GRUPO SBS

GC Letter V2, #1, Thursday 16, February 2017

The Bayesian Staker

Facing Uncertainty, Not Pricing It Fully

In our post 2016 US election issue we argued that the new US administration had the capacity to change the prevailing economic and financial paradigm: to move away from the quasi deflationary stagnation experienced in the last few years, towards faster growth-inflation equilibrium, at least temporarily. Specifically, we saw the possibility of some growth optimism re-emerging initially together with the revival of steeper global curves, raising term premium, and a new bias favoring equity investment. Furthermore, we stated that this changing outlook was a likely scenario in spite of uncertainties about Trump´s own policy type and a conservative Congress willingness to support him. And markets performance since November 6, 2016 appears to have been in line with this perception. However, Trump´s reflation trades have started to underperform since inauguration, once again confirming doubts about the outlook ahead.

Cautious optimism seems to remain on the pro-growth stimulus presented in Trump´s campaign agenda, but a resolute President, sometimes intransigent, facing a complex reality seems to have been undermining expectations. Trump´s boldness is surely the main reason for markets confidence on a positive outcome. His conviction to push for comprehensive deregulation in the banking and other business has been certainly a big support for such hope. However, the same audaciousness in other policy fronts might well represent the main effective threat to the combined policy effort. Deregulation together with a sizeable fiscal stimulus and a high dose of protectionism could be powerful enough to foster economic activity in the short term, in the US at least. Nonetheless, the bigger and more powerful fiscal stimulus, the greater concern it could create among fiscally hawkish conservatives. Similarly, the higher protectionism, the more significant the resulting wealth and income shocks, and the greater resistance in Congress, particularly the Senate, permeable to specific sectoral interests. Ongoing discussions regarding the tax reform and the border tax perfectly reflect such a potential dilemma for the ruling party, even if the administration looks like minimizing it.

Incipient skepticism about the reflation scenario is therefore reasonable to last or even further nurture. Delays in the introduction of the fiscal stimulus are likely, and the FED seems to have internalized that, implicitly assuring no rush to hike unless economic conditions were to surprise on the upside. The US economy, however, continues to recover, the orderly US rate sell-off appears even losing steam, aside inflation jitters early this week, and asset market volatility remains subdued, particularly in FX and credit given the potential shocks ahead. Such relatively quiet market conditions are really remarkable, particularly given the degree of policy uncertainty in the US and of political ambiguity in Europe, ahead of critical elections in Netherlands, France, Germany, and Italy. Yes, as noted, excess global savings remain, and the changing paradigm in the US might have too much uncertainty to robustly test that deflationary global setting. But after many years without inflationary threats, this economic background could rapidly change under different combinations of Trump´s policy promises.

The status-quo is probably close to what some economic schools like to call “true uncertainty”[1], as the uncertainty that can-not be easily modeled through probabilistic processes. A good characterization of the existing backdrop is the fading in recent weeks of standard correlations in asset markets. That probably argues in favor of a rather humble and nimble approach to investment

[1] Paul Davidson´s piece “Is Probability Theory Relevant for Uncertainty? A Post Keynesian Perspective”, published in the Journal of Economic Perspectives, winter 1991, is one example.

nowadays. This is not time for just conviction; it is also time for prudence and preservation. It is time for risk diversification and hedges as well.

Notwithstanding the discussion above, we feel now more comfortable holding Argentine risk than what we felt in the weeks after the US Presidential election, as discussed in our recent publication, *Argentina: Safeguarded by the Tax Amnesty*[2]. Strengthened by an extraordinary adhesion to the tax amnesty, the government has regained political initiative and battled successfully against an onerous tax reform driven by the opposition. It has also introduced promising changes in the economic cabinet and streamlined the creation of tax consolidation and economic modernization policies, such as the recent agreement with unions, companies and provinces to promote investments in Vaca-Muerta shale field, or the new push to pass legislation reducing labor insurance costs. This renewed political drive, together with the foreseen economic improvement for 2017, can help the government consolidate its power to advance further an economic and institutional normalization process, although it will not be free of stress, particularly in an election year. Meanwhile, fiscal gradualism –facilitated in the short term by the massive tax amnesty– still represents the biggest medium term fragility in the government's project, especially with an increasingly uncertain international context where the possible increase in international rates still poses a serious threat. Anyway, the last weeks have renewed the reasons to remain cautiously optimistic about Argentine assets, without underestimating the external risk and the pending domestic challenges.

