THE WEEK AT A GLANCE

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Editorial: A Peculiar Orthodox Approach

The Government panicked when the dollar peaked at ARS 195, and it took a small but noticeable turn toward orthodoxy in the last 3 weeks, as we have reported in previous editions. From a quality point of view, the high profile land squattings have ceased, it embraced the cause of the extended facilities fund program with the International Monetary Fund, and the treasury returned temporary advances to the Central Bank as a gesture of good will, although later on it will need to resort to the distribution of dividends from the same source to finance the December deficit.

From a quantitative point of view, there were a couple of adjustment signs. Minister Guzmán said it was not the time for IFE4 (social handout) and the social security adjustment formula sent to Congress has a major adjustment implicit in 2021. The Government saved around ARS 190 billion between January and September this year by not using the previous government's formula. And by 2021, we estimate that inflation will exceed revenues and wages and therefore, there will be a further fiscal saving since the new formula avoids inflation as an adjustment factor.

The spirit of the social security adjustment is in the 3% cap established by the second mobility formula, since by definition the state will apply the lesser of the two formulas. In view of the weight of pension spending in primary spending, it is almost impossible to make a considerable adjustment without affecting this item. In the last 12 months, social security payments represented 41% of primary spending. And that number underestimates the problem because the original formula was lowered and Covid's extraordinary expenses arose. Last year, the average was almost 45%. The formula also affects beneficiaries of social plans: it is more influential than that.

The formula chosen to adjust pensions is controversial. No relevant country adjusts by revenues collection any longer. Most of them adjust with a combination of wages and inflation. There are many arguments to criticize the new formula. It is literally impossible for the people to follow. Revenues are much more volatile than the rest of the economy. Some components of revenues such as the PAIS tax are especially volatile as they depend on the nominal exchange rate. There are some other faults in design. For example, an increase in the tax on credits and debit revenues might create more social security expenses than what it collects, potentially jeopardizing sustainability. The same can happen with other taxes that are relatively small, but which impact the formula.

This almost essential adjustment clashes with this Government´s DNA. Guzmán, Alberto Fernández, and the fear of a major currency crisis had put the tax on large fortunes in the background, but it only took a few days of "calm" in the FX market for the bill to resurface once again and tomorrow it will be presented with all the paraphernalia and an "anti-business" tint that is not in keeping with the 21st century. In addition to this, the letter sent by the ruling party senators to the IMF, which, although addressed to a domestic audience, adds more racket. The budget soap opera added its own noise. The classic "happiness spreadsheets" were sneaked in, this is a group of works that have no funding and probably will not be executed, but they bring joy to the benefitted provinces. The worst part is a set of new taxes on computers and insurance that not only increase the Argentine cost, but also take away the transparency of the whole process.

This constituted a turn to a very *sui generis* orthodoxy. The week ended with the blue dollar breaking away from the strongly intervened blue chip swap and with the CB losing reserves. Inflation sent a clear sign that the demand for money is low and devaluation expectations high. The CB reacted quickly by raising all rates (repos, Leliqs, time deposits), but in doses that will hardly calm the market since rates are clearly negative in real terms. In addition, there are no changes in the active rates for credit cards yet, so the roadmap remains unclear. The demand for money so far has not taken note.

What's coming up this week...

- On Tuesday 17 the CB will release its quarterly monetary policy report.
- On Thursday 19 INDEC will release October's wholesale inflation and construction costs.
- On Thursday, the Treasury will launch a new auction for bonds in pesos. It will be the next to last of the month.
- October's cash-basis fiscal data will be available on Friday 20. We expect a primary deficit around 100 billion pesos.

