VanEck®

Argentina: Charting A Course Through Rough Seas

By Eric Fine, Portfolio Manager

VanEck - Unconstrained Emerging Markets Bond UCITS

USD R1 Inc: IE00BYXQSJ74
USD I1 Inc: IE00BYXQSF37
USD I2 Inc: IE00BYXQSG44
USD M Inc*: IE00BYXQSH50
EUR Hedged I1 Inc: IE00BYXQSD13
EUR Hedged I2 Inc: IE00BYX22V58

Average Annual Total Returns (%) as of 31 August 2019

	1 Mo†	3 Mo†	1 Yr	3 Yr	Life
USD R1 Inc (Inception 12/6/14)	-5.87	-0.32	3.79	2.33	-1.73
USD I1 Inc (Inception 20/8/13)	-5.80	-0.10	4.74	3.17	1.49
USD I2 Inc (Inception 20/8/13)	-5.79	-0.07	4.83	3.35	1.63
USD M Inc* (Inception 18/9/14)	-5.80	-0.14	4.54	3.10	-0.80
EUR Hedged I1 Inc (Inception 6/10/15)	-6.07	-0.84	1.65	0.69	2.07
EUR Hedged I2 Inc (Inception 22/08/17)	-6.05	-0.79	1.65	-	-2.18
50% GBI-EM/50% EMBI USD[1]	-0.95	4.57	12.90	4.22	3.59

* *Investment through authorized financial institutions only.*

† *Periods greater than one year are annualized.*

[1] *Life performance for the 50% GBI-EM/50% EMBI - USD benchmark is presented in U.S. Dollars (USD) as of Class I1 inception date of 20/8/2013*

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Fund Review

The VanEck - Unconstrained Emerging Markets Bond UCITS (Class USD I1) lost 5.80 in August, compared to a loss of 0.95% for the 50/50 J.P. Morgan Government Bond Index-Emerging Markets Global Diversified (GBI-EM) local currency and the J.P. Morgan Emerging Markets Bond Index (EMBI) hard-currency index. Turning to the market's performance, GBI-EM's biggest winner was Thailand. The biggest losers were Brazil, South Africa, and Russia. The EMBI's biggest winners were Mexico, Saudi Arabia, and Qatar. The biggest losers were Argentina, Lebanon, and Ecuador.

Market Review

Our Fund's overweight exposure to Argentina has made August a terrible month. In August, the Fund was down 5.80% (Class USD I1), compared to local currency (down 2.64%), hard currency (up 0.75%), and the Fund's 50/50 benchmark (down 0.95%). For the year, the Fund is up 5.33% (Class USD I1), compared to local currency (up 6.83%), hard currency (up 13.50%), and the Fund's benchmark (up 10.16%). We had a significant overweight in Argentina, in our case in short-dated, liquid, external law bonds.

However, we remain profoundly bullish on Argentina, and remind that we cut our exposure significantly, including closing local currency, just before the setback, in order to be able to rebuild positions. We are not tourists in Argentina. The fund has had a mostly overweight exposure since its inception seven years ago. Put differently, the end of a slow August, with forced selling of bonds on the part of an overweight market, is not the time to pronounce the bather drowned. Markets over-react, and we see current levels as the opportunity of a lifetime (explained in more detail below). Just before the setbacks in Argentina, we should note, we closed all of our local currency and illiquid exposure, with the idea of being flexible if there were buying opportunities. We didn't anticipate the event that triggered the sell-off, and obviously with a crystal ball we should have had no exposure for the month, and only then start to buy, but that seems unrealistic, and our plan was to be in liquid external-law bonds only, and to increase almost regardless of the outcome of the "Paso" (explained below).

Separately from Argentina, we continue to be very cautious about EM local currency, for the same reasons we've been noting (but with much more confirming evidence now): If

U.S. growth continues to diverge it is bullish for USD, and if a recession countdown has begun, it is even more bullish for USD. This summary of the argument that we've been making over the past several months is the simplest way to explain our low exposure to EM local currency and spread duration (the argument is much more detailed and bottom-up than that, but we won't repeat it in any detail in this particular monthly). Suffice it to say, the view continues to get confirmation from underlying growth data showing a better-than-ROW (rest of world) U.S. economy, as well as growing recession fears. Lower interest rates are not always good for local currency and spread duration; you need relative growth as well, and we're not seeing it in key EM names that make up the bulk of the EM indices.

