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Investing in Argentina

Greg's Note: Fred Sheehan returns today with a historic analysis of the string of financial calamities that struck Argentina over the past 150 years. Might these calamities parallel the present state of the U.S. markets? And, if paper assets eventually wither to worthlessness, what might be a better type of asset to own? Please read on and find out – and send your opinions to your managing editor here: greg@whiskeyandgunpowder.com

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By Frederick J. Sheehan

From Paper Assets to Real Assets: An Assessment From the Pampas

"Prices on the New York Stock Exchange are affected by French politics, German banking conditions, wars and rumors of war in the Near East, the Chinese money market, the condition of the wheat crop in the Argentine, the temper of the Mexican Congress, as well as by a host of domestic influences."

-- Philip Carret, [*The Art of Speculation*](#), 1931

In a list of things to be avoided, 14 hours in an airplane will always deserve a top ranking. On the other hand, the vanishing net worth of U.S. dollars is fair competition. Sifting through this calculation, The Argentina Reader made a worthy companion on the flight to Buenos Aires. The endless wave of paper dollars and credit that have enveloped markets around the world called for a search that might encompass the antithesis: a country that produces real goods. To simplify: wheat, soybeans, and beef.

Argentina is also a country that has suffered many financial calamities over the past century. It remains rich in productive assets. The United States seems intent on fostering its own financial calamity, so conversations with those who have suffered

and bounced back were another motivation for the bum-numbing trip.



Cutting to the conclusion, it is clear dollars have contributed to -- if not produced -- both asset and goods inflation. The dollar flows are swamping asset markets, to which the Argentine government has responded by withholding 30% of foreign investments from the markets. (The conduits of the central bank hold the 30% for a year at 0% interest. The regulation does not apply to real estate or farmland.) This may seem an odd decree from a country that has long been dependent on foreign investment, but Argentina is not unique. Countries around the world wring their hands at the havoc wreaked by leveraged credit filling every last crevice of value.

Armed on the flight south with recent warning shots from the frontiers, a confirmation that all points on the compass suffer likewise was fired by Bill Belchere of Macquarie Securities. From Hong Kong, Bloomberg quoted Belchere on the peculiar position of Asian governments and their bloated financial structures: "It doesn't take a lot of capital inflows to create very bubbly positions, inflationary positions, financially destabilizing positions... They have to do something to absorb all that liquidity, all those inflows, or they risk a massive inflationary outbreak."

The standard response, raising interest rates, has not produced the textbook solution. Last year, *Bloomberg* reports, Asian central banks raised interest rates 25 times, yet capital inflows were 400% greater than average foreign investment between 1998-2004. The Chinese central bank finds itself in the position of seemingly inciting speculation every time it raises rates. The *Xinhua News Agency* reports that a succession of interest rate increases in China this year has produced the unintended effect of "driving hundreds of thousands of people to open trading accounts... each day." The average number of new accounts opened on China's new exchanges has increased from 3,000 in January 2005 to 90,000 per day in January 2007. It should be obvious by now that Ben Bernanke inhabits a position of shrinking importance; he could raise the Fed funds rate to 10% and Fed policy would still sit in the rumble seat compared with the real drivers of the world's financial economy -- the rate of credit and derivative creation must keep increasing or we run over the cliff.

Bloomberg's investigative reporters also find the South Korean government in a similar fix: "While South Korea's central bank increased rates three times in 2006, Seoul's real estate boom has continued unabated, jeopardizing President Roh Moo-hyun's pledge to make housing more affordable." Eugene Kim of Tribridge Investment Partners in Hong Kong takes a similar view: "Short of establishing currency controls like we've seen in Thailand, I don't think measures to reduce property prices across the region will have much of an impact." Then, Kim states the short-term thinking that destroys fortunes under such circumstances: "The wealth out there needs to go somewhere."

This is the road to wealth destruction. An overabundance of capital collaring the last basis point has produced a sad history, much of it in Argentina. Now that the country sits on the opposite end of an overleveraged world, it might be worth looking at the country's troubled history to anticipate disarray in the Northern Hemisphere today.

