Juan Manuel Pazos
Chief Economist
Santiago Resico
Economist

TPCG

Argentina – Strategy
March 8, 2024

A Tale of Two Economic Programs.

- **IN THIS PIECE.** With the Milei Administration closing on its first 100 days, we look deeply at the two economic programs it launched and the challenges ahead.

- **OUR KEY TAKEAWAYS.** After the inauguration, the Government implemented two economic programs simultaneously. A short-term stabilization program seeking to bring down inflation to low-single digits before the end of the year and normalize the FX market, and a long-term, structural reforms program. While the structural reforms program was rejected in Congress, the short-term program is moving ahead faster and more effectively than expected, bringing the economy closer to stabilization. In our view, the Milei Administration had four challenges to overcome in 2024: (i) achieve a rapid fiscal consolidation to push the economy into recession and inflation on a downward trajectory, (ii) normalize the FX market, floating the currency and gradually releasing capital controls, (iii) align Governors and Congress behind his short-term stabilization program, to minimize political risk, and (iv) hope for voter tolerance. Almost one hundred days into his term, Mr. Milei has made deeper inroads into each of these four challenges than we expected. On the disinflation front, the Government reached an overall fiscal surplus in January through a mix of higher revenue, allowing inflation to dilute social security benefits and payrolls, accumulating energy arrears, and cutting capex and discretionary transfers to provinces. While creditors seem concerned about the quality of the consolidation of the risks of reversibility due to reflation, we believe that the CPI trajectory for the rest of the year should allow the Government to lock in the gains in 2024 (2025 is a different problem). The FX side seems a little more problematic than the fiscal side. For starters, despite the December deval, the BoP still ran a current account deficit in December and January, and most of the GIR improvement resulted from accumulating import arrears. Still, we believe that the depth of the recession is so deep that our BVAR model estimates that under the current trajectory, a 2Q24 unification of FX rates could have less than half of the pass-through of the December devaluation and about one-quarter of the pass-through of Mr. Massa's August devaluation. In this context, we estimate that the Government is probably getting to a point where it will be able to unify FX rates without a spike in inflation aborting the downward trajectory of the CPI. The political challenge has been the hottest over the past few weeks, but we believe that the Administration has maneuvered itself to a position of strength relative to the Governors. Following the collapse of the Omnibus bill, Mr. Milei opted to go to war with Governors, cutting them off from a series of fiduciary funds established decades ago, which financed programs that the 1994 Constitutional reform devolved to provinces. For the first time in decades, Governors suddenly faced the need to foot the entire payroll of teachers, medics, and constables without Federal Government aid. In his SOTU address last week, Mr. Milei offered Governors a way out of the conflict: support in Congress for the Government's reforms, join the consolidation effort, and in return, Mr. Milei vowed to discuss a new rules-based relationship between the Federal Government and provinces, to make the latter financially independent from the former. A group of 15 governors has already signaled their willingness to re-engage with Mr. Milei and negotiate a deal. The final challenge is social tolerance. The Government has shown a remarkable talent for weaving a narrative that takes voters' focus off the short-term stabilization plan and blames the political establishment for the pain. So far, polls suggest that Mr. Milei's approval ratings remain around 50%, with the President retaining the support of almost 90% of his October voters and approved by over 60% of Mrs. Bullrich's voters and 45% of Mr. Schiaretti's voters. In this context, the Government's handling of the narrative seems to boost voter tolerance.

- **STRATEGY IMPLICATIONS.** With the Government securing faster-than-expected fundamental corrections while managing the political conflict and getting better-than-expected social tolerance, the market has become increasingly constructive on the odds of Mr. Milei succeeding. Over the past three months, we've gone from being more constructive than average to consensus. Still, we remain OW on the ARGENT curve, favoring the 35s.

TPCG ARGENTINA
STRATEGY VIEW

Juan Manuel Pazos
Chief Economist
Santiago Resico
Economist

Strategy – Argentina

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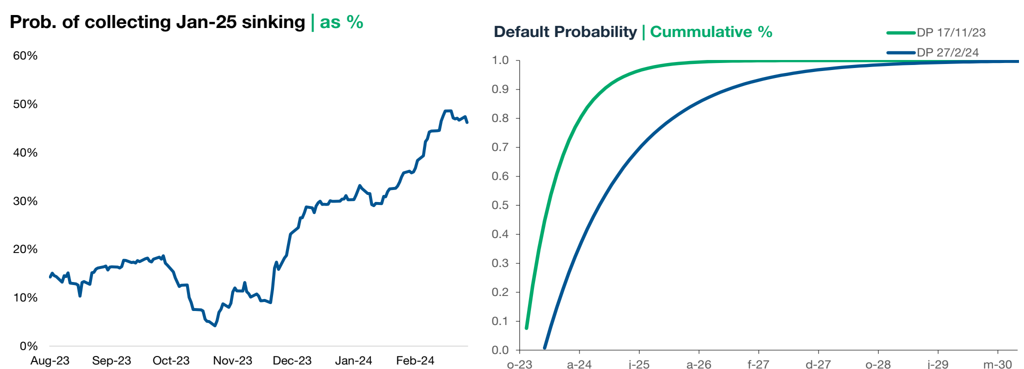
A Tale of Two Economic Programs

A read-between-the-lines interpretation of the first 100 days of the Milei Administration. A little conflict was unavoidable.

At the start of the Milei Administration, we believed that the new Libertarian Government would need to clear four challenges during 2024 to project policy continuity beyond its first year successfully. Within his first 100 days, Mr. Milei has exceeded our expectations wildly.

At the start of the Milei Administration, we believed that the new Libertarian Government would need to clear four challenges during 2024 to project policy continuity beyond its first year successfully. Within his first 100 days, Mr. Milei has exceeded expectations wildly. The Milei Administration came to office as a conundrum. The weakest Government in history institutionally, not controlling a single province and with caucuses smaller than one-quarter of each of the Houses of Congress, was intent on implementing the most ambitious reforms agenda in decades. In our view, to be successful, Mr. Milei will need to overcome four challenges this year. The first is implementing a Greece-like austerity program, combined with a painful relative price correction and a hawkish monetary policy bias to create a recession, softening aggregate spending's impact on inflation. Second, his Government needs to stabilize the FX market and move the current account from a deficit into a surplus. Third, his Administration needs to navigate the implementation of his program politically in a context where the political establishment's incentives diverge from those of Mr. Milei. Finally, the Government needs to hope for social tolerance. On December 10th, the consensus was that the new Government had limited chances of sorting out all four challenges. Assuming that the probability of default for the January 2025 Argent30 sinking closely matches the odds of the Administration failing, the market assigned Mr. Milei about a 25% probability of success in early December. Fast forward 100 days, and the consensus now assigns the Gov't a 55% chance of success in 2024 because of a swifter-than-expected fiscal consolidation, shrewd political maneuvering, and robust approval ratings.

Figure 1: Implicit default probability by Jan-25 is collapsing. The market is getting increasingly constructive about Mr. Milei's chances of success.



Source: TPCG Research based on the TPCG Trading Desk

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Since its inauguration, the Milei Administration has implemented two economic programs simultaneously: (i) a short-term cyclical stabilization plan and (ii) a medium-term deregulation program designed to boost potential GDP. The economic strategy of the Milei Administration seemed to be split into two. On the one hand, Minister Caputo unveiled a new FX framework and put in place an ambitious consolidation program, seeking to achieve a balanced fiscal position in CY24. On the other hand, the Government pushed ahead with Federico Sturzenegger's deregulation and modernization program through a massive Decree and a behemoth 600-article bill, ranging from labor reform to a new antitrust law, from Congress

bestowing the President with extraordinary powers to allowing soccer clubs to become publicly traded companies. These two economic programs were completely independent of one another; their fates were not connected. Mr. Caputo's program aims to stabilize the economy by triggering a recession through a mix of negative fiscal impulse, relative price corrections, and a hawkish monetary stance. Mr. Sturzenegger's plan is about boosting potential GDP in the medium term, with few relevant provisions affecting the 2024 outlook.

The Government's cyclical stabilization program is critical to (i) lower inflation to low single digits before the end of 2024, (ii) release capital controls and float the currency, and (iii) create the conditions for a rebound of economic activity in late 2H24 and 1H25. Mr. Milei received a clear mandate from voters to stabilize the economy and lower inflation. The Government is betting that the electorate is willing to tolerate a higher dosage of austerity than in the past if it leads to stability. Considering the end-2023 snapshot, we believe that stabilization means achieving three things in 2024: (i) bringing inflation below 5%mom by 4Q24, (ii) floating the currency and releasing capital controls, and (iii) setting the conditions for a V-shaped recovery of economic activity in 4Q24 and 1H25. To achieve these objectives, the Milei Administration has taken the most painful road: (i) a shock fiscal adjustment based on scrapping subsidies and capex, diluting social security benefits and public sector payrolls, and redefining the relationship between the Federal Government and provinces; (ii) rapid deregulation and normalization of relative prices; and (iii) a hawkish monetary policy stance, swiftly cutting real money balances. The program's configuration differs greatly from previous attempts to stabilize the economy. Three of the last four of these attempts, Mr. Kicillof's 2014-15 plan, Mr. Macri's 2016-17 plan, and Mr. Massa's in 2022-23, shared a common strategy: normalize relative prices (including devaluation) and move the monetary policy stance towards a hawkish bias, but compensate the program's hit on disposable income by increasing fiscal impulse. The 2018-19 stabilization attempt was based on cutting fiscal impulse and a hawkish monetary bias, but the decision to freeze tariffs and repress the FX made it unsustainable. Mr. Milei's program makes no allowances to shield disposable income from its impact. The program eschews a nominal anchor (FX, incomes, interest rate, etc.) to coordinate downward inflation expectations for a real anchor, a deep recession cooling off price pressures.

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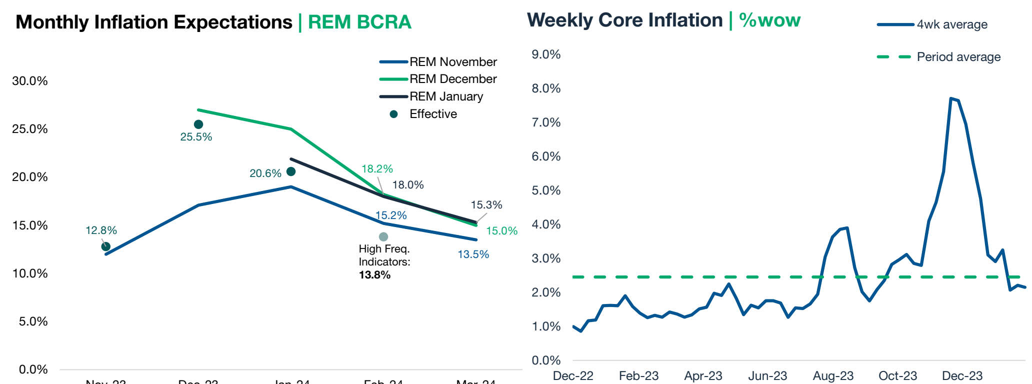
Figure 2: The Government's stabilization program is bringing down inflation faster than expected in 1Q24.



