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Markets in High Resolution

Great Risk-Reward in the Argie Carry Trade

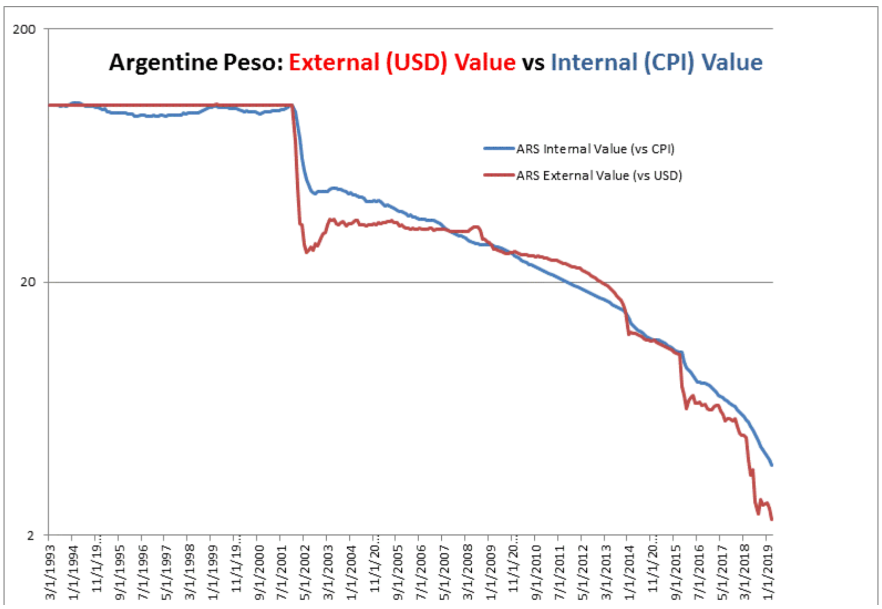
- Peso stabilization should produce a rapid deceleration in inflation
- Restricting monetary base growth should stabilize the Peso
- Political risk is extreme, but market outcomes appear asymmetrically bullish near-term

A Bloomberg story on Tuesday's Argentine inflation print (4.7% m/m) quoted an analyst as follows: "*The new inflation highs put USDARS on an upward, longer-term trend.*"

I'm afraid he has the causality backwards. The inflation process begins with excess money creation (relative to demand), resulting in a decline in the external value of the money in close to "real time." The internal value of the money (a.k.a. inflation) "catches up" to the external value over some period of time, largely depending on the "stickiness" of domestic prices.

Domestic prices in countries with a poor inflation track record (like Argentina) will adjust more quickly as the economic structure is designed to be less "sticky" (and contracts will tend to be shorter in length). Also, a maxi-devaluation is generally "passed through" quite quickly given the starkness of what's going on.

Here's the history of this process in Argentina. The chart (log scale, indexed to 1993 = 100) shows the value of the Peso against the Dollar and against the Argentine CPI Index.



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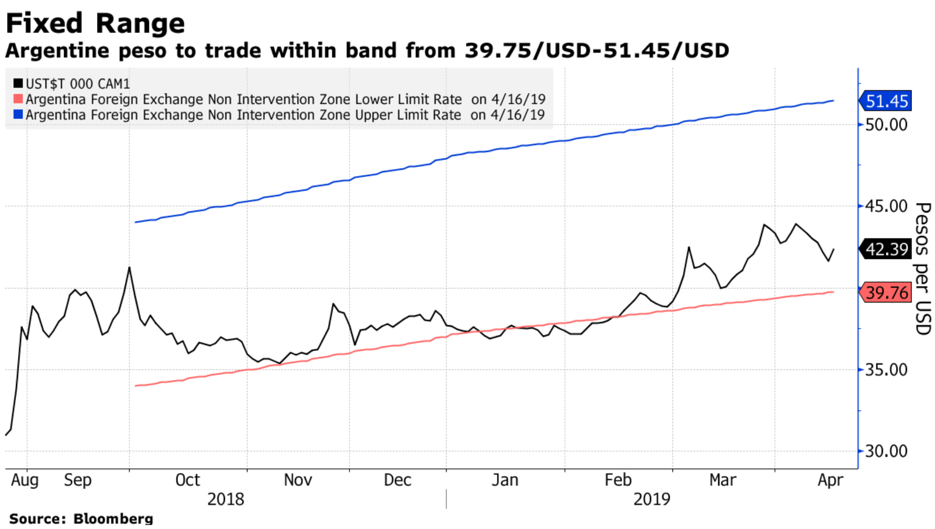
The chart suggests the domestic price level in Argentina will have to rise by around one-half again in order to come back into balance with the Peso's heavily depreciated external value, *assuming no further Peso depreciation from here*. While a 50% rise in prices sounds like a lot, if the process were to take 18-24 months, as one might expect, it would entail a significant deceleration in inflation from the March print of 74% annualized (54.7% y/y).