Implicit in Philip Carret's description of financial contagion above is the long history of globalization. An instance of the wheat crop on the Argentine getting pummeled by "wealth needing to go somewhere" was the failure of J. Cooke & Co. in 1873. This Wall Street firm, described as "the Goldman Sachs of its day," caused a depression that wound its way to the Argentine. Wheat prices collapsed, Argentina's export revenues fell short of its fixed lending obligations, and the country veered toward default. President Nicolas Avellaneda declared Argentina would "willingly suffer privations and even hunger" to service its debt. He introduced an austerity program.

Such an unpopular mandate looks archaic in our world of populist politics. But a parallel to the situation of Avellaneda and the United States today should not be overlooked. Local banks defaulted as money was withdrawn and deposited in the London and River Plate Bank. The Argentine government attempted to restore the luster of local banks by taxing the London and River Plate and by seizing its gold reserves. The British then threatened a cascade of firepower from the British fleet to repossess the Bank's reserves. The Argentine government remained unmoved. In [*British Imperialism*](#), P.J. Cain and A.G. Hopkins found that the Argentine government finally came to its senses with the "realization that the dispute would severely damage Argentina's standing in the city."

Likewise, the U.S. government today is not susceptible to foreign military threat, but a warning by the Thai government that it is prepared to dump \$100 billion worth of Treasury and Fannie Mae bonds is the Achilles' heel of American power projection. The U.S., like Argentina, is entirely dependent on foreign capital to keep the wheels moving. Should others' willingness to finance the American dream evaporate, the U.S. economy will go begging. Americans do not expect privations and hunger; it would behoove us to thank China and the United Arab Emirates from forestalling such a condition.

A lesson from 1873 for today is the never-ending destructive behavior of investors. Dumb money searches to throw wealth somewhere. Inevitably, not understanding what it has bought, it sells when problems arise. This will be true today when the leveraged trades gone wrong force liquidations of assets. Argentina is, by and large, an unleveraged economy: Opportunity awaits.

The lenders to Argentina were mostly British. When wheat prices fell and debts could not be paid, the sales desks that had touted Argentine investments were the first to run for the hills. One seasoned city (of London) broker, Montague Newton, gave a speech that might soon repeat itself, if we substitute "hedge fund" and

“private equity” for the idiom of 19th-century London:

“Men go to the stock exchange now as a sort of a refuge for the destitute. A man leaving the army [Harvard Business School today] who does not know what to do with himself, or how to make a living, says I will go into the stock exchange...Mercantile profits are so much reduced now in comparison with former years, owing to a variety of circumstances -- possibly the quickness of communications, telegraphs, and so on -- and he does not see his way to making the profit that was formerly made. Then he goes into the stock exchange, and puts his sons into the stock exchange...[Globalization had the same effect on industrial economies as today: Making things was cheaper abroad, the financial economy grew in magnitude.]

“The vast majority of stockbrokers are decidedly an ignorant class who know very little beyond 8ths, 16ths, and 32nds.... Take a case [that] has frequently attracted the attention of the public. Some of you gentlemen may have heard of the Argentine securities. The Argentine securities used at one time to stand in the prices 95-100, and in those days, the great majority of stockbrokers to whom you spoke would tell you that they were the finest securities open for investment; certainly, the very best 6% security that was ever introduced upon the market. And those same brokers, any of them who held arguments with me as to the sterling nature of these securities at those prices of 95-100%, when the prices went down to 30-40, told me they ought to be sold, that they were thoroughly rotten, and they ought never to have been introduced into the London market...

“I have asked several of these gentlemen who took a particular interest in this stock, what they chanced to know about it and its intrinsic worth. ‘Do you happen to know anything about the resources of the Argentine Confederation?’ And their minds were an utter blank on the subject. ‘Do you know what the population is, and what their sources of revenue might be?’ No answer could I get. ‘Could you point out on the map to me within 2,000 or 3,000 miles where the territory lies?’ And their minds were an absolute blank; there was no answer. I state as an absolute positive fact that has occurred within my own experience, and I should think amongst 20 or 30 brokers.”