This leaves us with a very idiosyncratic portfolio that doesn't seem to be driven by the market's primary concerns – China/U.S. trade, recession, Fed uncertainty, etc. We wake up in the morning thinking about Argentina, Ukraine (which continues to do extremely well), Brazil (ditto) and our other country- and company-specific views. We do not wake up in the morning worrying about non-EM phenomena such as the Fed, the latest Trump/Xi story, or even global recession fears. They are incorporated in our process, but don't drive it. Put differently, we think we have a portfolio built for the current environment, if you want to not worry about those major risk-drivers that seem to be dominating all asset prices. Our carry is 6.9%, our duration is 4.4, and we have roughly 19% of the fund in local currency. (The local currency exposure we do have tends to be outside the big index components, other than Indonesia, and are idiosyncratic themselves, such as Ukraine, Uruguay and Dominican Republic.)

On to Argentina - we see a very strong case for Argentina, where our view that this is an incredible buying opportunity is based on the following:

1. A market-friendly government is likely to be elected on October 27.
2. A good economic and policy setup for the new government
3. Prices that reflect extreme bearishness – one has to expect a return to the worst of the Cristina Kirchner days to not see a buying opportunity
4. A liquidity problem, not a solvency problem
5. Putting aside the arguments above, and just looking at charts, current prices look to be attractive compared to the price histories of other default or near default scenarios.

Reason 1 – We expect a market-friendly government to be elected on October 27. Current President Mauricio Macri's political future has imploded, with the nail in the coffin being the re-imposition of capital controls at the end of August. Their removal was his signature accomplishment. With their re-imposition, he appears to have no political argument. As a result, opposition candidate Alberto Fernandez should do even better than the shockingly strong numbers he showed in July's "Paso" (a mandatory but non-binding primary of all candidates) where he was 17 percentage points ahead of Macri. We have met with a top economic adviser and see a very market-friendly attitude, though one it is reluctant to highlight in the midst of an election. Among the examples:

- They want a quick resolution of any debt reprofiling on a voluntary basis. We were told explicitly that debt restructurings were too painful to the economy, so voluntary and quick, if needed, or not at all.
- They want to encourage investment, particularly in shale resources. This is consistent with wanting any debt extensions to be voluntary.
- They want no capital controls.
- Despite the International Monetary Fund's (IMF's) unpopularity in Argentina, Fernandez said he broadly accepts the goals of an IMF program.
- When we asked, there seems to be a strong desire to have a good relationship with the IMF's biggest shareholder, the U.S.

A really good comparison may be "Lula 1" in Brazil (former President Lula's 1st "good" term, in 2002), where he and the IMF expanded their IMF program (at the time the IMF's biggest lending program, as is the case in Argentina today) following the big Brazilian real sell-off that accompanied his election and made debt sustainability an issue. There were no restructurings. The sell-off and rally ended up being swift and in a lot of instances career-making, as the market was basically overweight at the highs and underweight at the lows.

Reason 2 – The economic and policy setup is nowhere near as bad as it was in the prior Argentina default, nor as bad as it was in all the other sovereign defaults of the past 20 years. Exhibit 1 below shows Argentina today (2019) compared to the starting point of Argentina in 2005, and to a range of other recent defaults. Gross domestic product (GDP) per capita is higher now in Argentina than it was in its previous default

(2005) and compared to the other examples. Debt/GDP is lower now than all of the examples, barring Ukraine's 2000 default. Ditto with the fiscal balance. The current account adjustment (how much the current account has moved in the right direction, from peak-to-trough, in a crisis), though, is still small in Argentina, pointing to the need for the currency to do more work and underlining our aversion to local currency still. The news flow will likely show ongoing growth weakness, and all the symptoms of uncertainty and loss-of-confidence (inflation expectations, low investment, etc.). But, when viewed in overall context, this is simply not that bad of an economic setup compared to Argentina in 2005 or any of the major sovereign default situations of the past 20 years.

