Cumberland Advisors Market Commentary – Cry for Argentina

Argentina's primary election on Sunday, August 11, surprised everyone and shocked markets as the current president, Mauricio Macri, was defeated by 15.6 percentage points by the left-wing Peronist candidate, Alberto Fernandez. Macri now appears to have only a very slim chance to win the October 27 presidential election. His tough austerity measures, which were needed because of the serious state of the country's economy and finances, have not been successful and have proved to be very unpopular.

Markets reacted strongly early last week, with stocks, bonds, and the peso tumbling. At the end of the day on Monday, August 12, the main Argentina stock index, MERVAL, closed down 31% and Argentine sovereign bonds were down by 15 to 20 points. During the week Fitch cut the sovereign bond rating by three notches to CCC and S&P Global cut its rating on notch to B- with outlook negative At the end of the week the 10-year bond rate was 25.14 %, calculated from the yields of other available durations. One month ago the rate was 24.5%. The peso was down 15% after having initially swooned 30%. There has been some, though still modest, contagion spreading to other emerging-market sovereign credit markets. Argentina accounts for 5.5% of the Bloomberg Barclays EM US Dollar Sovereign Index.

Investors are clearly fearful of economic policies taking a left turn at a time when the economy is in recession: Growth declined 2.5% last year and 5.8% in the first quarter of 2019. Argentine inflation is among the world's highest, registering

22% for the first half of the year.

Alberto Fernandez was declared a candidate in May by the former president, Cristina Fernandez de Kirchner, who declared herself as the candidate for vice-president. Kirchner's period as leader was marked by heavy-handed government intervention in the economy and ill-conceived currency controls and government subsidies. Fernandez has not provided any details of his economic policies. He is strongly critical of Macri's austerity policies, but he has indicated he will be more pragmatic and moderate than Kirchner was.

Macri, seeking to close the shortfall in his popularity, looks likely to move to the left, easing the austerity imposed as part of the country's agreement last year with the International Monetary Fund for a $50 billion "preventive credit line." He already has announced income tax cuts, increases in welfare subsides, a second increase this year in the minimum wage, and a 90-day freeze on gasoline prices. His economy minister Nicolas Dujovne has now resigned, saying the economic team needed "significant renewal".

Investors' concerns about these developments are well-founded. Argentina's ability to meet its financing needs is at risk as investors appear increasingly hesitant to buy the nation's bonds. Interest rates on seven-day notes were increased from 63% to 74% after the election. The country may need to ask the IMF to bring forward scheduled 2020 disbursements of its credit line.

The currency looks likely to remain under pressure. Macri's presidency, which began in 2015, has already witnessed two other steep falls in the peso, one of 30% when Macri ended currency controls and one of 25% last year. These devaluations have serious effects on domestic businesses, for which most costs are dollar-based. And consumers are hit by a crippling increase in inflation.

The Global X MSCI Argentina ETF, ARGT, declined 24% on Monday August 12, and a further 4% on Tuesday. The markets for Argentine assets stabilized mid-week after speeches by both presidential candidates. ARGT ended down 24.4% for the week. These developments are a good example of how individual emerging-market economies can experience significant unanticipated risks. Emerging markets are currently experiencing high volatility and are under pressure from slowing global markets, trade wars, and a strengthening US dollar. At Cumberland Advisors we do not hold ARGT in our International or Global ETF Portfolios and have reduced our emerging-market holdings.

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Sources: Financial Times, Barclay's, BBC.com, CNBC, Yahoo Finance, Global Government Bonds

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Market milestone: This is the longest bull run in history

Excerpt from "Market milestone: This is the longest bull run in history" by Matt Egan (@MattEganCNN)

"While this bull market and economic recovery may very well be old," LPL Financial strategists wrote to clients, "we see few signs that suggest an end is near."

David Kotok, chairman and chief investment officer of Cumberland Advisors, agrees. He believes that strong corporate profits could lift the S&P 500 to 3,000 before the end of the decade.

But the economic expansion, already the second-longest in history, also faces threats from tariffs and inflation.

An escalation of the trade war between the United States and China could derail global growth while causing headaches for the Federal Reserve.

"If the trade war does not ratchet down," Kotok said, "the Fed will have to fight more inflation with slower rates of growth. Therein lies a stewpot of risk."

Read the full article at CNN Money.