Stoplight for Economic Activity

Seasonally adjusted variations

		m/m	q/q	Last data vs previous quarter
Industrial production - INDEC	*Sep-20*	4.3%	21.7%	4.5%
Automobile production - ADEFA	*Oct-20*	-11.2%	72.5%	4.5%
Steel production- Chamber of steel	*Oct-20*	8.1%	33.1%	14.3%
Poultry production - Min. of Agriculture	*Sep-20*	15.5%	-2.3%	10.9%
Dairy production - Min. of Agriculture	*Sep-20*	-2.2%	-1.8%	-3.5%
Beef production - Min. of Agriculture	*Oct-20*	-6.1%	-3.3%	-4.5%
Real Estate transactions City of BA	*Sep-20*	50.4%	87.9%	82.1%
Flour Production - Min. Of Economy	*Sep-20*	2.2%	0.3%	-2.0%
Oil production - Min. of Production	*Sep-20*	-0.9%	0.9%	-2.1%
Gas production - Min. of Production	*Sep-20*	6.1%	1.9%	5.0%
Cement production - AFCP	*Oct-20*	1.7%	16.4%	11.5%
Construction activity - INDEC	*Sep-20*	4.0%	58.7%	5.4%
Retail sales - CAME	*Oct-20*	-2.8%	24.1%	4.6%
Gas sales - Min. of Economy	*Aug-20*	0.8%	24.8%	8.9%
Motorcycle licenses - ACARA	*Oct-20*	-4.0%	13.5%	4.1%
Use of electricity - CAMMESA	*Oct-20*	1.9%	7.6%	2.9%
Subway rides - City of Buenos Aires	*Sep-20*	35.0%	-4.9%	-8.8%
Imports CIF - INDEC	*Sep-20*	22.7%	12.3%	26.4%
Exports FOB - INDEC	*Sep-20*	-4.7%	3.0%	-2.0%
Loans in ARS to private sector (real) - BCRA	*Oct-20*	1.6%	5.0%	3.0%
VAT-DGI Revenues - AFIP	*Oct-20*	4.0%	11.2%	8.4%
Formal private jobs - SIPA	*Aug-20*	0.0%	-1.2%	-0.3%
Formal private jobs - Min. of Labor	*Sep-20*	-0.2%	-0.3%	-0.2%
Consumer confidence - UTDT	*Oct-20*	-3.7%	3.8%	-2.8%
Government confidence - UTDT	*Oct-20*	-12.1%	-20.0%	-16.9%

Note: stoplight color depends on last data vs previous quarter

Inflation Threatens the FX Spread

- *Financial doll ars and the informal exchange rate recorded rises last week after several days of FX calm; the FX spread with the blue dollar exceeds 100%, though it dropped to 99.5% yesterday*

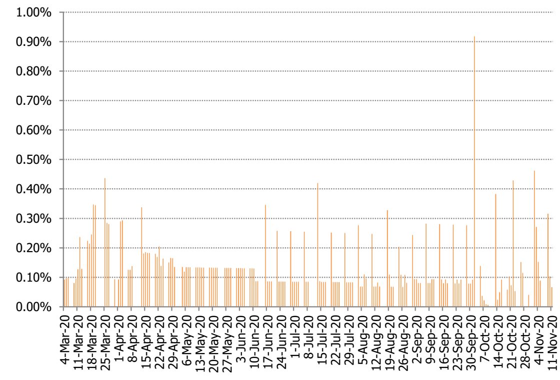
- *October's bad inflation record fed the already high devaluation expectations: if the CB wants to uphold the real exchange rate, it must accelerate the depreciation rate*

- *As a response to October's inflation and the hard fall in private time deposits, the Central Bank has risen the rates of Leliqs, repos, and reverse repos; real ex-ante rates are still negative*

- *The negotiations of a new program with the IMF began last Tuesday, a key factor to provide certainty and rebuild confidence*

Rate of depreciation

Daily, official FX (Com "A" 3500)

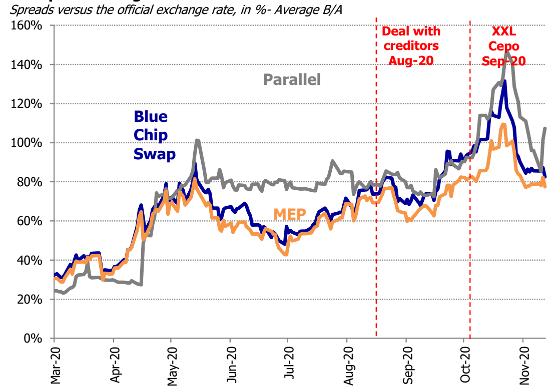


The FX calm lasted two weeks and a half. The financial dollars awakened after several days in decline and the public sector settled bonds again to contain the FX spread. The strong rise of the blue dollar, together with October's bad inflation record and the relentless fall in reserves, fed devaluation expectations and made the CB act fast and announce a rise in rates.

