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Argentina: Back to default

Emerging Markets • Economics • Latin America • Argentina

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The question is how long will it last …

- This report discusses the latest developments in Argentina's debt saga. Holders of most of Argentina's Discount bonds did not receive their payment before the end of the grace period yesterday, and one rating agency has already placed Argentina in default.
- CDS are likely to be triggered. The International Swaps and Derivatives Association's (ISDA) Determination Committee should decide in the coming days whether a credit event has occurred and if/when an auction should be held to determine the clearing price at which all CDS contracts will be settled.
- Our central case is that Argentina will attempt to cure this default and settle with all holdout creditors during the first half of 2015. An upside resolution scenario could involve a private deal, such as the one recently proposed by a group of local banks, in the near term. In a downside scenario, these issues would be left for the next government to resolve in 2016.
- The market reaction to yesterday's developments will likely be negative. We believe that news of advances towards a private solution could be the only support for asset prices in the near term. In terms of trading convention, EMTA will most likely recommend that foreign law bonds trade flat starting today, 31 July.
- The economic impact of this default will depend on its duration as well as the government's communication strategy. If it turns out to be brief and bonds are not accelerated, the fallout could be negligible. A default that lasts through year-end or longer, on the other hand, could lead to a deepening of the ongoing economic recession and increased currency pressures.

Where do things stand?

Holders of most of Argentina's Discount bonds did not receive their payment before the end of the grace period yesterday. Standard and Poor's downgraded Argentina's long- and short-term foreign currency sovereign credit ratings to selective default (SD) as a result. Other rating agencies are likely to follow suit in the coming days.

Economy Minister Axel Kicillof announced yesterday that there was no agreement with the plaintiffs following extensive meetings mediated by Special Master Daniel Pollack. Kicillof repeated that Argentina could not offer the plaintiffs better terms than the exchange bondholders received at this time due to the constraints imposed by the Rights Upon Future Offers (RUFO) clause. He said that the plaintiffs were unwilling to support a stay despite Argentina's repeated requests and willingness to negotiate if one were granted. He also reiterated Argentina's intention to settle with all of its creditors under fair conditions.

Kicillof made clear that Argentina does not recognize this as a default. The government will likely continue insisting that it complied with its obligation to make this payment and blame Judge Thomas Griesa for impeding it. We expect Argentina to keep depositing the funds required for future interest payments. The next interest payment due is on the Par bonds on 30 September.

Daniel Pollack also released a statement confirming that no agreement was reached. He said that he would remain available to help the parties reach a resolution and expressed concern about the harm that default will cause. The plaintiffs, for their part, said that Argentina chose to default by being unwilling to consider any of Pollack's proposals.

Meanwhile, there were conflicting press reports about whether a group of banks had agreed privately to purchase the plaintiffs bonds for the full amount of their claim ($1.6bn). Ambito initially said that a deal was in place, but various others, including Bloomberg and Reuters, later reported that these talks also failed. We thinik it was noteworthy that Kicillof mentioned this possibility during the question and answer portion of his press conference. While he said that he would not be surprised by this sort of solution given the interests of various third parties, he made clear that he was not involved in the process.

CDS likely to be triggered

Emerging Markets Credit Default Swaps (CDS) are governed by the 2003 ISDA Credit Derivatives Definitions guidelines[1]. According to these guidelines, a credit event for sovereign CDS includes Failure to Pay, Obligation Acceleration, Repudiation/Moratorium and Restructuring.

Argentina's credit event seems to fall under "Failure to Pay". Despite that Argentina has deposited the payments on foreign law Discount bonds the trustee's (Bank of New York Mellon) account, Argentina's obligation terminates when the payments reach the holders of the bonds. According to the language of the Exchange Bonds' Indenture, "*Notwithstanding anything herein to the contrary, (i) the Republic's obligation to make payments of principal of and interest on the Securities shall not have been satisfied until such payments are received by the* <u>*Holders*</u> (our emphasis) *of the Securities, and (ii) Holders shall be entitled to receive the last installment of principal payable by the Republic hereunder only upon surrender of this Security to the Trustee or a trustee paying agent for cancellation thereof.*" The Indenture defines the "*Holder*" as any person in whose name a Security shall be registered.