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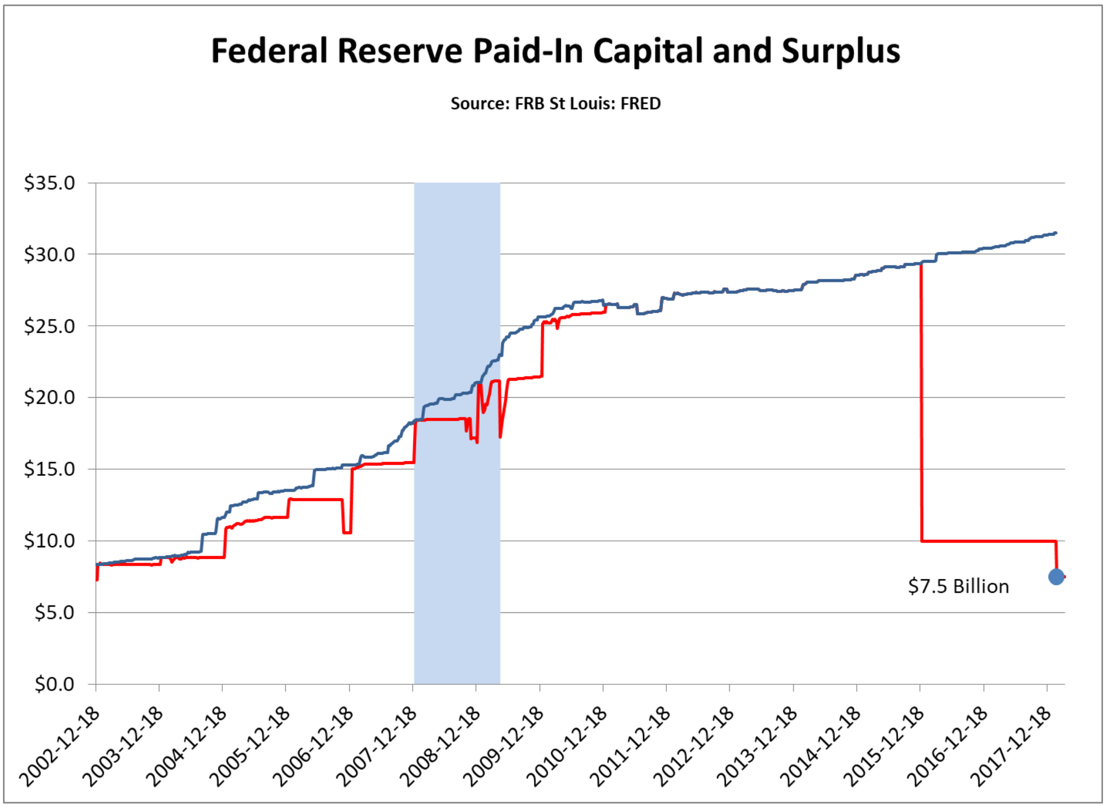
Piggy Bank

One of the characteristics of a struggling republic is the inability to separate its central bank's resources from the fiscal largesse of the federal government. Using central bank resources to avoid addressing funding of the government is a sure path to runaway inflation, economic decline, and periodic financial crisis. Take the example of Argentina, whose economy was the same size as that of the US at the turn of the century in 1900. Since then it has experienced repeated bouts of rapid inflation and crises both real and financial. Today its GDP is about the same size as that of North Carolina, which is the US's 9th largest state in terms of GDP. One of the problems Argentina faced was the ability of the federal government to finance expenditures by relying upon central bank assets. Indeed, "The central bank was lender of first resort to the treasury," according to Alfonso Prat-Gay, who ran the central bank from 2002 to 2004.

Early on, the US Federal Reserve was a source of rediscount finance to support the agricultural cycle. During WWII, the Fed subordinated its balance sheet and independence to support the war effort, transferring funds to the Treasury and pegging Treasury rates. That policy culminated in the 1951 Accord, reestablishing the Fed's position as an independent central bank. In 1996, Congress requested that the GAO study the Fed's policy of maintaining its surplus account equal to its paid-in capital as of year-end the previous year. The purpose of the surplus accounts to provide a buffer against which losses could be recognized.[1] Member banks are required by the Federal Reserve Act to subscribe to stock in the Federal Reserve Bank in the district in which the member banks are headquartered, and the subscription is to equal to 6% of their paid-in capital and surplus. Hence, the Fed can add to its paid-in capital only as member banks grow and not by issuing more stock.

