The Brady Bunch

That investors in bonds have different outlooks on life and different imperatives than stock investors do is hardly front-page news, is it? The names of the basic documents they hand you in exchange for your hard-earned money say it all. Stocks have a *prospectus*, which is Latin for "they'll never read this." It's a fair bet the Russians used to transmit uncoded nuclear secrets in the appendices of secondary rights offerings.

Bonds, however, have a *covenant*, which in addition to its religious connotation derives from the ancient Sanskrit word for "deathly dull legal boilerplate." Since the best thing that can happen to a buy-and-hold bond investor is getting paid back, it's no wonder so much attention gets paid to what happens when the sheriff comes.

Some borrowers, however, through a combination of innate mismanagement or true natural poverty, have a standing date with trouble. Natural poverty is pretty rare; a landlocked desert like Mongolia will always be poor, that whole unfortunate fracas with Genghis Khan and his Golden Horde notwithstanding. Most poverty is self-inflicted, and there's no better place to look for this than Argentina.

Adding Mea Culpa To Caveat Emptor

If bond buyers truly adhered to the principles of due diligence, the Argentinas of this world would be shut out of the market. That this has not occurred we can ascribe to my Poker Principle of international finance: You've got to keep the sucker in the game. If your customers go bankrupt, you as a producer and exporter have a problem.

One way of solving this problem is to socialize and globalize credit through international agencies such as the IMF, whose motto might as well be "Only one building, but every policy error." Another method is creating taxpayer-backed loan guarantees and supports such as the Brady bonds launched by the previous Bush administration's Secretary of the Treasury.

The last time I wrote about Argentina, July 2001, I was sure the end game would involve another IMF bailout, a peso devaluation that retained a link to the dollar, and the issuance of another round of Brady bonds to roll the problems forward. This assessment was incorrect; the outcome instead was an Argentine default, a de-linkage of the peso to the dollar, no IMF bailout, the arrest of the former Finance Minister and a tragicomic parade of five Argentine presidents in a 13-day span.