Needless to say, Montague Newton spoke at the bottom of the market.

Moving forward, the Baring Crisis of 1890 is a case study for today. Barings' lending to Argentina was declared “gaucho banking” by *Bankers' Magazine*. *The Statist* declared, “Messrs. Baring have grown bolder and bolder [since 1884] in their invitations to the public. In that year, they offered little more than 6.5 millions sterling; in 1886, they offered over 18.25 millions sterling; in the present year [1888], up to date, they have offered 28 millions sterling.” The periodical blasted the Baring brothers for not fulfilling their moral duty: “Their prospectuses too frequently are not merely meager, but quite insufficient to enable anyone to judge the character of the security.” Barings had failed “to exercise a restraining influence

upon borrowers, especially upon Argentine borrowers, when it became evident they were piling up debt too fast.”

The brothers had fallen prey to a sin not infrequently committed by the best and the brightest: They came to believe the myths spoken in the city. Just as Barings was going off the cliff, Bankers’ Magazine had pronounced the family as the prime case of a firm that had “never known, during the present century, anything but first-class credit, into which enters the elements of dignity -- moral, personal, and commercial alike.”

In David Kynaston’s account ([*The City of London, Vol. 1: A World of Its Own, 1815-1890*](#)), the brothers took on airs of immortality as their reputation grew. Awestruck were competing banks, and awesome was the growing Barings’ commitment to Argentina, “the country to which from the mid-1880s [the bank] devoted ever more of [the] firm’s resources, into which British capital was pouring into at an astounding rate.” This proverbial Greek tragedy was brought to a finish by the Bank of England, which ordered Barings to moderate its behavior. It was too late. To keep the fraud going, it needed to continually expand its balance sheet at an exponential rate (the newer junk it was selling camouflaging the older securities that were defaulting). Handcuffed, the brothers Baring revealed the Argentine distress had left the bank close to default.

(Incidentally, we can be sure that today’s denouement will not receive a similar catalyst. Every government regulating body in the world stops short of actual investigation. It is often said that if regulators were as smart as those they regulate, they would work for the financial institutions. Maybe so, but at this point in the avalanche, they are smart enough to know they do not want to know too much -- they will prosecute later.)

Cain and Hopkins write: “The Baring crisis struck right at the heart of the British financial system: If the unthinkable happened and Barings were made bankrupt, large segments of the City of London, including the Bank of England, might also be pulled down.” And yes, it has been claimed Barings was “the Goldman Sachs of its day.”

Much as when the Federal Reserve forced the leading money center banks to bail out Long-Term Capital Management in 1998, the Rothschilds whipped a bolo around the neck of joint-stock and private banks from the city. Gaucho banking may have ended, but globalization reigned, and this commitment of British capital caused the banks to deleverage and to halt lending to the United States, Australia, and South Africa.

Barings may have been reckless, but the Argentines were also up to no good. They borrowed too much. In 1890, the cost of servicing foreign debt had risen to 60% of export earnings. Raw material prices were falling in 1890, and obligations could not be met. The Argentine government had set in motion its own form of gaucho

banking by detaching its finances from the gold standard and by allowing the peso to depreciate; it was printing unconvertible paper money. Most of Argentina's debts were payable in gold or gold-backed currencies.

There was no easy way out as there is today. Just as President Avellaneda committed his country to privations two decades earlier, President Carlos Pellegrini declared, "Rather than suspend service on the debt, I would prefer to renounce the presidency." This may sound high-minded or pro-British (he was a Harrow man), but the Argentine economy would collapse if not for foreign creditors. Presidential contenders in the United States may want to reflect and sit out the 2008 election. Whoever wins will confront a world that now decides whether the U.S. Navy receives the funding to sail the oceans blue.

Argentina recovered quickly enough. This is the silver lining of an overpriced Argentina today. After the global carry trade unwinds, countries with real assets -- and not just paper promises that cannot be met -- will offer something worth buying.

