GRAMERCY
EM WEEKLY

May 9

Featuring:
Argentina |
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U.S-China Tensions

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This week we discuss what we perceive to be improved flexibility by the authorities on the terms of Argentina's sovereign debt restructuring and offer our perspective on the post-COVID-19 credit prospects for two of the worst affected EM economies: Brazil and Turkey. We also flag the risk of U.S.-China tensions re-escalating amid looming Phase One trade deal implementation.

Argentine government indicates degree of flexibility on debt terms, despite initial offer expiration

Market Event: The authorities' offer presented last month expired on May 8th following unsurprising rejection by major creditors. Minister Guzman gave a presentation alongside Columbia University professors Martin Uribe and Jeffery Sachs this week where Guzman emphasized lack of capacity to pay, but flexibility on the combination of terms possible to reach debt sustainability. According to Guzman's comments, the government intends to continue to negotiate with the IMF with the aim to eventually agree to a new program that allows for an extension of its maturities. Details on medium-term economic policy to spur recovery remained light but focused on export growth. Meanwhile, the central bank's recent tightening of FX controls failed to prevent further depreciation of the parallel rate, pushing the gap with the official rate to 80%.

Gramercy View: The expiration of the offer does not preclude a deal from being reached, albeit the window between now and hard default (expiration of grace period on May 22nd) remains narrow. We view Guzman's newly stated flexibility on terms as constructive, but the economic and

external backdrop continue to pose significant challenges to a deal in the near-term. Guzman's presentation this week affirmed our views. Uribe's suggested offer of a shorter grace period but similar debt relief helped lend credibility to alternative solutions. The crux of his proposal was for the Fernandez Administration to share in the burden of debt service as opposed to fully pushing it to the next administration, allowing Argentina to more swiftly and reliably reduce debt. Conversely, Sachs shared strong views that Argentina's interest rate in the backdrop of sustainable debt was justifiable at a level just above other 'risk-free' debt, such as the U.S. or Germany. This sentiment is inconsistent with market reality in our view given credit quality variation across EM and the structural and institutional challenges faced by an already fragile Argentine economy amid the COVID-19 crisis. On the macroeconomic front, we expect continuation of the current dynamic between the parallel and official FX rates to weigh on FX reserves and inflation. This is due to reliance on deficit monetization, lack of clarity on the debt situation, and deepening of the economic contraction. This will only worsen with hard default and as such, we continue to believe that incentives will grow for the gap between creditors and the government to narrow, allowing for an attractive deal relative to current pricing to ultimately be reached.

Turkey's slide toward crisis amid an ad-hoc macroeconomic policy framework that lacks credibility and is being severely challenged by the pandemic's heavy economic toll

Market Event: A tense and confrontational conference call between Turkish Minister of Finance, Berat Albayrak, and thousands of global investors this week highlighted the uphill battle that Turkish authorities face as they try to mitigate the fallout from COVID-19, while walking a fine line between political priorities and economic realities.

Gramercy View: The multiple vulnerabilities of Turkey's fragile macroeconomic framework have been significantly exacerbated by one of the worst COVID-19 outbreaks globally, based on confirmed cases and deaths. The pressures are becoming even more difficult to control by authorities who are split between trying to manage the public health emergency and political considerations that dictate half-hearted containment efforts and less than orthodox economic policy measures. The economy is projected to contract by at least 5% YoY, a huge swing from the government's pre-COVID-19 target of 5% growth in 2020. Given President Erdogan's practice to anchor his political legitimacy in Turkey's robust economic growth under his leadership, the ongoing economic collapse feeds directly into one of our main concerns about Turkey's credit story: elevated risks for more costly and frequent policy adventurism and miscalculations. The TRY is flirting with levels last seen during the currency crisis of summer 2018 and the Central Bank's (CBRT) dwindling FX reserves highlight the costs associated with Turkey's chosen policy mix. We expect downward pressures on the currency and Turkish assets in general to persist for the foreseeable future. CBRT has maintained an ultra-aggressive monetary policy easing stance in an effort to backstop growth (cutting its policy rate by 325bps YTD) and pushing real interest rates to around -2%, which severely limits incentives for foreign and local investors to hold TRY denominated assets. Furthermore, current account dynamics are deteriorating again as any positive impact of lower oil prices (Turkey is a significant net energy importer) are being offset by