In summary, while doubts on the US and the global scenario remain, holding a core mid-duration USD EM debt, with an important Argentine bias, seems to remain a good investment proposition. We would also add some Argentine, Brazilian, and global equities to that portfolio, as the current backdrop continues to be relatively benign for EM equity in particular for countries not impacted directly by Trump´s protectionist plans. Furthermore, we would add some short term Peso assets with active hedging, as the macroeconomic forces in Argentina continue to push for further real appreciation of the currency, absent external shocks. Finally we would include some global rate and FX volatility protection as a defensive tactic amid high global uncertainty and the view that global rates and asset price volatility have more space to rise than otherwise.

Doubting Reflation, Without Reflecting Increasing Risks

As discussed, the ability of a new US administration to impose a relative aggressive fiscal and de-regulatory agenda features a game changer event, potentially able to move the US economy away from its protracted anemic growth, at least temporarily. President-elect Donald Trump has also promised to curb free trade and free labor mobility, which could eventually represent a handicap for economic growth, nevertheless exacerbating the combined impact on inflation in the short run. This "fresh" policy gust was able to move rates and equities up initially, but more recently there have been increasing doubts regarding the new administration ability to deliver effectively on its pro-growth promises.

Right after inauguration day, on January 20, 2017, President Trump confirmed its decision to deregulate, particularly in the financial sector, signing an executive order to revise Dodd-Frank, and identify regulations that impair growth. Likewise, although following some hesitation and delays, it also indicated the coming up of a "phenomenal tax plan" in few weeks, and the execution of a one trillion USD infrastructure plan. However at the same time, the President re-affirmed its decision to restraint immigration by issuing a controversial order to prevent entry to the USA of individuals from seven mostly Muslim countries, measure immediately rejected by corporate America, and also challenged by the Judiciary. Similarly, Mr. Trump also insisted in tough talks to a number of trade partners, first rejecting TPP and putting NAFTA under review, lately including China, Japan, and even Germany in the list of potential currency manipulators. In addition, it is well known that legislators in the Republican Party include a number of fiscal hawks that might block a widening deficit through higher expenses. Or that the House Republican "Better Way" tax print is not only "too complicated" for the very same President Trump, but also possibly quite disruptive given the likely transferring of wealth among sectors,

[2] "Argentina: SBS Monthly Report", January 23, 2017.

not to mention the possible further strengthening of the USD and financial conditions, surely in the short term. Worth recalling, it would take only three Republican Senators to block passage of new legislation in the Upper House, at least until the 2018 mid-term election if Democrats were to fail keeping their sharing by then.

Specifically on the tax front, the Speaker Paul Ryan´s initiative aims at cutting US corporate tax rates to make them more comparable to other OECD countries, while introducing a border tax (or taxing where consumption occurs), to reduce incentives for companies to move production offshore and/or restrain their ability for tax elusion. The latter includes a tax on imports equal to the corporate tax rate, which is reduced to 20% under Ryan´s plan, and the exception of such tax for exports. The combined tax initiative achieves a number of goals explicitly outlined by President Trump. At the same time, it generates new resources to please fiscal conservatives in Congress. However it markedly divides winners and losers (net importing sectors would see an after-tax cost increased by 25%, while exporting sectors would receive a subsidy of equal magnitude)[3]. Similarly, the GOP´s tax blue print also envisages eliminating the interest expense deduction from income tax filing. The latter is relatively costly, in particular if corporate rates do not go down to 20%, as corporate debt is already high at 45.2% of GDP as of 3Q2016, or above the pre-2008 crisis level of 44.9%, and well above the most recent minimum of 39.8% reached in early 2011. Taxing interest expenses will probably reduce the incentive for leverage at the corporate level, but the transition might not be without pain.

