Strictly Macro

Converging to a New Equilibrium

October 16, 2018

TABLE OF CONTENTS

Gradual global deceleration amid imminent QT

A decade after the last serious economic crisis, the global economy is on solid ground, in our view, with its largest engine, the US economy, generating enough momentum to keep recession risks relatively low. Nevertheless, we have adopted a cautious stance, as we believe financial markets could undergo further risk repricing if the following global catalysts take a turn for the worse: (i) a faster shift out of quantitative easing (QE) into quantitative tightening (QT), led by the leading central banks; (ii) a global trade contraction amid a further escalation of tariffs led by the US and China; (iii) an unexpected China slowdown, which in turn could trigger a disorderly adjustment across EM; and (iv) a more complex growth-fiscal scenario for some of the most advanced economies (particularly the UK and Italy). We believe any of the above would be negative for the Latin American region. As we highlighted in our July SM publication (cover essay), while the risks are not uniform, some of the largest vulnerabilities across the EM universe still lie in LatAm.

Indeed, our G-10 specialists believe that the likelihood of an economic slowdown in coming quarters will continue to increase gradually. Santander anticipates lower GDP growth for all advanced economies in 2019 compared to this year. The US economy is expected to decline slightly to 2.7% next year from a projected 2.8% pace in 2018. Consistent with a gradual US slowdown, our G-10 team has a more dovish position with respect to the FOMC projections but more hawkish than market expectations, which means they believe the Fed could stop hiking once the neutral rate is reached in 2019 in order to avoid a hard landing. For the ECB, in contrast, Santander's view is that the ECB should see a macro setting solid enough to start hiking rates sooner and will be able to hike a bit more than is currently priced in. CB's balance sheet should turn restrictive (net QT) in 2020 according to our team.

LatAm Vulnerabilities Are Concentrated on Fiscal Dynamics

	PS pension expenses	Public debt in hard FX	Foreign ownership of PS local debt	Pension Funds AUM	CA deficit ST financing
	% of total expenses	% of total PS debt	% of total outstanding	% of GDP	% of CA deficit
Argentina	8.7	70.0	na	11.4	58
Brazil	8.5	3.9	12.6	25.0	58
Chile	4.0	21.0	10	71.0	nm [2]
Colombia	4.0	33.0	25.4	25.0	23.4
Mexico	3.2	36.5	31.3	15.0	51
Peru	1.5	40.2	40	22.5	nm [2]
Uruguay	10.7	44.3	1.6	22.3	nm [2]

1.This figure drops to zero once including the IMF program. 2. Non-meaningful issue, as both Chile and Peru have net portfolio outflows, which makes a well-contained CA vulnerability indicator.

Source: Santander, using official figures from Central Bank and Finance Minister in each country.

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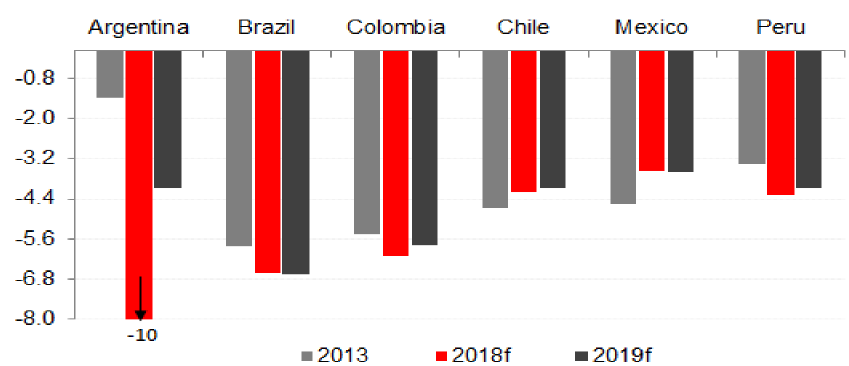
LatAm fiscal viability to remain lackluster at best

After several years of QE-infused liquidity but below-par GDP growth across EM economies, financing needs shifted from manageable to worrisome in only a few years, which was a noteworthy shift across LatAm. Note that the public sector deficit widened by nearly 3.5 pp to around 4% of GDP since 2012 across our seven-country universe, which means gross issuance will remain relatively high. Given the liquidity drainage associated with rising DM interest rates, we expect the fiscal side of the idiosyncratic story to remain lackluster at best for quite some time. For the two major LatAm economies (Brazil and Mexico), where the newly elected governments will debut at the turn of the year, a fiscal stress test from investors will come rapidly, meaning there is limited room for policy mistakes. As shown in the table on the previous page, whereas Brazil's blend of USD and local currency sovereign debt, in addition to a low sponsorship of local debt by foreign investors, is sustainable, the ballooning pension bill is not. For Mexico, continuing the fiscal consolidation effort under way since the beginning of Fed normalization in December 2015 will remain on investors' radar, with the performance of Pemex and the FX remaining key drivers. Overall, this sets up a challenging 2019 for the region, also considering that Argentina's delivery on the IMF's fiscal targets will be highly scrutinized. Moreover, with the exception of Mexico, where the central bank reacted ahead of the Fed shock, all central banks are expected to raise interest rates over the next quarters, which also reduces the likelihood of improved fiscal accounts. FX performance should explain net fiscal impacts, since the region looks divergent in terms of buffers and policy response. Here our assessment assigns better vulnerability scores to Chile, Peru, and Mexico.

Although the Fed's normalization has been well telegraphed, the broader vulnerabilities for the Latin American countries in general, which can be summarized by the sum of current account and public sector balance (twin deficit) and the gap of GDP growth relative to its potential, have failed to improve at the pace needed to keep investors' confidence balanced. We thus fear a sharper response across local assets if the top global risks unfold. On a glass-half-full perspective, however, local assets are ending 2018 on a less bearish note, which we believe points to an incipient stabilization after the unusual shocks hitting the three largest LatAm economies. In our judgment, this reflects the other significant variable at play in the risk-reward equation: an enduring search for high yield but with global investors now increasingly looking to differentiate among the least-vulnerable and highly liquid riskier assets. Indeed, we think the valuation is turning attractive, with current local prices better reflecting the mix of external and idiosyncratic risks. Regarding the USD outlook, our G-10 team thinks the support from a firm economy and rate hikes should start to fade out gradually; however, we suspect LatAm FX could see additional weakness vs. USD in case of renewed EM stress.

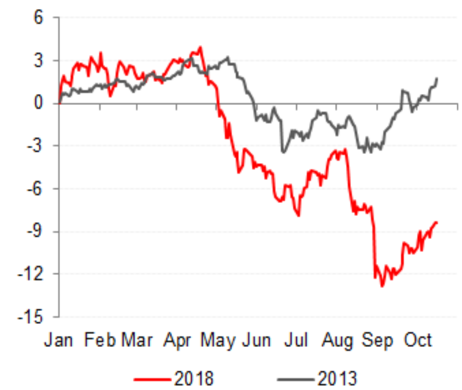
LatAm Twin Deficits Underscore Divergent QT Vulnerability



% of GDP, CA deficit plus PS balance. Sources: Central Bank and Finance Minister in each country

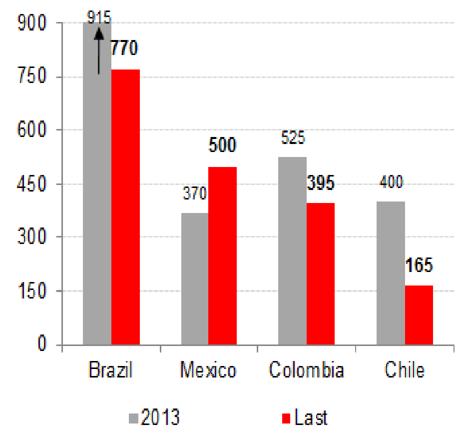
In addition to fundamentals and yield spreads over US TSY, market positioning will play a role in determining local asset performance. Our anecdotal evidence indicates that, with the exception of overcrowded positions in Argentina, the market has undergone a healthy cleanup of bearish positions, as witnessed by the bounce in FX carry return (top chart at right). The sensitivity to unexpected changes in US yields remains high, so drawing parallels with 2013 or the Fed's "taper tantrum"

LatAm FX carry returns: What a difference higher US rates make



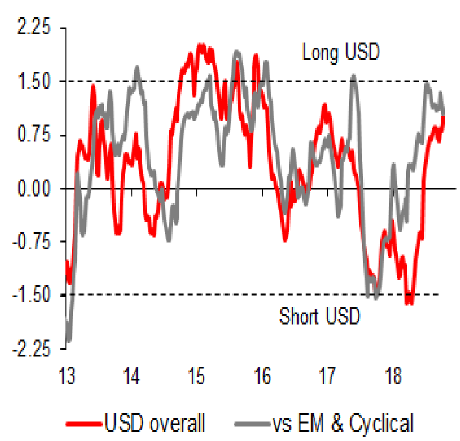
YTD, cumulative total return of buy and hold carry trade (long LatAm FX vs. short USD). Source: Bloomberg.