Exhibit 1 – Argentina Economic and Debt Starting Point Much Better Than Previous Examples

Scenario	GDP per capita	Months in default	Haircut	Participation Rate	Debt to GDP	Fiscal Balance to GDP	CA adjustment
Argentina 2005	$ 8,387	38	66%	76%	152%	-5.4%	12.4%
Brazil 2003	$ 3,086	n/a	n/a	n/a	79%	-5.2%	6.0%
Ecuador 2000	$ 1,462	10	40%	97%	84%	-4.6%	13.7%
Uruguay 2003	$ 4,073	9	0%	93%	112%	-3.7%	n/a
Ukraine 2000	$ 664	3	0%	95%	59%	-3.2%	10.5%
Ukraine 2015	$ 2,125	0	20%	100%	81%	-4.5%	10.9%
Argentina 2019	$ 10,604	?	?	?	*76%*	*-3.5%*	*3.4%*

Note that many of the "hard" but necessary decisions have already been made by the current administration, saving the political capital of the new incoming government. Fernandez specifically asked for a forced restructuring of local-law debt (again, we own only foreign-law debt). The IMF has been asked for a new deal with extended terms. The currency has weakened significantly, giving a tailwind to the external accounts. We could go on. Important to keep in mind is that Alberto Fernandez has significant legislative support from Peronism, and experience in getting policies done. We expect to see this to be made clear as soon as he gains power.

Reason 3 – Market pricing is anticipating huge haircuts and/or long delays that we think are extremely unrealistic. Exhibit 2 below shows the total return over 12 months, depending on the type of outcome you expect, across a few benchmark external-law bonds. We also assign what we think are extremely conservative probabilities to the scenarios. The probability-weighted average 12 month expected returns for front-end bonds (ones we own and which we think represent the best buying opportunity) are 50%. We'll let the numbers speak for themselves, and note that the scenarios are detailed in the footnotes. The bottom line is that you have to expect a repeat of Argentina 2001 to be bearish at current prices. We've outlined above why we think the new government will be market friendly (unlike in 2001), and we should highlight that the 2001 default was defined by holdouts, which made it a very long default, which is simply not feasible in the current situation. All external law bonds in Argentina (and pretty much all sovereigns these days) have collective-action-clauses (CACs) that basically allow an agreement of 75% of bondholders to be accepted by all bondholders. It means deals are much easier and quicker to negotiate and why Ukraine's recent restructuring was able to get 100% participation.

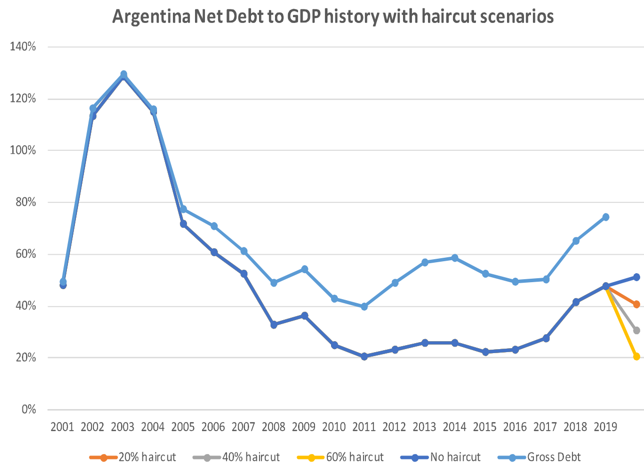
Exhibit 2 – You Have to Expect a Repeat of 2001 to be Bearish

		Expected Return by Bond		
Scenario	Probability	Arg 21	Arg 26	Arg 46
No Restructuring	5%	110%	115%	105%
Uruguay 2003[1]	10%	108%	112%	102%
Ukraine 2015[2]	35%	75%	82%	68%
40% Haircut	45%	20%	12%	-13%
Argentina 2001[3]	5%	-37%	-33%	-36%
Expected Value		*50%*	*49%*	*32%*

Reason 4 – Argentina looks to be facing a liquidity problem, not a solvency problem. This is a pretty important distinction, as liquidity problems can be solved with short-term financing as long as there is eventually good policy to rebuild confidence (which we argued above is very likely). Also, liquidity problems are solvable if there is a "reset" (something like a new government) in the near term (and we argued above we still think we're looking at 2 months before there's policy clarity, not 2 years). Finally, liquidity problems can be sorted with harsh short-term moves like capital controls (restricting dollar purchases to preserve reserves), and forced debt extensions on local-law debt (postponing maturity dates on local-law dollar debt, which we don't own, to preserve reserves). Preserving reserves keeps liquidity available for the government's priority dollar spends, which in the current government (and we think future government) are paying their external law bonds. We'll reiterate that it is extremely favorable as a political-economy dynamic when a previous government makes all of those tough decisions for you, which seems to be completely the case right now in Argentina.