Also important, retail, healthcare, restaurants, hotels/leisure, and education sectors, which are likely to face increasing headwinds from the new tax, health insurance, and immigration policies proposed by the Trump´s administration, are relatively heavy-weight in terms of employment. On the contrary, likely beneficiaries of policy measures being discussed, as financials, constructions, and capital goods producers, employ less than half the number of workers in industries being eventually negatively affected. Partly explaining the political incentive for current policies, potential beneficiaries have been declining in employment in the last decade steadily, in excess of 10%.

In the meantime, the US economy seems to be recovering. Consensus estimates point to growth exceeding 2.0% this year while the Fed's GDP trackers already suggest 2.5-3% growth. Survey data have been rather strong, but exacerbated by measures of consumer and business sentiment, which are forward looking or simply expectations. This notwithstanding, wage growth has softened recently and indicators of labor market have held broadly steady in recent months, which has placed the Fed in a wait and see mode in the near-term, or while fiscal policy uncertainty continues. This backdrop continues to suggest two hikes by the Fed starting in May or June, and a possible decision to slow the reinvestment of its portfolio close to the year end. Inflation surprises early this week might drive an earlier reaction from the Fed, but more and stronger evidence is needed before confirming that new path.

Such a benign view about the next few months nonetheless coincides with huge uncertainty about policy changes and economic prospects, as reflected in the wide range of forecasts available in the market place. Figure 1 below precisely shows implied uncertainty from economic forecasts for the US economy, were 2017-2018 growth projections range from a minimum of 1.2% to a maximum of 4.5%, consumer price inflation from 1.3% to 4.0%, the EUR/USD exchange rate from 0.90 to 1.28, and 10Y treasury rate oscillates within 200bps! Worth noting, different expectations about the future of the US economy exists even between the major global banks as illustrated by 5 representative examples in the table below, although with less amplitude than in the sample of 62 forecast institutions surveyed by Bloomberg L.P.

[3] For a detailed discussion see Avi-Yonah, Reuven and Kimberly Clausing: “Problems with destination-based corporate taxes and the Ryan Blueprint”, University of Michigan Law and Economic Research Paper Series, #16-029, January 2017.

Figure 1: US Economic and Financial Forecasts 2017-2018

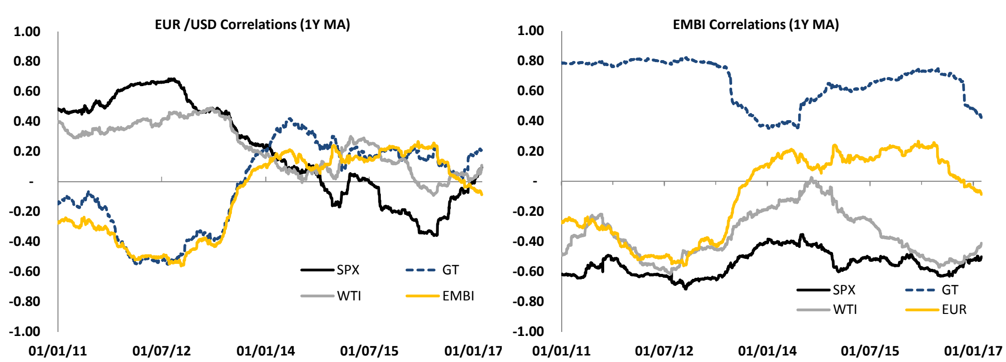
	GDP (%)		CPI (%)		EUR/USD		UST 10Y (%)
	2017	**2018**	**2017**	**2018**	**2017**	**2018**	**2017**
Bloomberg Median	2.30	2.30	2.40	2.40	1.05	1.10	2.80
Min	*1.20*	*1.50*	*1.30*	*1.20*	*0.90*	*0.96*	*1.35*
Max	*3.30*	*4.50*	*3.70*	*4.00*	*1.19*	*1.28*	*3.50*
Bank of America	2.10	2.50	2.50	1.90	0.97	1.05	2.85
Citibank	2.10	2.60	2.70	2.30	0.99	1.05	2.65
Deutsche Bank	2.50	3.60	1.90	2.20	0.95	1.00	3.10
JP Morgan	2.10	1.80	2.50	2.40	1.15	n.a.	2.85
Morgan Stanley	2.00	2.00	2.40	2.40	0.97	1.05	2.50