10-yr local yield spreads over UST mostly narrower vs. 2013



Using bond yields. Spreads for 2013 are the widest recorded during that year. Source: Bloomberg.

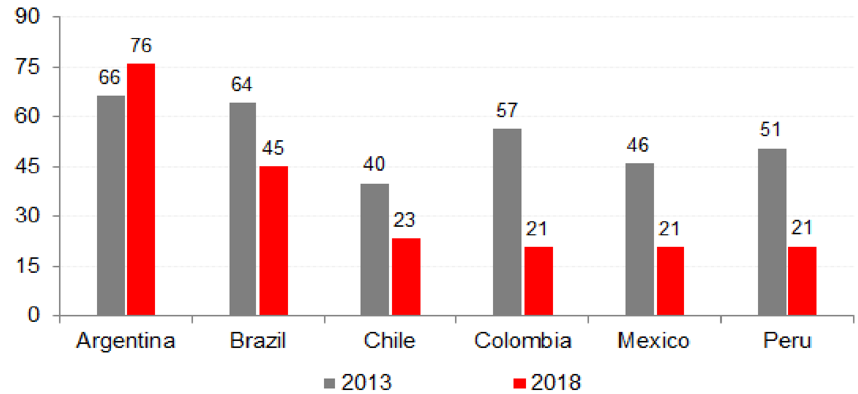
Market positioning still favors long USD



Z-scores calculated since 2010. EM & Cyclical includes CAD, AUD, NZD and MXN. Source: Bloomberg.

year makes sense, in our view. Back then, the USD strengthened similarly compared to this year (7% peak to trough), but US yields have climbed 100 bps so far this year (peak to trough, using 2yr TSY), or threefold the spike seen in 2013. Against this significant global market development, risk premia in both FX and local rates across LatAm increased sharply this year, while sovereign credit spreads in USD terms have remained lower. Our interpretation is that the market perception of a general EM systemic crisis remains well contained despite lingering vulnerabilities and still plenty global liquidity. As shown in the chart below, the correction in 5yr CDS so far this year looks nothing like in 2013 for all countries (exc. Argentina).

LatAm Sovereign Credit Looks More Stable Than in 2013



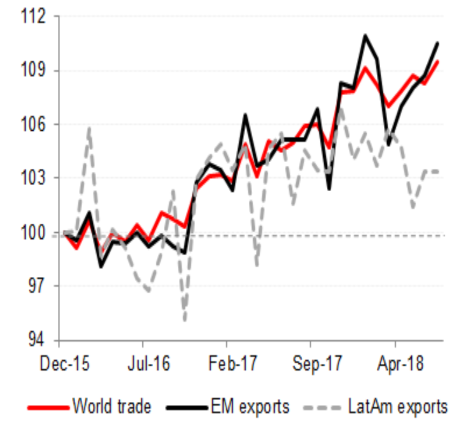
%, retracement on 5yr CDS using YTD periods through Oct-15. Source: Bloomberg.

LatAm expansion expected to contrast with slowing global growth

We expect economic dynamism across LatAm to gain some momentum going forward, albeit after a disappointing 2018. We have revised lower our LatAm GDP growth for this year to 1.6%, a pace well below potential and also below that of the US economy. However, we forecast an improvement to a decent 2.7% pace next year, which, if realized, would be one of the strongest since the 2008 crisis. Our out-of-consensus view is that Brazil, the largest economy, will outperform and deliver healthy 3.2% growth, which is more than 1pp above the potential we calculate for the country. Here we expect that the mix of below-trend inflation and a solid external position (low CA plus FX reserves) will support local activity, as we project the central bank to keep an accommodative monetary stance for longer than market expectations. Regarding the much-awaited social security reform, our reading is that producing the credible fiscal plan needed to close down the PS primary deficit worth 2.3% of GDP will be a feasible task with relatively quick benefits, and one demanding not too much political capital. Indeed, we think the immediate challenge for the next administration lies in restoring confidence after a highly polarized election. We also acknowledge that the next president faces a fragmented Congress, which means governability risks cannot be ignored.

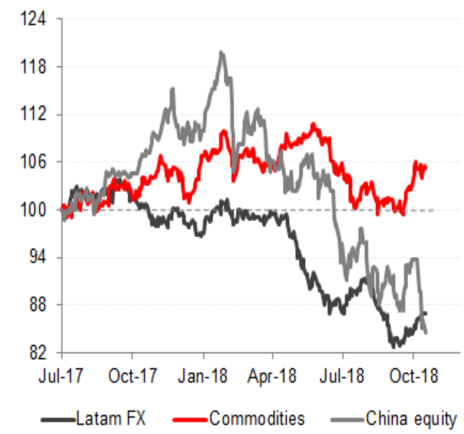
For the rest of the countries, we believe GDP growth will likely land close to our estimate of their potential pace (within a +/- 0.25pp range), with the exception of Argentina, where activity should fell short of potential by some 2pp. The toll from the softer global demand our G-10 team projects should be offset by the following headwinds, in our view: (i) benign underlying inflation supporting consumption and investment; (ii) a rebound in net exports fueled by weaker FX and high commodity prices (note that LatAm exports have underperformed EM even as world trade remained resilient, top right chart), and (iii) lower uncertainty regarding politics and economic policy leading to restored confidence. Regarding external demand, the outlook for the region could turn divergent, in our view. For Mexico, we believe the new NAFTA deal (USMCA, awaiting legislative ratification in each country) should put structural uncertainty to rest and help to unlock FDI, which has not flourished since early 2017. Here, a more sustainable mix with a greater contribution from investment and trade should help boost productivity. In contrast, the ability of policymakers in China to avoid a hard landing amid trade protectionism could easily become a headwind for the southern cone economies. However, if the current high-stakes tariff drama is resolved more quickly than expected, this should create an upward bias for our regional growth outlook.

LatAm exports underperformed despite still solid world trade



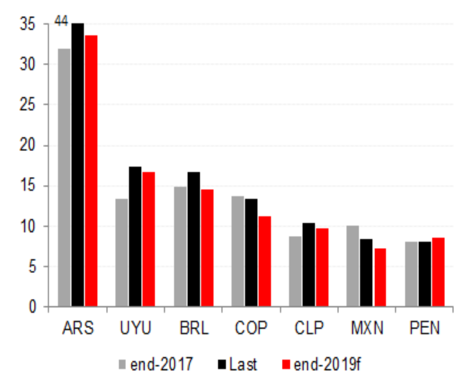
Index, Dec-2015 is 100. Source: CPB.

Commodities remain firm despite China's clouded growth outlook



Indices normalized starting Jul-2017.
Source: Bloomberg.

LatAm misery indices expected to continue diverging going into 2019



% sum of CPI annual rate and Unemployment rate.
Source: Bloomberg.

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FORECAST SUMMARY TABLES

KEY MACRO INDICATORS

GDP growth	2016	2017	1Q18	2Q18	3Q18F	4Q18F	2018F	2019F	Last Review '18	Nom GDP '18
Argentina	-1.8	2.9	3.6	-4.2	-5.0	-3.9	-2.4	0.5	Down	453
Brazil	-3.6	1.0	1.2	1.0	1.5	2.0	1.5	3.2	Down	1,889
Chile	1.3	1.5	4.2	5.3	3.2	3.4	4.0	3.5	Unchanged	321
Colombia	2.0	1.8	2.2	2.8	2.9	3.0	2.7	3.3	Up	337
Mexico	2.9	2.0	1.4	2.6	2.1	2.2	2.1	2.3	Down	1,217
Peru	4.0	2.5	3.1	5.4	3.5	4.0	4.0	4.1	Up	229
Uruguay	1.7	2.7	2.2	2.5	1.2	0.3	1.5	1.0	Down	61
LatAm-7	**-0.3**	**1.7**	1.9	1.5	1.3	1.7	1.6	2.7		1,204

In %. Year-on-year basis. Nominal GDP in US$ billions. LatAm 7: Nominal GDP-PPP Weighted Sources: IMF, National central banks, finance ministries, and Santander.

