Fed Eases. Stop Crying For Argentina

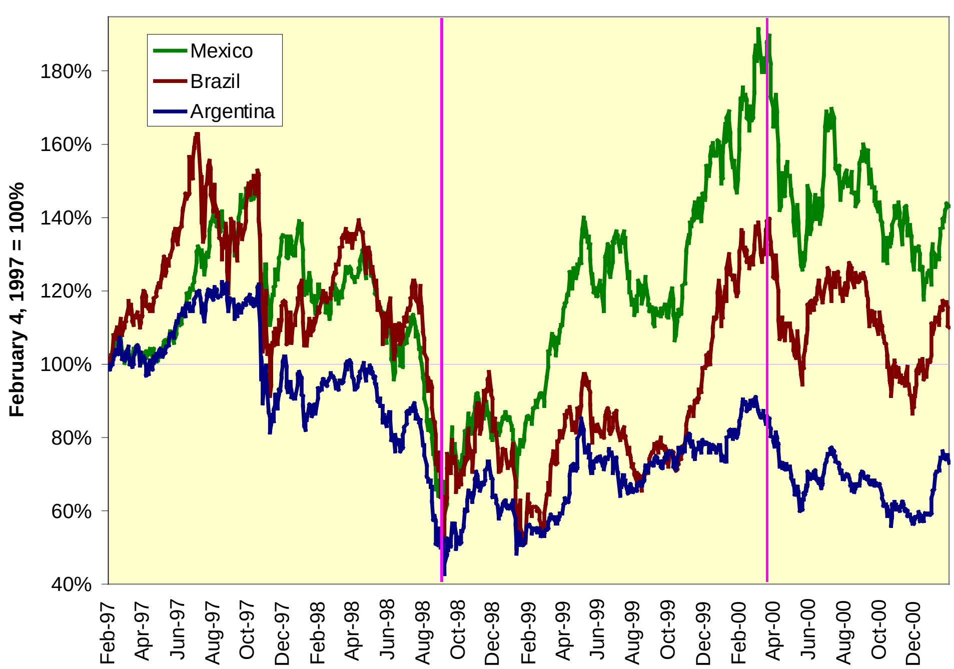
Some nations, like Poland, have tragic histories by virtue of their bad choice of neighbors. Other nations, Argentina in particular, are the victims of self-inflicted wounds. At the start of the 20th century, Argentina's rich mines, fertile pampas, and above all, its pre-Mad Cow beef exports propelled it to the rank of seventh wealthiest country in the world. Since that time, Argentina has been a case study in how reliance on commodity prices and socialist/labor politics can send an economy into reverse. We must marvel how a country self-sufficient in petroleum and a major exporter of foodstuffs has been in chronic distress.

Dollarization

Like most Latin countries, the 1970's and 1980's were time of high inflation, currency devaluation, and international payments default for Argentina. By 1992, around the same time the Europeans decided they'd seen enough of perpetual currency crisis, Argentina decided to peg its peso (ARS) to the U.S. dollar. The costs of dollarization would include importing U.S. monetary policy and facing strong export competition from other Latin countries with weaker currencies, especially Brazil.

A strong stock market is not one of the macroeconomic advantages associated with a firm currency and low inflation produced by tight monetary policies. Let's compare the relative paths of Argentina's Merval index with Brazil's Bovespa and Mexico's IPC in USD terms over the past four years.