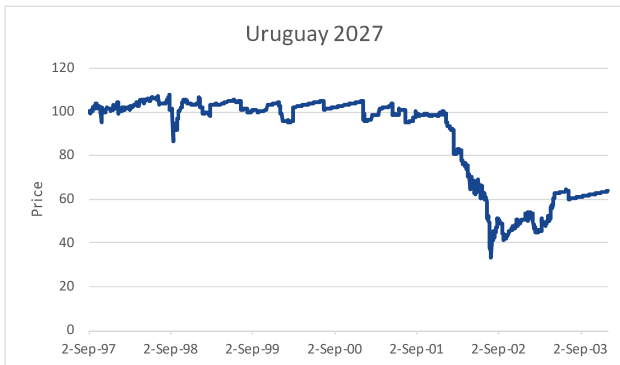
Exhibit 3 below shows Argentina's far superior solvency now versus the past, graphically, so we won't comment beyond that picture.

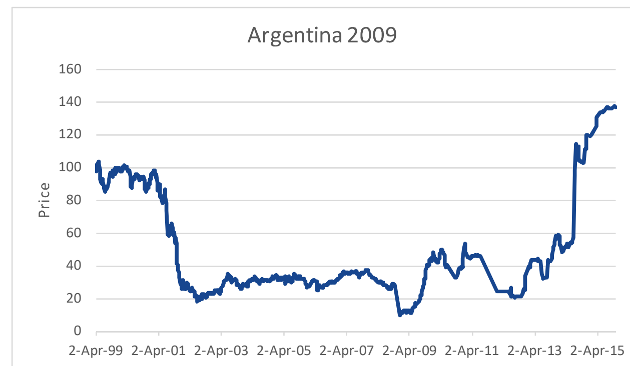
Exhibit 3 – Argentina's Solvency Over Time



Reason 5 – Notwithstanding all of the arguments above, and simply looking at price charts of previous defaults, current prices look very attractive, and no matter what, you never get a chance to buy bonds after the market concludes the worst is over – bonds just gap up on one trade. If one is going to take a view, now is the time, not after all of the issues we expressed views on above are clarified. We could be wrong on our arguments above. A key usefulness of charts, though, is that they show human behavior without adjustments for anything else (debt levels, policy, broader market environment, or whatever, as we've done in the first four arguments). What do those charts/histories seem to point at? Argentine bond prices are attractive, is what we think they show. The only chart that doesn't support this is the Argentina 2001 chart, but we already noted above a key difference – that in 2001 the problem was holdouts and their delays, which is not technically feasible in the current situation as all external law bonds now have CACs.

Exhibit 4 – Uruguay 2027, Ukraine 2022, Brazil 2020, and Argentina 2009 bond Price History During Default Phase





In our view,some risks are coordination problems with the likely incoming government, an IMF rupture, "fait accompli" thinking, and new actors in the legislature. The market could still be overweight, so selling presure could resume, and it is ultimately a judgement as to when the pressure is relieved. Related, the notional amount of Argentine foreign-law hard-currency debt is just under $70 billion, which is large, so non-dedicated-EM investors taking up the slack could be more important than for other EM countries that don't have debt servicing histories as volatile as Argentina.

