September 26th 2024
Argentina Yield Curve

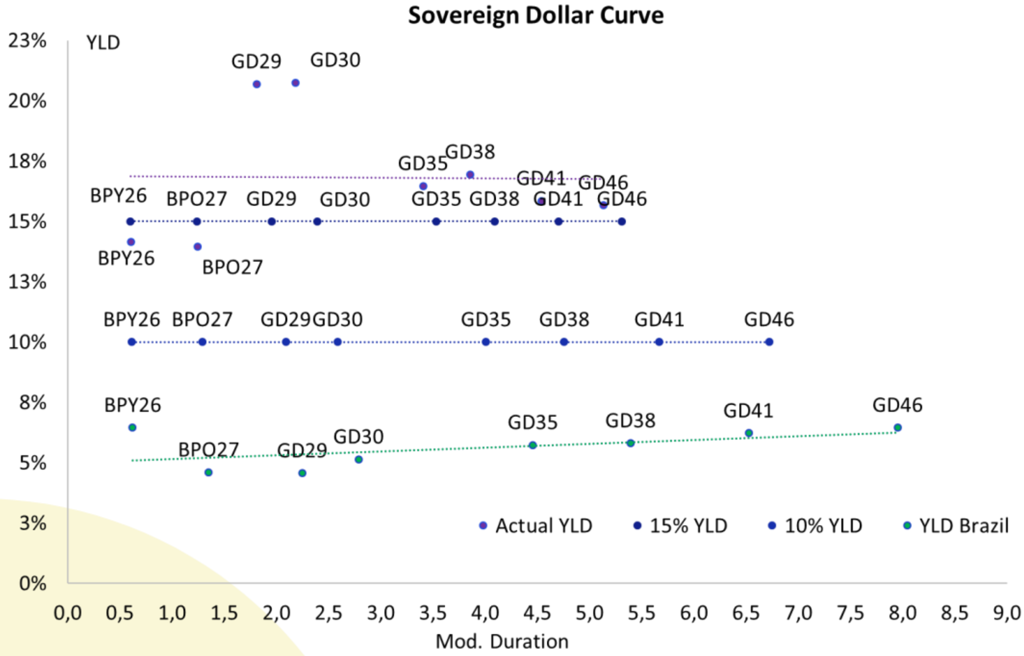
In our report last month (see here), we analyzed the Argentine economy, its figures and its implications as determinants for the prices of sovereign bonds. The conclusion was that we liked (and still like) sovereign bonds. Why do we like sovereign bonds? First, because the fiscal anchor is so strong that we see the bottom price of the bonds not too far from the current levels. Second, because the President shows a strong commitment to honoring debt obligations. If we reach a restructuring phase, we believe it would be a rather friendly agreement for bondholders. In our opinion, the major negative factor for bond prices is the exchange rate framework and the scarcity of international reserves. Under the current framework, we see it as almost impossible for the Central Bank to accumulate reserves. And with negative reserves, we don't see much room for a significant recovery in debt prices. That said, the current exchange regime can be modified. If it changes to a more flexible scheme that involves a higher official exchange rate (with some political and social cost), we still see high potential for a rise in sovereign bonds and the current coupons are quite interesting. Finally, an extremely relevant and positive factor for Argentine debt is the decrease in global rates. While Argentine bonds have performed somewhat better than their comparable, the correlation has been very clear and the path very similar in recent quarters.

Now, once you decide to embark on the adventure of Argentine debt, the second question would be: which bond or part of the curve should you position yourself in?

Choosing the place in the curve

To decide where to position ourselves on the curve, we will conduct a very simple exercise. We will move forward in time to June 30, 2025 (just before the second coupon of the coming year) and assume that by that date the securities continue performing, paying on time and in full. By that date, we will value the bonds using different discount rates, considering five scenarios. At the end of the day, the return of each bond is simply the theoretical price on June 30, 2025 (in each scenario) plus the coupons and/or amortizations received by that date, against the current price (total return). The valuation date seems reasonable as projecting further in an environment of negative reserves is complex. The five scenarios cover a broad spectrum of intermediate situations but provide a good conceptual framework. In the end, we will also provide some ideas about potential rollovers or debt exchanges.

Our analysis focuses on the ARGENT curve (New York law) and the BOPREA series 1D and series 3 (issues by the Central Bank). Remember that local bonds (ARGENT) have the same cash flow as their respective counterparts, so the price sensitivities to changes in discount rates are equivalent. In the end, we will extend these conclusions to ARGENT looking at the spreads by legislation. In the case of Bopreales, we set aside series 2 since it is very short (not as comparable to the rest of the curve) and series 1 A, B, and C since they can be used for tax payments (their duration may vary). To simplify, Bopreales series 1D and series 3 are the most comparable against the sovereign curve. Let's look at the scenarios.



Source: Sekoia Research based on BYMA.

Scenario 1. "Wait and see": The first scenario assumes that the market remains expectant. Essentially, it demands the same current yield from Argentine debt, with no compression of risks and the yield curve remains as is. This scenario could arise for various reasons, such as a stumble in the fiscal program, an increase in the exchange gap (as seen in June/July), a drain of reserves, or a reversal or pause in the decline of global interest rates, etc. As shown in the table below, in this scenario the total returns are very similar; GD29/GD30 would be the preferred ones. With no risk compression, capital repayments weigh more in total return.

