

Argentina Cannot Get Its ARS In Gear

You would be hard-pressed to explain Argentina to a Martian assuming, of course, you could find a Martian willing to talk to a currency trader. A Martian sojourner to our fair planet would find only a few places with Argentina's natural endowments of water, soil, minerals and energy, a fine temperate climate and the advantage of producing its grain and livestock during a different season than its Northern Hemisphere competitors. Argentina, unlike Brazil, did not evolve as a state based on slavery during the colonial era.

But, to paraphrase an old joke several nations tell about themselves, God was alleged to have told an angel inquiring about these outsized gifts, "Just wait until you see the people I put there!" Very sadly, this is true. It is hard not to hold the Argentines in some measure of contempt (here I defer to Josef Stalin as an expert on squandered patrimony: "Lenin founded our state, and we've [fouled] it up!" he was alleged to have snarled in the early days of the German invasion) for their declining status over time.

At the beginning of the Twentieth Century, Argentina was the seventh wealthiest country in the world; they were not chewed up in either World War and then they proceeded to destroy themselves with an astonishing blend of corruption, the labor socialism of Juan Peron and his successors including at one point himself, and a blend of assorted left-wing losers and vicious military despots. Argentina and the newly born Russia after the fall of the Soviet Union have to be the dual poster children arguing for private property rights and the rule of law. Countries who expropriate foreign investors, as Argentina did with Spanish oil company Repsol in 2012 tend to attract fewer foreign investors. Some things are very predictable.

The Irish dramatist Brendan Behan wrote, "Other people have a nationality. The Irish and the Jews have a psychosis." What would he have said about Argentina?

Don't Cry For Me, Little Peso

In that spirit, other currencies exist but the Argentine peso has a history, and a tragic one at that. Consider:

- In 1970, the peso moneda nacional became the peso ley. Lop off two zeroes in recognition of the 100:1 conversion rate;
- In 1983, the peso ley became the peso argentino. Lop off four zeroes in recognition of the 10,000:1 conversion rate;
- In 1985, the peso argentino became the austral. Lop off three more zeroes;
- In 1992, the peso was pegged to the dollar, effectively making Alan Greenspan the director of Argentine monetary policy;
- In 1999, the peso was allowed to float, more or less

For those not versed in scientific notation, all that lopping off of zeroes puts the post-1970 loss of purchasing power at 10^9 , or one billion to one to the USD, and that is before the dollar's loss of 83.9% of its own domestic purchasing power since the end of 1969 and another 32.85% loss of the dollar's purchasing power on an ICE dollar index basis. The absolute loss of purchasing power before hedonic adjustments and any coupons you might have lying about has been close to 100 billion to one.

This monetary history is independent of Argentina's default on its international debt in 2002; this followed years of various U.S. and multilateral arrangements to keep rolling the bad debt forward through devices such as Brady bonds.

Some countries – and you probably could name a few – engage in a pretense their central bank operates independently of the political process. Score one for Argentina in intellectual honesty department: President Cristina Kirchner, the widow of the former president Nestor Kirchner, moved her hand-picked central banker Mercedes Marco del Pont, to allow the government to "borrow" the excess foreign exchange reserves held by the central bank. The central bank has become a piggy bank; the outcome is as much in question as to which way the Rio de la Plata flows.

The Peso Market

The most fascinating question about the peso market is why it exists at all. Just like the Venezuelan bolivar or the Zimbabwe dollar, who on earth or even Mars would want to go long the ARS? The answer is some Argentine

exports have to be paid for with pesos at some point, and foreign investors or multinationals in Argentina have to acquire pesos for operations. Enough of those trades exist to prevent shorting the ARS from being a one-way trade.

The option market is never comfortable with the ARS rising, as seen in the excess volatility of three-month ARS forwards for USD holders. This is the ratio of the implied volatility for three-month non-deliverable forwards to high-low-close (HLC) volatility, minus 1.00. It serves as a measure of the market's demand for insurance.