Source: Bloomberg L.P.

A fair degree of uncertainty has been reflected in changes in historic financial asset correlations as well, as pictured by Figure 2 below. For instance, the varying co-movement in the EUR/USD vis a vis other financial aggregates has been remarkable. Up to late 2013, a strong US equity market and/or a high oil price were positively correlated with a strong EUR/USD, and a high 10Y treasury rate and/or a wide EMBI spread were associated negatively with the EUR/USD, or holding reasonable relationships (by first approximations at least). By early 2014, these correlations turned around but they had started to move towards their old values when the US presidential election took place. Since last November, we have seen a continuation of recent trends, at least for the EUR/S&P and EUR/EMBI, where now a weak positive and weak negative relationship holds respectively. On the contrary, recent trends reverted since late 2016 for the EUR/Oil correlation, and even more surprisingly for the EUR/US Rates correlation, moving both towards positive territory (so higher US rates imply a weaker USD).

Correlations between the EMBI spread and other critical asset prices have changed less dramatically than FX correlations, but still reflect fluctuating degrees of ambiguity. For example, it is clear from the picture below that since the November 2016 US election most EMBI correlations have weakened compared to their recent past, although they have maintained their signs. The only exception to that behavior has been the EMBI/Oil correlation, that is turning again negative, or towards its historic relationship when oil (and other commodities) used to be a fundamental driver of Emerging Market spreads, tighter when commodity prices were high.

Figure 2: Changing Financial Markets Correlations



Source: Bloomberg L.P.

As noted in the introduction, the current status quo is probably close to what some economic schools like to call "true uncertainty" as such uncertainty can-not be easily modeled through probabilistic processes. The latter seems to suggest the need of a rather humble and nimble approach to investment nowadays. This is not time for conviction only; it is also time for prudence and preservation.

It is time for risk diversification and hedges as well, particularly after analyzing the way markets are pricing the existing degree of uncertainty and risks, as discussed next.

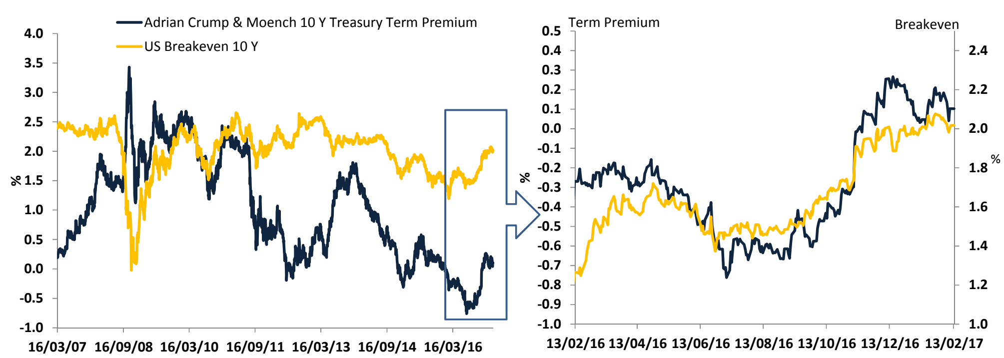
Precarious Low Risk Premium - Low Volatility Backdrop

As noted above, and also elaborated in our previous Letter, the Trump campaign budget plan might be too ambitious, given the Federal deficit in the US is already 3.3% of GDP and the federal net debt amounts to 77% of GDP, according to the Congressional Budget Office. Furthermore, even if passed, its full implementation might barely close the existing excess of global savings, while relaxed monetary policies are expected to continue in EU and Japan, both containing rates pressure. However, as also discussed, Trump´s policies could well push US inflation up significantly in the short term while demanding a large amount of debt financing, both likely to press rates meaningfully up, or beyond what market technicals seem to be suggesting.

