❖ By Renmax Sociedad de Bolsa S.A.
info@renmax.com.uy

Uruguay's return to International Markets and Indexed Units of Account

Uruguay's return to international markets was marked by a debt issue in Unidades Indexadas (UI - Indexed Units of Account), followed soon after by a bond issue in Pesos protected against currency depreciation. This article will examine the motives that drive international investors to buy debt in UI.

Two years after their creation, local market securities denominated in UI make up 23% of the total stock of bills issued by the government[1], and the total debt in UI represents 4% of total public debt. By this date, the Central Bank has already issued eight series of Letras de Regulación Monetaria, (LRM - monetary regulation bills) in UIs for a total of U$S 225 million[2]. On the other hand, the Central Government has issued two series of Treasury Bills for U$S 57 million and placed in the international market an issue[3] for approx. U$S 288 million. Domestically, the highest demand for UI financial instruments is found among institutional investors, principally AFAPs[4] and Insurance Companies. But international issues have also been received with significant interest by US-based investment funds[5].

Considering that emerging market investors usually acquire US Dollar or Euro-denominated fixed income instruments, we believe it is of interest to explain the factors which drive them to acquire UI instruments.

Inflation-indexed securities are essential in a diversified portfolio.

The governments of several OECD countries regularly issue inflation-indexed securities in their local currencies[6]. In every case, these bonds are mostly sought after by domestic pension funds, which consider them an ideal instrument for achieving their investment objectives[7], which would not be attained by investing solely on nominal bonds and shares.

Nominal bonds guarantee a nominal return rate, but the principal is not protected from unexpected inflation. For example, if you purchase a fixed-rate 10-year US Treasury bond at a face value of USD 10.000, at maturity the capital will have suffered a loss in purchasing power. If the average annual inflation rate in the U.S. is 3%, on maturity the investor will end up with USD 7.441 in constant currency, therefore suffering a real loss of 26%. To protect himself, the investor might purchase Inflation-Indexed Treasury Bonds (TIPS[8]). Their nominal value adjusts perfectly to inflation, so at maturity, the nominal value would amount to U$S 13.439, thus maintaining the purchasing power.

Empirical studies on U.S. inflation reveal that in the period between the post-war and the early 80's —except for a brief lapse of five years— holders of nominal bonds suffered negative real returns[9].

Besides guaranteeing stable returns in real terms, these instruments also contribute to diversifying risk in a portfolio. Its low correlation with traditional assets produces important diversification benefits. According to recent studies, 10-year TIPS have approximately a 0.90 correlation with nominal bonds with similar maturity, and -0.50 with the

[1] Includes Treasury and Central Bank debt..
[2] An exchange rate of 29.40 and UI value of 1.407 was used to obtain this result in USD.
[3] The first issue took place in October 2003 amounting to U$S 200 million, and there was a U$S 88 million increase in March 2004.
[4] Uruguayan pension funds
[5] Foreign investors bought 83% of the international issue.

[6] Today the governments of the United States, Canada, France, Italy, Sweden, England and Australia are regularly issuing inflation-indexed securities in their own currencies.
[7] The goal of a pension fund is to maximize the real value of its pensions. In this context, an inflation-indexed security plays the role of a "secure asset", while nominal bonds and shares are used for more speculative investments.
[8] Treasury Inflation Protected Securities, emitidas por el Tesoro de los EEUU.
[9] Jones, Charles and Wilson, Jack. *"The Changing Nature of Stock and Bond Volatility"*. Financial Analysts Journal, Jan/Feb 2004.

equity index[10]. Secondly, volatility of returns is lower that that of nominal bonds. What one can conclude from these two factors is that an efficient portfolio should include a significant percentage of inflation-indexed assets[11].

The demand in the international market

In view of what was expressed in the previous section, it is natural that international investors should find UI securities an attractive option when buying Uruguayan bonds. These investors do not have inflation-indexed liabilities in Pesos —as is the case of the AFAPs—, therefore their demand for these securities cannot be explained by hedging considerations. Current foreign buyers of Uruguayan debt are total return investors, and thus attempt to maximize their expected returns per unit of country risk. Below we will analyze the main factors involved in the demand for UI:

a) <u>Expected returns in US Dollars</u>: Those who decide to invest in Uruguay do so because they have a positive view of the country in terms of economic growth and fiscal solvency. In a recovery scenario, it would be normal to expect an inflation rate superior to the peso depreciation rate, which would translate into a higher UI return with respect to the US Dollar.[12].

b) <u>Credit risks</u>: the possibility of Uruguay not being able to pay its debt in Pesos is lower with respect to the US Dollar. This view is validated by the rating agencies, who rate local-currency debt higher than US dollar debt. Another factor that should be considered in these local issues, is that Letras de Regulación Monetaria in UI (monetary regulation bills) constitute liabilities of the Central Bank of Uruguay, Uruguay's monetary authority.

c) <u>Diversification</u>: investors who already own Uruguayan bonds will benefit by adding an asset not perfectly correlated with dollar-nominated global bonds.

d) <u>Relative value with the region</u>: after the default, Argentina issued inflation-indexed securities with similar characteristics to the UI[13] bills. These securities offer a real return of 6%, compared to the 11% offered by the UI securities. Given the different paths chosen by Argentina and Uruguay to resolve their crisis, many investors consider this wide differential to be an anomaly.

Outlook

The main difficulty faced by foreign investors when buying UI securities is that it involves a foreign exchange transaction, and this creates uncertainty when the time comes to sell. It is because of this that the government has come up with an innovative structure for the international issue of UI securities. The bond is issued in pesos with the returns indexed to the evolution of the UI, but its payment is in US Dollars. This way, foreign investors are not forced to sell US Dollars in order to purchase the bond.

One could take this innovation one step further promoting the development of a swap markets for UI/ US Dollars. A swap transaction would effectively break the link between UI-risk and the government-issued securities, permitting investors to position themselves in UIs without taking on country risk. This would allow domestic agents with foreign currency exposures[14] to hedge them in conditions more favorable than currently available. This will be the theme of a future article.

[10] Roll, Richard. *"Empirical TIPS"*. Financial Analysts Journal, Jan/Feb 2004.
[11] Khotari, S.P and Shanken, Jay. "Asset Allocation with Conventional and Indexed Bonds", 2002.
[12] Protasi, Juan C. "¿Invertir en unidades indexadas a la inflación?". Revista Portafolio, 2004

[13] Boden 2008.
[14] Normally, importers and corporations from the non-tradable sector.