TOTAL RETURN			
Scenario 1: Actual YLD			
Bond	MD	Actual YLD	Return
BPY26	0,6	14,2%	10,5%
BPO27	1,2	14,0%	9,9%
GD29	1,8	20,7%	14,0%
GD30	2,2	20,7%	14,0%
GD35	3,4	16,5%	12,0%
GD38	3,9	16,9%	12,3%
GD41	4,5	15,9%	11,0%
GD46	5,1	15,7%	10,7%

Scenario 2. Gradual risk compression: The second scenario involves a slow compression of risk. We could think that the fiscal adjustment continues, the exchange rate gap remains contained, and the Central Bank manages to avoid losing reserves even with capital controls and effective exchange rate lag. Essentially, the slight optimism of recent weeks continues. This scenario leads to a compression of spreads to 15%. The flat curve makes a lot of sense in this scenario, as sovereign curves with these spreads tend to be flat. As can be seen, GD29/GD30 would be preferred, closely followed by GD35/GD38, as the larger cash flows received in January 2025 start to offset the spread compression.

TOTAL RETURN			
Scenario 2: YLD 15%			
Bond	MD	YLD	Return
BPY26	0,6	15%	9,9%
BPO27	1,2	15%	8,2%
GD29	2,0	15%	22,5%
GD30	2,4	15%	24,9%
GD35	3,5	15%	20,2%
GD38	4,1	15%	21,3%
GD41	4,7	15%	16,3%
GD46	5,3	15%	14,2%

Scenario 3. Exchange rate regime reform and rally: An optimistic scenario involves a flat curve of 10%. This assumption is based on emerging economies comparable to Argentina with yields of 10%, such as Angola, Egypt, and Pakistan (to name a few). These countries have current accounts with moderate deficits or surpluses (Angola), primary fiscal surpluses (before interest), and external debts close to 40% of GDP. For now, the numbers aren't so different from the Argentine economy. The big difference lies in reserves, where these three economies have reserves to cover short-term maturities. Reserve levels range from 4% to 10% of GDP (Pakistan has fewer reserves and higher yielding bonds), values that currently seem very distant for the Argentine situation. We are talking about an equivalent of USD 20 billion to USD 50 billion considering Argentina's size. For the curve to compress to 10% levels, we believe a change in the exchange regime that allows for reserve accumulation is necessary. We're not necessarily talking about a complete exit from capital controls or unification of the exchange rate; it could also include gradual flexibility that includes a slightly higher commercial exchange rate. In this scenario, duration becomes more significant, and long bonds fare better, especially GD35 and GD41.

TOTAL RETURN			
Scenario 3: YLD 10%			
Bond	MD	YLD	Return
BPY26	0,6	10%	13,1%
BPO27	1,3	10%	17,6%
GD29	2,1	10%	31,5%
GD30	2,6	10%	36,4%
GD35	4,0	10%	55,6%
GD38	4,8	10%	51,2%
GD41	5,7	10%	52,7%
GD46	6,7	10%	45,2%

Scenario 4. The long-awaited stability: Dreaming costs nothing. Betting on Argentina's long-term stability, akin to what its neighboring countries have achieved in recent decades, still seems somewhat distant. Notably, Brazil could practically buy all its external debt with the reserves held in its Central Bank. In this scenario, long bonds are undoubtedly preferred, again GD35 and GD41 leading the way.

TOTAL RETURN			
Scenario 4: YLD Brazil			
Bond	MD	YLD	Return
BPY26	0,6	6,45%	15,6%
BPO27	1,3	4,60%	29,3%
GD29	2,2	4,57%	43,2%
GD30	2,8	5,14%	50,0%
GD35	4,5	5,74%	98,4%
GD38	5,4	5,81%	86,7%
GD41	6,5	6,22%	93,6%
GD46	7,9	6,45%	79,3%

Scenario 5. Chaos and a devastating default: The worst-case scenario, where the probability of default skyrockets and bonds return to parities of 20%-25%. We don't see this scenario as very likely. This potential path would involve a forced restructuring process. While the positioning on the curve will depend on the exchange conditions, recent history shows that low parities are a good strategy. Lower parity means less potential price drop and more bonds (face values) for exchange. In this scenario, GD41 is a good instrument, not only because of its low parity but also because it has a 2005 indenture, with a defensive contract for the holder in New York courts.

Summary

Considering the different scenarios, we feel comfortable with GD41 and GD35. We believe that the low spread by legislation does not warrant positioning in AL41 and AL35, especially considering the much more limited liquidity of these ARGBON compared to the ARGENT. As you might notice, the BOPREA are not among our preferences, particularly after the rally in recent weeks. Considering that the credit risk of the Central Bank is lower than the credit risk of the Treasury for dollar-denominated instruments seems more an act of faith than of fundamentals. On the other hand, despite the market's optimism with new government, we prefer not to pay higher parities in Argentina currently. Even being optimistic, its credit history forces us to take precautions.

In the immediate future, the probability of a voluntary debt rollover will largely determine price dynamics. To move forward with a partial exchange for short bonds, especially AL30/GD30 whose amortizations account for a significant part of the outflows in 2025 and 2026, the country risk must decrease. Essentially, for such a debt exchange to make sense for Argentina, it must clear short-term capital maturities. However, for AL30/GD30 holders, the present value of the new bond must have a price equal to or greater than the AL30/GD30 being delivered. With the current credit spread, this exchange is not possible today, because the new longer bonds would need to have a very high coupon to reach a present value similar to the 30s, a coupon that would imply a very high interest burden for Argentina. This makes the exchange illogical from the perspective of short-term outflows. We'll leave this for a future report.

Kind regards,

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