In fin de siècle Argentina, railways rolled inland, cattle and wheat export industries boomed, real wages of the Argentinean workman rose from 76% of the British worker's in 1864 to 94% in 1913, and the place to shop in Buenos Aires was Harrods. Stephen Schwartz described this world of yesterday in *The Atlantic Monthly*: "In 1929, Argentina was one of the 10 richest countries in the world...it was populated by a highly educated middle class...[It] was democratically governed. Its capital, Buenos Aires, boasted the largest opera house and probably the finest publishing firms, newspapers, and universities in the Hispanic world. In fact, the only city in the Western Hemisphere that rivaled it for sophistication was New York -- and Buenos Aires, with its broad boulevards and Beaux-Arts architecture, was grander by far."

The 1929 Wall Street stock market crash was just a part of a larger credit speculation, the Federal Reserve playing a prominent role. Financial contortions are generally a sign to head for the hills. One warning was the market for call loans. Borrowing rates for this stock market, leveraged-financing mechanism rose steeply in the latter stages of the frenzy. By October 1929, corporations, individuals, and foreigners issued over 60% of the call-money debt. U.S. Steel, General Motors, Standard Oil of New Jersey, and AT&T committed a good portion of their short-term cash to speculate in brokerage call loans. When commercial enterprises chase profits so far from their field of competence, something is amiss. Similarities to 2007 are obvious.

Philip Carret's *The Art of Speculation* was a contemporary account of the globalization that joined the New York Stock Exchange to the Argentine wheat crop. Economic historian Charles Kindleberger also wrote of this linkage: "[Milton] Friedman and [Anna] Schwartz state, 'It would be difficult indeed to attribute the sequence of bank failures [in the United States] to any major current influence from

abroad.” Kindleberger continues: “I find it easy. Depreciation of the Argentine, Uruguayan, Australian, and New Zealand currencies in early 1930 helped push wheat prices down in the United States. Falling prices of grain were communicated to grains and other feeds, sowing bankruptcies among farmers, as well as failures among banks in farm communities, particularly in 1930.” [Kindleberger’s footnote: In a world of inflation, it would have raised them in depreciating countries, as we discovered in 1971; in a world poised on the brink of deflation, it lowers them in the appreciating country.]

Author’s footnote: A military coup in 1930 put an end to the democratically governed Argentina.

And so Max Winkler, in his 1933 book *Foreign Bonds: An Autopsy*, was as gloomy as one would expect at the very bottom of the credit cycle: “Borrowing and default [in Latin America] follow each other with almost perfect regularity. When payments are resumed, the past is easily forgotten and a new borrowing orgy ensues. This process started at the beginning of the past century and has continued down to this present day. It has taught us nothing.”

On the contrary, Winkler teaches us a quite a bit. The trends of financial books are an excellent contrarian indicator -- who could forget Dow 36,000 in 1999? Winkler’s subtitle indicates where his mind was heading: *A Study of Defaults and Repudiations of Government Obligations*. As it happened, long-term Argentine government bonds, introduced in 1928, sold off from a yield of 6.34-7.15% in 1932. They steadily declined in yield (and thus moved up in price) for the next two decades. When the world was at war, Argentina exported the produce to feed the troops -- a reminder that when the world is in chaos, it still needs to eat and will find some way to pay for it. The long bond traded at 4.13% in 1944 and fell to 3.24% in 1953. By then, the nationalization and government-subsidized industrialization policies of Juan Peron were too much for the economy to bear. Subsequent fiscal and monetary policies led to a 94% depreciation of the currency in the 1950s. By the 1970s, hyperinflation ran at 400% a year.

All this was forgotten by the late 1970s. Walter Wriston, chairman of Citibank, led the charge into the Southern Hemisphere. He declared that sovereign governments never default, then compounded his ignorance by declaring, “For the first time in history, it is within the power of a less-developed country to obtain from external savings the capital needed for growth.”