Source: TPCG Research based on Indec and the BCRA

Reaching political consensus around the short-term stabilization program has been elusive, as Mr. Milei's political objectives conflict with those of Governors. To Mr. Milei, political survival means bringing inflation down, as his Administration gambles that voters will endure a deep recession if it results in nominal stabilization. In other words, the short-term austerity program is critical to the continuity of his political project. For Governors, on the other hand, austerity is the biggest threat to their continuity. Out of the twenty-four provinces (including the City of BA), twelve changed political color in 2023. Most of them, like Chaco, San Juan, San Luis, Entre Rios, or Chubut, had been under Peronist governments for decades. Contrary to popular belief, which sees governors as all-powerful strongmen controlling every aspect of their turfs, provinces work through a symbiosis between the Governor and a series of deeply entrenched structures forming a "deep state." This symbiosis ensures the political sustainability of the regime, with the Governor working to benefit these structures and the "deep state" strengthening the Governor's hand. An anger-driven electoral tsunami broke this dynamic, filling about half of the country's Governor mansions with politicians who weren't part of the regime. The new Governors are finding that the "deep

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state" wheels, ranging from school councils to munis, from assemblies to Congressional delegations, are slowly churning to ensure that things return to "normal" in the next electoral term. To Messrs. Zdero, Orrego, Poggi, Frigerio, and Torres, political survival means coopting these structures so that they work for them rather than trying to get them replaced. In other words, for the new Governors, continuity requires them to increase spending, defying Mr. Milei's austerity strategy.

Figure 3: The Government, Congress, and Governors couldn't find a political compromise that led to the passing of the Omnibus bill.

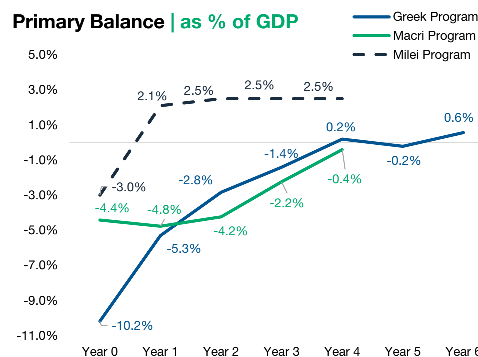
	LLA			Pro			Formerly JxC UCR			Hacemos CF			UxP			Left			Others			Total		
	Aye	Nay	Abs	Aye	Nay	Abs	Aye	Nay	Abs	Aye	Nay	Abs	Aye	Nay	Abs	Aye	Nay	Abs	Aye	Nay	Abs	Aye	Nay	Abs
Omnibus Bill	**40**	**0**	**0**	**38**	**0**	**0**	**32**	**2**	**0**	**18**	**4**	**1**	**0**	**98**	**1**	**0**	**5**	**0**	**16**	**0**	**2**	**144**	**109**	**4**
Art. 1	40	0	0	38	0	0	28	6	0	13	10	0	0	98	1	0	5	0	15	2	1	134	121	2
Art. 2	40	0	0	38	0	0	29	5	0	18	5	0	0	98	1	0	5	0	15	2	1	140	115	2
Art. 3	40	0	0	38	0	0	29	4	1	12	11	0	0	97	2	0	5	0	15	2	1	134	119	4
Art. 4 A-G	40	0	0	38	0	0	29	4	1	10	13	0	0	98	1	0	5	0	15	2	1	132	122	3
Art. 4 H	38	2	0	38	0	0	21	12	1	9	14	0	0	98	1	0	5	0	6	11	1	112	142	3
Art. 4 I-J	40	0	0	38	0	0	28	4	2	9	14	0	0	98	1	0	5	0	8	9	1	123	130	4
Art. 5 A	40	0	0	37	0	1	22	12	0	2	21	0	0	98	1	0	5	0	8	8	2	109	144	4
Art. 5 B	40	0	0	37	0	1	30	4	0	12	11	0	0	98	1	0	5	0	15	1	2	134	119	4
Art. 5 C	40	0	0	37	0	1	13	20	1	4	19	0	0	98	1	0	5	0	4	12	2	98	154	5
Art. 5 D	40	0	0	37	0	1	17	17	0	9	14	0	0	98	1	0	5	0	7	7	4	110	141	6
Art. 5 E	40	0	0	37	0	1	16	18	0	2	21	0	0	98	1	0	5	0	6	10	2	101	152	4
Art. 5 F	40	0	0	37	0	1	16	18	0	4	19	0	0	98	1	0	5	0	6	10	2	103	150	4
Art. 6	40	0	0	37	0	1	32	2	0	12	7	4	0	97	2	0	5	0	16	0	2	137	111	9

Source: TPCG Research based on the House of Representatives

In other words, Mr. Milei's biggest challenge has become to effectively run a Greece-like austerity program without the political consensus that galvanized the early 2010s Greek program from policy reversibility.

In other words, Mr. Milei's biggest challenge has become to effectively run a Greece-like austerity program without the political consensus that galvanized the early 2010s Greek program from policy reversibility. Mr. Milei's decision to eschew a nominal anchor and build his program around a fiscal austerity-driven real anchor makes his plan reminiscent of the Greek program following the European Periphery crisis. The difference is that, whereas the Greek program was backed by an overwhelming majority of the country's political establishment, Mr. Milei is having difficulty rounding up the political support to underpin his plan. It's not that the Greek political establishment was inherently better than the Argy one; if the program failed, Greek politicians would have faced an existential threat: the exit of the Euro Area. Argentina, on the other hand, lacks such an existential threat. Kirchnerism and the Left don't seem to consider hyperinflation as such a kind of threat. Whereas for the Greek political establishment, consensus meant sticking up to an austerity program that 80% of voters rejected, for Argy mainstream politicians, consensus means that their political needs must also be taken care of. This divergence leads to policy reversibility risk. Unlike Greek voters, Argy voters will find a political offering promising to right the ship next year without the need to endure the pain the Milei Administration is causing. The offering will be a magical solution that could appeal to ailing voters unless Mr. Milei manages to bring down inflation materially.

Figure 4: Mr. Milei's austerity program is as ambitious as the Greek program of the early 2010s and the 2018-19 Macri Administration consolidation.



Source: TPCG Research based on the Treasury and the IMF

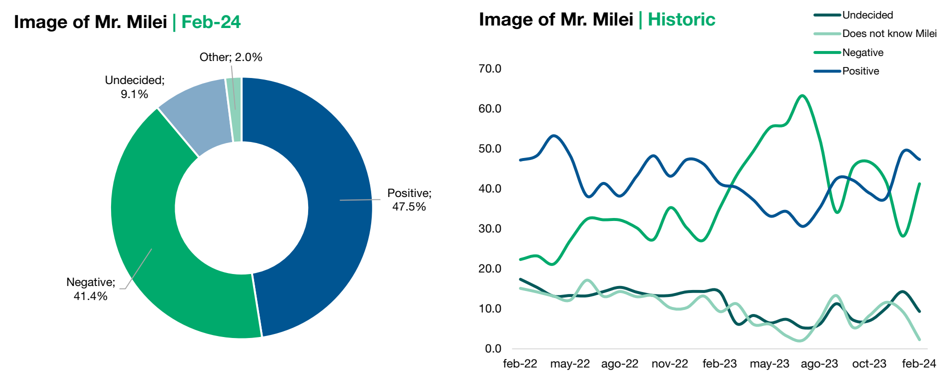
Rather than compromising his program and his Administration's chances of success, Mr. Milei opted to

Rather than compromising his program and his Administration's chances of success, Mr. Milei opted to go to war with Congress and Governors, choosing to build political power through conflict. Mr. Milei's political construction method is disturbingly reminiscent of Kirchnerism's. Like the Kirchners, Mr. Milei is less interested in wooing votes from the other side

go to war with Congress and Governors, choosing to build political power through conflict.

of the ideological divide than he is in galvanizing his voter base. Whereas Pro has been historically obsessed with fishing votes from the Peronist pool, Mr. Milei has little interest in any of the 44% of voters who opted for Mr. Massa in November. In other words, Mr. Milei isn't afraid of a political conflict that runs along the ideological divide, separating his voters from those willing to side with Kirchnerism. The compromise that Governors and Congress offered Mr. Milei would have derailed his political chances by allowing (i) provinces to increase fiscal impulse, compensating the impact of the Federal Government austerity measures on disposable income, and preventing inflation from coming down, and (ii) Governors to present themselves to voters as a policy reversibility option in the 2025 midterms. Mr. Milei would have had his Omnibus bill at the cost of mortgaging his Administration. Unsurprisingly, he opted to go to war with Congress and Governors. More interestingly, his approval ratings are faring better than expected as the electorate navigates through the stabilization program, as voters tend to side with his view that a conflict is necessary to rein in the worst excesses of the political elite.

Figure 5: Mr. Milei's approval ratings remain robust at almost 50%, as the Government retains the support of his original voter base, as over 60% of the JxC voters seem to support the Libertarian strategy.



Source: TPCG Research based on Isonomía Consultores

All in all, despite triggering a political conflict that has some creditors concerned, Mr. Milei seems to have maneuvered his Government to a stronger-than-expected position, pushing ahead with a stabilization program, while voters blame his political rivals for the pain.

All in all, despite triggering a political conflict that has some creditors concerned, Mr. Milei seems to have maneuvered his Government to a stronger-than-expected position, pushing ahead with a stabilization program, while voters blame his political rivals for the pain. Circling back to where we started, in under 100 days, Mr. Milei has practically cleared his first challenge, executing a rapid consolidation that has put the primary position on track to post a surplus for the calendar year for the first time since 2007, the economy sliding into recession and inflation on a downward path. The recession also helps with the second challenge, in a context where the pass-through moderates as aggregate spending suffers, giving the Government a shot at normalizing the FX market and releasing capital controls. Regarding the third challenge, getting politics on board with his short-term stabilization program, we believe that Mr. Milei has outmaneuvered Governors, taking the excuse of the botched Omnibus bill vote to squeeze provincial finances by deftly going for the lifeline of provincial spending: twenty-nine discretionary funds covering the monies for everything ranging from teachers, doctors and constable payrolls, to capex. The final challenge, securing voter tolerance, remains the make-or-break ultimate frontier. The failure of the Omnibus bill was an opportunity here as well. Had Governors allowed Mr. Milei to have his Omnibus bill, the narrative today would be exclusively about the misery and the pain that the Libertarian program is putting the populace through. By denying the Government passage of the bill, Governors allowed the Government to spin a different narrative about how it had a plan to make the stabilization painless until a corrupt claque of politicians botched it to defend their special interests. This narrative resonates with a large share of voters, boosting social tolerance for the stabilization program.