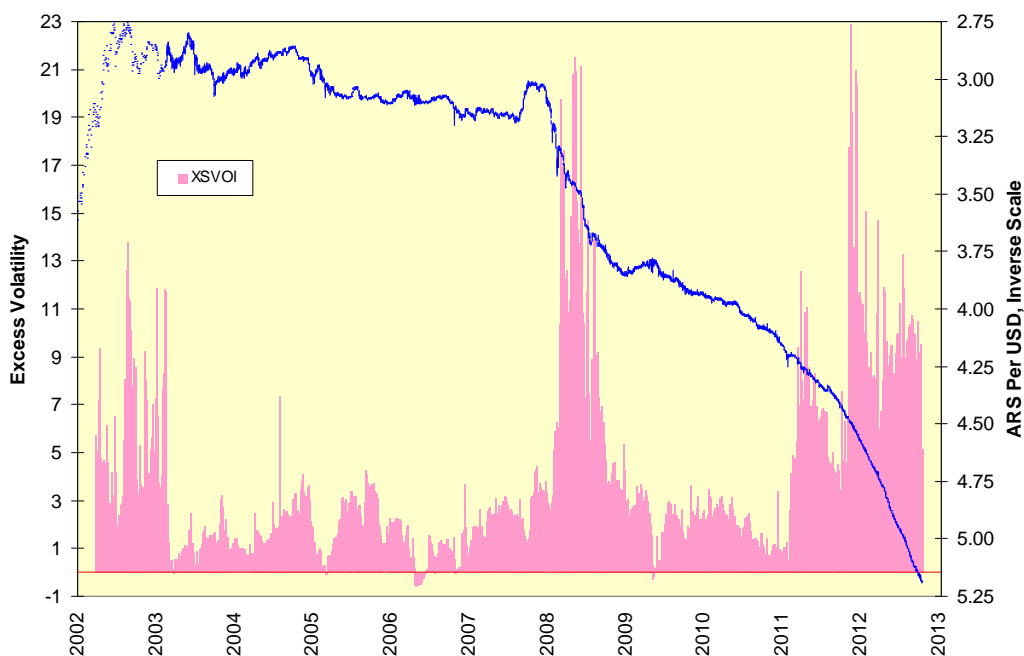
HLC volatility is defined as:

$$\sum_{i=1}^N \left[\frac{.5 * \left(\ln \left(\frac{\max(H, C_{t-1})}{\min(L, C_{t-1})} \right) \right)^2 - .39 * \left(\ln \left(\frac{C}{C_{t-1}} \right) \right)^2}{N} * 260 \right]^{1/2}$$

Where N is the number of days between 4 and 29 that minimizes the function:

$$\frac{1}{N} * \sum_{i=1}^N \frac{N}{Vol^2} * |(P - MA)| * |\Delta MA|$$

Is The Option Market Ever Comfortable With The Peso?



The excess volatility readings for the ARS jumped during the 2002 default period, the 2008-2009 financial crisis and during the 2011-2012 expropriation of Repsol and de facto politicization of the central bank. Even when these periods are excepted, the levels of excess volatility have been high by currency market standards.