In line with Guzmán strategies to remove some of the pressure of financial dollars from the markets, quotations had been strongly shrinking since their peak on October 22. Likewise, after reaching its ARS 195 historical peak (ask price) on October 23, the informal dollar had been turning around and dropped during 12 business days in a row. But **last Wednesday, the three rates went up,** a warning sign for the CB. **What changed in the market that made the "FX peace" disappear? The answer is, precisely, that nothing changed.** As we have been remarking in our last reports, a ARS 180 rate for the dollar is even higher than in 2001, measured in current prices, and is not backed by current fundamentals. The latest Treasury auctions have also helped remove pressure from the financial dollar markets. But **the core problem is still unsolved:** the demand for pesos is still down, the fiscal deficit is still high, and more help from the CB will be needed toward the end of the year. In sum: there are way more pesos than what the market wants.

Multiple exchange rates

Spreads versus the official exchange rate, in %- Average B/A



Source: Econviews based on Reuters

With rises contained by the public sector's bond sales, the blue chip swap jumped from ARS 147.55 **to ARS 149.15 and the MEP rate** went from ARS 141.44 **to ARS 144.97,** ask price. But the greatest rises were recorded **in the informal market,** where the CB does not have the power to intervene and **the rate** went from ARS 147 to ARS 160, **reaching ARS 172** on Friday. **Yesterday, the blue chip swap and the MEP rates rose ARS 1.06 and ARS 1.77,** while **the informal rate dropped ARS 10, reaching ARS 162. The FX spreads are at 84.4%, 78.6%, and 99.5%,** respectively. In parallel, **the official dollar went up 3.0% over the last 30 days and accelerated its depreciation pace last week,**

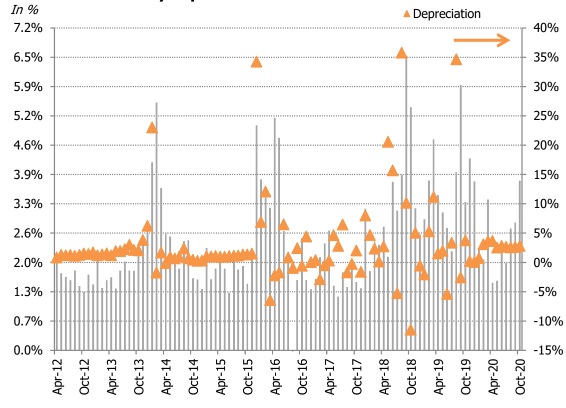
increasing 64 cents (0.8%). Yesterday, the daily rise was almost 23 cents (0.28%). But October's bad inflation record, which stood at 3.8% when the market forecasted something closer to 3.2%. fed the already high devaluation expectations. **If the CB upholds the idea that the evolution of the official exchange rate will follow inflation closely, this trend should worsen.**

As a response to the accelerated inflation and the hard fall experienced by the private sector's time deposits (-6.1% in the last 30 days), the CB announced another rise in rate: **the Leliq rate went up from 36% to 38%** (reversing the last two drops), **the 7-day repo rate increased to 36.5% and the 1-day repo rate now stands at 32%.** The CB has also raised the **minimum guaranteed rate of time deposits,** with a **30-day 37% nominal annual rate yield (44% effective annual rate)** for deposits of individuals **under ARS 1 million, and 34% nominal annual rate (39.8% effective annual rate) for the rest.** Unlike the last communications from the CB regarding interest rates, in which they lowered Leliq rates and increased the rest, **this rise was a generalized one and the message was crystal clear: to continue absorbing pesos from the market.**