Risk assets responded in the way expected right after the November US election, while the US curve was steepening, driven by a combination of stronger perspective for growth and inflation. The latter move however has started to fade away in recent weeks as doubts on the US administration ability to deliver increase. Currently, appetite on High Yield Corporates and Emerging Markets seems even stronger than pre-US election days, with the US High Yield sector yielding less than 100bps than in early November, and the EMBI spread approximately 20bps less as well, while 10Y treasury rates are more than 55bps higher than before the election but 20bps lower than its peak in December 2016, and certainly still well below their post-taper tantrum pick of 300bps.

The partial retracement in 10Y rates of the last few weeks has been accompanied by a steady increase in breakeven inflation, from almost 1.7% in early November to 2.0% in recent days, and a more oscillating upsurge in bond term premium, but of similar magnitude on average, as pictured in Figure 3 below. Based on the discussion above, both rate factors have room to move higher, although risk premium might be less confined based on the prevailing policy uncertainty and its relatively low level from historical standards.

Figure 3: Inflation Expectations Up, Risk Premium Not Much

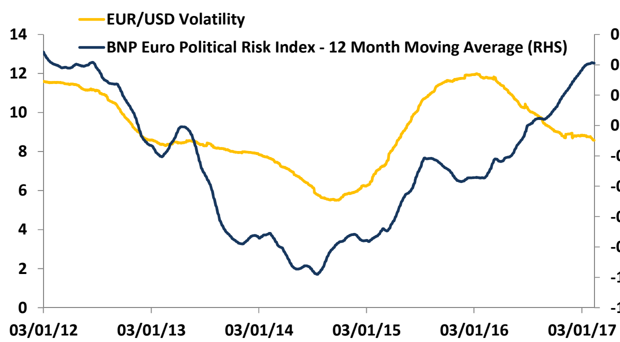


Source: Bloomberg L.P.

The apparent disconnection between existing market uncertainty and some elements of asset pricing is also deftly present in the case of FX, where policy uncertainty is significant and geopolitical risks continue to flourish. Passed the Italian referendum, the uncertainty regarding the next Italian government is on the rise. With Italy´s well known banking fragility, policies affecting negatively growth could trigger a banking run and the further raise of populism and euro-skepticism. The next test against EU-mainstream parties comes in March 15, with the Netherlands parliamentary elections. Although the anti-EU PVV has some support, it does not seem to be strong enough to build a government coalition. But weakness among the main parties is simply increasing. Likewise, there is the French Presidential election in May, where the National Front leader Le Penn is proposing to run a referendum on France membership to the EU and defends economic protectionist policies. Le Penn seems unlikely to win in the two stage French election system, but her popularity might still raise market concerns while a leftwing surprise cannot be totally disregarded. Later the Germany´s election will be the focus, where Chancellor Merker is once again gathering support, but controversies over her refugee policies could maintain some degree of political anxiety.

Figure 4 below pictures one index of political risk, constructed by BNP, steadily rising since mid-2014, even exceeding the heightened uncertainty surrounding the Brexit vote. In contrast, EUR/USD volatility has been declining since early 2016, reflecting just a small blip surrounding the Brexit vote on June 23, 2016. The latter appears at least surprising, not only given the magnitude of EU political noise ahead, but also the degree of uncertainty regarding US policies that might affect the USD in a material way, not to mention commodities, risk appetite, and term premium. Indeed, FX volatility seems to us the strongest candidate for hedging given prevailing policy perils and potential market sensitivity to them.