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In his SOTU address, Mr. Milei revealed his endgame: offer the Governors a rules-based framework that makes provinces financially independent from the Federal Government in exchange for supporting the short-term stabilization program and revisiting the long-term potential GDP plan. Most creditors we've talked to over the past few weeks wondered what Mr. Milei's endgame was. In his escalation, the Government weaponized and started dismantling the framework governing the relationship between the Federal Government and provinces over the last thirty years. Surely, Mr. Milei couldn't win a fight against a united front of the twenty-four provinces. Friday's SOTU address gave us a first glimpse of Mr. Milei's strategy out of the political

the short-term stabilization program and revisiting the long-term potential GDP plan.

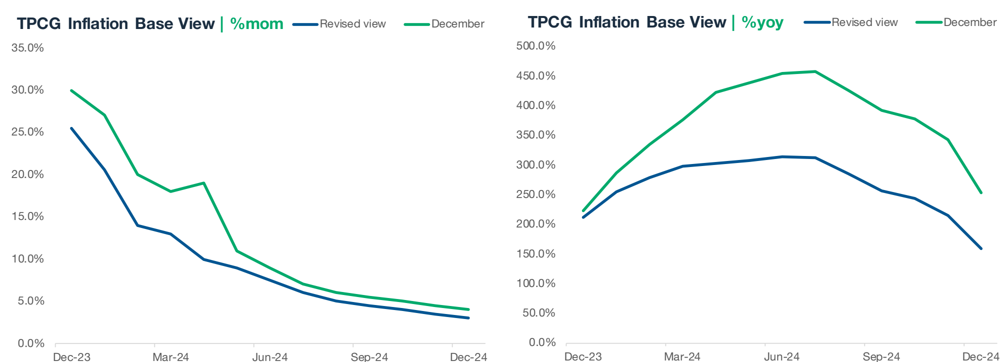
conflict. At the core of his May Accords, Mr. Milei is offering Governors a new rules-based framework to govern their relationship with the Federal Government. This deal would make them financially independent from the Administration. In exchange, the Governors would need to support the rest of the May Accords, which would double down on Mr. Milei's Decree and the Omnibus bill, rounding up the most substantial reforms agenda since the 1990s. In the rest of this piece, we'll go through two deep dives: the first into the execution of the stabilization program YTD, the second regarding the political conflict, its deep-seated roots, Mr. Milei's strategy to get the upper hand over Governors, and how it's helping the Administration boost social tolerance at a delicate time.

The short-term stabilization program: Welcome to the recession, hope you enjoy your stay. Is the fiscal anchor sustainable?

Inflation is responding faster than expected to the Government's treatment, with core prices moving at a pace similar to 2023, when Mr. Massa's controls repressed most of the index.

Inflation is responding faster than expected to the Government's treatment, with core prices moving at a pace similar to 2023, when Mr. Massa's controls repressed most of the index. If inflation is the grounds on which Mr. Milei's political fate will be determined, the first signs seem encouraging. For starters, the initial shock was substantially lower than expected. Coming out of four years of increasingly stringent price controls, with about two-thirds of the index repressed in some way before the end of the Massa tenure at the Economy Ministry, in early December, we estimated that Mr. Milei's devaluation and rapid normalization of regulated prices could result in about 90% accumulated inflation in Dec-Feb. The market consensus was not far from our view, expecting 87.6% inflation for Dec-Feb in the last 2023 expectations survey. Inflation turned out better behaved than expected, with less intense core prices and some drops in volatile prices after the initial correction, resulting in 73% accumulated inflation in Dec-Feb (the February print is due in a week and a half, but high-frequency gauges point to a 14%mom increase). In other words, inflation has consistently moved at a slower pace than what the consensus expected. On the margin, weekly inflation has eased to about 2%wow, a similar pace to the average of 2023, albeit without the need for repression or price guidelines. In this context, we're revising our base inflation view for 2024, from our original 250%yoy expectation in early December to 160%yoy currently, with a very different trajectory. Our BVAR model suggests that the economy has slid sooner than expected into a deeper-than-expected recession, reducing substantially the pass-through of the reunification of the FX market to prices, which we expected to drive the 2Q24 CPI. While regulated price hikes and the prospect of a second deval (to unify FX rates) are likely to keep monthly inflation elevated until 2H, we now expect inflation in 2Q to average 9%mom, 6%mom in 3Q, and less than 4%mom in 4Q.

Figure 6: We're changing our CPI baseline view for 2024.



Source: TPCG Research based on Indec

The faster-than-expected disinflation results from the real anchor of the program becoming operational. We estimate that the economy is dropping 5%qoq SAAR in early 1Q24 and that GDP could deteriorate as much as -7%yoy in the 2024 CY, excluding agriculture.

The faster-than-expected disinflation results from the real anchor of the program becoming operational. We estimate that the economy is dropping 5%qoq SAAR in early 1Q24 and that GDP could deteriorate as much as -7%yoy in the 2024 CY, excluding agriculture. Mr. Milei eschewed using a nominal anchor to coordinate inflation expectations on a downward path, opting to build his program around a real anchor. Minister Caputo has repeatedly argued that the program had a fiscal anchor, but in truth, the primary surplus is just one of the transmission mechanisms. The actual anchor is one of the deepest recessions we've seen since the 2001 collapse of the economy. In December, the economy contracted -3.1%mom seasonally adjusted, with IP dropping -4%mom, construction -8%mom, durable goods sales dropping over 20%, retail sales collapsing 13%, gasoline and other liquid fuels sales plummeted -7.4%mom. In January, IP

dropped an additional 0.9%mom seasonally adjusted. Construction continues to plummet. Car registrations anticipate that the durable sales slump deepened. Consumer confidence continued to deteriorate at a two-digit pace, and tax collections dropped in real terms in January and February. We estimate that these contractions are consistent with the economy dropping 5%qoq SAAR in 1Q24, and the recession will deepen in 2Q to about 9%qoq SAAR, excluding agriculture. All in all, we estimate that GDP excl agriculture could drop by -7%yoy in CY24, more than twice as much as the IMF January estimates.

Figure 7: The economy is sliding into a deeper-than-expected recession. Our revised view is that the ex-agricultural GDP will drop -7% in 2024.

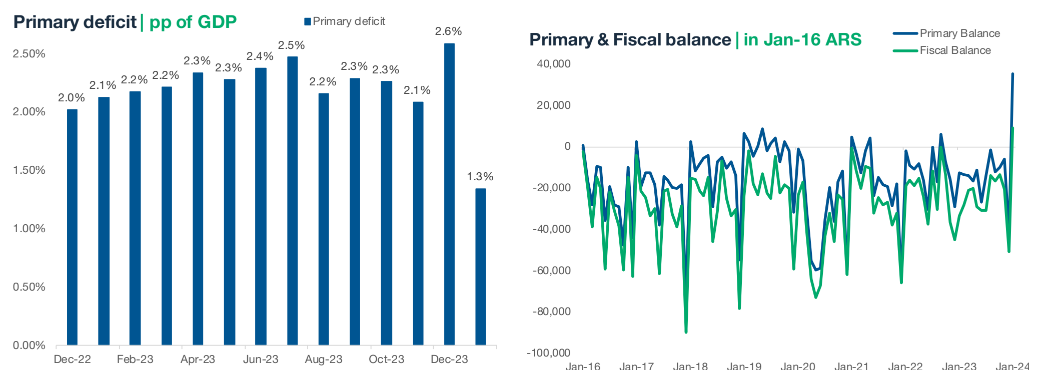
	%yoy						%mom SA					
	1H23	3Q23	4Q23	dec-23	jan-24	feb-24	1H23	3Q23	4Q23	dec-23	jan-24	feb-24
Overall Activity												
Economic Activity Indicator	-2.0%	-0.8%	-1.5%	-4.5%	-	-	-0.4%	2.5%	-1.9%	-3.1%	-	-
Industry												
IPI (Fiel)	-0.7%	-1.8%	-2.0%	-5.6%	-6.3%	-	0.4%	-1.4%	-2.9%	-4.0%	-0.9%	-
IPI (Indec)	1.3%	-3.5%	-5.9%	-12.8%	-12.4%	-	0.0%	-2.9%	-4.6%	-6.7%	1.4%	-
Construction												
ISAC	-2.1%	-4.4%	-3.3%	-12.2%	-21.7%	-	0.8%	-2.8%	-5.5%	-9.4%	-10.2%	-
Cement Sales	0.9%	-5.4%	-8.0%	-13.3%	-20.0%	-	0.9%	-7.5%	-3.6%	-1.8%	-	
Construya Index	-8.2%	-9.9%	-4.9%	-17.4%	-35.2%	-25.6%	3.0%	-3.7%	-4.8%	-14.8%	-18.1%	6.8%
Consumption												
Car Registration	12.2%	4.2%	12.1%	-5.8%	-32.7%	-	1.3%	-3.1%	1.1%	-8.9%	-34.5%	-
Car Sales	14.1%	12.1%	-6.1%	-25.2%	-27.9%	10.3%	3.8%	-5.6%	-10.2%	-21.3%	-0.9%	63.1%
Shopping Sales	12.8%	14.9%	10.5%	-0.4%	-	-	6.5%	-14.1%	-10.6%	-13.1%	-	-
Supermarket Sales	1.4%	2.0%	-0.8%	-6.6%	-	-	0.0%	2.2%	-3.0%	-6.3%	-	-
Consumer Confidence	1.1%	20.2%	24.1%	10.9%	-7.6%	-0.4%	2.5%	4.8%	2.3%	-14.0%	-12.4%	4.7%
VAT	7.8%	16.4%	2.6%	0.2%	8.3%	1.2%	1.8%	1.6%	-8.2%	-0.8%	5.3%	-4.4%
Debits and Credits Tax	1.5%	-0.5%	0.6%	-13.2%	-16.1%	-4.1%	0.3%	-2.3%	-2.1%	-13.2%	-3.9%	12.8%
Fuel sales	5.8%	2.3%	3.8%	0.0%	-6.1%	-	2.2%	-5.2%	-2.6%	-7.4%	-0.1%	-

Source: TPCG Research based on Indec, FIEL, ACCARA, AFIP, CONSTRUYA, Di Tella University, Economy Ministry

The recession is deeper than expected because the Government frontloaded the fiscal consolidation, achieving an ARS2tn primary surplus in January and an overall fiscal surplus for the first time since 2012. The twelve-month rolling primary deficit dropped by half to 1.3% of GDP.

