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And now, what do we do?

The results of the primary election shook everyone to the core. As usual, polls missed by a wide margin. The other indicators or variables we usually monitor were pointing towards a clear victory for the opposition: real wages, wages in dollars, confidence indicators in the government, and electoral results in Latin America during the post-COVID era. However, when looking at the opposition, most of us imagined a big victory for Juntos por el Cambio (JxC). The impressive performance of Milei and the catastrophic outcome for JxC is a major electoral shock that no one expected. Even though JxC made mistakes that make it look like it did everything necessary to lose, it doesn't take away the surprise from the electoral outcome, at least for us.

Now, thinking about what this electoral outcome might entail, from the overall economy to specific assets, I will try to summarize the internal debate (quite heated this time) we had during our weekly Monday meeting. The opinions summarized represent the views of the research team, our traders, and company directors. It's much better to hear various voices than just one.

Let's start with politics. The outcome highlights a few clear points. The first is that the votes belong to the people. They do not belong to electoral coalitions or politicians; these primaries made that clear once again. There's no bigger waste of time than trying to predict where Larreta's votes will go, where the votes of the electorate that didn’t vote this time but will do in the general elections go, or projecting whether Milei's 30% is closer to a floor or a ceiling. Let's not waste our valuable time on nonsense. So, what political insights do the elections bring for asset prices?

The first insight is negative. Argentina has been a country with significant economic instability in recent decades, but with a stable political environment due to bipartisanship. Now we're flirting with hyperinflation and frequently defaulting on our debt, but there's no impeachment, Presidents complete their electoral mandates regardless of the macroeconomic context. On the opposite end is Peru, with as much political instability as striking economic stability. In this regard, we're worse off today than we were last Friday, simply due to the uncertainty brought by Milei as a potential winner and his strong emergence in the traditional bipartisanship.

Let's move to the positive outlook. The vast majority of the electorate turned away from populism or, at the very least, fiscally irresponsible populism. Society voted for clear concepts like reducing the State's deficit and not squandering public resources, normalizing the exchange market despite this implying a painful devaluation, and radically changing how Argentina engages with the rest of the world. This potential new direction could never be bad news for asset prices in the long term.

Now, on to the economy. The natural distinction is between the short term and the medium term. In the short term, we agree that we'll need to brace ourselves. Milei's emergence as the winner of the primaries not only changes the political landscape but also the economic one, and as usual, the market tends to anticipate future economic measures. In the case that Milei is elected, his plans are well-known: reducing spending and lowering taxes, and removing exchange controls as a step towards a dollarization of the economy. This last point is crucial in the behavior of variables. Even though dollarization seems like a terrible idea for Argentina, its implementation is extremely complex and we don't believe it could happen in the short term. Looking at the FX market, a higher dollarization of flows in pesos is expected due to a probability of dollarization, even if it's not the baseline scenario. Why? Primarily because in order to achieve a reasonable dollarization at our exchange rate, our economy or, more accurately, our public sector lacks between 30,000 and 40,000 million dollars. Where are we going to get this amount if we're desperately asking Qatar, the CAF, and China for money to pay the IMF? The market's natural response would be an expected higher exchange rate. When implementing a dollarization or a fixed exchange rate

scheme, the fewer foreign reserves a country has at the start of the scheme, the higher the conversion exchange rate becomes. While dollarization might seem distant today, it's normal for the market to hedge its bets.

In the short term, the free-floating dollar will be the bad news, exchange rate instability negatively affects other macroeconomic variables. However, during the course of our meeting, the official exchange market opened with a surprising devaluation of the dollar and a significant increase in interest rates was announced. According to the textbooks, higher interest rates contain the exchange rate gap. Also according to the textbooks, the devaluation of the official exchange rate is great news for cushioning the drain on central bank reserves and, consequently, for the country's risk profile. The flip side will be a heavier blow to activity through a reduction in imports.