Here, the chairman of the world’s most prominent bank showed Montague Newton’s dire assessment had now reached the very highest levels of banking. (And Wriston’s father was a historian.) In fact, the ability to borrow from abroad as long as 150 years ago was essential to both the United States and Argentina. From Cain and Hopkins: “The ability to borrow on a massive scale and to make repayment through exports of primary products became the basis of the power and prosperity of the 400 or so wealthy families who formed the Argentine elite, and also their

allies in banking and commerce.” The railroad system that transported the wheat from the Pampas was a product of British capital.

James Grant’s *Money of the Mind* is chock full of warnings that are aped by today’s wealth destroyers: Grant writes: “In 1977, Argentina, a disastrous third-world debtor in the making, was described by Euromoney as a ‘much needed sinkhole for excess credit bank liquidity.’” In 1978, the Saudi International Bank declared, “We’re in the banking business, and if the world is doing 5/8% business [that is, lending at that margin over the cost of funds], we may be forced to participate.” From Dresdner Bank in 1978: “Once a bank is in the international market, it wants to stay there, especially if it has a large volume of funds to lend. So the theory of limits rarely functions.”

Until it does.

The most recent Argentine financial crisis began to unravel in 2001. The Argentine peso had been pegged at a 1-to-1 ratio to the U.S. dollar in the 1990s. The peso was devalued against the dollar, losing 75% of its value before rebounding to an exchange rate of approximately 3 pesos to one U.S. dollar today. One reason for devaluation was the decline in commodity demand (prices of wheat had fallen to their lowest “real” prices -- after inflation -- in at least a century, after the Asian and Russian financial collapses). In the initial phase of devaluation, bank withdrawals were restricted to 250 pesos a week. The run on banks gathered momentum and all banks were closed for 60 days. Whatever money Argentines had, they spent -- on anything.

Dinner conversations (always more engaging when consuming Caipirinhas, actually an import from Brazil) reveal that after this last debacle, there is little trust in the banks or the stock exchange. Banks permit residents to buy only \$10,000 worth of gold each month. So what to do? Buy bricks. Everyone has a real estate deal going - - apartments, houses, and farms. The time when foreigners could buy cheap assets has withered. They exist, but are few and far between.

The time will come again. Unlike local speculation, foreign inflows are more vulnerable. Mortgages require a 30% down payment. Compared with U.S. housing speculation, these are restrictions not seen since grandfather’s day. Hedge fund speculation is a different matter. In meetings with local investment and property firms, they report money being thrown at them. “Go buy a wheat farm.” Often, there are none to be bought. One suspects such managers could not point out on the map to within 2,000 or 3,000 miles where the territory lies.

One knows hedge funds as a whole will deleverage at a ferocious pace. On the day of departure from Buenos Aires (where the broad boulevards and Beaux-Arts architecture are still truly captivating), *The Daily Reckoning* broadcast a warning from Ed McCarthy, president and CEO of Financial Risk Management Advisors:

“1. Over the last five years, the balance sheets of the investment bank community have expanded exponentially. We include all of the major foreign financial institutions of this caliber, as they already are as much or more investment as they are commercial. In the aggregate, globally, the total footings of these majors are well over \$7-8 trillion.

“2. Hedge fund total assets have grown from \$300 billion to approximately \$1.4 trillion, and the leverage on top of that is unknown but, in all probability, at least another [\$1.5-2] trillion.

“3. Private equity funds availability has gone to approximately \$1.1 trillion, and the leverage can be as little as [4] or [5] times cash flow on the deals they are in, or as much as 10, 12, or even 15 times.

“4. Credit default swaps have grown from less than \$1 trillion to \$14-16 trillion in the United States and at least \$26 trillion globally, as last reported by the Bank for International Settlements, and probably substantially more.”

When the trades reverse, cattle ranching will capture the attention of those looking for real assets. They may be too late. The victors will be those who knew the first rule of investing one's wealth is to preserve it, those who had spent their time studying future opportunities when most investment managers were consumed by quarterly return comparisons.

Regards,
Fred Sheehan