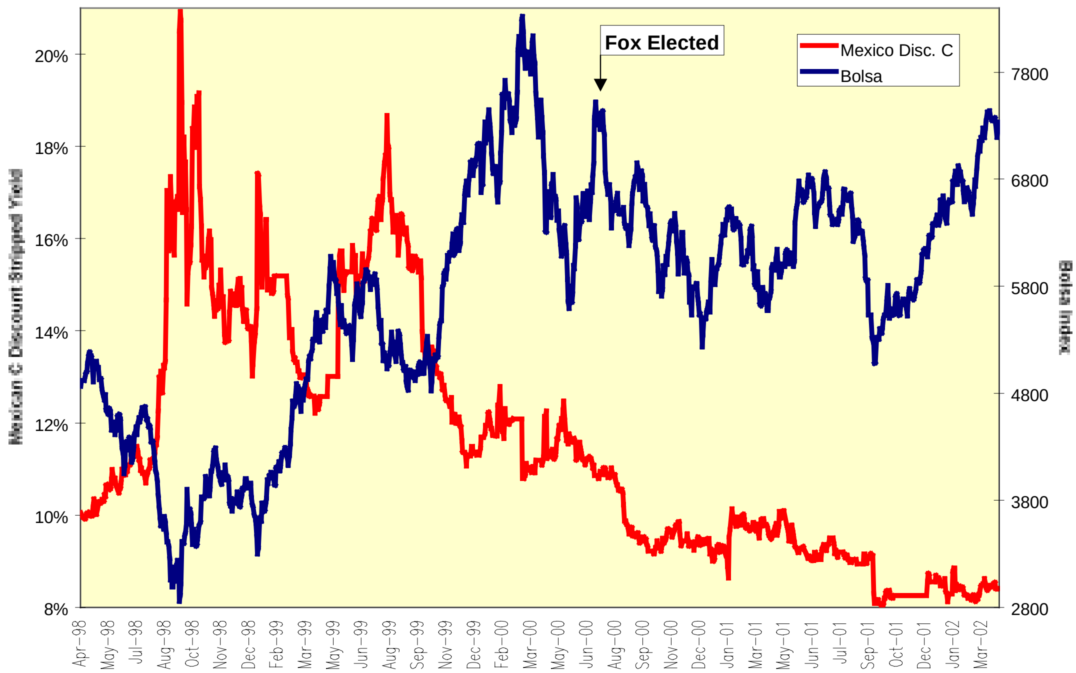
Stripped Yields

The components of a Brady bond include a floating-rate note issued at LIBOR-plus-a-spread and a par bond paying a below-market coupon. The end result of all these moving parts is a principal and a rolling guarantee of interest both fully collateralized by the U.S. Treasury, and the remaining cash flows subject to specific country risk. The difference between the total price of the bond and the collateralized portion is the stripped price, and the internal rate of return on these cash flows is the stripped yield.

Can we use these stripped yields as a thermometer of country risk, not only for the credit markets, but for the equity markets as well? Let's take a look not only at Argentina, but also at Brazil and the far more successful case of Mexico. Each of these three countries is at a different stage following a crisis, and each has a different story to tell.

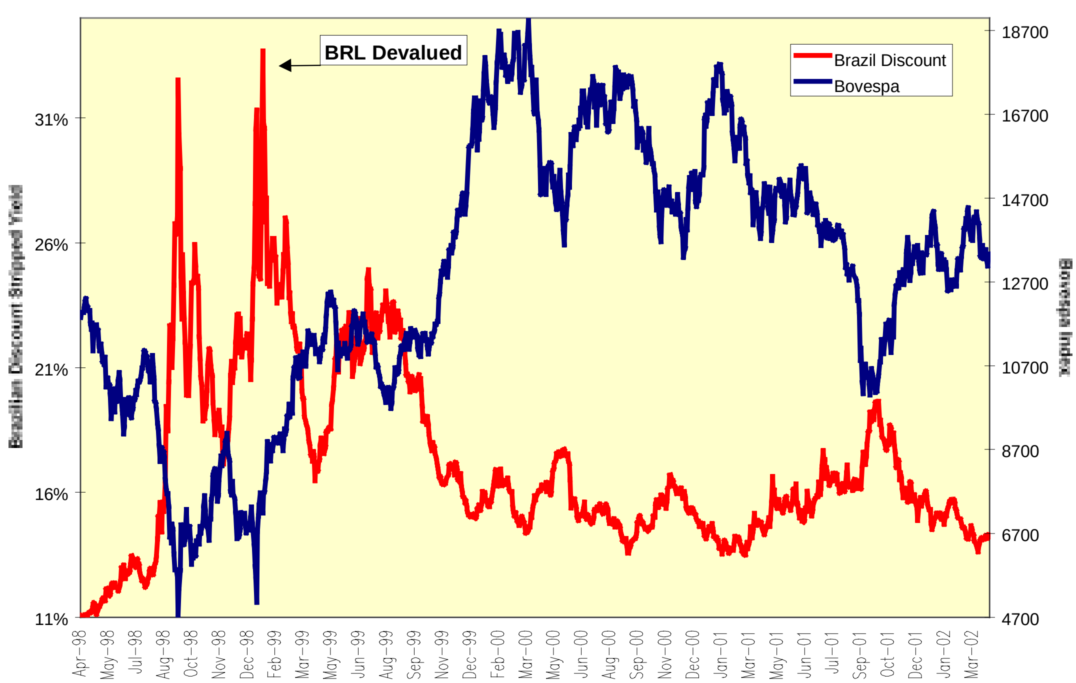
Mexico's most recent trip to the global currency woodshed took place in December 1994. It stabilized itself with the aid of NAFTA and a real commitment to reduce inflation. By the time Vicente Fox was elected in July 2000, the country risk premium was shrinking, the Mexican peso (MXN) was strengthening and the Bolsa was doing as well as any market in the world.