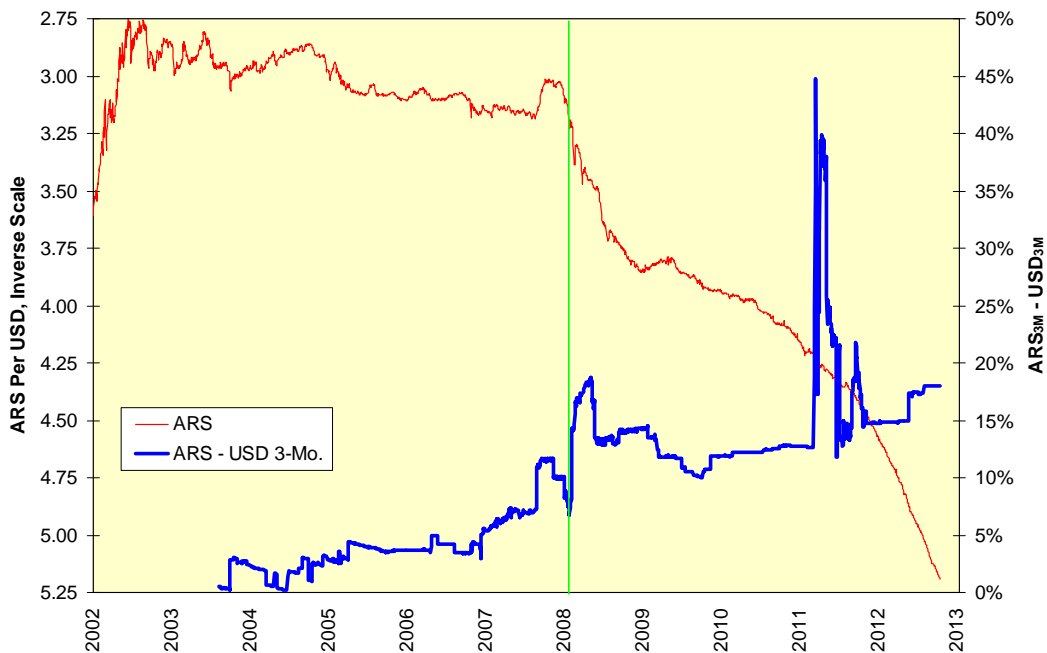
Of course, any resident of the Society of Quantitative Easers can and should be cautioned about throwing stones whilst living in a glass house. An analysis of expected short-term interest rates in Argentina is no longer possible given the demise of BAIBOR (Buenos Aires interbank offered rate; who knew?) at the end of 2011. This still does not make LIBOR look good in comparison given its reporting problems (see “Major Currencies And The Great LIBOR Kerfuffle,” June 2013).

However, consistent with observations made last month (see “Minor Currencies Less Affected By Great LIBOR Kerfuffle,” July 2013).

Prior to BAIBOR's unfortunate exit from the world scene, the course of the ARS was related to the difference between the forward rate ratios between six and nine months ($FRR_{6,9}$) for the ARS and USD. These are rates at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate. The more the $FRR_{6,9}$ exceeds 1.00, the steeper the yield curve; an inverted yield curve has a $FRR_{6,9}$ less than 1.00.

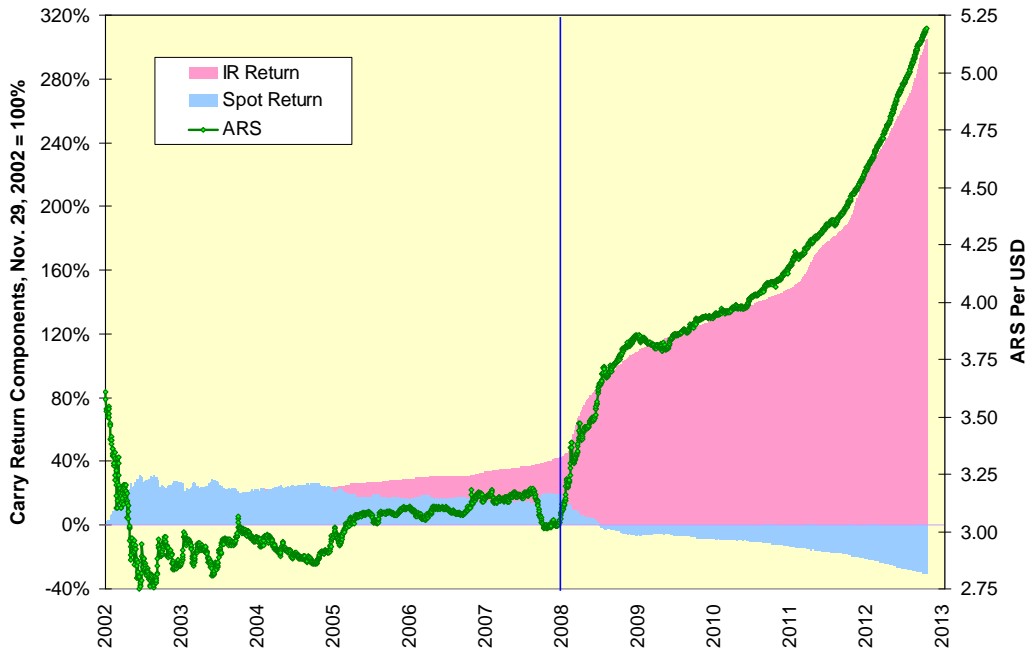
As is the case with other illiquid capital markets, the simple spread of three-month swap rates has to substitute for the FRR differential. The story for Argentina remains unchanged. Once the financial crisis hit its peak in September 2008, marked in the chart below with a green vertical line, the ARS, like almost all other emerging market currencies started to collapse. The U.S. abandoned monetary discipline, the interest rate gap started to widen in favor of Argentina. While the rate gap has not been causal of the ARS rate, the pattern has been both countries have been on a path of monetary ease wherein the U.S. has been trying to achieve the impossible mission: Win a money-printing race with Argentina. In homage to Groucho Marx, the U.S. under the stewardship of Ben Bernanke has joined a club to which no one should want to belong.