Of course, there is no guarantee the peso won't depreciate still further, but BCRA does seem to realize the centrality of peso stability to their macroeconomic goals. Having initiated the peso trading band at a 3% sliding monthly depreciation rate in 2018, they reset that to 2% for 2019, and finally this week pledged to halt the sliding of the band altogether, and maintain the band at fixed levels for the remainder of the year.



It would be preferable if the band, which entails a commitment to unsterilized intervention of $150m per day at the top end, were not so wide, but the central bank's actions of late suggest they have little appetite for allowing the Peso to trade in the upper portion of the band.

Through a bit of trial and error, BCRA has arrived at the optimal policy approach for stabilizing a currency under attack: target the exchange rate itself using money supply as the policy tool, and allow rates to float as necessary. While BCRA is officially targeting base money while allowing for a managed float of the Peso, recent actions to alter the base money target for the purposes of peso stabilization suggest the currency is effectively the policy target. (Trying to defend a currency under attack by setting sky-high interest rates will almost always fail, as high interest rates tend to dampen demand for the currency while leaving the over-supply problem unaddressed. Better to target the supply problem directly).

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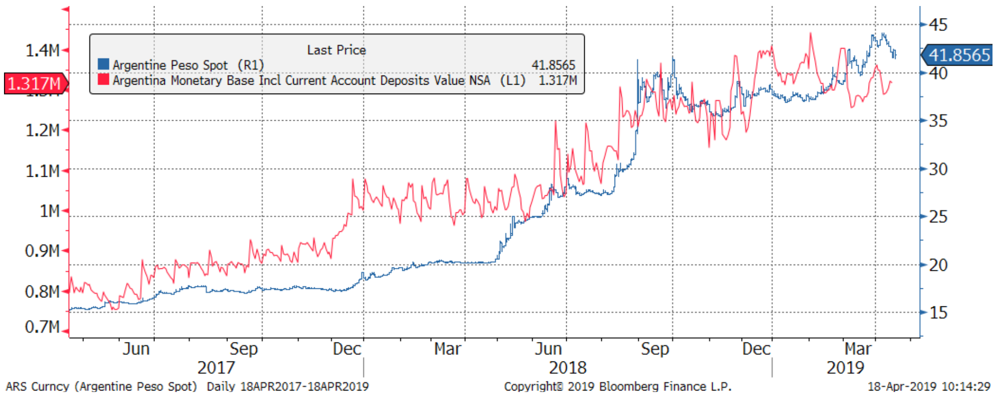
The remaining question is whether stability in the monetary base will produce stability in the currency. Assuming confidence in (and demand for) the Peso doesn't further collapse, it should. For starters, the Peso has shown broad stability in the past six months against a backdrop of a largely stable monetary base.



Secondly, we can guesstimate whether or not the currency has fully responded to the excess money creation by looking at the Dollar value of the monetary base. Excess money will generate inflation until the nominal economy "grows into" the newly expanded money supply. The "real money supply" should grow at some "normal" rate in line with the economy. With inflation responding one-for-on with exchange rate changes, the Dollar value of the money supply becomes a live proxy for the real money supply.

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That Peso depreciation has pushed the Dollar value of the Argentine base money supply back to near decade lows is a good indication that the Peso has fully adjusted. As domestic inflation catches up to the peso depreciation, the current money supply will come to be genuinely needed again in the newly expanded (via inflation) nominal economy.

Of course, if the politics goes off the rails and confidence in the Peso collapses you can toss all of this analysis out the window.

I have little to offer on the political risk outside of the consensus view that its broadly a “toss-up” at this point. However, the risk-reward of a long-Peso carry trade appears bullishly asymmetric for the Peso.

If the political news flow in coming months stacks up negatively, you at least have on your side a central bank which should remain strongly committed to fighting any resulting exchange rate weakness so as to keeping Macri’s hopes alive.

In the event of good news politically you have the potential for a virtuous circle to unfold. If inflation decelerates and the peso-stabilization policy bears fruit in coming months, interest rates will fall and the economy will appear to be on a sounder footing. Macri’s political fortunes should improve as a result. That in turn will bode well for the Peso, reinforcing the credibility of the central bank’s approach.

<u>Conclusions</u>

- Peso stability will bring about a significant deceleration in inflation
- The commitment to monetary base stability should stabilize the Peso
- Near-term market outcomes around political risks are asymmetrically bullish

The ideal expression would be to sell a 1-year USDARS ndf to take advantage of a potentially sharp fall in interest rates in coming months. However, liquidity in that tenor has deteriorated significantly, so investors wanting to maintain tactical flexibility should stick to the 1-month NDF at implied yields in excess of 60%.

I’d risk the trade to 45 USDARS (~8%) for now, looking to roll that up gradually as the position accumulates carry profits.

This is obviously a high-risk position. Size accordingly.