The GAO study came on the heels of two raids of the Fed's surplus initiated in the Omnibus Budget Reconciliation Act of 1993. That act, according to the GAO, directed any Reserve Bank whose surplus exceeded 3% of the paid-in capital and surplus of member banks in its district for fiscal years 1997 and 1998, to transfer those surplus funds to the Treasury. And the Reserve Banks making those transfers were not permitted by the Act to replenish their reserves during those two fiscal years.[2]

The table below shows the relationship between the Fed's surplus and paid-in capital accounts since the GAO's 2002 study. There have been some temporary deviations of the aggregate Federal Reserve Bank surplus from paid-in stock.



In 2006, for example, there was a temporary decline, but the Federal Reserve's 2006 annual report indicated that this decline was attributed to adoption of FAS 158, which required a reduction in surplus of $1.849 billion and then required the sharp subsequent adjustment shown in the chart.[3]

Recently, Congress has repeatedly resorted to tapping the

Fed's balance sheet in an effort to fund pet projects, creating a dangerous precedent and threatening the Fed's independence. The first nose under the tent occurred with the 2010 Dodd-Frank Act, which created the Consumer Financial Protection Bureau. Congress mandated the Fed to fund the new bureau rather than subjecting the agency to traditional financing through appropriations.[4]

Then in December 2015, Congress struck again and reduced the Fed's surplus even further with passage of the $305 billion Highway and Transportation Funding Act of 2015. That Act expropriated about $19 billion of the Fed's surplus and capped the amount in the Fed's surplus account going forward to $10 billion. It further reduced the 6% dividend on Federal Reserve stock paid to member banks.[5]

There are two important facts to recognize about these actions. First, as the 2002 GAO report points out, transferring resources from the Federal Reserve creates the appearance of an increase in federal receipts because of the peculiarities of government accounting; but such transfers don't actually increase government resources when viewed on a consolidated basis. Federal debt held by the public declines but, again, only because Federal Reserve Treasury holdings are considered debt held by the public, even though the Fed is a government entity (or at least the Board of Governors is).[6] Viewed properly, all that is happening is an intra-governmental transfer of resources. Moreover, such a transfer reduces future remittance transfers from the Fed to the Treasury unless offset by additional asset purchases by the Fed.

Second, as a result of the financial crisis and expansion of the Fed's balance sheet through its quantitative easing programs, the Fed's leverage and loss absorption capacity has been radically reduced since its capital-to-asset ratio has declined to 0.9 percent, and we have estimated that an acrossthe-board 17 basis point increase in the term structure would be sufficient for the market value of Federal Reserve system assets to be less than the value of its liabilities.[7] To make matters even worse, the two-year budget passed by Congress last week further expropriated another $2.5 billion of the Fed’s surplus, reducing it to $7.5 billion.

In the context of the budget and policies now in place, the $2.5 billion of surplus transfer is no more than rounding error, relative to the size of projected budget deficits, which could reach $1.2 trillion. But the risks to the Fed and its ability to carry out policies are now extremely limited when it comes to the ability to sell assets, if needed, as one way to reduce the size of its balance sheet. In particular, because the Fed carries securities on its books at par, any increase in interest rates would reduce the market value of its securities, which, if sold, would require recognition of those losses. The $7.5 billion surplus is clearly inadequate to absorb the potential losses. So the Fed will have to either forego assets sales or take advantage of an agreement struck by Chairman Bernanke with the Treasury permitting the Fed to record losses in a negative asset account instead of booking losses against capital. Should a negative asset account become necessary, then remittances to the Treasury will cease until the negative asset account is extinguished.

As we have written previously, the optics of an insolvent Federal Reserve – even if it is of little substantive relevance since the Fed is backed by the Treasury and the resources of the United States – does not convey an image of strength and may not be well received in financial markets both domestic and (especially) foreign. Congress is serially weakening the Fed by tapping its resources, reducing its policy flexibility at just the wrong time and for no fiscally substantive reason.[8] That practice is wrong and dangerous for our country. Let us not emulate struggling economies like many of those in Latin America.

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[1] Historically, such losses have typically been temporary and associated with foreign exchange transactions. The system has never had an annual loss, and Reserve Banks have recognized only temporary losses against their surplus accounts.

[2] See GAO, Federal Reserve System: *The Surplus Account, Report to Congressional Requesters,* September 2002.

[3] See *Annual Report 2006,* Board of Governors of the Federal Reserve System, https://www.federalreserve.gov/boarddocs/rptcongress/annual06/pdf/ar06.pdf, pg. 128

[4] The legality of the structure of that agency is under scrutiny by the Administration.