Mexican Stabilization



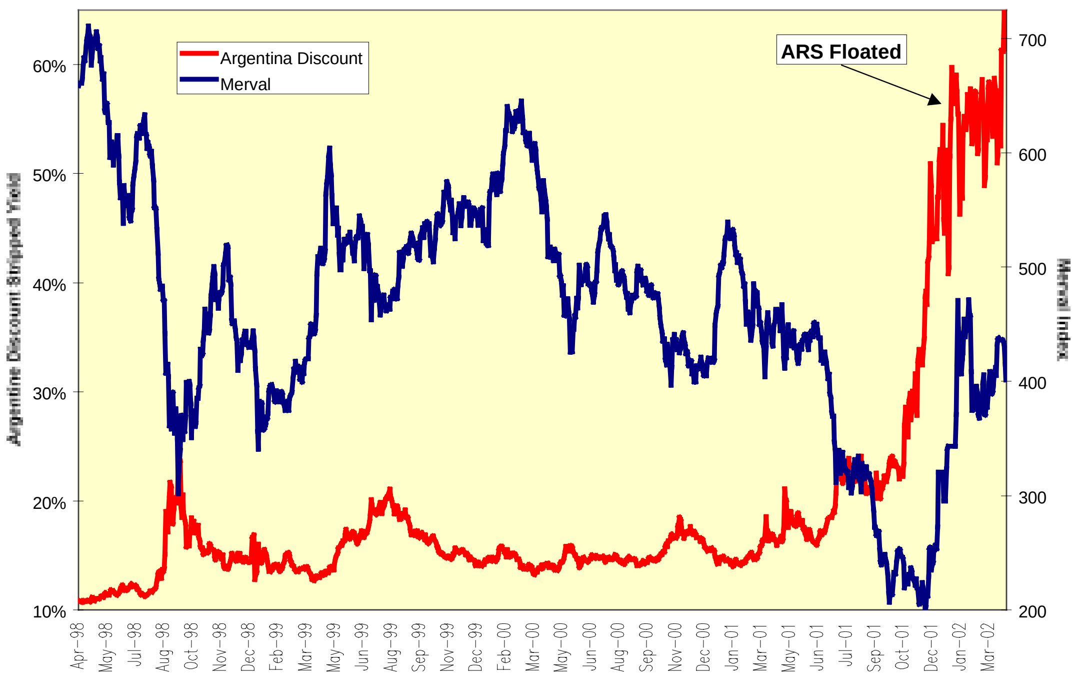
Brazil had its currency crisis in January 1999; indeed, this devaluation almost can be considered the end of the global currency crisis that started in Thailand in July 1997. Once the Brazilian real (BRL) fell from 1.21 to 2.10 to the dollar in three weeks' time, the markets proceeded to price the country risk out of holding Brazilian financial assets. The real stands at 2.277 to the dollar today. And, for those of you who want a good cry, consider this: Since the start of 1999, the Bovespa index has returned 95.7%, as compared to a loss of 6.77% for the Wilshire 5000.

Brazilian Devaluation Precedent



Argentina is in the immediate aftermath of its January 2002 devaluation, or floating if you prefer, of the Argentine peso (ARS). The stripped yield spread on its Brady bonds is still moving skywards, which is unsurprising considering the anti-capitalist route chosen by the Duhalde regime. But, the Merval index started to rise in December 2001, and has retained most of these gains despite the obvious country risk premium.

Will Mervals Never Cease?



The bet here seems simple: Both Brazil and Mexico stabilized and provided good returns to those stock investors who bought when the stripped yield premium in their Brady bonds signaled blood in the streets. So, if it worked for those two, shouldn't it work for Argentina?

In a perfect world, yes. But, I'm going to take a contrary position and consign Argentina to the financial dustbin of history. Until they have the political will exhibited by Ernesto Zedillo and Guillermo Ortiz in Mexico to take some short-term pain for some long-term gain, they'll simply lurch to the next crisis.

Kind of makes you want to cry.