The Peso Broke As U.S. Abandoned Monetary Discipline



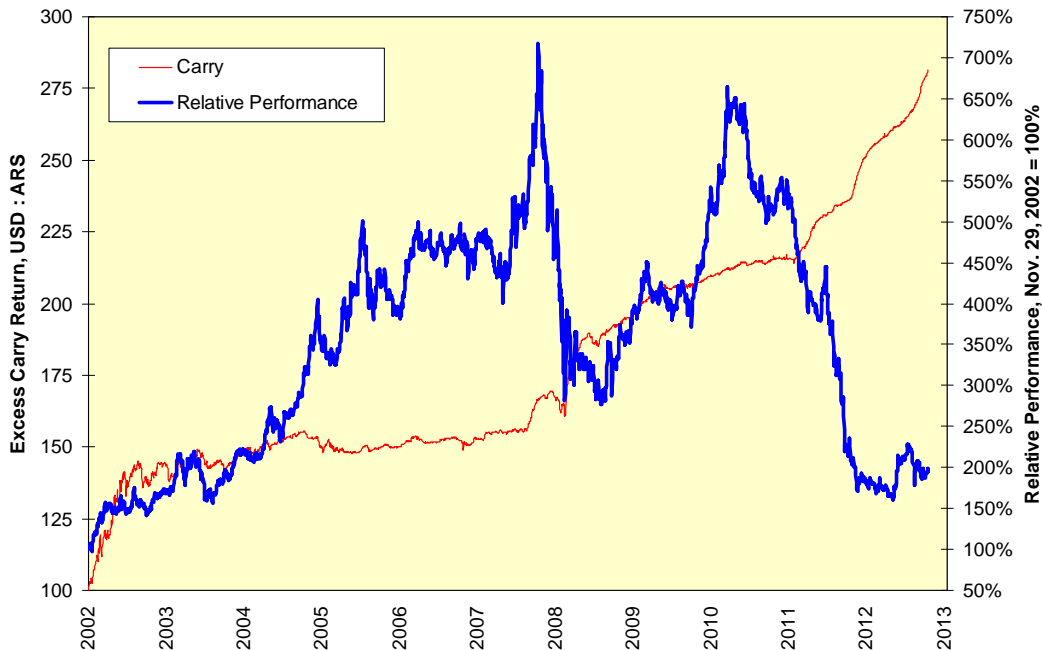
What has been true over the post-September 2008 period is Argentine interest rates have exceeded their American counterparts consistently. The carry trade from the USD into the ARS can be decomposed into interest rate and spot rate components. If we re-index both to the startdate of consistent data, November 29, 2002, we can see how the interest rate spread has accelerated after the financial crisis at a rate consistent with the ARS' spot rate weakness. Restated, Argentina's interest rate inducement to hold pesos has been insufficient.