[5] Small community banks were exempted.

[6] Presumably, this treatment is due to the fact that the Reserve Banks are technically owned by member banks in their respective districts, and reserve bank employees are not considered federal employees.

[7] See http://www.cumber.com/~cumber/pdf/duration.pdf

[8] See Charles Plosser, "Argentina Redux," July 2, 206 https://www.hoover.org/research/argentina-redux for a former Federal Reserve Bank president's concern about potential polarization of the Fed.

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In South America: Mendacity versus Perspicacity

I write as a follow-up to our South America trip. For a terrific summary of the Argentina-Uruguay experience, we offer the "Weekly Economic Update" from Michael Drury, GIC chairman and chief economist at MacVean. The report is available here: http://www.cumber.com/pdf/EU05-13-2016.pdf. We thank Michael for permission to link to his commentary.

Meanwhile, the former president of Argentina is now facing criminal charges. (See http://dw.com/en/ex-argentine-president-cristina-fernandez-charged-with-defrauding-the-state/a-19257386.)

And the former president of Brazil is facing her own versions of corruption charges and political retribution. (See an overview of the charges which occasioned her suspension at http://www.nytimes.com/2016/05/13/world/americas/questions-and-answers-dilma-rousseff-impeachment-brazil.html and possible political motives behind those charges http://www.nytimes.com/2016/05/24/world/americas/brazil-dilma-rousseff-impeachment-petrobras.html.) With the Summer Olympics looming, Brazil faces not only a presidential crisis but the world's pointed worries over the Zika virus, though the World Health Organization has just nixed requests to move the Games: http://world.einnews.com/article/328341819/dgaMgwl4OTly7hvN.

In Venezuela, a tyrant continues to govern while the overwhelming majority of his citizens suffer or are suppressed or actually disappear. For the latest on Venezuela, see http://www.nytimes.com/2016/05/28/world/americas/venezuela-economic-government-collapse.html. For the desperation of Venezuela, which now is selling its holdings of gold to raise cash, see http://www.oilandgas360.com/venezuela-selling-gold-collapse-near.

We characterize the South American disease as the frequently reasserted gravitational pull of mendacity when perspicacity is required instead to power a social, political, and economic liftoff. We ask, can perspicacity prevail over mendacity in South (or Central, for that matter) America? Over a century of history suggests it cannot. Country after country has fallen victim to dictatorship, military coups, a culture of corruption, and governments that oppress. That has been the persistent theme since the first Spanish conquests, Portuguese colonization, French exploitation, and subsequent independence. Heroic figures like Simón Bolívar and José de San Martín attempted liberation but failed to create a sustainable model. They did help create national identities for countries and regions that now bear their names. They sponsored perspicacity.

Contrast them with Allende, Peron, or Chavez, some of the many examples of mendacity. Ex-presidents like Argentina's Cristina

Kirschner and Brazil's Dilma Rousseff join Venezuela's Maduro in the lengthening list of failures that were or are mendacious.

So a very important question now faces this continent. Can the most recent examples of political change in Brazil and Argentina become a newer model for transition? Both are happening without a military coup. Both are underway in a form of democracy. Voters are prevailing, so far, over guns. Not so in Venezuela, but that outcome is still undecided. In Chile, the regime changes after Pinochet have been democratic and peaceful. In Colombia, there is economic growth and openness. That country has become a tourist destination. I can recall a time when I landed in Bogotá and the worry was a guerilla-army gunfight near the airport. Things have changed in Colombia. Will the transformation be sustained?

Maybe, just maybe, the introduction of social media and interconnectedness and instant information is working. Maybe, just maybe, voters can overpower guns. We shall see as the situation in Venezuela worsens daily and the ultimate test of a regime change occurs.

If there is a change that redirects the historical record from mendacity to perspicacity, then there is a possible strong and bullish outcome for the entire continent. Argentina can be a litmus test as the newly elected Macri regime attempts to correct the damage done by its predecessor. Venezuela's overthrow of Maduro and expansion of democracy would add to a positive continental outlook.

Meanwhile, investors can find values in South America. The more dollarized the economies there, the more stable they are and the more potential they have. Uruguay is an example in the Mercosur group, which comprises Argentina, Brazil, Paraguay, Uruguay and Venezuela. Costa Rica is also a case study of success, in Central America.

Maybe, perspicacity can prevail in this 21st century. Stay tuned. After 16 visits over 20 years, we now await success for perspicacity in Argentina.