One problem remains the weak incentives any incoming government has to step up and help a flailing outgoing government. We wrote about that previously, so it's not a new risk, and Fernandez's ongoing rise means he'll be President according to the market any week now, in our view, but it remains a problem even if it is diminishing. Fernandez will be especially tempted to speak badly about the IMF while running, in particular. Another risk, we believe, is that the IMF simply washes its hands of Argentina until there's a new government. There's not much precedent for a government broadly implementing a program's targets (which Macri had done for the current IMF review), but it is conceivable. Against this are that the IMF wants to show future sign-ups that they'll stick with them if they do what they said they will. Finally, what often happens in situations like Argentina's is that any government comes in and says "well, we might as well go scorched-earth on debt, as we can blame it on the previous government and the bonds/ratings are already reflecting it so there's no cost". That's possible, but very unlikely, in our view. Mainly because a) the likely policymakers in a new government have said the opposite; and b) they are saying this having been deeply involved in Argentina's 2001 restructuring, which they unequivocally said was much more costly and lengthy than it should have been.

A last risk would be gains by La Campora (the Marxist party led by Cristina Kirchner's son, Maximo), that might pressure a new Fernandez administration. Such a scenario would involve a turn to China and Chinese financing, and would put Argentina in the Venezuela camp. We don't see that as the point of the election, and one of Fernandez's key strengths is his ability to unify Peronism, but it's a risk. Anyway, there are risks to our view, and we obviously have to lay them out.

The real bottom-line, though remains – we expect a market-friendly government to be elected in two months, and see a market pricing in nothing of the sort. We believe, in fact, that what you are reading is perhaps the only explicitly bullish Argentina view in the market.

Exposure Types and Significant Changes

The changes to our top positions are summarized below. Our largest positions are currently: Brazil, Indonesia, Argentina, Ukraine and Belarus.

- We increased our hard currency quasi-sovereign and corporate exposure in Brazil. We express our positive view of Brazil through corporate holdings in the country. During the month we added new holdings in several Bucket 1 corporates, primarily beef companies with an already strong global presence, including significant operations in the U.S. We added to our Petrobras holdings as it continues to offer a favorable spread to sovereign for a credit that continues to improve. Finally, we added a new issue, an established offshore, FPSO with a proven operating history and long-term contract.
- We also increased our hard currency corporate exposure in Argentina and Peru. All Argentine corporates followed the sovereign downward, creating, in our opinion, some opportunities in corporate bonds as well. In each case, we focused on companies with strong credit metrics, even with a weakened currency (including strong cash positions), dollar (or dollar-indexed) earnings, and a positive payment history throughout various Argentine crises over the past two decades. In Peru, we picked up a Bucket 1-rated, export-oriented corporate with a strong balance sheet and strong ownership.
- Finally, we increased our hard currency sovereign exposure in El Salvador and hard currency corporate exposure in Georgia. El Salvador's politics and economic test scores continue to improve following the election of Nayib Bukele as the country's new president, and this includes a prospect of better relations with the U.S. In Georgia, we "topped off" our allocation from a new bond deal.
- We reduced hard currency sovereign exposure in Costa Rica and Jordan. In Costa Rica, we were concerned about the impact of President Alvaro's decision to exempt workers from the payroll component of the fiscal reform on the budget performance (and, hence, on the financing needs). In addition, Costa Rica's spread-to-yield/duration profile was among the least attractive in our portfolio. In

terms of our investment process, this worsened the country's economic, policy and correlation test scores. Jordan's spread-to-yield ratio was also among the lowest, especially when considered against the backdrop of the bond's long duration. In terms of our investment process, this worsened the country's correlation test score.

- We also reduced hard currency sovereign exposure in Ghana and Nigeria. Ghana's fiscal deterioration (higher headline deficit and concerns about the energy sector's liabilities), as well as concerns about the handling of local asset managers' liquidity issues were our key concerns. In terms of our investment process, this worsened the country's economic and policy test scores. In Nigeria, we reduced the long-end exposure due to concerns about duration in the U.S. In terms of our investment process, this worsened the country's correlation test score.
- Finally, we reduced local currency exposure in Indonesia. The main reason was the country's potential exposure to China, in particular the uncertainty about the trade talks with the U.S. and the ensuing negative impact on growth and the currency (AXJ currencies have the strongest correlation with the Chinese renminbi). In terms of our investment process, this worsened Indonesia's correlation test score.

R-Squared is the percentage of a fund's movements that can be explained by movements in a benchmark index.

DXY is the U.S. Dollar Index that measures the value of the United States Dollar relative to a basket of foreign currencies.

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