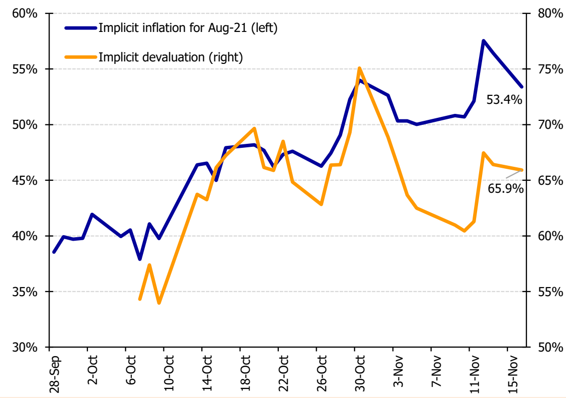
Did the rise in rates fall short once again? Although the measure is pointed in the right direction, **the new rates are not attractive, neither for savers nor for banks.** For the former, time deposits are still paying negative real rates ex-ante. **A retail time deposit yields scarcely over 3% monthly, way below** inflation in October and also below the expected inflation for the coming months, which will accelerate instead of slowing down and will be around 4% toward the end of the year according to our estimations. In a scenario in which **the break-even of inflation for the next 12 months is around 53% and the break-even of devaluation is around 66%,** the time deposit falls short of indexed instruments, such as dollar-linked bonds or the ones adjusted by inflation. As for **banks, their placements now yield 38% and they must pay a rate between 34% and 37% to time deposits,** which leaves them with a practically null margin in a scenario in which loans also have maximum rates imposed.

Last Tuesday, the negotiations of a new program with the IMF began, and the Government's bets are now placed on **an agreement that will grant certainty and help rebuild confidence.** Our baseline scenario assumes the monthly depreciation pace of the FX rate will accelerate in the next few months and high chances of a discreet rise in the first quarter of 2021. Likewise, we expect inflation to accelerate hand in hand with the rise of the exchange rate and the de-freezing of tariffs and other regulated prices, so we could witness records around 5% during the first months of the coming year. However, **an improvement in expectations boosted by a new program with the IMF, greater foreseeability brought by a sustainable economic plan, and pro-market political signs could contribute to a change in assumptions.**

Inflation vs monthly depreciation
In %



Implicit inflation and devaluation in market prices
Annualized %



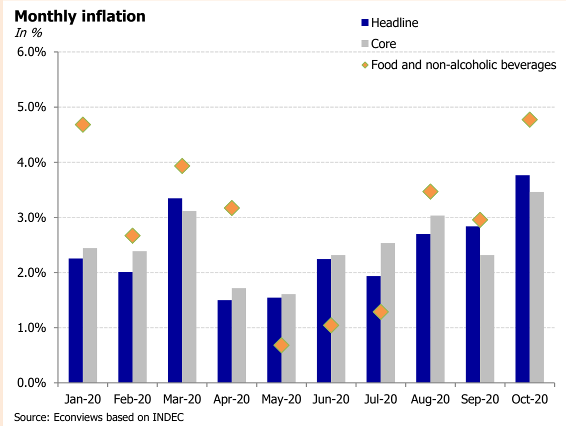
Upside Surprise in CPI: 3.8%

- *The consumer price index jumped 3.76% monthly in October, above the market's expectations (3.2%)*

- *Both core inflation (3.5%) and inflation in seasonal goods and services (9.6%) accelerated and scored their highest records this year; conversely, inflation in regulated prices dropped to 1.5%*

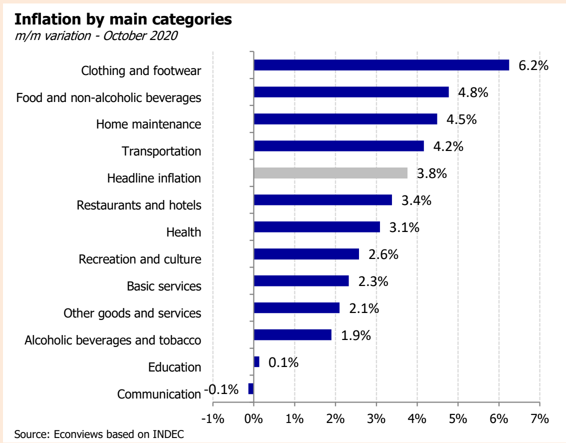
- *The prices of goods went up 4.6% while the ones of services did so 1.9%; restrictions on imports and the record FX spread played an important part*

- *Inflation in food and non-alcoholic beverage, the most important item in the index, was 4.8% and contributed 1.34 p.p. to general inflation*