The recession is deeper than expected because the Government frontloaded the fiscal consolidation, achieving an ARS2tn primary surplus in January and an overall fiscal surplus for the first time since 2012. The twelve-month rolling primary deficit dropped by half to 1.3% of GDP. Achieving a primary surplus in January is hardly a feat. Seasonality, including lower spending and high revenue on the back of the winter crops and the December VAT, have resulted in a primary surplus in five of the last eight years (in all of which the Government posted a primary deficit for the remaining eleven months and the calendar year). The January print is a feat because (i) the primary surplus is, in constant ARS, more than 5X larger than any primary surplus attained over the past decade, and (ii) because it's the first time since 2012 that the Federal Government posts a fiscal surplus (that is, after the interest expense). In nominal terms, Mr. Caputo consolidated the primary position to an ARS2tn surplus (fully compensating for the December primary deficit), which was enough to cover the entire ARS1.5tn interest expense (the highest since the Guzman restructuring due to the step-ups) and leave an ARS518bn fiscal surplus for the first time in over a decade. In real terms, the twelve-month rolling primary deficit, which finished 2023 at 2.6% of GDP (40bps tighter than what the Milei Administration expected but 60bp higher than what Mr. Massa had agreed to with the IMF in August), dropped by half to 1.3pp of GDP in January 2024, the lowest since March 2020.

Figure 8: The Government achieved a fiscal surplus for the first time since 2012.



Source: TPCG Research based on the Treasury

The January fiscal consolidation was achieved through a combination of higher revenue and cuts to social security, opex, capex, subsidies, and provincial transfers. The January print confirms our view that the Omnibus Bill's fate shouldn't substantially impact the 2024 fiscal plan. When we look at how the Government achieved an ARS2tn primary surplus in January, we identify six drivers: (i) a rebound of export taxes thanks to the winter crops, (ii) the normalization of the liquid fuels sales tax, (iii) the dilution of social security and (iv) opex in real terms, and the cutting of (v) subsidies, (vi) transfers to provinces, and (vii) capex. All in all, out of the 1.35pp of GDP fiscal savings, higher revenue explains 0.55pp while spending cuts explain 0.7pp. Since the print, the local market has debated whether the savings are sustainable in time, arguing that most of the consolidation resulted from inflation diluting spending in real terms rather than actual cuts. We believe that the discussion is missing the mark. For starters, the improvement in the fiscal position resulting from the improvement in revenue is permanent, as it comes from the normalization of export taxes following the rebound of the winter crops and the indexation of the sales tax on gasoline (which under Mr. Massa had diluted almost entirely). The recession will likely hurt tax revenues and social security contributions in the coming months. Still, the additional income resulting from the summer crops is likely to offset most of that. On the spending side, the Government seems to be moving faster than expected in scrapping economic subsidies (though in January, most of the savings came from accumulating arrears with generation companies), capex, and provincial transfers. The inflationary dilution seems concentrated the most in social security benefits (-0.2pp of GDP in January) and personnel spending (-0.05pp of GDP), which combined total less than one-fifth of the January consolidation. In other words, the January consolidation confirms our view that the Government can reach its fiscal targets despite Congressional opposition to the Omnibus Bill. Moreover, as we argued before, Congressional pushback makes it easier for the Milei Administration to justify some of the more controversial cuts, like the scrapping of the fiduciary fund for teachers' wages.

The January fiscal consolidation was achieved through a combination of higher revenue and cuts to social security, opex, capex, subsidies, and provincial transfers. The January print confirms our view that the Omnibus Bill's fate shouldn't substantially impact the 2024 fiscal plan.

Figure 9: In January, the Government cut primary spending by 40% in real terms, while the increase in fuel sales tax and the normalization of the drought kept revenue constant.

	4Q23				Jan-24			
	ARStn	%yoy nominal	%yoy real	pp of GDP	ARStn	%yoy nominal	%yoy real	pp of GDP
Revenues	**11.6**	**152%**	**-5.7%**	**16.2%**	**6.1**	**257%**	**0.8%**	**16.8%**
Tax revenues	6.9	140%	-10.2%	9.5%	3.9	321%	18.8%	10.0%
Social security contributions	3.1	142%	-9.4%	4.8%	1.7	166%	-25.0%	4.9%
Income from Treasury property	0.8	262%	35.3%	1.0%	0.2	327%	20.7%	1.0%
Non-tax revenues	0.8	237%	29.9%	0.9%	0.3	204%	-14.0%	0.9%
Primary spending	**14.1**	**163%**	**-3.4%**	**18.8%**	**4.1**	**115%**	**-39.4%**	**18.1%**
Personnel spending	2.0	204%	10.0%	2.5%	0.7	158%	-27.1%	2.5%
Social Security	7.6	149%	-7.5%	10.2%	2.7	149%	-29.6%	10.0%
Subsidies	1.3	150%	-12.0%	2.0%	0.3	28%	-64.0%	1.8%
Energy	0.9	144%	-16.0%	1.5%	0.1	-19%	-77.2%	1.3%
Transportation	0.3	132%	-13.3%	0.5%	0.1	194%	-17.0%	0.5%
Other	0.1	927%	283.3%	0.1%	0.0	-72%	-92.1%	0.0%
Transfers to Provinces	0.6	261%	31.5%	0.7%	0.1	-1%	-72.0%	0.7%
Capex	1.0	116%	-18.1%	1.5%	0.1	-50%	-86.0%	1.4%
Other	1.5	218%	14.4%	1.8%	0.4	124%	-36.8%	1.7%
Primary balance	**-2.5**	**228%**	**10.4%**	**-2.6%**	**2.0**	**-1086%**	**-378.5%**	**-1.3%**
Interest payments	1.1	71%	-36.6%	1.6%	1.5	347%	26.2%	2.0%
Overall balance excl SDRs	**-3.6**	**158%**	**-10.8%**	**-4.2%**	**0.5**	**-196%**	**-127.2%**	**-3.4%**

Source: TPCG Research based on the Treasury

After scrapping the fiscal part of the Omnibus bill, which included the tax hikes, the Government pivoted away from the program negotiated with the IMF. It tilted the fiscal consolidation to rely more heavily on spending cuts. The January consolidation can be summarized as 30% from higher revenue without changes to the tax structure, 14% from the normalization of the harvest, 19% from the dilution of personnel spending, social security, and other outlays, and the remaining 37% from program cuts, mostly around capex, subsidies, and transfers to provinces. The path is very different from the one negotiated with the IMF, which included 1.7pp of the 5pp consolidation or 34% of the savings coming from an increase in the tax pressure from the higher rate in the PAIS tax on imports, a hike in the export tax rates, and the scrapping of the income tax exemptions irresponsibly granted by Mr. Massa; 6% in spending dilution (mostly from replacing some welfare programs with others while diluting pensions), 16% from the rebound in the grain harvest, and 38% from cutting discretionary programs. In other words, the actual execution is substantially more reliant on grain revenue and on diluting spending via inflation than the original program in response to Congress blocking the hike in export taxes

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and the Government's decision not to reintroduce individuals' income tax to deprive provinces of the additional revenue.

Figure 10: The Government achieved a fiscal surplus for the first time since 2012.

	Program Objectives negotiated with IMF		January consolidation	
2024 Fiscal consolidation	5.0	100.0%	1.2	100.0%
Additional tax pressure (excl. drought normalization)	1.7	34.0%	0.4	29.3%
Import taxes	0.8	16.0%	0.0	3.6%
Export taxes	0.5	10.0%	0.0	0.0%
Reversal of Income Tax exemptions	0.4	8.0%	0.0	0.0%
Fuel sales tax & other	0.0	0.0%	0.3	25.7%
Spending cuts	2.2	44.0%	0.7	56.4%
Spending diluted by inflation	0.3	6.0%	0.2	19.0%
Pensions	0.1	2.0%	0.2	14.7%
Net welfare programs	-0.3	-6.0%	0.0	1.4%
Personnel spending	0.5	10.0%	0.0	2.9%
Program cuts	1.9	38.0%	0.5	37.3%
Subsidies	0.7	14.0%	0.2	12.6%
Capex	0.7	14.0%	0.2	14.1%
Transfers to provs / SOEs	0.5	10.0%	0.1	10.7%
Normalization of drought	0.8	16.0%	0.2	14.4%
Additional measures	0.3	6.0%	-	-

Source: TPCG Research based on the Treasury and the IMF

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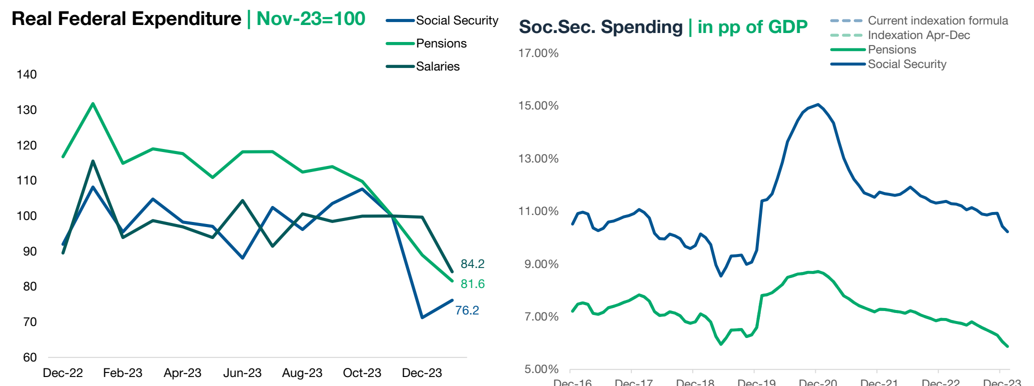
Market participants and local analysts see a vulnerability in the reliance on diluting social security benefits and personnel spending via inflation. In our view, on the other hand, the risk of reflation in 2024 is low as inflation is likely to remain elevated throughout the year. In January, social security and personnel spending was about 22% lower in real terms than in November. We estimate they dropped an additional 15% in real terms in February, accumulating close to 40% deterioration in Dec-Feb. In that context, it was unsurprising that pension reform was among the most contentious issues in the Congressional debate over the Omnibus Bill. The pension indexation formula introduced by the Fernandez Administration is problematic whenever the inflationary pace changes rapidly. Dependent on the social security system revenue and formal workers' wages, the formula lags inflation considerably. In this context, whenever inflation accelerates, social security benefits dilute rapidly against inflation, but whenever inflation decelerates, benefits re-inflate almost as fast. With inflation accelerating from 1.5%mom in late 2019 to 25.5%mom in January, pension benefits have currently dropped from 8.7pp of GDP in 2020 to 5.75%. The current formula is likely to continue to help with the consolidation. For the quarter Dec-23 through Feb-24, in which inflation accumulated over 75%, the procedure yielded a pension hike of just 28%. In other words, March pensions would be almost 30% lower than in December, ending 1Q24 with a 40%yoy drop. Still, reflation doesn't look like an imminent risk. Just to keep benefits and payrolls at January levels, the Government should hike them by about 14%mom in February and March, and on average by 9%mom in 2Q24. To bring them back to November levels, you should add a 30% discretionary jump on top of that. Ultimately, reflation is a risk at 2-3%mom monthly inflation rates. At rates closer to 10%, the grind of inflation on spending is still too elevated to threaten gains achieved in 1Q24.

