSCI stated it will be constantly monitoring daily turnover to incorporate locally listed Argentine names into the index when liquidity improves.

As the market is integrated into the emerging-market universe, we expect this situation to likely be reversed. The market's liquidity profile should improve and align with other emerging market countries. At the same time, pursuant to the recently enacted Amendments to the Capital Markets Act, Argentina's government has been actively working to foster the development of capital markets, which will allow companies to seek financing in the equity markets and should increase the number of listed companies, providing additional depth to the market.

Given the expected assigned weighting to Argentina in the Emerging Markets Index of between 0.4%–0.5%, we do not believe the amount of potential foreign flows will likely be disruptive to the market. So, liquidity is not a concern to us at this time.

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What Are the Risks?

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.

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1. Source: MSCI, as of December 31, 2017, as reported on March 31, 2018 by eVestment, Morningstar and Bloomberg. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-markets countries. Indexes are unmanaged and one cannot directly invest in them. They do not reflect any fees, expenses or sales charges. There is no assurance that any estimate, forecast or projection will be realized. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.

2. Sources J.P. Morgan, Merrill Lynch. There is no assurance that any estimate, forecast or projection will be realized.