Figure 4: FX – Political Risk Disconnection



Source: Bloomberg L.P.

While referring to global uncertainties, we have not yet mentioned that subpar economic growth has continued globally, with EM economies recovering but at a feeble pace. Higher US rates and stronger USD do not bode well for a brighter EM outlook, unless US growth drives a global recovery. Meanwhile, the Chinese slow transition towards a domestic demand drive for growth is continuously threatened by high leverage and a delicate financial system. Data published by the PBoC early this week indicate that the Central Bank has failed to control credit growth, and might not yet have a firm handle on shadow banking activities and financial leverage hazards.

In summary, the victory of Donald Trump in the US presidential elections have potentially set the stage for a dramatic change in US policies with far reaching implications for global markets. Whether Trump´s pro-growth agenda is not overshadowed by his other policy initiatives remains a question mark, but markets seem to have granted the new administration the benefit of the doubt. The resulting reflation trades have been underperforming recently but financial markets do not appear to reflect the increased uncertainty associated with such underperformance. That is why we suggest a prudent investment approach to grip the current conjuncture. In the meantime, risk assets could do well, but demanding active management and the use of hedges to remain protected against extreme scenarios.

Argentina: Safeguarded by the Tax Ammensty

As noted in our recent piece on Argentina, events over the last few weeks have renewed reasons to remain cautiously optimistic about Argentine assets, without underestimating the external risks and the pending domestic challenges. The most important positive factor on the credit has been the extraordinary success of the tax amnesty, providing enough resources to safeguard Argentina´s heavy financing needs from global market uncertainties, at least for this year. The tax amnesty is expected to add another USD3.0bn in financing by March, completely overshadowing Argentina´s financing vulnerability in the short term. Despite declining financing from public entities, Argentina has already secured all the financing envisaged from global markets and 50% of the needs to be collected in local markets. Anyhow, net financing still remaining for 2017 will be negative given amortization for USD20.2bn yet to come.

Figure 5: Reduced Financing Needs Post-Tax Amnesty

USES (USD MN)	2016 Estimated	2017 Official
Primary Deficit	24,283	23,000
Interest	7,032	8,603
Capital	8,720	20,247
Sovereign Debt	4,507	17,428
Multilateral and Bilateral	4,213	2,819
Pension Reparations Law		-3,100
Central Bank	-10,838	-8,400
Agreement with hold-outs	10,600	
Others (difference not	18,347	
Financing Needs	**58,145**	**40,350**

SOURCES (USD MN)	2016 Estimated	2017 Official
Multilateral and Bilateral	3,000	3,850
Public Entities	7,500	2,000
Treasury Refinancing	7,645	4,500
Private Banks (repo loan)	0	6,000
Local Market	17,000	14,000
Peso	5,818	7,000
Dollar	11,182	7,000
International Markets	23,000	10,000
w/o Hold-outs	12,400	10,000
Financing Sources	**58,145**	**40,350**

Source: MECON and SBS Research

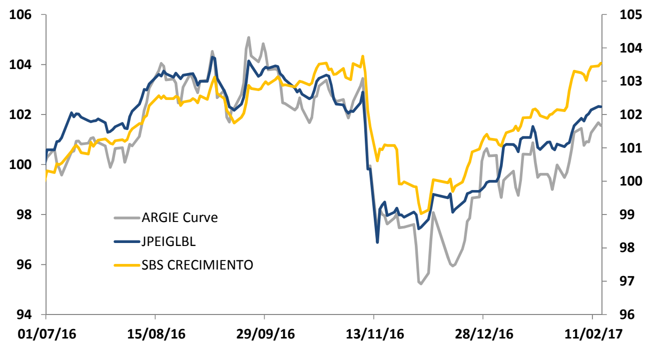
The decision by the government to battle an onerous tax reform driven by the opposition, after some lack of legislative coordination, was also an important contributor for a more constructive mood, as it showed the government re-taking political initiative, and at the same time a moderate opposition weighting on the political cost of being characterized as opportunistic and without a well-defined policy agenda. The authorities also introduced promising changes in the economic cabinet and streamlined the creation of tax consolidation and economic modernization policies, such as the recent agreement with unions, companies and provinces to promote investments in Vaca-Muerta shale field. This renewed political drive, together with the foreseen economic improvement for 2017, can help the government consolidate its power to advance further an economic and institutional normalization process.