Figure 11: The risk of reflating social security benefits or personnel spending looks low for the rest of 2024



Source: TPCG Research based on the Treasury

The subsidy cuts, on the other hand, are still mostly ahead of us. The subsidy savings in January resulted mostly from accumulating arrears with GenCos and NatGas producers. Tariff hikes started in February.

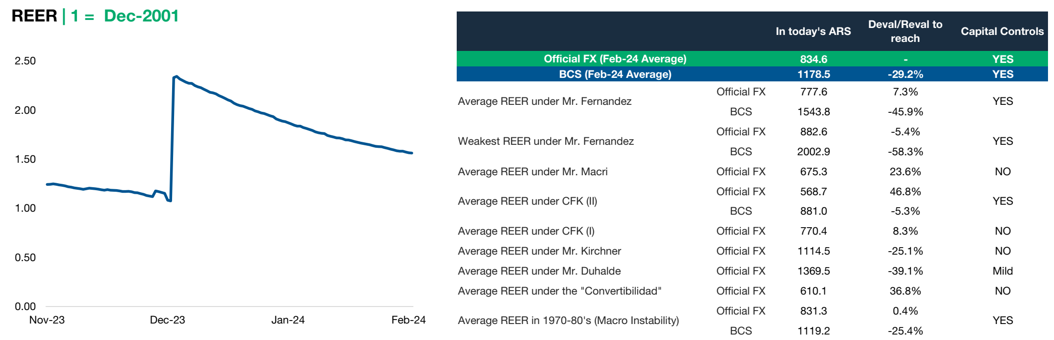
The subsidy cuts, on the other hand, are still mostly ahead of us. The subsidy savings in January resulted mostly from accumulating arrears with GenCos and NatGas producers. Tariff hikes started in February. The January subsidy bill totaled ARS254bn, less than a third of the previous quarter's monthly average adjusted by the December devaluation. Given the lack of tariff adjustments, we estimate that subsidies for January should have risen to about ARS850bn, suggesting a substantial uptick in energy arrears. Our conversations with the industry confirm this suspicion. Cammesa's revolving payments have extended as the centralized market accumulated arrears with generators. Similarly, many O&G players report that Plan Gas payments are also behind schedule. Interestingly, the Government hasn't even accounted for the invoices. Accrued-basis data reports zero budgetary credit used in January for energy subsidies, suggesting that the Government hasn't acknowledged the spending (which also makes calculating the actual subsidy bill and the size of the accumulated arrears more challenging). Still, this is not the first time we have seen similar behavior. Mr. Massa did the same thing in January 2023. February figures should be similar to January's, but we expect the situation to begin normalizing in March as the system stats receive the February tariff hikes. In other words, why do the January subsidy cuts look flimsy? These savings should become permanent in the coming months as the Government moves ahead with its scheduled tariff hikes. The risk is not so much about reflation, like in social security, but rather about the Judiciary blocking the hikes. Under a 2016 Supreme Court ruling, the tariff hikes need to be "reasonable." The problem is that the Court never bothered to define what "reasonable" means, so you can expect consumer organizations, provinces, and political parties to file court complaints arguing that the proposed hikes are unreasonable. Some of these claims may get injunctions, like Chubut's suit over the Transportation Compensation Fund monies. In that context, we could see a conflict between the Government and the energy industry over who covers the cost that consumers don't pay for in a context where the Milei Administration has signaled that it intends to phase out subsidies quickly, even at the expense of straining contracts with GenCos and O&G producers.

The FX market: a deeper recession makes unifying the FX rates easier without aborting the disinflationary process.

With the fiscal challenge mostly locked in, the next challenge will be floating the currency. Gauging the success of the December devaluation is complicated. The BCRA is back to buying dollars in the FX market, and the BCS premium is down to four-year lows, but the framework isn't sustainable without a new correction.

With the fiscal challenge mostly locked in, the next challenge will be floating the currency. Gauging the success of the December devaluation is complicated. The BCRA is back to buying dollars in the FX market, and the BCS premium is down to four-year lows, but the framework isn't sustainable without a new correction. The FX market had been the death knell of both the Macri and the Fernandez administrations. Mr. Macri rushed to release capital controls, underestimating the strain a freely floating currency would impose on a destabilized economy with large twin deficits. On the opposite side of the ideological spectrum, Mr. Fernandez opted to make a highly restricted FX market, where dealing with hard currency was punished more harshly than drug trafficking, the foundational stone of his Administration. Both bets failed, dragging both governments with them. Mr. Milei opted for a different approach. He devalued the currency almost as soon as he was inaugurated, but it was less than what would have been required to attain a current account surplus. As a result, the currency wasn't allowed to float after the devaluation, as the Government kept most of the FX controls in place, including current account restrictions on import payments. Still, Minister Caputo designed the new framework to look successful, at least initially. With import payments restricted by regulations, the BCRA managed to purchase most of the sales of winter crops, adding about USD7.5bn to its gross international reserves. Also, the Government opted to maintain Mr. Massa's blended FX, which allows exporters to sell part of their USD proceeds through the BCS. With the BCRA dumping about 20% of exports into the financial account, the BCS premium tightened to four-year lows. Still, the regime isn't yet ready to float the currency, as the REER remains consistent with a current account deficit.

Figure 12: The REER doesn't look expensive in historical terms, but…



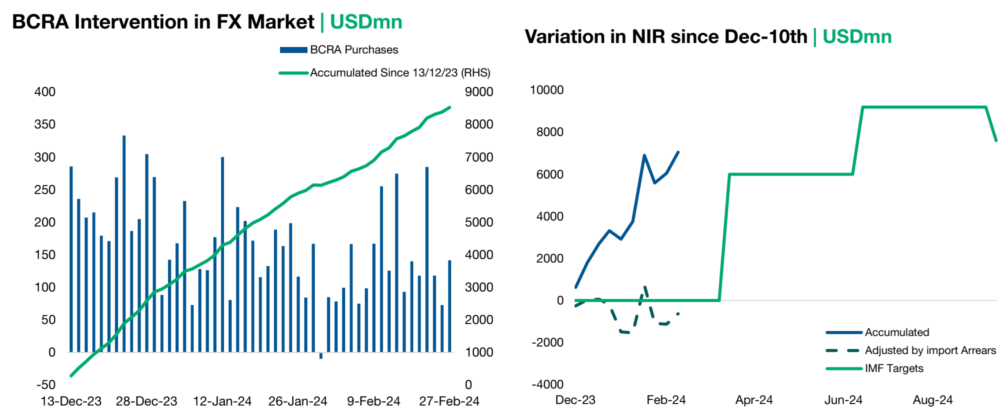
		In today's ARS	Deval/Reval to reach	Capital Controls
Official FX (Feb-24 Average)		834.6	-	YES
BCS (Feb-24 Average)		1178.5	-29.2%	YES
Average REER under Mr. Fernandez	Official FX	777.6	7.3%	YES
	BCS	1543.8	-45.9%	
Weakest REER under Mr. Fernandez	Official FX	882.6	-5.4%	YES
	BCS	2002.9	-58.3%	
Average REER under Mr. Macri	Official FX	675.3	23.6%	NO
Average REER under CFK (II)	Official FX	568.7	46.8%	YES
	BCS	881.0	-5.3%	
Average REER under CFK (I)	Official FX	770.4	8.3%	NO
Average REER under Mr. Kirchner	Official FX	1114.5	-25.1%	NO
Average REER under Mr. Duhalde	Official FX	1369.5	-39.1%	Mild
Average REER under the "Convertibilidad"	Official FX	610.1	36.8%	NO
Average REER in 1970-80's (Macro Instability)	Official FX	831.3	0.4%	YES
	BCS	1119.2	-25.4%	

Source: TPCG Research based on the BCRA

The current REER doesn't seem so expensive in real terms, and the BCS looks outright cheap when compared with past regimes. Still, most of the supply excess in the FX market results from accumulating import arrears.

The current REER doesn't seem so expensive in real terms, and the BCS looks outright cheap when compared with past regimes. Still, most of the supply excess in the FX market results from accumulating import arrears. The Government insists that the REER looks about right in historical comparison. During periods of dangerous currency overvaluation without capital controls, like under Mr. Macri or the Convertibilidad, the FX was between 24% and 36% stronger than the current REER. The currency is also marginally weaker than during CFK's first term when the country ran a healthy current account surplus and had no capital controls. Moreover, for a regime with substantial FX control, the gap between the free FX and the official fixing looks tight. Under Mr. Fernandez, the official fixing ran stronger and the BCS weaker. The same thing happened during the 1970s and the 1980s, which in many ways best resemble the sorry state that the Argy economy was by the end of Mr. Massa's tenure at the Economy Ministry. The Government also argues that a weak FX like the BCS under Mr. Fernandez wouldn't be necessary under a fiscally disciplined regime with a stabilized economy. While we agree with that view, the problem is that the REER implicit in the official fixing doesn't seem enough to hit the IMF net international reserves targets. Since December 13th, the BCRA bought USD8.5bn in the FX market, adding USD7bn to the NIR position, according to the IMF criteria. However, the number including import arrears is closer to a -USD5.7bn deterioration. In other words, the Government seems on track to hit the 1Q24 NIR target. Except that most of the improvement is based on accumulating import arrears. Under the framework introduced on December 13th, the BCRA will only allow importers to purchase reserves to pay for their shipments in installments 30, 60, 90, and 120 days after nationalization (with a 14-day grace period). Between December and January, the BCRA paid a mere USD1.8bn in import payments despite shipments accumulating USD8.9bn. In short, every single one of the USD6.1bn that the BCRA purchased between December 13th and January 31st resulted from accumulating import arrears (USD7.1bn in the two months).