Peso Weakened As Interest Rate Gap Grew After Financial Crisis



A second measure of failure has been the strong underperformance of Argentine stocks vis-à-vis their U.S. counterparts. A common pattern in emerging markets – and why do we call a country independent for almost two centuries “emerging”? – has been for the relative performance to follow the carry trade. Here Argentine stocks have underperformed drastically since the launch of QE2 in November 2010. The money printed in the U.S. supported U.S. stocks and may have rewarded those willing to hold ARS-denominated short-term interest rate instruments, but it did not reward Argentine investors. The earlier comments on private property and the rule of law apply.

Carry Return Into ARS Has Worked; Stock Trade Has Not

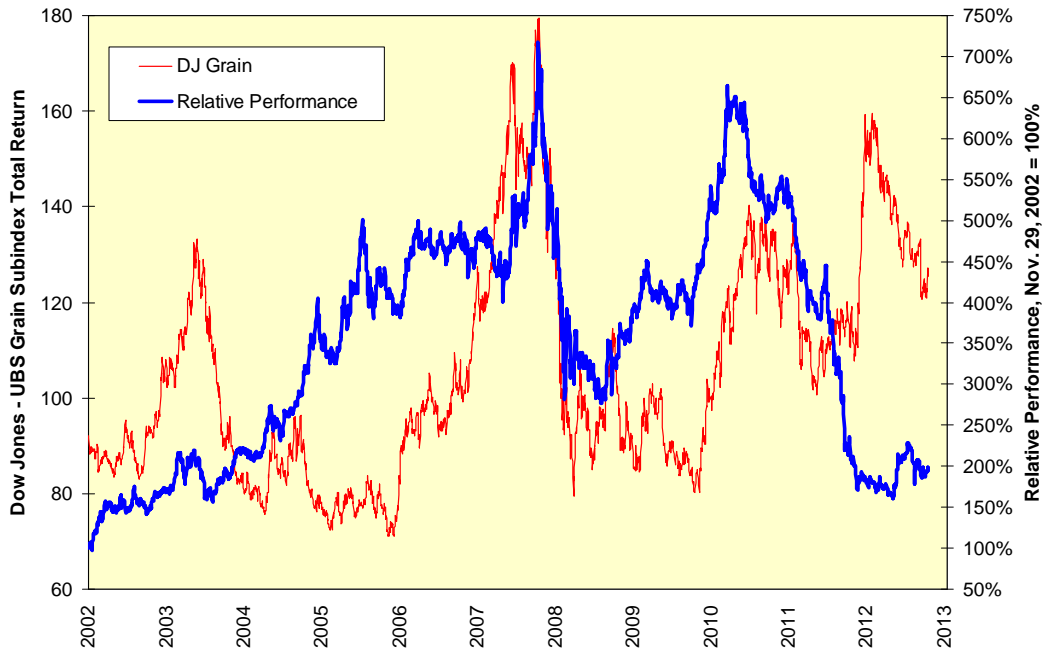


A Pampas ARS

Argentina is a major player in world agricultural export markets; this is despite the burdens thrown on it in the form of taxes and price controls by the Kirchner government. It should be no surprise, therefore, Argentine relative equity performance was unaffected by the global grain rallies of 2010-2011 and 2012, as well as during the 2013

price decline. Both rally periods should have allowed the government to replenish its foreign exchange reserves; neither did as those reserves were “borrowed” to finance ongoing expenditures.

**Argentine Relative Performance Ignored 2010-2011 and 2012 Grain Rallies
And 2013 Selloff**



The net result of all this is Argentina would have to do what no leopard has done yet, and that is change its spots. If it keeps oscillating between left- and right-wing ineffectiveness and continues to ignore the one set of policies ever proven to pull a country into prosperity, the free-market capitalism adopted but not embraced permanently by its trans-Andean neighbor, Chile, its currency will continue to descend into exponentially greater levels of worthlessness. Yes, lopping off zeroes is cheap, but as every trader has learned the hard way, there is no wrong time to get on the right side of a market...or of history.