GDP Components	Priv Cons '16	Priv Cons '17	Priv Cons '18F	Pub Cons '16	Pub Cons '17	Pub Cons '18F	Investment '16	Investment '17	Investment '18F	Exports '16	Exports '17	Exports '18F	Imports '16	Imports '17	Imports '18F
Argentina	-1.0	3.5	-2.1	0.3	2.2	-1.9	-4.9	11.0	-3.8	5.3	0.4	3.2	5.7	15.0	1.9
Brazil	-4.3	1.0	2.3	-0.1	-0.6	-0.2	-10.3	-1.8	3.5	1.9	5.2	4.0	-10.2	5.0	5.4
Chile	2.4	3.8	4.3	4.0	3.3	2.8	-1.1	5.7	6.0	-0.9	6.8	4.8	4.7	7.5	7.8
Colombia	1.4	1.8	2.7	1.8	4.0	4.6	0.3	0.6	0.4	-1.4	-0.7	1.5	-4.0	0.3	3.8
Mexico	3.8	3.0	2.8	2.3	0.1	2.0	1.1	-1.5	2.5	3.5	3.8	4.7	2.9	6.5	5.8
Peru	3.3	2.5	3.5	-0.5	1.6	3.0	-3.9	-2.3	6.0	9.5	8.5	3.5	-2.2	4.0	4.3
Uruguay	0.1	4.4	2.1	2.9	-1.3	0.0	-3.9	-13.8	0.6	-0.2	7.6	-2.5	-6.2	-0.4	-1.9
LatAm-7	**-0.3**	**2.2**	**2.2**	**1.0**	**0.6**	**1.0**	**-4.6**	**0.2**	**2.4**	**2.7**	**4.0**	**3.9**	**-2.8**	**6.2**	**5.0**

Annual changes in %. na: Not available. LatAm 7: Nominal GDP-PPP Weighted Sources: IMF, National central banks, finance ministries, and Santander.

Inflation	Headline CPI (YoY)							Core measure		
	2016*	2017*	Oct-18F	Nov-18F	Dec-18F	2018F*	2019F*	2017	2018F	2019F
Argentina	37.7	24.8	41.8	44.0	43.3	43.3	26.1	21.1	44.2	27.9
Brazil	6.3	2.9	3.6	3.8	4.1	4.1	4.0	3.4	3.2	3.5
Chile	2.7	2.3	2.9	3.0	3.1	3.1	3.1	1.9	2.7	3.3
Colombia	5.8	4.1	3.3	3.3	3.3	3.3	3.2	5.0	3.7	3.5
Mexico	3.3	6.8	4.9	4.6	4.5	4.5	3.9	4.9	3.7	3.7
Peru	3.2	1.4	1.9	2.2	2.3	2.3	2.5	2.3	2.5	2.5
Uruguay	8.1	6.6	8.3	8.4	8.4	8.4	8.0	6.6	8.0	7.8
LatAm-7	**8.5**	**6.5**	**8.1**	**8.4**	**8.4**	**8.4**	**6.3**	**5.8**	**7.9**	**6.3**

*Year-end levels, YoY. Core measure as per national definitions. LatAm7: Nominal GDP-PPP Weighted Sources: Sources: IMF, National central banks, finance ministries, and Santander.

Macro Miscellanea			ARS	BRL	CLP	COP	MXN	PEN	UYU
Fiscal balance	% of GDP	2016	-5.9	-8.9	-2.7	-4.0	-2.6	-2.3	-3.9
		2017	-6.1	-7.8	-2.8	-3.6	-1.1	-3.1	-3.5
		2018F	-5.6	-5.6	-2.2	-3.1	-2.0	-3.0	-4.0
		2019F	-3.2	-5.6	-1.9	-2.4	-2.0	-2.7	-3.9
Public debt	% of GDP	2016	26.7	46.2	9.6	44.0	48.7	23.8	30.7
(Net terms in ARS, BRL, CLP)		2017	29.4	51.6	13.3	45.0	46.0	24.8	32.3
		2018F	54.0	57.9	15.6	45.0	45.3	25.8	37.7
		2019F	53.0	62.8	17.2	44.0	44.8	27.5	44.1
Current account	% of GDP	2016	-2.4	-1.3	-1.4	-4.3	-2.2	-2.7	0.6
		2017	-4.8	-0.5	-1.5	-3.4	-1.7	-1.3	0.7
		2018F	-4.3	-1.0	-2.0	-3.0	-1.6	-1.3	-1.2
		2019F	-0.9	-1.0	-2.2	-3.4	-1.6	-1.4	-1.8
Trade balance	US$ bn	2016	1.9	47.7	5.4	-9.2	-13.1	2.0	2.7
		2017	-8.5	67.0	7.9	-4.8	-11.0	6.6	3.6
		2018F	-6.1	55.5	3.9	-3.3	-11.9	8.0	2.5
		2019F	4.7	54.5	3.2	-4.0	-12.5	8.7	2.3
Unemployment	% of workforce	2016	7.5	12.0	6.5	8.7	3.9	6.7	7.8
		2017	7.2	11.8	6.7	8.6	3.4	6.9	7.9
		2018F	7.5	11.2	6.8	8.4	3.3	6.0	8.6
		2019F	7.5	10.6	6.6	8.0	3.4	6.0	8.6

Source: Santander.

MONETARY POLICY MONITOR

	Current	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
ARGENTINA	72.80	60.00	51.25	42.50	33.75	25.00
		-1280	-875	-875	-875	-875
BRAZIL	6.50	6.50	6.50	6.50	6.50	7.50
		0	0	0	0	100
CHILE	2.50	2.75	3.25	3.50	3.50	3.50
		25	50	25	0	0
COLOMBIA	4.25	4.25	4.50	5.00	5.25	5.25
		0	25	50	25	0
MEXICO	7.75	7.75	7.75	7.75	7.50	7.25
		0	0	0	-25	-25
PERU	2.75	3.00	3.25	3.50	3.75	3.75
		25	25	25	25	0

Central bank reference interest rates. Levels in %, monthly changes in bps. Sources: Central banks and Santander.

- **Brazil expected to remain on hold: In Brazil, we believe that 2019 inflation expectations are the most important component for Copom's reaction function. We forecast that inflation will remain below the target for most of 2019, and thus we expect Copom to remain on hold until 2H19, assuming that the recent improvement in financial market variables (especially the BRL) will be extended beyond the end of this year.**
- **New monetary policy in Argentina: Authorities adopted a new monetary policy, from interest rate targeting to direct control of monetary aggregates. The Central Bank committed to deliver monetary base 0% monthly growth until June 2019 as a way to recover credibility among market participants. As a result, the reference rate should fall slowly, in our view, in line with the monetary contraction.**
- **Mexico expected to keep high rates until 3Q19: We expect Banxico to remain on hold for a while but to maintain a hawkish tone. We think the recent announcement of USMCA, the trade agreement to replace NAFTA, has tilted the balance to hold. However, we consider than in its latest communique Banxico still kept the door open for another hike, as it expressed concerns about the complex global economic environment.**
- **Low interest rates in the Andeans: In Colombia, we expect BanRep to remain on hold at 4.25% for the rest of the year, as inflation remains under control. We believe Peru will hike in December as the output gap closes and inflation reaches its target. In Chile, we expect the BCCh to hike in December, as the BCCh has suggested that growth and inflation conditions have normalized and there is no need for an expansionary policy.**

FOREIGN EXCHANGE RATES

	BRL	MXN	CLP	COP	ARS	PEN	UYU
Last*	3.74	18.8	678	3095	36.7	3.34	33.0
Dec-18	**3.80**	**18.9**	**680**	**3000**	**41.0**	**3.40**	**33.5**
Mar-19	3.88	18.6	680	3100	43.6	3.44	34.2
Jun-19	3.95	18.5	680	3000	46.2	3.49	34.8
Sep-19	4.10	18.8	685	3150	48.7	3.53	35.5
Dec-19	**4.10**	**18.8**	**685**	**3200**	**51.3**	**3.57**	**36.2**

End-of-period levels. * October 15 2018 Sources: Bloomberg and Santander.

- **Year-to-date, LatAm currencies – with the exception of the MXN – have depreciated, reflecting in part a less favorable external environment with lower metal prices, higher US rates, a stronger USD, and increasing trade tensions between the US and China. In the case of BRL and ARS, idiosyncratic factors also added pressure, in our view. In general, we see more pressures in the FX markets in the coming quarters due to high uncertainty in external markets and tighter international financial conditions.**
- **BRL is a high-beta currency, and we believe that a lower yield premium and political uncertainty could continue to pressure the *real* in the short term. We expect MXN to remain at current levels, as USMCA removes three years of uncertainty in the trade outlook. We expect peso depreciation in Argentina to continue, albeit at a slower pace, as Argentina remains the most vulnerable to external shocks. In Colombia, we believe high oil prices will remain supportive of COP in the coming months. In Chile, we think CLP may continue to be pressured due to lower copper prices.**

ARGENTINA

SLOWLY IMPROVING; UNCERTAINTY LINGERS

- **An expanded IMF line with higher disbursements in 2018-19, together with the government's commitment to 0% of GDP primary balance next year, helped calm market concerns on short-term solvency issues.**
- **We expect the sizable FX shock, coupled with austerity measures and a stringent monetary policy, to lead to a deeper slowdown in the short term; inflation expected to continue climbing due to high pass-through.**
- **Although there are incipient signs of FX stabilization, all eyes are now on the social consequences of austerity and its political implications ahead of a challenging presidential race next year.**

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Slowly coming out of the woods

After a string of exogenous negative shocks throughout the year (which were deepened by a score of policy mistakes, in our view), recent developments (new IMF accord, revamped monetary/currency policy) helped the government regain some foothold. However, it is clear that the country is not out of the woods yet. The international backdrop will likely continue causing volatility for local asset prices. US monetary policy tightening, together with uncertainty about the policy steps to be taken by a new president in Brazil, could prove a drag on the economy in the short term, in our view. Within a bleaker economic scenario, investors' concerns are now focused on current policies' political implications and how they could affect the next presidential election.