Figure 13: … it doesn't seem enough to hit the IMF net reserves targets



Source: TPCG Research based on the BCRA

Ultimately, the problem is that the current REER failed to drive a current account surplus despite the winter crops. The 2Q seasonality should help normalize

Ultimately, the problem is that the current REER failed to drive a current account surplus despite the winter crops. The 2Q seasonality should help normalize import payments and accumulate reserves along the sales of the summer crops. Still, a weaker REER will be needed to maintain a current account surplus in 2H24. In 2023, the BCRA drained USD21bn in gross reserves. With the drought, exports dropped more than USD30bn to USD61bn. Mr. Massa tried to keep the trade surplus from collapsing by accumulating import arrears and blocking

import payments and accumulate reserves along the sales of the summer crops. Still, a weaker REER will be needed to maintain a current account surplus in 2H24.

shipments. He managed to offset about two-thirds of the drought shock in this way. Still, he couldn't prevent the trade surplus from dropping almost USD10bn relative to 2022, which, combined with growing services and income deficits, slid the current account into a deficit. The Massa FX framework was obviously untenable in a context where adding to the current account deficit, the FX market posted a USD18bn financial account deficit, resulting from USD4.4bn net payments from the private sector, USD4.8bn in net payments from the Treasury and USD8bn in BCS selling. The new FX framework established on December 13th didn't make a material difference in the BoP dynamics. The current account posted a surplus in December and January, but only because the BCRA accumulated about USD7.1bn in import arrears. Without those, the trade surplus would have been almost nonexistent, and the current account would have posted a USD2.1bn deficit despite the selling of the winter crops. The financial account didn't fare much better, posting a USD1.2bn surplus on the back of a USD1.8bn net disbursement from the IMF. In other words, without accumulating import arrears or IMF financing, gross reserves would have dropped by -USD2.7bn rather than improving USD6.1bn.

Figure 14: The December deval hasn't changed BoP dynamics materially. There's still work to be done to float the currency.

	2023		Dec-23 - Jan24	
	CY	Jan-Nov	Official	Adjusted for import arrears
Current Account	**-3,581**	**-6,544**	**4,926**	**-2,138**
Trade Balance	12,486	9,104	7,260	196
Exports	61,663	57,559	9,052	9,052
Agri-flows	21,265	19,742	3,022	41,527
Energy exports (Indec)	7,911	7,192	1,396	1,396
Rest	32,488	30,625	4,634	-33,871
Imports	-49,178	-48,455	-1,792	-8,856
Energy imports (Indec)	-7,924	-7,610	-602	-602
Rest	-41,254	-40,845	-1,190	-8,254
Services Balance	-6,195	-6,176	64	64
Income Balance and rest	-9,872	-9,472	-2,399	-2,399
Capital & Financial account	**-18,105**	**-16,580**	**1,226**	**1,226**
Retail dollarization	-725	-1,055	310	310
Non-residents net lending	-4,454	-4,070	-190	-190
FDI	913	823	135	135
Portfolio	6	6	4	4
Financial loans	-5,373	-4,899	-329	-329
Treasury Net indebtness	-4,809	-4,122	1,547	1,547
IFIs	1,134	917	-233	-233
Public sector dollarization	189	174	21	21
Net payments	-1,054	-1,053	-32	-32
IMF	-5,078	-4,159	1,791	1,791
Rest (incl. BCS sales)	-8,117	-7,334	-440	-440
Valuation effects	**162**	**40**	**-23**	**-23**
Change in reserves	**-21,524**	**-23,084**	**6,128**	**6,128**

Source: TPCG Research based on the BCRA

The critical challenge on the FX front is unifying the FX rates to drive a current account surplus without creating a spike in inflation.

The critical challenge on the FX front is unifying the FX rates to drive a current account surplus without creating a spike in inflation. We estimate that the recession has become deep enough that the Government has a decent shot at succeeding. Any inflation resulting from a devaluation in December was easily attributable to Messrs. Massa and Fernandez. As we move deeper into 2024, blaming the previous Administration for another REER correction becomes harder. In this context, the Government needs to square a round peg: it'll need to engage in a 15% REER correction to unify the FX rate at some point in 2Q24 without aborting the disinflationary path. In other words, the Government needs the pass-through to drop considerably in the coming months. Our BVAR inflation model estimates that the pass-through of Mr. Massa's August devaluation was 80%. With such a pass-through, a 15% REER correction would add 12pp to the month's inflation, derailing the disinflation trajectory. Our model puts the pass-through of the December devaluation at about 50%, bringing down the incidence of a 15% REER correction on the CPI to about 7.5pp. Still not good enough to ensure a downward inflation path. We compute the recession's trajectory into our BVAR and find that the pass-through could be as low as 20% by May, which would cap the impact of a 15% REER correction to a manageable 3pp.

In terms of sequencing, we expect the FX reunification to happen in May, helped by the sale of the summer crops and the blended FX, which will bring the BCS closer to the official fixing.

In terms of sequencing, we expect the FX reunification to happen in May, helped by the sale of the summer crops and the blended FX, which will bring the BCS closer to the official fixing. With the Government maintaining the conviction that the current official fixing REER is okay, reunification can only happen if the BCS premium compresses a little more. We believe that the Government could try to incentivize farmers to sell the summer crops by introducing changes to the blend, increasing the share of BCS allowed. By raising the amount of export proceeds diverted to the BCS and the financial account, a higher mix during the sale of the summer crops would probably drive an additional compression of the "brecha," putting reunification within reach. We estimate that the timing would also coincide with the deepest of the recession, bringing down the

pass-through considerably. In other words, a partial release of FX control to unify FX rates could be feasible. After that, we expect the currency to float, though probably with some drift due to inflation.

The Political Conflict: There's method to the madness

The third challenge is getting politics aligned with the Government's stabilization plan. Due to diverging incentives, a conflict was unavoidable. Mr. Milei's success depends on Governors consolidating in lockstep with the Federal Government; for Governors, success depends on increasing fiscal impulse. A consensus between these two positions looks unattainable.

The third challenge is getting politics aligned with the Government's stabilization plan. Due to diverging incentives, a conflict was unavoidable. Mr. Milei's success depends on Governors consolidating in lockstep with the Federal Government; for Governors, success depends on increasing fiscal impulse. A consensus between these two positions looks unattainable. Mr. Milei's political success depends exclusively on coming through on his promise of lowering inflation. A recent poll by Isonomía Consultores shows that most voters are confident that Mr. Milei will successfully stabilize the economy. We believe that Mr. Milei's approval ratings are likely to remain strong as long as he can continue showing progress toward that objective. Under the Government's program, stabilizing the economy requires a massive reduction in fiscal impulse that sends aggregate spending into a deep recession. To do so, he needs all levels of Government to consolidate. If the Federal Government reduced its fiscal impulse, but Provincial Governments added stimulus, aggregate spending would be more resilient, making inflation more persistent. In other words, Mr. Milei's political fortunes depend on every level of Government, including provinces and munis, to go into consolidation mode. For Governors, the incentives are the exact opposite. Twelve provinces changed political color last year, with a tsunami of voter discontent electing JxC Governors in deeply Peronist strongholds. These Governors are facing a deeply entrenched political machinery that's trying to get them replaced as soon as possible with a Peronist governor. For these Governors to survive politically, they need to coopt this machinery and put them to work in their favor rather than replace them. That takes money. So, for most of the Governors, success requires increasing fiscal spending. A compromise between these two divergent positions is unattainable. A conflict where one of the sides would win, and the other would lose was unavoidable.

Figure 15: Most voters are confident that Mr. Milei will be able to curve inflation and seem willing to suffer austerity measures to accomplish it.

Milei will tame inflation	Mean	Desilusioned Voter (15%)	Happy non-voter (24%)	Willingness to withstand austerity measures	Mean	Desilusioned Voter (15%)	Happy non-voter (24%)
Yes, he will	45%	77%	72%	Would be willing to withstand austerity measures, if that reduces inflation	59%	90%	87%
No he will not	34%	5%	4%	Would rather have high inflation than withstanding austerity measures	20%	2%	2%

Source: TPCG Research based on Isonomía Consultores

Mr. Milei has another reason to force Governors into consolidating: it minimizes the risk of policy reversibility next year.

Mr. Milei has another reason to force Governors into consolidating: it minimizes the risk of policy reversibility next year. Besides the need for provinces to cut fiscal impulse to have inflation converge, a second political incentive pushes the Milei Administration into a conflict with governors. As we argued before, there isn't a consensus in the political establishment backing the short-term stabilization program. Some governors, including BUENOS's Kicillof, PRIO's Quinela, and PDCAR's Llaryora, are already positioning themselves as proponents of an alternative, which seeks to stabilize Argentina by "focusing on the people, workers, and industries." Translation: a magical solution where the ship can be righted without pain. These governors are sowing the terrain to offer voters a policy reversibility alternative in the 2025 mid-terms, a proposal that could prove attractive to hurting voters from a volatile and angry electorate. By forcing every Governor into consolidating, Mr. Milei is forcing them all with him on the Raft of the Medusa, limiting their chances of presenting themselves as credible alternatives.

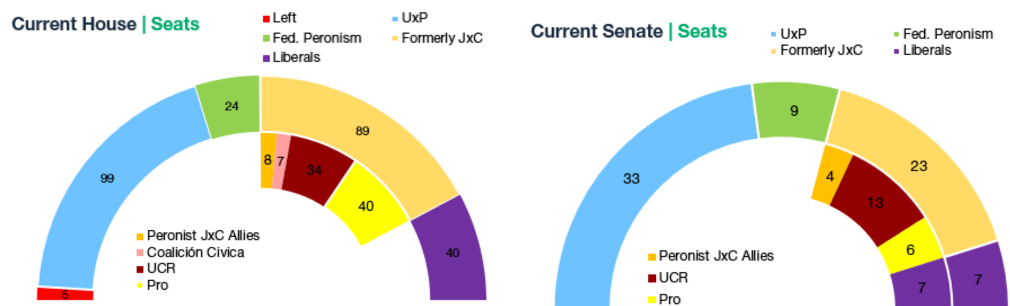
For most of the investor base, opting for conflict with Governors and Congress was a risky move. The Omnibus bill showed that the critical swing votes

For most of the investor base, opting for conflict with Governors and Congress was a risky move. The Omnibus bill showed that the critical swing votes of UCR, CC, and HCF in the House could side with Peronism and Kirchnerism to create a majority against the Government. An investment thesis that the consensus built after November was that a critical mass of lawmakers would opt to support the Libertarians rather than appear to be voting with Kirchnerism. That allowed creditors to expect that a politically weak Government, controlling no

of UCR, CC, and HCF in the House could side with Peronism and Kirchnerism to create a majority against the Government.

provinces and less than a quarter of each House of Congress, could manage to enact at least a part of its reforms agenda. The Omnibus Bill vote disproved that thesis. At the end of the day, the 38-seat Pro caucus supported the Government with no reservations. Still, the rest of JxC splintered, with as many as 39 former JxC representatives (from the UCR, the CC, and the Federal Peronism) siding with Kirchnerism to strike down critical provisions in the bill. The problem is the fracturing of the former JxC. If the coalition had remained together and negotiated a deal with the Libertarians, they would have easily controlled the House, commanding 135 Representatives, a six-seat majority. In reality, the ideological bridge between Mr. Milei and the UCR caucus proved too large, and a large chunk of the Hacemos Consenso Federal Caucus (nee Federal Peronism) seems remotely controlled by the Governors and their financing needs. The Omnibus Bill vote confirmed a view we had after the October general election; the median voter in the House is a left-leaning UCR representative, potentially responding to Mr. Lousteau's, a former Cristina Kirchner finance minister, faction. Things are even more complicated in the Senate because Mr. Milei's natural ally, Pro, has a smaller footprint, and Kirchenrism is stronger. In the Upper House, the median voter is a Senator responding to a Governor from a small province used to trade its Senate votes for federal monies.

