Argentina: Sovereign Debt Investment Opportunity

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The sovereign debt of Argentina experienced a significant increase in value during 2010, resulting in strong performance for holders of the debt and of *Gramercy Argentina Opportunity Fund*. We believe the outlook for the debt in 2011 is quite favorable and we continue to view the opportunity as a top sovereign investment opportunity. A clear improvement in fundamentals, cheap valuation and market mis-pricing, along with the ability to purchase a robust and efficient hedge strategy give Argentina a unique advantage in terms of the significant potential upside and limited downside risk over the next twelve months. We see the anticipation and culmination of the 2011 elections next October as a catalyst to drive the yield on Argentina's debt to more normal and therefore considerably tighter levels resulting in continued out-performance for investors.

Strong Government Finances

Argentina's adherence to policies designed to keep its government budget in surplus is the key mechanism assuring the long-term sustainability of its public debt. Argentina's total sovereign debt fell below 50% of GDP in 2010, and it has been on a substantially declining path since the peak at 151% of GDP in 2002. The government's primary surplus, net of interest on its outstanding debt, was 1.8% of GDP and it is likely to remain in surplus in 2011. The total government budget, including all interest payments, was also in surplus in 2010 and over the long term seems unlikely to deviate from the current balanced trajectory. January's fiscal results support a positive outlook for Argentina's public finances. Value added tax (VAT) receipts rose 42% year-over-year in January, while total tax revenues of the central government were up 40% year-over-year. Argentina's Central Bank foreign exchange reserves reached $52.1billion at the end of 2010, up from $47.9 billion at the end of 2009. Recurring fiscal surpluses, moderate debt levels and large foreign exchange reserves put Argentina in a strong position to service its debt service obligations. Argentina's willingness to pay is also strong, having recently completed a long and complex process to normalize relations with the international capital markets, and they are in the final stages to do the same with the Paris Club under the auspices of the IMF.

Positive economic fundamentals

Argentina's international balance of payments is also in surplus, evidenced by the accumulation of foreign exchange reserves, and directly attributable to strong trade surpluses and a positive current account balance. Argentina's exports grew 23% in 2010 and its trade surplus reached $12.1 billion. The current account was also in surplus during 2010 by approximately 1% of GDP. The economy grew 9.6% through November of 2010 and industrial production was 10.6% year-over-year in December of last year. While these rates of growth are likely to moderate somewhat going forward, the outlook for growth remains robust. Automobile registrations were up 29% year-over-year in January, and the comparative advantages that Argentina enjoys in the production of commodities, energy, soybeans, wheat and food products in general puts the country in a privileged position to benefit from global trends favoring commodity exporters.

Political environment more investor friendly

Following the political crisis of 2000 and economic collapse and sovereign default in 2001, Argentina experimented with a series of left wing policies that ultimately proved to be unsuccessful and unpopular. Since the election of President Cristina Fernandez in October of 2007, the country has been moving gradually to reverse these policies and to improve relations with the international capital markets and with the Paris Club and the IMF. The death of former President Nestor Kirchner in October of 2010 marked the symbolic end of the dominant left wing movement within Argentina's political establishment. The transition towards a right-of-center regime is likely to be completed when a new market-oriented and investment friendly administration is elected in the upcoming October 2011 elections. All viable presidential candidates support a shift in economic policy towards the markets to improve the investment climate in Argentina.

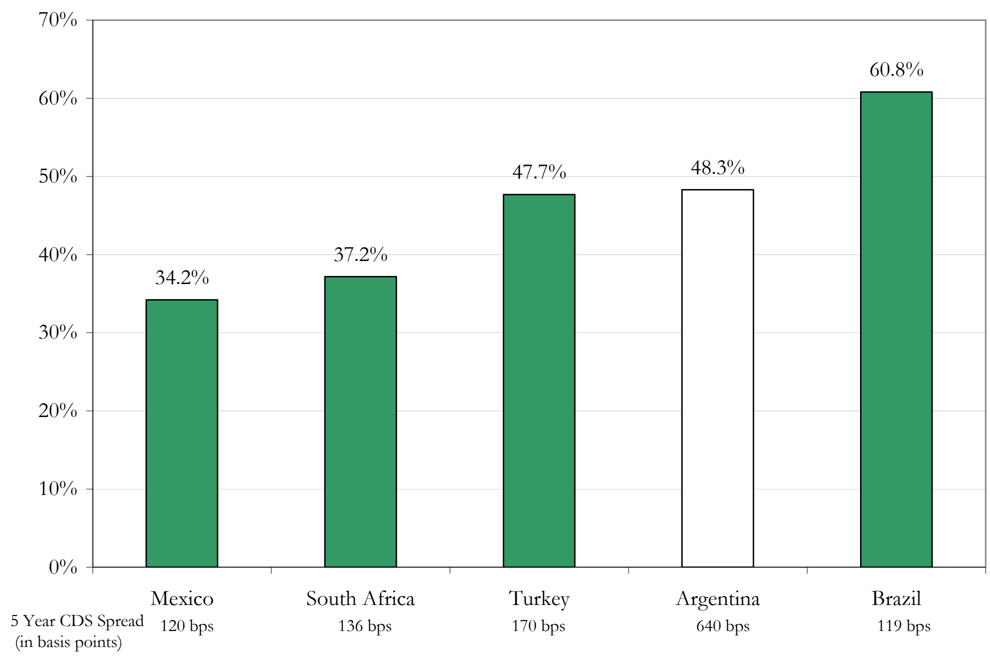
Regained access to the capital markets and to official financing