Challenges do remain, with 2017 anticipating increasing political confrontation ahead of the mid-term election, and 2018 embodying the real test to start adjusting fiscal imbalances. The government, however, has looked firm in its anti-inflationary effort, even blocking some private agreements with wage increases well above the 12-17% range targeted by the Central Bank. This will inevitably bring escalating labor market confrontation ahead of the October election but the government seems convinced this is a clash worth fighting. A recovering economy should somehow tame potential conflicts, while a declining inflation should help gain further credibility. The latter however is unlikely to prevent further real peso appreciation as the by-product of tight monetary policy and relaxed fiscal spending. Meanwhile fiscal gradualism still represents the biggest fragility in the government's medium term plan, especially with an increasingly uncertain international context where the possible increase in international rates still poses a real threat. However, such vulnerability has been meaningfully contained in the short term by the massive tax amnesty.

Favoring Humble and Nimble Investment Strategies

The analysis above justifies that idea that this is not time exclusively for conviction while investing, but prudence, simplicity, and nimbleness. This is exactly what we have been doing since the November US election with our *SBS Crecimiento FCI*, first described in our Letter V1,#1, on June 2016. While keeping our core Latin American sovereign and corporate debt portfolio, we accelerated the process of trimming duration of our debt holdings from 5.2 years as of the end of 3Q16 to 3.8 currently, although preserving some longer duration specific valuation bets, like Argentine Discounts. We also added protection to additional increases in global rates investing in ProShares UltraPro Short 20+ Year Treasury (TTT), and incorporated more aggressively equity positions, first in the US, then followed by Argentine energy and banks. In addition we first reduced the participation of ARS peso assets and increased ROFEX coverage, to later increase them back, as the tax amnesty numbers bought abundant USD flows to maintain the real appreciation trend of the peso. The chart below shows a relative performance of our portfolio vis a vis a weighted Argy curve and the EMBI; unable to avoid the US election shock, but managing risks more robustly and in a diversified manner since then, mitigating higher risk and market volatility from affecting negatively our performance.

Figure 6: SBS Crecimiento vs Argie Curve and EMBI



Source: SBS and Bloomberg L.P.

Looking forward, the investment outlook remains perplexing, but nevertheless inspiring. We continue to be worried about a potentially rapid increase in US rates, partly due to raising inflation expectations (growth and/or protectionism) but more importantly through higher term premium, justifying further rate hedges. Similarly, we find unfounded the subdued implied volatility in some asset prices, in particular the FX, also favoring as a protection device. Likewise we believe US equity valuations are pricing a lot of positives from the coming policy delivery in the US, apparently not consistent with the relatively low level of rates or the USD exchange rate vis a vis other major currencies. Notwithstanding such a backdrop, we see continued value in Argentina´s assets, particularly after the postponement of any embryonic financing stress for the next 12 months or until after the mid-term election. This together with regaining political initiative by the government should bring renewed hope of a more permanent policy improvement in the country. We instrument this view by holding average duration bonds (and Discounts on cheap valuation) and equity investments in banks (Frances and Galicia) and energy providers (Pampa and Transener), the clearest beneficiaries of the enhanced macroeconomic and regulatory environment. We also like short term ARS assets, particularly Lebacs and CER linkers, on the basis that further real peso appreciation is likely given policy trends while inflation will come down slowly. This notwithstanding, due to rapid strengthening of the peso in recent days, we recommend covering partly with the forward market. Finally, and helping on our constructive Argentine view, we also see improving the policy outlook in Brazil, supporting the economy, and offering good value in local equities.

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