

Argentina Provinces

The Best Way to Play Our Argentina OW

- **Today, J.P. Morgan upgraded Argentina in the model portfolio to overweight.** In his [report](#), Vladimir Werning mentions that Argentinean debt offers a very attractive high carry, especially if we take into consideration that litigation may linger, an attractive mid-term election, investor positioning is positive and the macro economy keeps muddling-through. In his report, Vladimir discusses the current status and potential scenarios of the holdouts' litigation case and the outlook for the economy and coming mid-term elections.
- **On the back of our overweight in Argentina, we also move our recommendation on provincial debt from marketweight to overweight.** We believe the provincial bonds offer the best value proposition for investors who would like to increase their exposure to the country. We expect the government and the provinces to empathize their willingness and ability to pay, despite an adverse ruling. In this case, we do not foresee any government actions that would jeopardize the debt service of provincial debt. In addition, as opposed to the sovereign, the provinces have been able to issue foreign-law bonds in the last couple of years, and we believe the probability of a default is much lower. Finally, the fundamentals of the provinces have improved in the last months.
- **Provincial debt has underperformed the sovereign in the last three months.** Only the AR 11.75% 2015s have underperformed provincial debt. During the first quarter of the year, the spread between provincial bonds and foreign-law sovereign bonds tightened as the market was assuming that an adverse result for Argentina weighted more on the sovereign curve than on the provincial curve.

Emerging Markets Corporate Strategy

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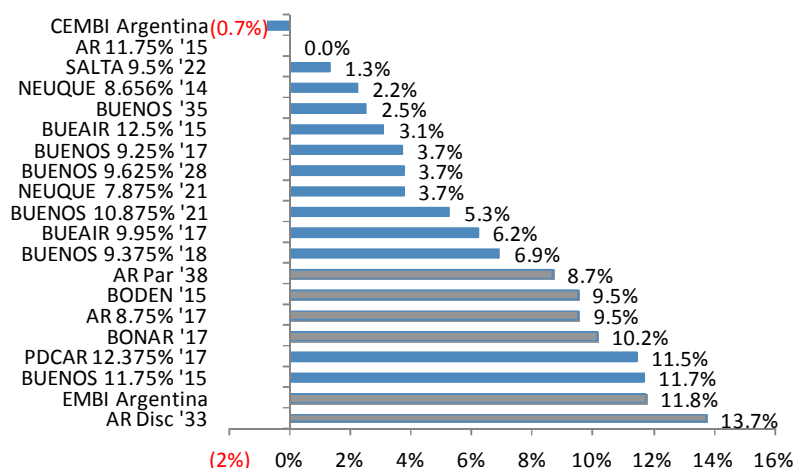
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Figure 1: 3-Month Performance



Source: J.P. Morgan

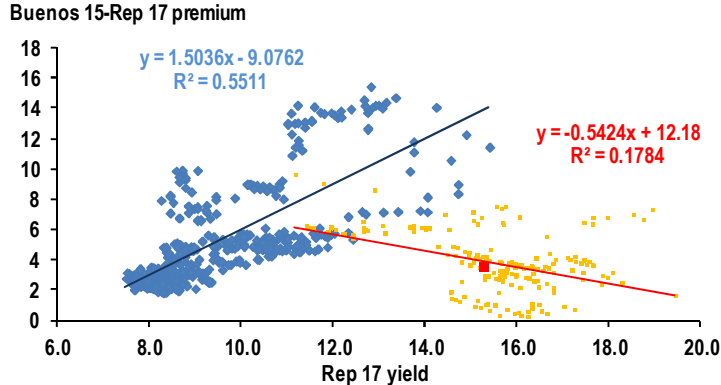
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- **In the case of an adverse result for Argentina, both local-law sovereign and provincial bonds could provide appealing opportunities for investors once the market digests the initial correction.** Even though we expect some volatility on the back of the different rulings made by the NY Appeals Court and the US Supreme Court, we expect some rotation in positioning from sovereign law to local-law sovereign bonds and provincial debt. We believe both yields (BUENOS '15s: 19.4%, BODEN '15s: 14.3%) and jurisdiction (BUENOS: New York law) are factors that investors may weigh in favor of provincial bonds.
- **Moreover, since the ruling, the spread between the Province and foreign-law sovereign bonds has been relatively unaffected by sovereign risk, as litigation risk weighs more on the sovereign curve than on the provincial curve.** We illustrate this point in Figure 2. Indeed, before the ruling, the premium was positively related to sovereign risk (e.g., for every 100bp increase in sovereign yield, the premium would rise by nearly 150bp). However, after the ruling, an increase in sovereign risk is related to a decline in the spread between the Province and foreign-law sovereign bonds (e.g., for every 100bp increase in sovereign yield, the premium would decline by nearly 54bp).