The movement to the political center and the gradual shift towards market oriented economic policies has been complemented by a determined and focused effort to restore and normalize Argentina's relations with international investors and with official multilateral and bilateral financial institutions. The 2010 restructuring of a majority of the debt to bondholders that still in default since 2001 has practically completed the normalization of Argentina's relations with the international capital markets. Argentina has regained access to financing from the markets and the earliest beneficiaries have been local corporate, municipal and provincial issuers that are now able to tap the markets. Argentina has re-engaged the IMF in a technical policy dialogue, focused on improving its economic statistics, which also helps bring the IMF into the picture with the Paris Club. Argentina has reconciled the outstanding amount of its bilateral debt with the Paris Club and is in advanced negotiations towards a Paris Club refinancing agreement targeted to be in place by June.

Argentina's debt metrics compare favorably to those of its peers

Argentina's fundamental sovereign creditworthiness statistics, public finances, reserves, and capacity to pay indicators show considerable strength. A good summary statistics is the ratio of total government debt as a percent of GDP. Argentina's debt to GDP stood at 48.3% at the end of 2010, not far above Turkey's 47.7%, and well below Brazil's 60.8%. In contrast, the spread on 5 year sovereign CDS for these countries priced (or mis-priced) Argentina at 640 basis points (bps) above U.S. Treasuries, while the comparable CDS spread was 119 bps for Brazil, 170 bps for Turkey, 136 bps for South Africa, and 120 bps for Mexico. A similar deviation between CDS spreads and sovereign fundamentals can be observed when looking at fiscal surpluses or deficits as a percent of GDP, and at current account and reserves in their international balance of payment statistics.

Exhibit 1: Comparison of Argentina to emerging market sovereigns



Spread compression delayed by unwarranted contagion

The yields at which Argentina's debt currently trades are too wide relative to its fundamentals and to where comparable sovereigns and the EMBIG are trading. Looking at the positive events on the horizon for Argentina, including normalization of relations with the Paris Club and a significant improvement in its political environment and economic policy regime following the October elections, the gap between where Argentina trades and where it belongs based upon fundamentals is very large.

The spread of the EMBIG index was 288 bps at the end of 2010 and stood virtually unchanged at 288 bps by February 14, 2011. In contrast, the Argentina component of the EMBIG widened from 507 bps at the end of 2010 to 544 bps by February 14th. During the same period, the Brazil component of the EMBIG tightened from 189 bps at the end of 2010 to 182 by February 14th. The market perception of Argentina's sovereign fundamentals seems to lack the economic and political dynamics that are taking place in Argentina in 2011. We would expect the market to reassess its perception of Argentina's sovereign credit and to re-price spreads to more realistic, lower levels in the months ahead as the changes that the election will bring become more evident.

Fundamentals support substantial additional spread tightening versus the EMBIG

Based upon Argentina's fundamentals and the political changes taking place in the country, we expect to see meaningful spread compression in the Argentina component of the EMBIG. In terms of Argentina's benchmark sovereign bond, the 8.28% 2033 Discount bond presently trading at a spread of 9.88%, we project it to yield 8% by 3Q11 and 7% in 1Q12.

Robust tail risk and systemic hedging via CDS remains in place

The main risk to our investment thesis for Argentina originates in the vulnerabilities and potential fragilities in the international economic environment. These external factors can be hedged fairly inexpensively and very effectively via our CDS hedge book, which we adjust dynamically to take advantage of cheap and underpriced protection opportunities that are available to us in the CDS market.

Alternative scenarios for the EMBIG and projected Argentina investment returns

We project returns ranging from 13.68% to 49.38% over a wide range of scenarios. Under a worst case scenario characterized as a 1000 bps widening in the EMBIG we project a positive return of 19.84% driven by the strong performance of our CDS book. And assuming a flat EMBIG over the next 12 months we project a return of 28.3%. In our "best case" scenario in which the EMBIG tightens to its 2010 tights, our total projected return reaches 49.4%.

Exhibit 2: Projected GAOF Performance (to February 6, 2012)

	Projected EMBI +1000	Projected EMBI +500	Flat Spreads	2011 Projected Tights
Long Sovereign Bonds	(48.41)	(27.85)	30.80	55.69
CDS Hedge	68.26	41.53	(2.47)	(6.31)
TOTAL GAOF PERFORMANCE	19.84%	13.68%	28.33%	49.38%