Relative Performance: Major Latin Markets In USD Terms



Regional Differences

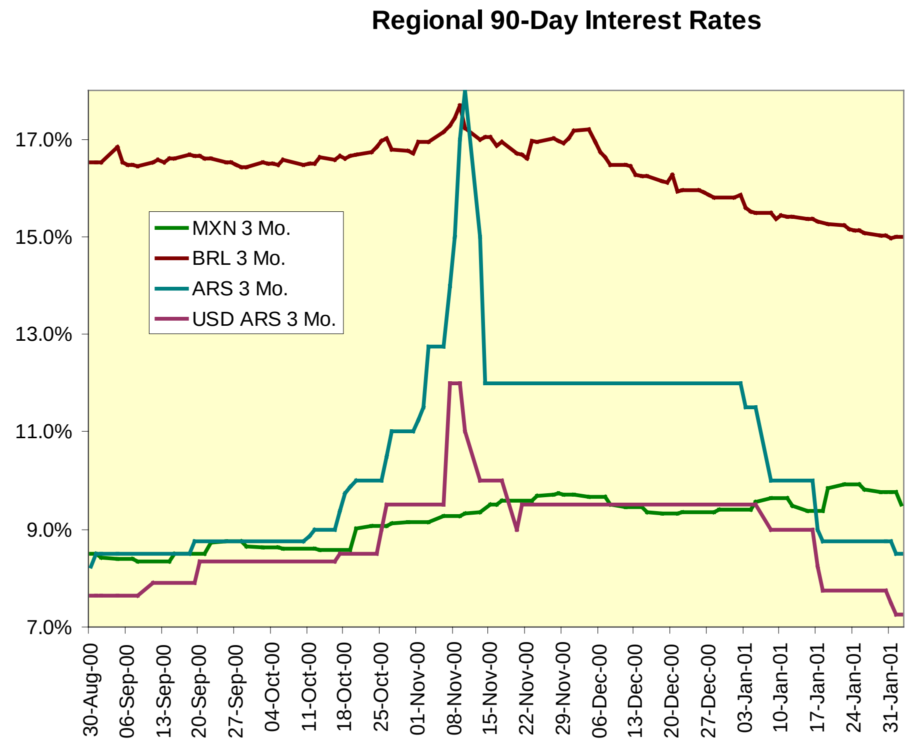
The Bovespa and IPC reflect the international appetite for financial risk quite well; both markets soared during the first half of 1997, retreated under the weight of the Asian crisis, and then capitulated during the Russian default of August 1998. At this point, highlighted on the chart above, the three markets diverged. Mexico remained committed to the management of a floating peso (MXN) by increasingly tight monetary policies – the Corto – administered by the Bank of Mexico. This policy allowed Mexico to recover smartly from its 1994-1995 crisis; its export-led prosperity was significant enough to allow the first change in ruling party in that country since 1930. Between September 1998 and March 2000, the IPC jumped nearly 170% in USD terms.

Brazil attempted to manage a continuous and gradual devaluation in the real (BRL), but failed miserably by January 1999, at which point the BRL collapsed. Policymakers quickly contained the crisis and adopted a more activist stance on the BRL, and the Bovespa gradually recovered to early 1998 levels.

The Merval never experienced a significant recovery from the Russian default period, and is still trading below levels of the reached during the first Asian crisis. On the other hand, it fared far better during the second half of 2000, highlighted on the chart above, than did the export-sensitive IPC and the Bovespa. All three markets have experience decent rebounds so far in 2001: The IPC is up 13.8% in USD terms, while the Bovespa and Merval are up 8.8% and 24.0%, respectively.

Argentine Sunrise?

Will the combination of lower interest rates in the U.S. and slower export growth in both Brazil and especially Mexico create a prolonged period of relative outperformance for the Merval?



One clue to this question lies in an artifact of the Argentine dollarization. Two deposit rates are available in Argentina, one for time deposits returning ARS and one for demand deposits returning USD (the 'USD ARS' label in the above chart). Just like the TED spread, the spread between the two rates expands during times of Argentine financial distress; witness last November's spike in the ARS time deposit rates when an international loan package was delayed during a government budget squabble. The spread contracts in periods such as the present when funds are flowing into Argentina.

A second clue lies in the absolute level of interest rates themselves. The high Brazilian rates are necessary due to the country's persistent inflation problems and fear of another BRL collapse. Mexico is keeping its rates high to rein in both inflation and its potential trade deficit with the U.S. Unlike Argentina, neither country has significant leeway to match the U.S. in a round of rate cuts. This should give the Merval a relative advantage.

The importance of lower interest rates to Argentina cannot be overstated. The strongest performers so far in 2001 have been the banks: Banco Rio Plata is up 68%, BBVA Banco Frances in up 49%, and Banco Galicia is up 34%. The index' underperformers include oil companies such as YPF and Repsol, and electricity generators Central Costanea, and Capex. These utilities are facing the problems in passing on their high fuel costs that are confronting firms worldwide in this sector.

Indices For The Brave

All of these Latin markets have associated stock index futures, and these could afford a lower cost way of playing a long Merval / short Bovespa trade. Of course, these contracts are thinly traded compared to U.S. futures; the open interest in the Mercado de Valores Buenos Aires is just over 310 contracts, and there is no open interest at all on the IPC futures. The Bovespa is a different story; the spot February contract has open interest over 35,000 contracts.

We all know from experience that sometimes the best spread trade is to buy the strong and sell the weak, and this certainly was the case for Argentina relative to Brazil. Reversing this trade now might be an interesting way of playing lower interest rates and a global economic slowdown.