lower tourism revenues. This trend will be exacerbated by a failed summer season due to the pandemic. Considering the confluence of risks that Turkey is facing, we are of the view that a truly material shift in economic policy, potentially anchored by a structural reform program in cooperation with the IMF, needs to take place to reverse the ongoing negative macroeconomic and sovereign credit trends. However, we note that the IMF scenario remains highly politically toxic for the current administration, so the authorities are likely to first explore all possible alternatives before finally succumbing to IMF assistance with strict reform conditionality attached.

Brazil's stretched fiscal and monetary policy mix exacerbating credit vulnerabilities

Market Event: This week Fitch revised its outlook on Brazil's BB- sovereign rating to "negative" from "stable", pointing to the deteriorating sovereign credit outlook that we flagged in last week's edition. Also, the Central Bank (BCB) delivered a 75bps rate cut, 25bps above market expectations, bringing the SELIC rate to a record low of 3.0% and pushing real interest rates into negative territory. Last but not least, Congress approved the so called "war budget", which suspends constitutionally imposed limits on fiscal spending and allows BCB to purchase government fixed income instruments in secondary markets.

Gramercy View: As we highlighted in our previous EM Weekly, we are growing increasingly concerned about Brazil's sovereign credit trajectory and the challenges that the economy and government are likely to face in the post-COVID-19 environment. Our concerns were corroborated by Fitch's negative rating action with the agency pointing out the "deterioration of Brazil's economic and fiscal outlook, and downside risks to both given renewed political uncertainty including tensions between the executive and congress". We worry that even after the acute phase of the public health emergency is over, the government's capacity to unwind the sizable fiscal easing it is deploying and its ability to implement economic reforms will be hindered by the political economy that is likely to emerge from the current crisis. Furthermore, with BCB's negative interest rates and ability to now engage in QE, the economy and credit markets in Brazil are entering in uncharted territory. One notable casualty of Brazil's current economic policy mix has been the BRL that reached record lows this week. We believe the currency is prone to experiencing further downside pressures despite already significant underperformance as the central bank's policy guidance points to further weakness. On the fiscal front, we think that the removal on legally imposed fiscal limits, albeit temporary in order to combat the COVID-19 crisis, will contribute to Brazil's growing sovereign debt problem. Debt/GDP will likely reach 90% this year and continue to edge higher, placing Brazil among the most indebted EM sovereigns globally and raising concerns about fiscal/debt sustainability over the medium-term.

Risk of re-escalation of U.S. – China tensions grows ahead of talks on Phase One trade deal implementation next week

Market Event: U.S. and Chinese trade negotiators, led by Robert Lighthizer and Liu He, are set to speak next week for the first time since the Phase One trade deal was struck in January. The

agreement stipulates that the two sides meet every six months for updates, putting this call ahead of schedule.

Gramercy View: The pandemic has emboldened President Trump to adopt a more negative stance towards China ahead of the U.S. election. The terms of the original deal were challenging to meet before the impact of COVID-19 and are now more difficult to adhere to in full. The question is what degree of flexibility the U.S. administration chooses to adopt, if any, and where the authorities may choose to exert further pressure. While President Trump will be influenced in part by the economic and market impact of disrupting the trade deal, he may begin to prioritize a tougher approach to China over economic risks given the already dire state of the U.S. economy and a recent Pew Research poll which indicates roughly two-thirds of the population has an unfavorable view of China. Tariffs remain an easy route of enforcement but other measures in the areas of technology (actions against Huawei, broader export restrictions) and supply chain adjustment are also likely to be prioritized. It remains unlikely in our view that the U.S. utilizes withholding interest payments to China on U.S. treasuries.

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