

Argentina

Caa1/SD

2004: Showtime for Debt Restructuring

- **Sustainability calls for: debt restructuring, a regulatory framework for utilities, bank lending**
- **We believe debt restructuring could be an investment opportunity later in the year**
- **We continue to see Bodens as an efficient vehicle for exposure, especially indexed to inflation**

Market Outlook

On a 12-month horizon, the question is whether debt restructuring will happen and provide the basis for a significant rally. We would define success as a high participation rate in a debt restructuring swap, which we believe is not likely to happen in the first few months of 2004. The recent change in the government's tone is not necessarily enough to make us believe the first formal offer will produce a successful deal. At the same time, we believe that well into 2004 we are bound to see domestic and external phenomena that produce better incentives for the government to strike a more efficient balance between a quick deal and a good deal. The risk to this view is that a successful deal happens during the first quarter of 2004, and a rally ensues. Given this risk, we see Bodens as an efficient vehicle to get exposure to Argentina's debt. The inflation-indexed series have further room to tighten, as inflation expectations pick up.

International conditions have clearly played a nontrivial role in the economic recovery, and the sustainability of that recovery depends to a large extent on a few government policies that would improve the incentives for investment. Some of those policies are a successful debt restructuring (which should reverse capital outflows), medium-term regulatory reform (which would allow investment in regulated sectors to surpass depreciation rates), and a resolution to different banking issues that could trigger a meaningful increase in credit.

Politics is certainly another crucial component of the medium-term view. President Kirchner has consolidated power beyond the most benevolent of expectations. The Peronist party enjoys political hegemony, but lacks cohesion on where to take Argentina, and how. This conflict is yet another phenomenon that can play a

destabilizing role in 2004. The "*piqueteros*" problem may be the short-term test.

Monetary policy and the real exchange rate are set to face important tests during the first quarter of 2004.

The government explicitly prefers a weak peso. The Central Bank has so far not had much trouble keeping inflation low and satisfying the government. However, inflation will not remain dormant forever, especially if the economy continues to grow or the monetary base continues to be expanded by reserve purchases. Seasonal patterns show that the demand for pesos softens by February, which is when we expect BCRA to have to make a decision between a higher FX rate, higher interest rates, or lower reserves. We believe it will let the peso weaken slightly, and let the local curve steepen, if possible.

Debt restructuring, and its legal consequences, could place Argentina in uncharted territory. If the first swap fails to produce a high participation rate, it could amount to a coordinating signal to those deciding whether to sue. A significant stock of judgments (well beyond the current US\$800-900 million) would put Argentina in an unprecedented position. The last stay on "executions" expires January 31, which means that those with judgments that have not reached settlements by then will most likely get execution orders.

Assuming a successful deal, how tight can Argentina trade post-swap? This is a relevant question for those that rely on the post-swap technical effect of Argentina's weight in the EMBI family of indexes. Let us assume a deal with an exit yield of 13% that makes defaulted debt worth 30 cents on the dollar. Can Argentina rally to trade through Brazil? We believe this scenario leads into a technical rally, but feel skeptical Argentina can trade through Brazil during 2004.

Investment Strategies

Underweight. We maintain a very small underweight, holding only Boden '12s in the model portfolio. We favor local performing assets for the first few months of 2004, especially inflation indexed Boden '08s. Given the technical limitations to quickly changing exposure, we recommend reducing underweights at levels of 25-27 cents on the dollar for globals.