[1] ISDA published the 2014 Credit Derivatives Definitions in February 2014, but trading using these new definitions is scheduled to begin on September 2014.

ISDA's Determination Committee[2] (DC) decides whether a credit event has occurred as well as its type and date. The DC also determines if an auction should be held to define the recovery for the defaulted entity and which obligations should be delivered.[3] DC decisions are published by ISDA on its webpage.

Once the DC has declared that a credit event has occurred and that an auction will be held, the auction terms (auction date, initial bidding information publication time, inside market quotation amount, etc.) are published. The objective of the auction is for the market to get a clearing price at which all CDS contracts will be settled. The auction ensures that the final price is reflective of the market value of the defaulted obligations, taking into account CDS parties' net physical settlement requirements. In general the auction should take place shortly after the Credit Event is determined. For example, in the case of Greece, the EMEA Determinations Committee resolved that a Restructuring Credit Event occurred on March 9, 2012 and set the auction for ten days later.

When and how could this default be resolved?

Taken at face value, Kicillof's address yesterday suggested that Argentina will remain in default as long as violating the RUFO clause remains a risk. This will continue to be the case until the clause expires on 31 December 2014, unless Judge Griesa's orders are stayed. The latter seems rather unlikely at this time, in our view.

Our base case is that Argentina will attempt to cure this default and settle with all holdout creditors during the first half of 2015. Efforts to do this will likely be motivated by the need to diversify Argentina's financing sources, including access to international debt markets, particularly as we expect stronger pressure on the currency and reserves later this year. We also think that the government could be incentivized to deal with this issue in advance of the October 2015 presidential election.

These prospects could be supported or complicated by the government's approach and communication strategy in the interim. Attempting to swap the exchange bonds in to local law could significantly complicate the situation. However, we doubt the practicality of this strategy given that international financial institutions and some investors would probably be unwilling to risk being held in contempt of court if they were to participate.

An upside resolution scenario could involve a private deal, such as the one recently proposed by the group of banks, in the near term. A private agreement seems like a challenging prospect though, in our view, and this latest plan was not necessarily the first of its kind. One major issue is that other "me-too" holdouts claims will also likely need to be addressed in the coming months. There is also the problem of whether private entities are willing to assume that the government will engage in good faith negotiations in the future when it cannot make any guarantee of that today.

A downside scenario, on the other hand, is one in which the default and the holdout problem are left for the next government to resolve. In this case, we would expect even greater economic consequences than the ones we will discuss later in this report, accompanied by more accelerated depletion of Argentina's international reserves.

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[2] The ISDA Credit Derivatives Determinations Committees were established on April 2009. There are five regional committees (Americas, Asia Ex-Japan, Australia/New Zealand, EMEA and Japan) and are composed of ten voting dealers and five voting non-dealer members. Membership is at an institutional, rather than an individual level, with membership reassessed on an annual basis.

[3] As outlined in the ISDA Credit Derivatives Physical Settlement Matrix, deliverable obligations for Latin America Sovereigns must be bonds with the following characteristics: not subordinated, not domestic law, not contingent, not domestic issuance, transferable, not bearer.

Market reaction will be negative unless private negotiations gain traction

We think that the market was overly optimistic that either a default could be averted or that this could be a short default once the government finally held talks with the plaintiffs. Yesterday's price action reflected this as USD Discount bond prices overshot around 10 points to $97, a new historical high.