Figure 2: Buenos '15s - AR '17s Premium



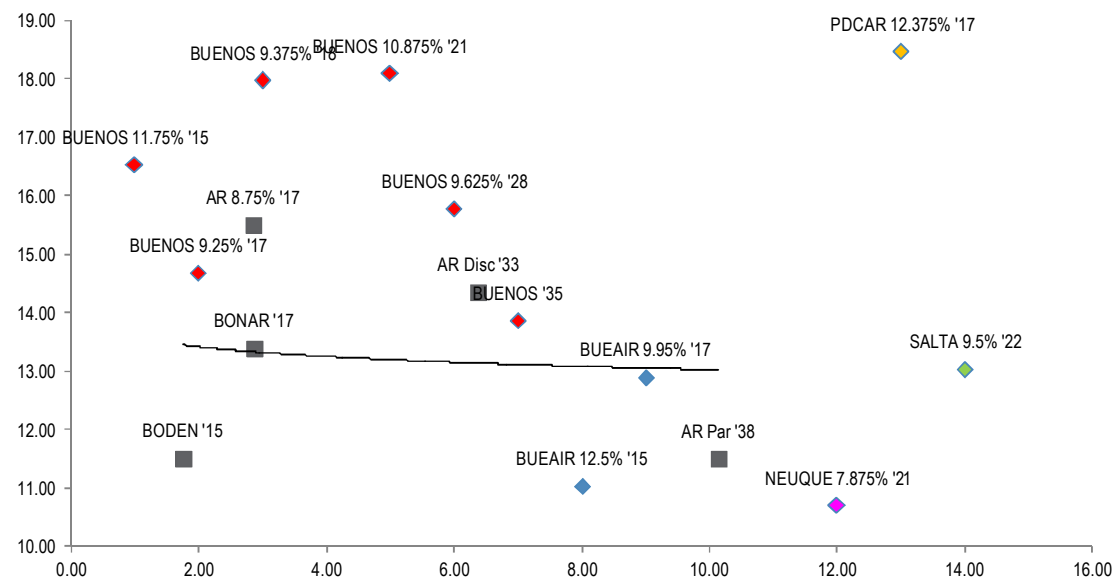
Source: J.P. Morgan.

- **On the fundamental side, we expect primary balances to improve in 2013.** Revenues of the Province of Buenos Aires have jumped on the back of normalization in agricultural production (post-2012 dry season) and the adjustments in real estate taxable valuation. Current provincial revenues were running at +58.9%oya in July (or 33.9% in real terms). The dependence on federal fiscal transfers remains high (around 61.0% for 2013). Going forward, we expect fiscal revenues to moderate in 2014. Data on spending is not available, so it remains to be seen whether the Province will be able to attain the primary surplus penciled in the 2013 Budget Law. Fiscal revenues in Cordoba and Mendoza are also on the rise, although their recovery has come short when compared to Buenos Aires Province. Indeed, standalone revenues were +44.0%oya 24.9% in July for Cordoba and Mendoza, respectively.

- **On the political front, tensions between Buenos Aires Province and Federal government subdued markedly.** Last year, political tensions between President Fernandez and Governor Scioli marked the first half of the year, as the Governor's comments on his desires to run for the first office in 2015 caused the Federal government to tighten liquidity strings, pushing the province to delay wage and bonus payments. This year, the situation made a 180-degree turn, as Governor Scioli supported the official candidate for congress representing the province. This could be seen as a sign of an improvement in the relationship between Kirchner and Scioli and even as a potential support of the government to Scioli's presidential aspirations.
- **We view the Province of Buenos Aires curve as the best instrument to play our OW.** First, we still believe that the province is "too big to fail," and headline risk should diminish going forward, although politics are tough to predict (particularly in Argentina). Second, the bonds offer a good pick-up vs. the City of Buenos Aires. Even though the City has better fundamentals, we believe the spread is too wide if taken into consideration that both credits have similar risks (mainly linked to the sovereign). Finally, the BUENOS bonds are the most liquid in the sector. We prefer the '18s, which are less liquid than the '15s and '21s but have a lower dollar price and higher yield than the '15s and flat to the '21s.
- **We also like the NEUQUE '21s.** Even though the bonds have a lower yield than the rest, we like to compare these bonds with O&G credits in Argentina, as they also depend on oil and gas production and regulations. Yesterday, Bloomberg reported that YPF is planning to issue between \$50-150 million at a rate of Libor plus 7.5% and the debt service will be secured by grain exports. The NEUQUE '21s offer around 300bp of pick-up vs. the proposed YPF bonds. We also like the structure of the NEUQUE bonds. The notes have a first lien and priority payment on the royalties paid by concessions that operate approximately 35% of Neuquén's production. Those fields paid approximately US\$ 200 million in royalties in 2010. It is worth noting that after the '14s are paid, the concessions that secured the bonds will be transferred to the '21s collateral package, adding 40% of the province's output.

Figure 3: Argentina Provinces Relative Value

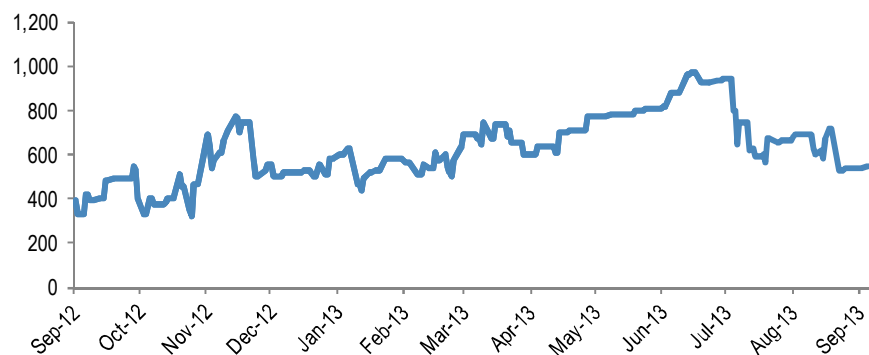
YTW vs. Duration



Source: J.P. Morgan.

Figure 4: BUENOS '15s - BUEAIR '15s

z-spread (bp)



Source: J.P. Morgan.

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