Figure 16: The median voter in both the House and the Senate looks very distant from the Libertarian Administration, ideologically and politically.



Source: TPCG Research based on Congress

In our view, Mr. Milei has deftly maneuvered himself to a position of strength in the conflict with Governors and Congress, exploiting deep-rooted design flaws in the Argy fiscal regime to weaken provinces' position.

In our view, Mr. Milei has deftly maneuvered himself to a position of strength in the conflict with Governors and Congress, exploiting deep-rooted design flaws in the Argy fiscal regime to weaken provinces' position. Following the failure of the Omnibus bill, the Administration opted to escalate tensions and go to war against Governors and Congress. Mr. Milei managed to minimize his Government's political weakness and gain the upper hand by exploiting two deep-rooted design flaws in the Argy fiscal regime. The first design flaw is that the main fiscal channel linking the Federal Government with provinces has been broken since the Constitutional Reform thirty years ago. The Coparticipacion, a revenue-sharing mechanism introduced in 1988 that has a percentage of taxes raised at a Federal level transferred to provinces automatically, was originally designed to be the only fiscal channel governing the relationship between the Federal Government and provinces. This mechanism is extremely rigid, as every province has a veto over proposed amendments. This rigidity has become a massive headache since 1994, as the Constitutional reform created two new provinces and devolved education, healthcare, and parts of security to regional governments. Still, the Copa bill could never be changed to accommodate for the changes. In other words, after 1994, the Federal Government transferred teachers, doctors, and part of the security forces over to provinces but kept the revenue to cover their payrolls (for an extremely detailed historical account, please see here). This problem created a structural surplus in the Federal Government and a structural deficit in provinces. A quick look at the balance sheets of the Federal Government and the provinces shows the magnitude of the imbalance. With a 10.2pp of GDP tax intake, the Federal Government's personnel spending is a lowly 2.5pp of GDP. By contrast, provinces receive 7.9pp of GDP in Coparticipacion but spend 7.5pp of GDP in wages. Most of the Federal structural surplus is used to finance the Social Security deficit and subsidies. Over the past thirty years, politics has tried to patch this design flaw by creating alternative channels to Copa by which the Federal Government could siphon money to provinces. The first of these mechanisms was discretionary transfers, introduced in the 90s. Those currently amount to 0.7pp of GDP, but their use has waned over the past two decades because they became overly politicized. Governors cannot rely on a fully discretionary mechanism to hit their payrolls. If the Federal Government withheld the monies for a few days, it would create a huge conflict for governors. To alleviate this problem, in the early 2000s, the Federal Government began

establishing fiduciary funds, which would quasi-automatically transfer the costs of the devolved programs to provinces. Politics buried these funds deep into the basement for twenty years and let them operate autonomously, keeping the lights and the heating on, covering the deficiencies of the old Coparticipacion. The second design flaw Mr. Milei exploited is that the Province of BA is severely discriminated against in the provincial Copa pot. This prevents the 24 governors from effectively banding together against the Federal Government, as any gains would more likely than not benefit PBA exclusively. Governors are better off cutting radial one-on-one deals with the Federal Government at the expense of PBA.

Figure 17: After 1994, the Federal Government kept most of the Copa revenue, but provinces were saddled with most of the employees.

Federal Government	
12m accumulated figures as % of GDP	jan-24
Revenues	**17.1%**
Tax revenues	10.2%
Social security contributions	5.0%
Income from Treasury property	1.0%
Non-tax revenues	0.9%
Primary spending	**18.5%**
Personnel spending	2.5%
Social Security	10.2%
Subsidies	1.9%
Energy	1.4%
Transportation	0.5%
Other	0.0%
Transfers to Provinces	0.7%
Capex	1.4%
Other	1.8%
Primary balance	**-1.4%**
Interest payments	2.1%
Overall balance excl SDRs	**-3.4%**

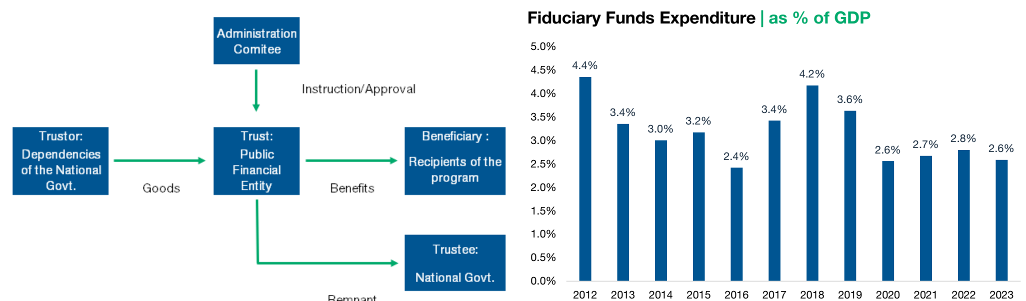
Consolidated Provincial Space	
12m accumulated figures as % of GDP	3Q23
Revenues	**17.4%**
Provincial taxes	5.2%
Federal taxes	7.9%
Discretional Federal Gov transfers	0.8%
Other	3.6%
Primary spending	**17.3%**
Personnel spending	7.5%
Social Security	2.1%
Goods and services	1.5%
Transfers to public sector	2.3%
Other transfers & expenditures	1.5%
Capex	2.3%
Real Investment	1.6%
Financial invest.	0.4%
Capital transfers	0.4%
Primary balance	**0.2%**
Interest payments	0.4%
Overall balance	**-0.2%**

Source: TPCG Research based on the Treasury and E&R

The Government decided to weaponize these fiduciary funds, making the current arrangement unreliable for governors. All in all, Mr. Milei compromised the financing for about 15% of the provinces' budgets.

The Government decided to weaponize these fiduciary funds, making the current arrangement unreliable for governors. All in all, Mr. Milei compromised the financing for about 15% of the provinces' budgets. Mr. Milei responded to the rejection of the Omnibus bill by eliminating a few of these fiduciary funds, the largest of which were the FNID, a fund covering 15% of the schooling system's payrolls, the Fondo Compensador, which provided monies to subsidize transportation in the interior and the FISU, a fund financing the urbanization of shanty towns. These three funds were elected to spread the pain among the governors of the uncooperating provinces. Currently, twenty-eight discretionary funds are covering 2.6pp of GDP in spending. The structure of these funds is designed to be quasi-autonomous. The Federal Government controls them through the Administration Committee but mostly allows them to operate independently, with no Congressional or political interference on a day-to-day basis. This structure ensures that provinces can rely on these funds to deliver monthly monies. By stopping these transfers, which cover about 15% of the provinces' budgets, Mr. Milei forced provinces into a cash crunch, forcing them to either burn through their cash reserves or consolidate. Either way, Mr. Milei accomplished his objective of having provinces cut fiscal impulse.

Figure 18: After 1994, the Federal Government kept most of the Copa revenue, but provinces were saddled with most of the employees.



Source: TPCG Research based on the OPC

In the SOTU, Mr. Milei advanced his terms to end the conflict and normalize the relationship with the provinces. Governors need to provide the votes in Congress to pass the Government's reform agenda. After that, Mr. Milei offered them a new rules-based Copa framework that would make Provinces financially independent from the Federal Government.

In the SOTU, Mr. Milei advanced his terms to end the conflict and normalize the relationship with the provinces. Governors need to provide the votes in Congress to pass the Government's reform agenda. After that, Mr. Milei offered them a new rules-based Copa framework that would make Provinces financially independent from the Federal Government. With the framework upon which they relied over the past thirty years in tatters and the prospect of cash constraints in the short run due to the cuts in Federal transfers and the collapse in the tax intake because of the recession, governors were caught flat-footed by Mr. Milei's challenge. Over the past two weeks, we have seen signs of rapprochement, as governors have tried to engage in negotiations with the Federal Government, and political ministers like Mr. Franco have opened themselves up to dialogue. In his SOTU, Mr. Milei took one step ahead, charting the path out of the conflict, which he coined as the May Accord. The Government expects governors to provide the votes to pass landmark pieces of legislation like the mega-decree and the Omnibus bill over the next two months. The legislation pack includes tax, labor, and social security reforms. If Congress passes this legislation by May, Mr. Milei will offer governors a chance to discuss a new Coparticipacion bill. For governors, it would mean a new rules-based financial relationship with the Federal Government that would make them financially independent. All in all, Mr. Milei detonated the new framework, making it unreliable for governors, only to offer a new one they could rely on to replace it.

We don't expect the May Accords to be completely successful. However, we believe they will drive a cluster of cooperative governors who will chip in enough Congressional votes to pass most of the legislation.

We don't expect the May Accords to be completely successful. However, we believe they will drive a cluster of cooperative governors who will chip in enough Congressional votes to pass most of the legislation. In our view, the maximalist objective of getting the Omnibus bill and the Decree in exchange for a new Copa bill looks beyond reach. For starters, there are red lines in parts of the Omnibus bill, like hikes to export taxes. On the other hand, the Government is unlikely to reach the level of consensus required to pass a new Coparticipacion. The Copa is a compact bill, meaning that it not only requires a special majority in Congress to pass but also that every province has a veto over it. Making an offer that works for the Federal Government, the Province of Buenos Aires, and the other 23 provinces seems an impossible task. The Province of Buenos Aires will assert its right to increase its Copa share closer to 40%, arguing that the 1988 Copa bill discriminated against it, and the Federal Government won't be willing to relinquish enough revenues for PBA to get what it wants and still leave money for the remaining 23 districts. Still, that doesn't mean the May Accords are doomed to failure. In our view, the Government's realistic objective is to align a cluster of 15 to 17 cooperative governors and build a majority in Congress to pass (i) the reform of the Social Security indexation formula, (ii) labor reform, (iii) the tariff package and the delegation of Congressional faculties, in exchange for a fiscal relief packages for provinces that include the reinstitution of income tax and a new set of fiduciary funds, untainted by the Government's discretionary management to handle most of the devolved services. We wouldn't be surprised if the new set of fiduciary funds discriminated in favor of the cooperative provinces and against the uncooperative ones.