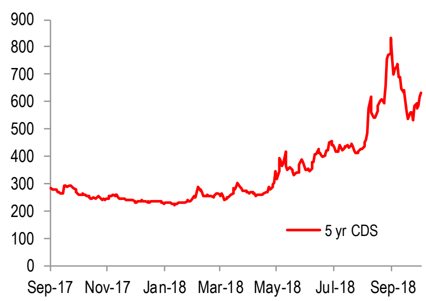
With (yet another) "little" help from our friends

The renewed accord with the IMF (which still awaits approval from the Fund's board) is the first factor that contributed to reduce uncertainty. Some weeks ago, market concerns were mostly concentrated on the government's solvency in 2019, in a scenario of difficult market access. The IMF package enlargement (to USD 57.1 bn), and, crucially, the acceleration of disbursements throughout 2018 and 2019, greatly contributed to reduce investor qualms about the government's short-/medium-term ability to meet its obligations. Total disbursements between 3Q18 and 4Q18 were increased from USD 18.7 bn to USD 36.2 bn (total disposable funding was enlarged by USD 7.1 bn to USD 57.1 bn). Needs for 2018 are completely covered, while the IMF disbursements and the funds from the international organizations will cover the financial needs for 2019, assuming convergence to a zero primary deficit next year. Under the new scenario, we estimate that total financial needs for 2019 will stand at USD 13.2 bn. Those will be mostly covered using some USD 5.4 bn of spare cash to be received during 2018 and by the rolling over of ARS and USD Letes. The final gap, after these funding sources are considered, is only USD 1.9 bn for all of 2019. Therefore, we think the government is shielded from market volatility until 2020. Investors' concerns now have shifted from liquidity issues to the impact of austerity measures on social and political trends, and on whether the Cambiemos government can retain power in the October 2019 presidential elections Overall, the enlargement of an already generous IMF line reveals firm backing from the international community for the current government.

Faster fiscal convergence

We believe the faster growth seen so far in revenue (+27% year to August) compared to expenses (+19.5% in the same period) should result in a rapid decrease of the primary deficit (which is set to reach 2.6% of GDP in 2018, according to our estimates, 1.2 pp below last year's). The government's commitment to reduce this to 0% of GDP next year has been a crucial factor helping allay market concerns about debt dynamics. The achievement of a primary balance is expected to be accomplished by a mix of expenditure cuts (-0.7 pp of GDP in subsidies, -0.5 pp of GDP in public works, -0.3 pp of GDP in transfers to provinces) and a higher tax take (of which 1.1 pp of GDP will be contributed by reinstated export taxes). Approximately two thirds of the primary deficit reduction will be due to a reduction in expenses, which we expect to

Easing (but still high) risk perception



Argentina CDS 5 years. Sources: Bloomberg and Santander.

Limited financial needs in 2019

2019	ARS	USD	Total
Primary deficit	*0*	*0*	*0.0*
Plan Gas	*24.1*	*0*	*0.5*
Interests	*132.3*	*10.8*	*14.1*
Amortizations	*379.3*	*18.1*	*27.6*
Paris Club		1.7	1.7
IFI's		1.9	1.9
Letes	276.7	7.6	14.5
Bonds	102.6	4.0	6.6
Repo		2.9	2.9
Uses	**535.7**	**28.9**	**42.3**
Repo		*1.7*	*1.7*
IFI's		*27.4*	*27.4*
IMF		22.8	22.8
Other		4.6	4.6
Sources	**0.0**	**29.1**	**29.1**
Gap	**-535.7**	**0.2**	**-13.2**
Letes	164.4	4.6	8.3
Cash	0.0	5.4	5.4
Local Market	0.0	0	0.0
International Market	0.0	0	0.0
Final Gap	-371.3	10.2	**1.9**

Estimated national government financial needs for 2019. Sources: Ministry of Economy and Santander estimates.

prove a drag on the economy next year. The government has already presented a budget proposal to the Congress reflecting these assumptions. Discussions of this plan in the Congress will be a key event to watch in the short term, in order to gauge the government's ability to secure fiscal convergence.

Trying to regain credibility the hard way

A new monetary/FX policy scheme is the second avenue to reduce uncertainty. The Central Bank resorted to a harder monetary policy as a way to recover credibility among market participants and is now committed to deliver monetary base 0% monthly growth (adjusting by seasonality factors) through June. This will be accomplished through Leliq issuance (7-day paper issued only to the financial sector), while the unwinding scheme for Lebacs (which were available to any type of investor) continues. This monetary rule will be in place as long as the exchange rate fluctuates within a predefined band. This was set between USDARS 34 and USDARS 44 (as of October 1); the upper and lower bound will increase daily at a 3% monthly rate until year-end (when the rate of growth will be revised). The more stringent monetary policy main's objective is to stabilize money demand (dampening the pressure on the exchange rate) and reduce inflation. As monetary policy has now completely shifted to direct control of monetary aggregates (from the interest rate setting), we expect policy interest rate volatility to increase significantly. If the exchange rate hits the upper bound, the Central Bank would sell reserves (up to USD 150 mn per day) to cap peso depreciation, leading to a contraction in monetary supply. In a scenario of constant testing of the upper bound by the market (with the Central Bank continuously selling FX), the monetary base contraction would be so severe that dollarization pressures should ease significantly. We estimate that, in this case, monetary base/GDP would decrease to below 6% by December, the lowest on record (since 2004; see chart). If credible, this would help automatically stabilize the FX quote. In contrast, if the FX approaches the lower bound, the Central Bank would step in to buy currency, expanding the monetary base and meeting the increase in money demand. The Treasury will also be a key supplier of currency in the FX market, selling most of the USD 13.4 bn IMF disbursement (until December) for budgetary purposes. Finally, the high level of exchange rate (in real terms) should be a stabilizing factor. As of September, the REER weakened almost 59% YTD. Valued at the band's upper bound, the REER would stand 41% above the 1996-2018 average and only 12% below the peak in June 2002 (then, a clearly overshot FX). Therefore, we believe the floating bands were set at relatively high real levels, which should result in less weakening pressure on the ARS once financial stress is overcome.

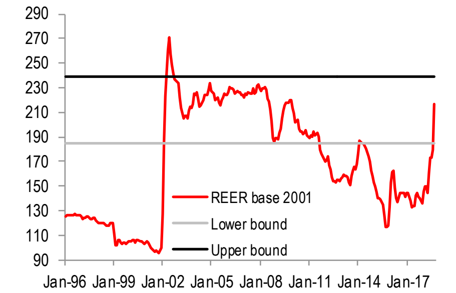
Inflation up, activity down

In the short term, the effect of the last exchange rate surge (in the last two months to October 4, it increased 40.5% m/m) will be substantial. We expect the September CPI print to be 6% m/m and forecast it will decline gradually thereafter, to converge to 44% annually by year-end (with risks tilting upward). However, the stringent monetary policy will likely translate into a faster decline going forward, in our view. We think the downward trend will likely be apparent starting in 1Q19, under the assumption that FX volatility eases significantly. The FX shock, in our view, will deepen the recession initiated by the impact of last summer's drought in activity (GDP declined 4.2% y/y in 2Q18, almost entirely due to this effect). We currently estimate a 2.4% GDP decline for the whole year. Measured in annual terms, we expect a pickup to be apparent only in 2Q19, propelled by recovering agricultural production. For 2019, we estimate GDP will expand 0.5%, with a positive bias compared to market expectations (mean of Central Bank poll now stands at -0.5%).

Politics

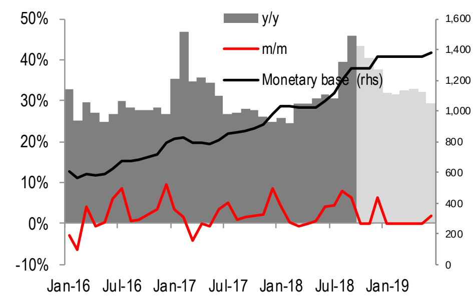
Despite the worsening economic backdrop, which continues weighing on the government's approval, the opposition's fragmentation continues to favor the ruling coalition. Lately, some Peronist major players (Massa, Urtubey, Schiaretti, and Pichetto) have shown increasing coordination, while trying to detach their segments from the more radical Kirchnerists factions. Cristina Kirchner remains an important figure for her populist constituency, but her high disapproval rating in the rest of the population may make her uncompetitive in a second-round bid. As a result, we believe the likelihood of a populist comeback is slim so far.