Furthermore, there's another very positive short-term reading: Massa's economic team opted for devaluation and raising interest rates, staying within the framework of the IMF agreement, despite these measures directly affecting their electoral chances. You could rightly argue that they didn't have many alternatives, but it's still good news. Doing a little bit, just a tiny bit, of the dirty work is better than doing nothing. Continuing an agreement with the IMF is better than breaking it. And not to be overlooked, Minister of Economy Massa applied a small dose of pragmatism, much welcomed considering that this pragmatism directly impacts Massa's electoral prospects.

In terms of the medium-term macroeconomy, there's not much more to add. Milei has the upper hand, but the elections are by no means decided. The medium-term macroeconomy will depend on the alternatives presented at the outset. Will we head towards more political instability and simply shift from left-wing populism to right-wing populism, or is there a real change in society that is now, according to the primaries, willing to tolerate short-term effort for long-term stability? Trying to answer this question wouldn't make us much different from pollsters.

Now, on to asset prices. Hard-dollar bonds started trading negatively abroad, but the drop moderated somewhat upon learning about the interest rate increase and devaluation, which seems reasonable. It's not a minor detail that the three candidates still in the race publicly express their intention to honor sovereign bond payments. Wanting and being able to pay are different things, but publicly stating payment intentions is a welcomed piece of information. In order to be able to pay, macroeconomic corrections are necessary in addition to the intention.

Something to watch in the future will be dollarization. When the economy is dollarized, the mechanism for absorbing external shocks (or a drought, for instance) shifts from the exchange rate to external debt, as seen in Ecuador, for example. This is a downside for bonds, but it's still a long way off. We're slightly more negative about sovereign bonds than we were last Friday, but in the short term. As for stocks, the analysis is similar. After the strong market rally recently, we're slightly more pessimistic in the short term today than we were on Friday. A correction appears natural. Regarding Argentine corporate bonds in dollars, they will likely experience some retracement in prices. However, the current coupons offer good coverage against moderate declines. The corporate bonds we like and recommend, we would keep in our portfolio.

In the local curve, we find the fixed-rate Lede bond interesting; its yield became quite attractive after the interest rate increase. For those who want to avoid credit risk, guaranteed securities are an interesting alternative. After the devaluation, CER-linked bonds over short-dollar Treasury bonds gained attractiveness, and the November CER bond seems like a good option as it will capture part of the growing inflation, given that CER adjusts with a lag. We would keep long-dollar link corporate bonds as this real devaluation will only be a short-to-medium-term patch.

Interest rates or dollar? Today's correction of the free-floating dollar along with the interest rate hike naturally makes the carry trade appealing. With a higher interest rate coverage and a higher entry level

for the exchange rate, the interest rate seems attractive. And the risks of interest rates? Nominal instability, a devaluation in a context of 7% monthly inflation, carries significant risks. Essentially, it flirts with a runaway race between inflation and devaluation. I'd say nominal instability, an elegant term for a runaway inflation scenario, is the primary short-term risk not only for carrying out the carry trade but also for the overall economic and political landscape.

Let me put it in more straightforward terms, as if we were at a trading desk. There's too much nominal instability today to go short on dollars, but at the same time, the interest rate is too high to go long. For those looking to conduct the carry trade, here's a humble piece of advice: think in the medium term. If the trade works out in the short term, great. If it doesn't, be prepared to hold onto the interest rate position for a few more months. The carry trade is a bet akin to buying dollar bonds or stocks – it's a bet that Argentina normalizes its situation, basically betting that the real free-floating exchange rate appreciates.

You probably have more questions now than before reading the report. We experienced something similar during our meeting. Simply put, the uncertainty is so great that the best we can do is to think and outline different scenarios with you, but never attempt to predict what will happen due to the concept of uncertainty. Let's leave that to the pollsters.

Regards,

Juan José Battaglia, trying to resume our meeting between the research team, traders, and company directors.

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