Voter tolerance remains the ultimate challenge. So far, the Government's handling of the narrative

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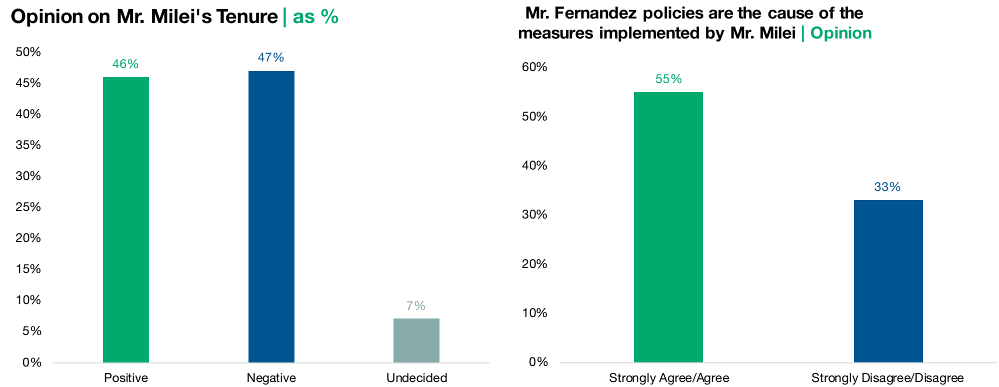
While Mr. Milei has deftly maneuvered his Government into a strong position vis-à-vis the Governors and Congress, his ultimate challenge is the one where the Government has the least control: voter tolerance. The Administration is betting that voters will tolerate the pain of the austerity program as long as inflation comes down. A recent poll by Isonomía Consultores supports that view, especially among Mr. Milei's voters. Over three-quarters of Mr. Milei's voters are confident that he can curb inflation, and around 90% argue that they're willing to endure austerity if it means stabilizing the economy. Fifty-five percent of voters still blame the previous Administration for the mess the economy is in, which matches Mr. Milei's vote in November almost perfectly. At the same time, 46% of voters have a positive opinion of Mr. Milei's tenure so far. These indicators are critical. While the Government is pushing faster than expected towards stabilization and fundamental improvements, and despite outmaneuvering Governors, Mr. Milei needs voters to stick to him during the coming months, when the recession will be the harshest and inflation will remain elevated. The JxC experience of 2016-19 left painfully clear that reforms only persist in time if the Administration that implemented them is successful. A hard-right Libertarian president, elected by a circumstantial majority of angry voters from a traditional left-of-center electorate, should raise serious concerns regarding policy reversibility, regardless of how shrewd Mr. Milei has been over the past few months. At some point, voter tolerance for austerity

might get stretched too thin, breathing new life on an opposition that's been in disarray since November.

Figure 19: Polls suggest that Mr. Milei maintains the majority of his November votes.



Source: TPCG Research based on Isonomía Consultores

Just like Mr. Milei's strategy to deal with Governors was conflict, his approach to building political support closely resembles that of the Kirchners. Mr. Milei splits voters between those who support him and those who voted for Mr. Massa, stoking polarization.

Just like Mr. Milei's strategy to deal with Governors was conflict, his approach to building political support closely resembles that of the Kirchners. Mr. Milei splits voters between those who support him and those who voted for Mr. Massa, stoking polarization. The Macri Administration tried to avoid conflict as much as possible because it always dreamt of eventually wooing a part of the Peronist electorate. Adding ten or fifteen percentage points of moderate Peronist voters to JxC's 40% core vote between 2016-19 would have given the coalition control of both Houses of Congress and a credible power project. Of course, that never happened. Peronist voters were never swayed, and the gradual approach to wooing them doomed the Administration's chances of success. Mr. Milei is making no effort to attract voters from the other side of the ideological divide. Like the Kirchners twenty years ago, he argues that a moral barrier separates his voters from Mr. Massa's. In other words, Mr. Milei is betting on polarizing society to an extreme, galvanizing the support of his voters. With the opposition in severe disarray following the implosion of JxC and the prospect of an ugly divorce between Peronism and Kirchnerism, we estimate that Mr. Milei only needs to retain two-thirds of his November vote to win the 2025 mid-terms.

To that end, the Government was quick to use the collapse of the Omnibus bill to its advantage, quickly changing the narrative to chastise the political establishment for prioritizing their special interests over the people.

To that end, the Government was quick to use the collapse of the Omnibus bill to its advantage, quickly changing the narrative to chastise the political establishment for prioritizing their special interests over the people. The night Congress rejected the Omnibus bill, we argued that Governors had miscalculated. The bill was mostly about structural reforms and potential GDP gains, none of which was of much use to the Government in this phase of the plan, which is about stabilizing the economy. The Omnibus bill was about 2024, not 2025. Yet, by making a pyrrhic stand on that hill, Governors gave Mr. Milei something far more valuable than a bill about potential GDP; they gave him an enemy on which to pin the blame for the pain of the austerity program. Had Congress passed the Omnibus bill, today's narrative would be about the misery in which the Government's stabilization program has sunk the Average Joe and whether there wasn't a less painful approach to stabilization. By defeating the bill, Congress allowed Mr. Milei to weave a different narrative about how the Government had a plan to make the walk through the desert painful for the people, but a corrupt claque of politicians bent on defending their special interests botched it. In other words, the Government is shifting the blame for the austerity program to Governors and the political establishment and away from itself.

Polls suggest that most of Mr. Milei's and JxC's voters are receptive to this narrative, increasing social tolerance.

Polls suggest that most of Mr. Milei's and JxC's voters are receptive to this narrative, increasing social tolerance. For the time being, the strategy of polarizing society and blaming the political elites for the pain of stabilization seems to be paying off. A full 89% of Mr. Milei's October votes approve the President, suggesting that despite the heterogeneity of his coalition of voters, including large swaths of low-income Peronist voters disproportionately affected by the austerity program, his core support is not diluting. More importantly, 65% of Mrs. Bullrich's votes and 45% of Mr. Schiaretti's voters (most of whom probably voted for Mr. Milei in the run-off) also approve of Mr. Milei. If we add these to the 9% of voters who don't approve nor reject, Mr. Milei's approval ratings are probably not so dissimilar from November's, despite the depth of the recession. Unsurprisingly, due to the strategy of polarizing, 86% of Mr. Massa's and Mrs.

Bergman's voters reject Mr. Milei. We believe that the Government has had superb agenda management, keeping voters fired over the Omnibus bill, his row with popular performance artists with meaty government contracts, the conflict with Governors and Congress, and now the May Accords. Every newsreel seems to bring a new conflict, designed to antagonize Mr. Massa's voters and galvanize Mr. Milei, keeping voters' attention off the recession and the short-term stabilization program. In the meantime, the economy is less than a quarter away from bottoming out, and inflation seems to be on a downward trajectory. If Mr. Milei can keep voters to tolerate a couple more months and retain these approval ratings, then the odds of policy continuity increase significantly.

Figure 20: Most of Mr. Milei's and JxC's voters seem receptive to the Government's narrative that the political establishment is to blame for the costs of stabilization.

		Vote in 2023 General Election				
	Mean	Massa (32%)	Milei (26%)	Bullrich (21%)	Schiaretti (6%)	Bregman (2%)
Positive	47%	4%	89%	65%	45%	12%
Negative	41%	86%	3%	23%	47%	86%
Undecided	9%	8%	7%	10%	5%	0%
Does not know Milei	2%	2%	1%	2%	4%	2%

Source: TPCG Research based on Isonomía Consultores

TPCG Analysts & Staff

Research

Juan Manuel Pazos	**Chief Economist**	**jmpazos@tpcgco.com**	**+54 11 4898-6606**
Paula La Greca	Corporate Research Analyst	plagreca@tpcgco.com	+54 11 4898-6638
Santiago Resico	Economist	sresico@tpcgco.com	+54 11 4898-6615
Camila Sanchez Lauria	Research Analyst	csanchezlauria@tpcgco.com	+54 11 6616-9512

Sales & Trading

Juan Manuel Truppia	**Head of Sales & Trading**	**jmtruppia@tpcgco.com**	**+54 11 4898-6659**
Institutional Sales			
Lucia Rodriguez Pardina	S&T Director	lrodriguezpardina@tpcgco.com	+54 11 4898-6614
Agustina Guadalupe	Sales	aguadalupe@tpcgco.com	+54 11 4898-6682
Maria Pilar Hurtado	Sales	mhurtado@tpcgco.com	+54 11 4898-6616
Juan Ignacio Vergara	Sales	jivergara@tpcgco.com	+54 11 4898-1936
Santiago Baibiene	Sales	sbaibiene@tpcgco.com	+54 11 4898-6648
Pedro Nollmann	Sales	pnollmann@tpcgco.com	+54 11 4898-6617
María Ruiz de Castroviejo Salas	Sales	mruizdecastroviejo@tpcgco.com	+54 11 4898-6643
Santiago Jauregui	Sales	sjauregui@tpcgco.com	+598 9933-9495
Victoria Faynbloch	Desk Analyst	vfaynbloch@tpcgco.com	+54 11 4898-6635
Trading			
Felipe Freire	Trader	ffreire@tpcgco.com	+54 11 4898-1921
Homero Fernandez Bianco	Trader	hfbianco@tpcgco.com	+54 11 4898-6667
Andres Robertson	Trader	arobertson@tpcgco.com	+54 11 4898-6693

Corporate Finance

José Ramos	**Head of Corporate Finance**	**jramos@tpcgco.com**	**+54 11 4898-6645**
Corporate Sales			
Camila Martinez	Corporate Sales Director	cmartinez@tpcgco.com	+54 11 4898-6621
Fernando Depierre	Corporate Sales	fdepierre@tpcgco.com	+54 11 4898-6636
Sol Silvestrini	Corporate Sales	ssilvestrini@tpcgco.com	+54 11 4898-6641
Nicolas Iglesias	Corporate Sales	niglesias@tpcgco.com	+54 11 4898-6612
Capital markets			
Nicolás Alperín	DCM	nalperin@tpcgco.com	+54 11 4898-6604
Wealth Management			
Josefina Guerrero	Private Wealth Management Specialist	jguerrero@tpcgco.com	+54 9 11 6556 2401

Asset Management

Ileana Aiello	**Portfolio Manager**	**iaiello@tpcgco.com**	**+54 11 4898-6611**
Claudio Achaerandio	**Portfolio Manager**	**cachaerandio@tpcgco.com**	**+54 11 4898-6618**

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