ARS is already at weak levels



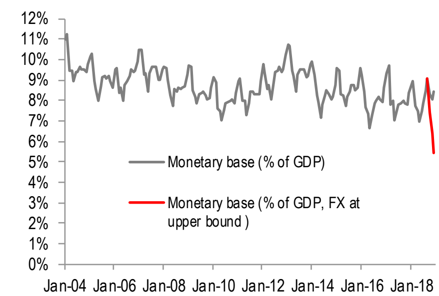
Real effective exchange rate (Dec 2001=100). Lower and upper bound corresponds to the REER level implied by the nominal bounds as of September 20118. Sources: Bloomberg, INDEC, and Santander.

Monetary restriction



Sources: Central Bank and Santander.

Harsh monetary contraction at upper FX bound



Monetary base as percentage of GDP. Red line is estimated assuming Central Bank currency sales of USD 150 per day until December 2018. Sources: Central Bank and Santander estimates.

ARGENTINA

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		2.4	-2.5	2.6	-1.8	2.9	-2.4	0.5
Private Consumption (Δ% y/y)	74.1	3.6	-4.4	3.5	-1.0	3.6	-2.1	0.1
Public Consumption (Δ% y/y)	12.6	5.3	2.9	6.8	0.3	1.9	-1.9	-2.0
Investment (Δ% y/y)	19.5	-3.5	-6.8	3.8	-4.9	11.3	-3.8	3.2
Exports (Δ% y/y Local Currency)	18.8	2.3	-7.0	-0.6	5.3	0.4	3.2	12.0
Imports (Δ% y/y Local Currency)	26.5	3.9	-11.5	5.7	5.7	14.7	1.9	5.8
GDP (US$ bn)		611	563	634	545	620	453	392
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)*		26.5	40.7	27.2	37.7	24.8	43.3	26.1
CPI core Inflation (Dec Cumulative)*		27.9	37.9	28.2	32.4	21.1	44.2	27.9
US$ Exchange Rate (Average)		5.5	8.1	9.2	14.7	16.6	29.9	46.4
Central Bank Reference Rate (eop)		15.40	26.90	33.00	24.80	28.75	60.00	25.00
Private sector credit (% of GDP)		14.5	12.7	13.7	12.9	15.3	16.2	16.9
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-3.6	-5.0	-6.1	-5.9	-6.1	-5.6	-3.2
Primary Balance, % of GDP		-2.3	-3.4	-4.0	-4.3	-3.9	-2.6	0.0
Balance of Payments								
Trade Balance		0.3	0.4	-0.6	0.3	-1.4	-1.4	1.2
Current Account, % of GDP		-0.7	-0.9	-1.5	-2.4	-4.8	-4.3	-0.9
Debt Profile								
Central Bank International Reserves (US$ bn)		30.5	31.4	25.5	38.7	55.0	64.0	69.0
Total Public Debt (net of public sector holdings, % of GDP)		19.9	18.4	22.8	26.7	26.6	54.0	53.0
Of which: Foreign-currency denominated (% of GDP)		12.3	11.9	15.3	18.2	18.1	37.8	37.1
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.4	6.9	5.8	7.6	7.2	7.5	7.5

E = Santander estimate. F = Santander forecast. Sources: Economy Ministry, Central Bank, and Santander estimates.
*From 2012-2016 FIEL inflation survey

BRAZIL

THE PRICE OF UNCERTAINTY: HIGHER INFLATION, LOWER GROWTH

- **We forecast that 2018 will probably end with higher inflation and lower GDP growth than we initially expected, due to a combination of local and external shocks.**
- **Markets currently price in high confidence in the election of a reformist government, although the composition of the newly elected Congress raises some concerns among investors.**
- **We believe conditions are in place for a relatively strong cyclical recovery in 2019, under relatively low inflation and interest rates.**

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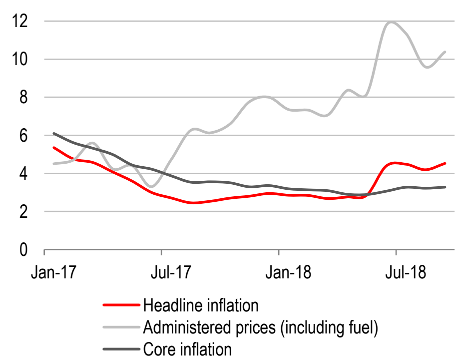
A disappointing 2018

Our most recent scenario revisions put our 2018 GDP growth estimate at 1.5% (vs. 2.0% previously) and year-end 12-month CPI inflation at 4.1% (vs. 3.9%). On the economic activity side, we had to discount the direct impact of the May truckers' strike (lost production and services) and its indirect impact (from the hit in consumer and business confidence), followed by a sharp deterioration in global and local financial conditions at the beginning of 3Q18 and the turbulent electoral environment. The recovery in household consumption, led by a (slowly) falling unemployment rate and expanding credit, continues to accelerate beyond headline GDP (we expect 2.3% growth this year), but there is no fiscal impulse in sight (government consumption is expected to stay practically flat during a long and gradual fiscal consolidation process), and in our view, a sharper recovery in investment will probably have to wait for the final election results and more visibility on the economic policy for next year. (For more details, see our report *Standby Mode*, September 12, 2018.)

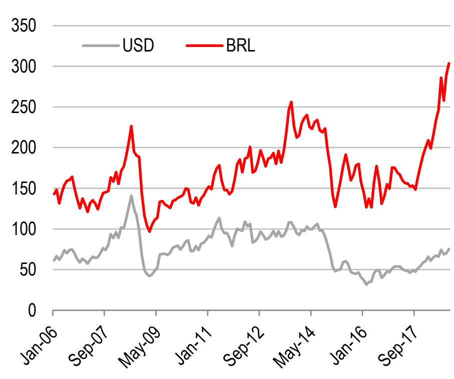
12-month CPI inflation (%)



Sources: IBGE, Brazil Central Bank, and Santander.

Headline inflation has accelerated significantly since May, first because of a spike in foodstuff prices and then affected by continually rising fuel prices and a weaker currency (nominal oil prices in BRL recently hit an all-time high). That has led us to revise our year-end CPI inflation forecasts twice since the middle of the year, from 3.5% y/y to 3.9% y/y in August and to 4.1% y/y more recently. However, we still see 2019 inflation below the target midpoint (at 4.0% y/y), which should allow the Central Bank to keep a stimulative monetary policy (with a Selic rate stable at 6.5%) until 2H19, in our view. There are few signs of spillovers to core inflation, which continues to show low volatility at a level well below the headline figure (3.3% y/y as of September 2018). In our view, slower than expected growth implies a more persistent output gap and a loose labor market, which should keep containing cost pressures for producers. Moreover, if the recent improvement in financial markets and the reversal in the BRL weakening trend persist, we should soon expect relief in non-core items and a deceleration in headline inflation.

Price of a WTI crude barrel



Sources: Thomson Reuters and Santander.

The next president's honeymoon

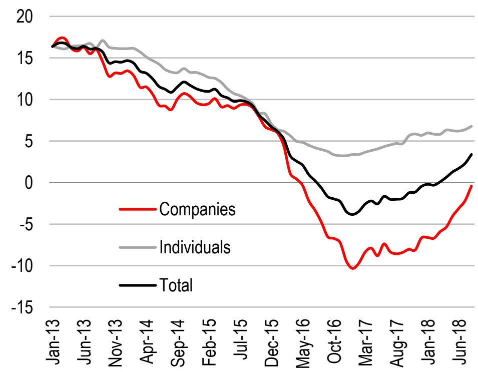
The results of the first round of voting in the presidential election led markets to strongly reprice Brazilian assets. At around 230 bps, Brazil's five-year CDS embeds negligible idiosyncratic risk, according to our models, suggesting that markets have high confidence in a fiscal consolidation path that would prevent further credit rating downgrades in the near term. (See our report *Risk Premium: Apples and Oranges*, October 9, 2018.)

However, the results of the other concurrent elections, for the Congress, suggest that such high confidence may be soon challenged, in our view. Following the recent vote, Brazil has managed to beat its own previous record for the most fragmented lower house in the history of the world's democracies, with 16.5 effective parties, according to calculations by political scientist Jairo Nicolau (30 parties will have at least one seat each, from 25 currently). The two largest parties will have, together, only 21% of the Chamber of Deputies' seats.