We believe a private solution could be the only support for asset prices in the near term. We see prices moving lower in the absence of a deal or news of negotiations advancing. In this scenario, we think that foreign law Discount bonds are likely to suffer the largest decline, at least erasing yesterday's 10 point rally. This is due to their recent outperformance and also because of their relatively high price. Par bonds should be more resilient given their lower prices and the optionality they offer through potential acceleration. Local law bonds could trade relatively well, though we think that concern about these instruments could rise quickly if international reserves come under increased pressure following this default. The upcoming $6.1bn Boden '15 maturity in October next year looks rather burdensome in the absence of access to foreign financing.

A longer default opens the door for investors to potentially accelerate other Exchange Bonds.[4] The risk of acceleration could be mitigated by clear communication from the government that it plans to ensure that exchange bondholders receive all their coupon payments plus penalty interest and negotiate with all creditors once the RUFO clause has expired. Otherwise, acceleration could further complicate curing the default by creating new holdouts with conflicting incentives that could generate principal–agent problems.

In terms of trading convention, following consultations with market participants, the Emerging Markets Traders Association (EMTA) will most likely recommend that foreign law bonds trade flat starting today 31 July. This means that trades will settle at an all-in (dirty) price and buyers will be entitled to all unpaid and accrued interest. This recommendation will likely exclude local law Discounts and local law Par bonds as well as provincial and corporate bonds.

Economic risks likely to rise

The economic impact of this default will depend on its duration as well as the government's communication strategy. If it turns out to be brief and bonds are not accelerated, the fallout could be negligible. In fact, the sooner default and the conflict with the holdouts are resolved, the sooner Argentina could benefit from access to a broader array of financing sources. This could eventually help boost investment, rebuild international reserves, support the currency and relieve some of the inflationary pressures associated with monetization of the fiscal deficit.

A default that lasts through year-end or longer, on the other hand, could weaken domestic confidence and deepen the ongoing economic recession. We would expect domestic consumption, which already took a hit following January's devaluation, to remain depressed. Investment would likely be negatively affected as well. Argentina's economy could contract again in 2015, albeit to a lesser degree than this year, rather that recover modestly as we would have otherwise anticipated.

[4] According to the Indenture 25% of holders of a series can "declare the Debt Securities of such Series to be immediately due and payable…" However, there also exists a "deceleration" clause that requires at least 50% of the holders of a series if the default has been cured within 60 days.

We would also expect greater pressure on the peso and widening spreads between the official and parallel exchange rates in the longer default scenario. This could accelerate the decline in international reserves as it remains unclear to us whether the recently announced foreign exchange swap with China will actually serve as an effective buffer. As a result, we would see increased risk of a second devaluation this year and would likely revise our year-end exchange rate forecast to a level weaker than our current projection of 9.80 pesos per dollar.

Any sort of fiscal adjustment would also be less likely to materialize in this context. In fact, the government could be inclined to expand spending to combat the recession. This would likely lead to higher inflation as more pesos would be needed to be printed to cover a wider fiscal deficit in the absence of alternative financing sources.

We also would not rule out increased challenges to governability if the economic situation were deteriorate further. Higher inflation and unemployment could lead to greater prevalence and intensity of anti-government demonstrations. Moreover, President Kirchner could face discontent from governors who had previously hoped to access international capital markets for funding or to refinance upcoming maturities.

Limited potential for contagion

Argentina's selective default will probably be a largely isolated event with little regional or global spillover, in our view. Exposure to Argentina is limited in terms of both financial and trade links. Moreover, the country is not experiencing a solvency crisis. We expect investors to distinguish between the Argentine case and other Emerging Markets countries with strong balance sheets and macroeconomic policy management. In Latin America, these include Chile, Colombia, Mexico, and Peru. Brazil is most likely to be affected through the trade channel, but our economists believe that Argentina's default would only reduce real GDP growth by a maximum of 0.1 percentage points.

Exhibit 1: Export exposure to Argentina

% of 2013 goods exports

Brazil	Chile	Colombia	Mexico	Peru	Uruguay	Venezuela
8.1	1.4	0.7	0.5	0.4	5.0	0.03

Source: IMF, national government s and central banks, Credit Suisse

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