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The Upper Band

We finally reached the upper band—the one that seemed so distant back in May or June has now been hit. The economic team underestimated the growing imbalance in the external sector and the excessive appreciation of the exchange rate. They implemented a band system, with a lower band that was as illusory as it was harmful, and an upper band that, in real terms, was not far from the recent historical average. Determining the true equilibrium real exchange rate is impossible, but setting an upper band with so little room for maneuver, in a country with no access to international credit and scarce reserves, is clearly a major diagnostic error. We even heard statements such as reserves being irrelevant to country risk, that current account balances don't matter if there is fiscal equilibrium, or that the new Argentine model works with a strong peso.

A simple midterm provincial election already pushed the band system to the limit. The victory in Buenos Aires Province by a political group still debating whether rain falls from the top down or bottom up was the perfect excuse to test the bands. Argentine assets had already been under pressure for several weeks, largely—in our view—due to a messy monetary and financial management that tried to contain the rise in the exchange rate with an exorbitant and unsustainable interest rate.

It took eight trading sessions after the elections for the exchange rate to reach the upper band. We believe that's not bad at all, considering the Central Bank cut the interest rate by 1,000 basis points just last week—a very welcome move. Yesterday, the BCRA sold USD 53 million. Extrapolating that pace of intervention through to the elections in late October, it would need to sell around USD 1.4 billion. Taking into account the BCRA's own reserves and the Treasury's dollar deposits, the capacity for intervention with own foreign currency stands around USD 8 to 9 billion. The economic team claims intervention power above USD 20 billion, but we don't think it's a good idea to consider private dollar deposits (held as reserve requirements at the Central Bank) as an intervention tool.

But dynamics are never linear. Will USD 1.4 billion be enough to defend the band? We have no idea—but we're quite sure the government would gladly sign up for that scenario. The REER (TCRM) has risen sharply since April and economic activity has stalled, which should help contain FX demand. Moreover, the band features a 1% monthly crawling peg. With peso interest rates near 3% monthly, carry trade positions might lend a hand. Similarly, the BCRA's forward sales are driving implicit rates well below peso rates, encouraging spot dollar selling from the private sector. The shift in electoral strategy after the poor result should also help. And finally, the global environment is supportive: the Fed is cutting rates and emerging market currencies are strengthening. Given this backdrop, the situation shouldn't spiral out of control.

But expectations rule. The market has already lost faith in the sustainability of the band. If people believe the exchange rate will adjust at T+1, then FX demand will rise at T. We think it's almost certain that the BCRA will defend the band until the elections. Honestly, we have no idea how many dollars will be lost in the process.

What we do firmly believe is that sovereign bonds are cheap. At these prices, there's far more upside than downside. For more aggressive investors, we like the Bonar 2038 due to its wide spread over the Global 2038. For the slightly less aggressive, we favor the Global 2041 for its low parity and strong indenture (which matters in tail-risk scenarios). We think the current FX regime will need to be revised after the elections. If the results are favorable to the government, it might buy some time—which would be welcome. If the results are negative, it will have to quickly adjust the real exchange rate. We don't know what FX level would bring equilibrium and allow the BCRA to start rebuilding reserves, but we suspect we're not too far off. Pass-through remains contained, fiscal discipline is still a key pillar, and we are among those who believe the market is not in love with Milei, but rather terrified of a Kirchnerist comeback. It's hard for us to believe that such a political space could win the October national elections.

We'll probably have to wait for the next harvest to see meaningful reserve accumulation, but by now it's clear that this is the only path to lower country risk. Disinflation will likely be slower with a slightly higher exchange rate, but it would be much more consistent and sustainable. Whether driven by economic pragmatism or political survival, we remain optimistic. We're not talking about an exchange rate much higher than today's. The government has already shown some political pragmatism after the elections—let's hope to see the same on the economic front.

Finally, and perhaps most importantly: we like Argentine sovereign bonds not only for domestic reasons but because of what's happening in the global fixed-income market. Since May, spreads have compressed to multi-year lows. Yield is hard to find in today's world. That should be a powerful tailwind.

Kind regards.

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