The number of seats won by parties that we expect to probably oppose measures such as pension reform remained stable (at around 135 seats). This is not enough to block constitutional amendment proposals (which require 308 of 513 seats), but more than 80% of the remainder of votes would be needed to approve such changes. Power in the lower house mostly shifted from large, traditional center-right parties to Jair Bolsonaro's PSL, which elected 52 representatives (up from 8 in the current legislature). Passing unpopular reforms through such a Congress will remain challenging, in our view, regardless of who is elected president. With no reforms, we believe Brazilian domestic debt will remain on an unsustainable path, leading markets to price in further credit rating downgrades.

Nevertheless, our base-case scenario still assumes a narrowing budget deficit in the coming years, resulting from a combination of some changes in pension rules, the end of tax breaks, and recovering economic activity. Risks to that scenario have increased, in our view, but it is still too early to draw more concrete conclusions before the process of building coalitions and forming the cabinet effectively begins following the run-off vote.

Total credit outstanding, y/y changes (%)

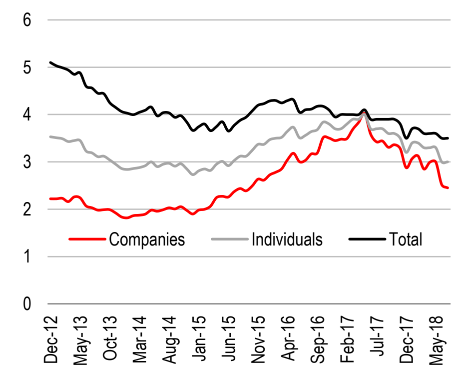


Sources: Brazil Central Bank and Santander.

A better 2019?

We believe the Brazilian economy is on the verge of a cyclical recovery, which will translate, in our view, into a period of GDP growth of around 3%, 1 pp above our estimates for potential GDP. Many conditions for a recovery are already in place, in our view: a strong financial sector, not severely hit by nonperforming loans and already back to borrowing; a recovering labor market, with the unemployment rate falling slowly but steadily; low inflation allowing for historically low real interest rates; still relatively loose external financing conditions; and a low probability of a meltdown in the exchange rate. An important missing element – confidence in the willingness and ability of the next government to maintain fiscal and monetary discipline – is likely to be present after the elections are decided, at least for some time, in our opinion.

NPLs (% of outstanding loans)



Source: Brazil Central Bank.

For the last quarter of 2018, we believe it will be important to watch the following developments:

- **The Central Bank's reaction to accelerating headline inflation and the election results:** We believe that 2019 inflation expectations will be the most important element in the Central Bank's reaction function, and, since we think both its models and surveys will continue to point to inflation slightly below the target midpoint, the year should end with the Selic rate still at 6.5%, with the outlook for 2019 depending on how tradable prices evolve.
- **Cabinet formation and coalition building:** Those processes are, in our view, strongly intertwined – the next president will have to be willing to share power in order to form a coalition in Congress large enough to pass important constitutional amendments, such as those linked to pension reform.
- **Policymaking priorities:** In our view, the next president should take advantage of his newly gained legitimacy and political capital to move rapidly on reforms that will contribute to fiscal consolidation. Shifting the new government's initial focus toward other areas may lead markets to discount a lower probability of such consolidation, in our view.
- **The external environment:** As we have seen recently, Brazilian assets continue to be perceived as relatively risky. Contagion from other emerging markets may jeopardize the incipient economic recovery and lead to monetary policy tightening earlier than we currently expect.

The short-term macroeconomic challenges are, in our view, concentrated on the fiscal side. In our opinion, getting them right will be key to potentially unleashing a virtuous cycle with growth and stability, after many years of disappointments.

BRAZIL

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		3.0	0.5	-3.8	-3.6	1.0	1.5	3.2
Private Consumption (Δ% y/y)	62.8	3.5	2.3	-3.2	-4.2	1.0	2.3	3.0
Public Consumption (Δ% y/y)	20.8	1.5	0.8	-1.4	-0.1	-0.6	-0.2	-0.3
Investment (Δ% y/y)	16.5	5.8	-4.2	-14.0	-10.2	-1.8	3.5	8.0
Exports (Δ% y/y Local Currency)	11.3	2.4	-1.1	6.9	1.9	5.2	4.0	3.7
Imports (Δ% y/y Local Currency)	-11.4	7.2	-1.9	-14.0	-10.3	5.0	5.4	4.2
GDP (US$ bn)		2,471	2,455	1,801	1,796	2,055	1,889	1,888
Monetary and Exchange Rate Indicators								
IPCA-IBGE Inflation (Dec Cumulative) (%)		5.9	6.4	10.7	6.3	2.9	4.1	4.0
IGP-M Inflation (Dec Cumulative) (%)		5.5	3.7	10.5	7.2	-0.5	9.9	4.5
US$ Exchange Rate (Average)		2.16	2.35	3.33	3.49	3.19	3.69	3.95
Central Bank Reference Rate (eop)		10.00	11.75	14.25	13.75	7.00	6.50	7.50
Stock of Credit To Nonfinancial Private Sector (% of GDP)		50.85	52.21	53.65	49.55	47.13	46.2	45.7
Fiscal Policy Indicators								
Public Sector Fiscal Balance (harmonized) (% of GDP)		-3.0	-6.0	-10.2	-8.9	-7.8	-5.6	-5.6
Primary Balance (% of GDP)		1.71	-0.56	-1.85	-2.47	-1.7	-2.3	-1.8
Balance of Payments								
Trade Balance, % of GDP		0.0	-0.3	1.0	2.7	3.3	2.9	2.9
Current Account, % of GDP		-3.03	-4.24	-3.27	-1.30	-0.50	-1.0	-1.0
Debt Profile								
International Reserves (US$ bn)		358.8	363.6	356.5	365.0	381.1	380.0	380.6
Total Public Debt (net of public sector holdings, % of GDP)		30.5	32.6	35.6	45.9	51.6	57.9	62.8
Of which: Foreign-currency denominated (% of GDP)		-10.2	-10.3	-10.5	-10.5	-10.0	-9.8	-9.8
Labor Markets								
Unemployment Rate (% eop)		6.2	6.5	9.0	12.0	11.8	11.2	10.6

E = Santander estimate. F = Santander forecast Sources: IBGE, MDIC, FIPE, FGV, Central Bank, SEADE, and Santander.

CHILE

Growth Expected to Remain Near Potential: Can We Ask for More?

- **We see GDP growth consolidating at 3.0-3.5% y/y in the coming quarters, slightly above potential, led by the non-mining sector.**
- **The slow job creation pace is a concern, but reflects an economic recovery based on rising labor productivity and falling unit labor costs.**
- **Investment has rebounded, but we see substantial room for further expansion once reforms are passed and large infrastructure projects start to materialize.**

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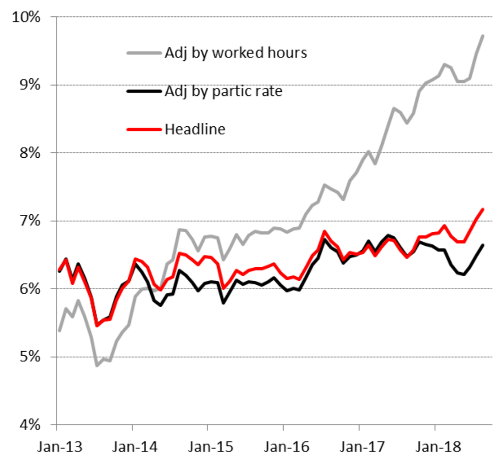
Slowdown in GDP, but more statistical than fundamental

After a positive 1H18, with GDP growth hitting 5.3% y/y in 2Q18, 3Q18 brought signs of a slowdown. July-August average growth was 3.4% y/y, and we estimate the full quarter is likely to close near 3%. Market consensus for 2018 remains at 4%, implying 2H18 growth at 3.2% and a sub-3% reading for 4Q18. However, a good part of the slowdown is due to a base-year effect in the mining sector (1H17 was poor for this industry, with an abrupt recovery in 2H17). The non-mining sector expanded 4.2% y/y in the July-August period, roughly unchanged vs. the 4.4% growth in 1H18.

Qualitatively, growth is proving to be relatively broad-based, with manufacturing, export sectors, construction, and corporate services leading the pack. With the exception of public administration, all sectors have accelerated so far this year (in y/y terms). Private consumption continues its steady growth, in line with recent years, and investment is growing 7% annually – not an impressive pace (no new large infrastructure projects have materialized in recent months), but still an improvement vs. the 2014-17 period (2% average annual contraction).