National inflation reached its highest record of the year in October. In effect, **the consumer price index rose by 3.76% m/m,** way above the market's expectations (3.2%). **While inflation is usually tied to the evolution of wages and the official exchange rate, which stayed stable, October's leap was affected by other factors.** On the one hand, **the FX spread broke a new record** last month (120% with the blue chip swap and 150% with the parallel rate), figures unseen since 1989's hyperinflation, which fed expectations of devaluation and higher inflation. On the other hand, **the growing restrictions on imports** made re-stocking prices go up, which are relying more and more on free exchange rates for reference. This was also reflected in the **goods price evolution (4.6%), which displayed the greatest difference compared to the price of services (1.9%),** since they include a high percentage of imported components.

Core inflation took off and scored its highest record this year (3.5%), although it was below general inflation. This was due to the strong jump in the prices of **seasonal goods (9.6%),** whose record **was the greatest in the historical series of the new index, which started in 2017,** although its impact was minor due to its low relative weight on the general indicator. Conversely, **the prices of regulated goods and services grew scarcely 1.5%,** despite the increase in fuels, which was partly compensated by the stability in education and communication prices.



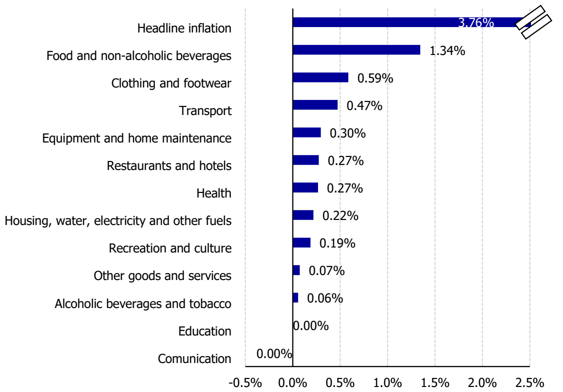
Four out of the twelve items of the CPI scored variations over the general inflation. The greatest rise took place in clothing and footwear (6.2%), but **food and beverage (4.8%) was the item that contributed the most to the general indicator (1.34 p.p.). In addition, this item raised the alarm:** the poorest sectors spend a greater part of their income on food, so they are even more affected **in a context where poverty affected 47% of the population in the second quarter,** according to the Minister of Social Development.

In y/y terms, national inflation went up from 36.6% to 37.2%, while the accumulated inflation rose to 26.9%. As for **the Greater Buenos Aires, its**

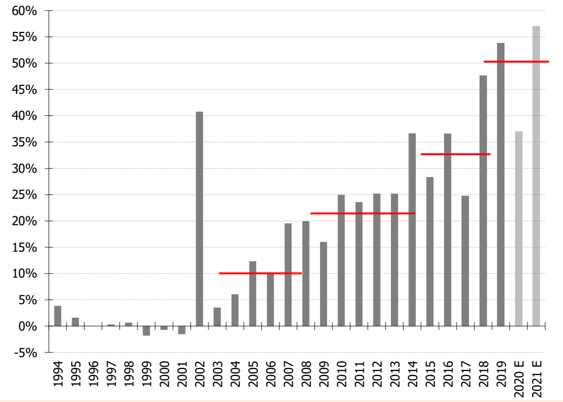
monthly inflation was 3.6%, in line with national inflation, and **it rose to 35.7% in y/y terms**. On the other hand, **in the City of Buenos Aires monthly inflation was scarcely 2.5% and y/y inflation was 31.3% according to CPI-BA.**

With the greater opening and the excess of pesos still around 20% their historical average (in relation to the activity level), **the economy started to ramp up and we expect inflation levels close to 4% for the next months.** The Government has authorized rises in the price-cap program –though not generalized rises– and another round of increases in fuel would be on its way in December, alongside the scheduled rise in prepaid medicine. Starting in January, the tariffs of public services will be de-frozen (although a rise in the subway tickets has already been authorized for next week in the City of Buenos Aires). **In this context, we adjust our inflation forecast to 37% for 2020 and we keep it at 57% for 2021.**

Incidence of main sectors on headline inflation
October 2020



Inflation
Annual variations - End of period



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