

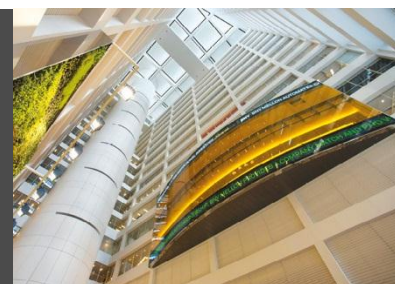
# News & Views

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For Professional Clients and, in Switzerland, Qualified Investors



BNY MELLON



## SHOULD YOU STEER CLEAR OF THIS EMERGING MARKET?

*Newton's Carl Shepherd says that despite a storming return to debt markets in April, Argentina faces some serious headwinds.*

Investors in emerging market sovereign debt could be well served by looking for yield beyond Argentina's recent issuance, according to Newton's Carl Shepherd.

Having been locked out of capital markets since defaulting on more than US\$80bn of debt in 2001, South America's second largest economy made a triumphant return in the second quarter of the year. Demand for its US\$12.5bn issue, the largest emerging market debt sale on record, was so strong the government was able to lower the yields on offer by 50 basis points and increase the size of the deal by US\$4bn to \$16.5bn.

But for Shepherd, a portfolio manager in Newton's fixed income team, the level of investor enthusiasm is at odds both with Argentina's status as a sub-investment grade country and the macro-economic hurdles it still faces. Instead, investors could look to local Peru or Colombia for bonds with both a better yield and a better credit rating.

"While we applaud the reforms implemented by the country's new centre-right president, Mauricio Macri, there remains a lot to be done and the government must continue with a package of severe fiscal consolidation," he says. "This has to be carried out against a backdrop of weak global growth and with Argentina's largest trading partner, Brazil, currently experiencing its own crisis."

"At the time of this issuance the bonds were yielding 7% and there were higher (9.2%) yields on offer in local Colombian bonds and +7%-yielding local Peruvian bonds, as the currencies had already been beaten up," he says. "Also, with 67% of Argentinian debt denominated in US Dollars, the newly issued debt, is not immune to domestic currency weakness."

He adds: "A single-B rating is probably not the space Argentina wants to be in – but until the economy improves, it's really the kind of peer group you're looking at. Of course, things are likely to change fairly quickly since the country does have the structural and technological advantages lacking in other less-developed countries. But right now, and given the degree of maladministration that flourished previously, we think it will take about 10 years for the full effect of the government's current reforms to come through."

After coming to power at the end of 2015, Macri lifted capital and trade controls, cut bloated power subsidies and agreed a debt deal with "holdout" sovereign bond creditors in the United States.

While in the short term, these measures have had a positive effect by instilling a modicum of investor confidence against a backdrop of very weak fundamentals, severe issues remain, including high inflation, a large fiscal deficit and a shortage of hard currency. The International Monetary Fund forecasts Argentina's economy will shrink by 1% in 2016.

But given this less-than-ideal macro-economic backdrop to Argentina's return to the bond markets, why was the recent issuance oversubscribed? For Shepherd, part of the answer lies in the reform programme, which was "well-liked by investors" and which offered "a bright spot in an emerging markets credit universe going through a tough period".

Argentina's programme was announced even as emerging market governments came under "tremendous pressure" to adopt credible reform packages to deal with the new reality of low commodity prices. "There weren't many that were forthcoming and Argentina was one of the few to come through with meaningful reforms," says Shepherd.

Another element, he says, is the size of the issuance, which made it difficult for benchmark-aware funds to ignore. “It’s not an exaggeration to say some funds were pretty much obliged to take notice,” he explains. “They were more or less forced into that space.”

Looking to the future Shepherd says he could revisit the Argentinian investment case but only after two key questions are resolved. “First, will Argentina’s regional governments continue to issue debt? Since the sovereign issuance in April, quite a few of the provinces have come to the market with their own US dollar-denominated offerings. Should they run into difficulty you’d expect the state to be the ultimate backstop, which would be a negative in our view.”

The second question is whether additional government debt will be issued by the Macri administration. Says Shepherd: “In April they only really borrowed enough to pay off the last round of creditors and so the expectation is they could return back to the market fairly soon. At present, they have around 4.5% of GDP in currency reserves which is low versus their peers. Our view is they’ll need more of a buffer in order to navigate any future economic weakness or unexpected negative events.”

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