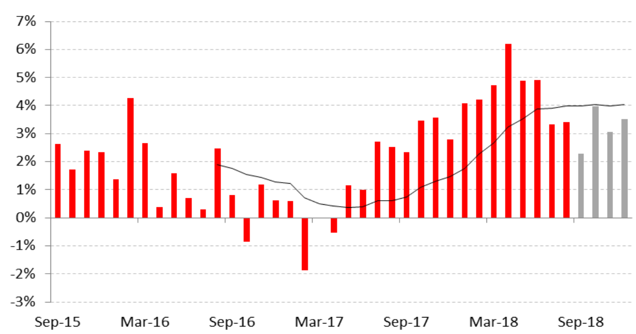
Looking ahead, we see GDP growing at the current marginal rate in the coming quarters – 4% in 2018 and 3.5% in 2019, somewhat above potential. The main risk is external, in our view, namely contagion from LatAm trading partners, tighter monetary conditions globally, and volatile copper prices. However, on the local front, the balance of risks is likely neutral, with investment and employment having room to accelerate further, while the policy mix (fiscal and monetary) should be slightly contractionary, in our view.

Unemployment rate (s.a.)



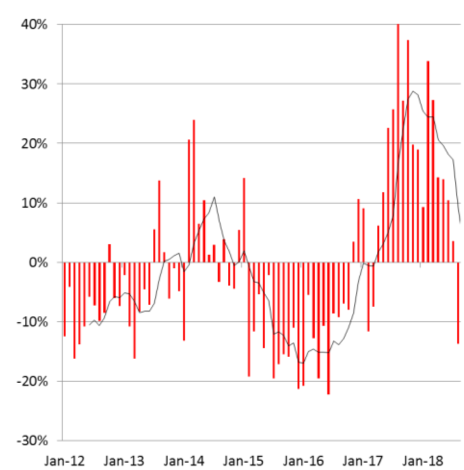
Sources: INE and Santander.

Overall IMACEC: y/y Change – 2015-2018E



Sources: BCCH and Santander.

Real income of the mining sector



y/y changes. Real income defined as value of copper production, expressed in UF. Sources: BCCh and Santander.

Labor market conundrum

Despite the pickup in GDP growth, the labor market failed to improve as expected. In August, the unemployment rate peaked at 7.3% – the highest level for this month in seven years. On the one hand, total job creation has slowed to 120k annually, which is low vs. the historical performance in good years. On the other hand, we estimate labor force growth is accelerating, in part due to a large inflow of immigrants, to around 170k annually. In this context, total employment is growing, but not fast enough to absorb all the new workers entering the market in the last few quarters.

Although several local analysts have expressed concerns on the job-poor economic recovery, we prefer to view the glass as half full: after many years of slowing or even falling average labor productivity (mainly as a result of fast-growing public sector jobs), a turnaround is taking place, with unit labor costs declining 2.5% annually, the fastest pace in six years. This is good for Chile’s competitiveness and the sustainability of the recovery phase, as it implies the absence of cost pressures on the inflation front.

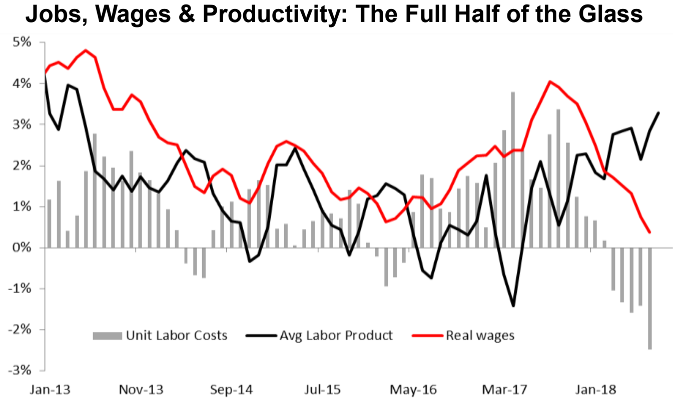
Monetary policy: not-so-expansionary interest rates

A rate-hiking cycle is imminent, according to recent BCCh statements, which indicate that growth and inflation conditions have normalized, so the need for highly expansionary rates (currently 2.50% vs. 4.25% neutral level) has passed.

On the inflation front, in our view the main risk is the FX rate, which has been increasing steadily since early this year, in line with the direction of USD globally. Based on this, we see CPI inflation staying somewhat above the target in the coming quarters: we forecast 3.1% y/y for year-end, in both 2018 and 2019. In turn, local price pressures look contained, with steady immigration keeping nominal salaries well disciplined.

The market is pricing in 100-125 bps of hikes in the next 12-15 months, but our call is that the policy rate will not go directly to neutral, but instead reach and stay at an intermediate level for some time, likely 3.50%. At that level, the BCCh would be in a good position to hike further toward neutral if growth remains above 3% in 2020, or alternatively, to start cutting again if the negative risks from the global economy finally materialize. In any case, we believe interest rates will remain in expansionary terrain for an extended period, as the risks of overheating are low, in our view.

Jobs, Wages & Productivity: The Full Half of the Glass



y/y changes, last 3 month basis. Sources: INE, BCCH and Santander.

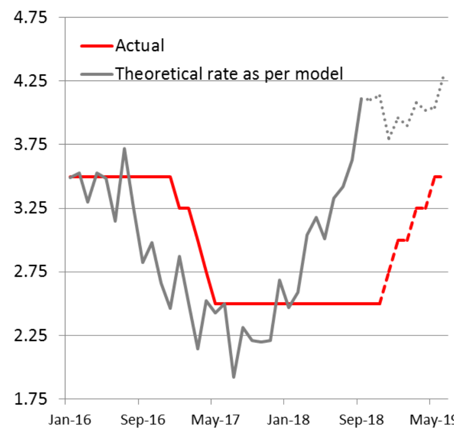
Politics and reforms: the government takes its time

The new Piñera administration recently launched the “tax modernization” bill, a revenue-neutral reform aimed at “reintegrating” the income tax system (i.e., shareholders are entitled to fully deduct corporate tax payments from their individual taxes). This change would lead to a revenue loss that would be offset by new taxes on offshore app services, and anti-evasion measures for VAT, among others. The government is also expected to submit pension reform to Congress soon (including measures to increase participants’ savings), which, together with the 2019 budget bill already under debate, will require considerable negotiating skills, as the ruling coalition bloc falls slightly short of an outright majority in both chambers.

Fiscal policy: prudent approach

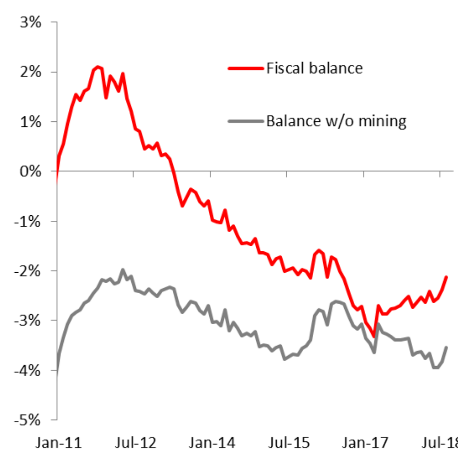
In the last 12 months, the actual deficit was 2.1% of GDP, vs. 2.7% in 2017. The new government has been attempting to contain primary spending through a relatively low execution rate vs. the budget, with the overall spending-to-GDP ratio falling 50 bps, to 23.1%. On the revenue side, non-mining tax collection is growing more slowly than GDP, partly because income tax collection has been disappointing. Copper-related revenue increased through July (in y/y terms), but in August we saw the first contraction in many months, representing a yellow flag for fiscal performance in the coming quarters. In any case, the new administration has maintained a prudent fiscal approach since it took office, aiming to curb public debt growth and provide support for the sovereign credit rating. The actual deficit target for 2018 stands at 1.8% of GDP, and although the possibility of reaching that level is decreasing due to volatility in copper prices, we expect the fiscal imbalance to still fall significantly from 2017’s 2.7%.

BCCh policy rate: actual vs. model



Sources: BCCh and Santander.

Actual fiscal balance (% GDP, last 12M)



Sources: Dipres and Santander.

CHILE

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		4.0	1.8	2.3	1.3	1.5	4.0	3.5
Private Consumption (Δ% y/y)	12	4.6	2.7	2.1	2.2	2.4	4.3	3.8
Public Consumption (Δ% y/y)	65	2.8	3.8	4.8	6.3	4.0	2.8	3.6
Investment (Δ% y/y)	28.4	3.3	-4.8	-0.3	-0.7	-1.1	6.0	4.5
Exports (Δ% y/y Local Currency)	39	3.3	0.3	-1.7	-0.1	-0.9	4.8	3.2
Imports (Δ% y/y Local Currency)	39	2.0	-6.5	-1.1	0.2	4.7	7.8	4.9
GDP (US$ bn)		279	261	244	250	277	309	321
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		3.0	4.6	4.4	2.7	2.3	3.1	3.1
CPI core Inflation IPCX1 (Dec Cumulative)		2.4	5.1	4.7	2.9	1.9	2.7	3.3
US$ Exchange Rate (Average)		495	570	654	677	649	644	684
Central Bank Reference Rate (eop)		4.50	3.00	3.50	3.50	2.50	2.75	3.50
Private sector credit (% of GDP)		83.2	85.0	88.0	88.2	90.0	88.0	89.5
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-0.6	-1.6	-2.1	-2.7	-2.8	-2.2	-1.9
**Primary Balance, % of GDP		-0.1	-1.0	-1.4	-2.0	-2.0	-1.4	-1.0
Balance of Payments								
Trade Balance, % of GDP		0.7	2.5	1.4	2.2	2.8	3.9	3.2
Current Account, % of GDP		-4.1	-1.7	-2.3	-1.4	-1.5	-2.0	-2.2
Debt Profile								
Central Bank International Reserves (US$ bn)		41.1	40.5	38.6	40.0	40.0	40.0	40.0
Total Public Debt (gross, % of GDP)		12.1	14.1	16.2	21.5	25.5	25.5	26.6
Of which: Foreign-currency denominated (% of GDP)		1.9	2.5	3.2	3.5	4.0	4.5	5.0
Labor Markets								
Unemployment Rate (% eop)		5.9	6.4	6.2	6.5	6.7	6.8	6.6

E = Santander estimate. F = Santander forecast Sources: Central Bank, Servicio de Estudios, and Santander.

COLOMBIA

STRONGER THAN EXPECTED RECOVERY

- **Growth surprised on the upside in 2Q18, suggesting a stronger recovery than initially anticipated, aided in part by a recovery in investment. We have revised upward our 2018 and 2019 GDP forecasts.**
- **We believe that BanRep is in no rush to hike, as inflation is under control and should remain low and close to the target by YE2018. We expect the MPC to be on hold until March 2019.**
- **All eyes are on fiscal policy, as the 2019 fiscal budget discussions are ongoing, and the Ministry of Finance is expected to present a fiscal reform proposal.**

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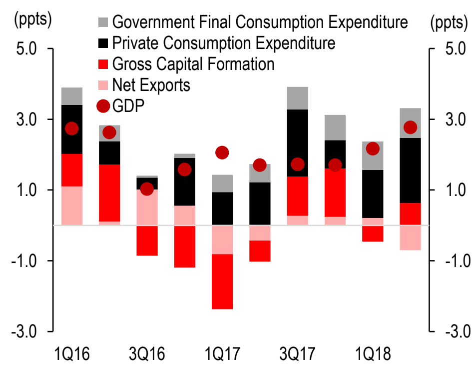
Stronger than anticipated recovery

Real GDP growth for 2Q18 surprised on the upside, increasing 2.8% y/y, up from 2.2% y/y in 1Q18. On the demand side, private consumption continues to be the main driver of growth, contributing almost 70% of annual growth and accelerating at the margin, as it expanded 0.8% q/q seasonally adjusted in 2Q18 from +0.7% q/q and +0.4% q/q in the previous two quarters. During 2Q18, investment surprised on the upside, as gross fixed investment increased 1.7% y/y, bouncing back from the 0.7% y/y contraction reported in 1Q18. The largest jump was reported in machinery and equipment, which expanded 6.4% y/y, after contracting 1.8% y/y in 2017. On the supply side, construction activity continues to lag the recovery, as it contracted 7.6% y/y in 2Q18, following the contraction of 3.9% y/y in 1Q18. The construction contraction was broad-based, with residential and commercial construction decreasing 7.6% y/y, civil works declining 5.7% y/y, and other construction activity falling 9.2% y/y. We estimate that construction has subtracted around 0.4 p.p. from GDP growth year to date, yet investment figures have begun to point to some improvement in the coming quarters. In effect, the gross fixed investment seasonally adjusted series reports that investment in the housing sector increased 3.6% q/q, posting its second consecutive positive variation Moreover, investment in other building and structures increased 1.1% q/q, after declining in the past four quarters. Given the stronger than expected readings in 2Q18, particularly in investment, we have revised upward our 2018 and 2019 GDP forecasts, to 2.7% from 2.5% and to 3.3% from 3.0%, respectively. We expect private consumption to remain the main driver of growth, based on positive consumer confidence and higher real wages. At the same time, we expect investment to continue improving in the coming quarters, providing more support to the economy.

Inflation low and under control in the short term

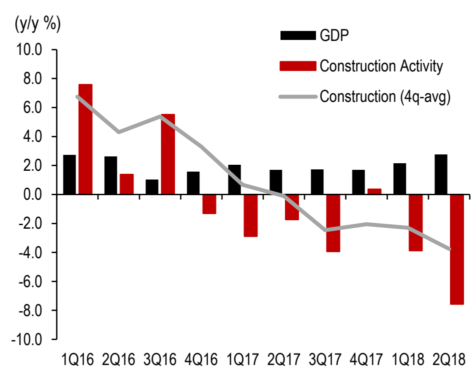
The inflation outlook remains positive, with headline inflation remaining close to the 3% target and expected to increase only moderately by year-end, ending 2018 at 3.3%, in our view. In September, headline inflation stood at 3.23% y/y, increasing from August's 3.10% y/y reading. In general, food prices are the main driver pushing inflation higher; these had remained subdued this past year but are slowly starting to normalize. In September food prices increased 2.1%, the first reading above 2% this year despite the higher statistical base, and food prices' contribution to the annual headline increased by 32 bps from February, when it reached bottom. In contrast, non-tradable inflation has surprised on the downside, offsetting some of the pressures. As of September, non-tradable inflation decreased to 4.13% y/y from 5.37% y/y in January, moving closer to the upper band of the target, after remaining high and sticky in 2017. In general, as we mentioned, we expect inflation to continue to increase moderately until year-end, as food prices continue to normalize and as we see some pressures from higher gasoline prices and related services. However, we note that risks are to the upside, in particular for next year, as the weather association reported a 70% probability of El Nino materializing at year-end. While the estimates still point to a mild El Nino, it could potentially create pressures on inflation.

GDP contribution by component



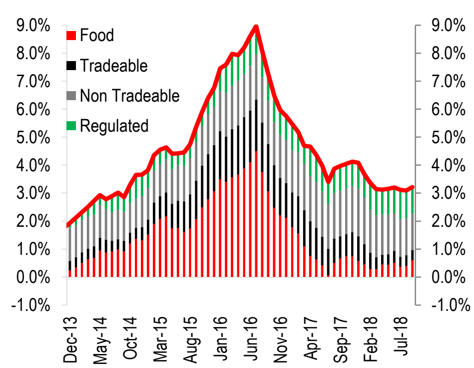
Sources: DANE and Santander

Construction activity lagging behind



Sources: DANE and Santander.

CPI breakdown by component



Sources: DANE and Santander.

BanRep on hold and accumulating FX reserves

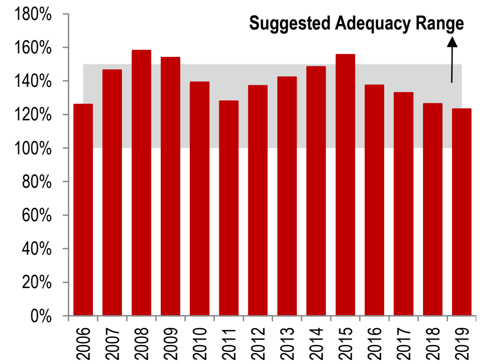
At its September meeting, BanRep kept the interest rate on hold, at 4.25%, for the fifth consecutive month, in line with expectations, but had a more dovish tone than in its previous communiques. In particular, the MPC noted again the weakness in the economy and uncertainty about the pace of the recovery, but did not mention upside risks to growth as it did previously. On inflation, the MPC noted that observed and expected inflation remains close to the target, and it removed the upside risks to inflation. Finally, the MPC noted that it is taking into account the impact of changing international conditions on the Colombian economy. In all, the statement gives a sense that the MPC would rather give the economy further support, yet the external environment is restricting it. This supports our view that the MPC is in no rush to hike and that it will remain on hold until the end of the year, possibly not starting to hike until March 2019. We believe that if there are no significant pressures from El Nino and if the COP remains somewhat stable, BanRep may start the hiking cycle later.

Additionally, BanRep surprised the market by announcing a program to accumulate international reserves through put options in order to add reserves as a preventive measure in case its flexible credit line (FCL) with the IMF of approximately US$11.5 billion is reduced in 2020. The options can only be exercised when the official exchange rate (TRM) is below the average of the previous 20 working days. Thus, BanRep will avoid purchases at times when FX is pressured. The first auction was held on October 1, and offered US$400 million. As of the second week of October, US$300 million of the $400 million put options has been exercised. The last time BanRep intervened in the FX market was in May 2016, when it reduced reserves by US$255 million through call options. Yet, the last time BanRep bought US dollars was in 2014 through direct auctions, accumulating US$4 billion. If we look at FX reserves as a percentage of the IMF's ARA metric, we notice that reserves remain within the range of adequacy. However, since 2015 this buffer has been declining. Moreover, we expect the current account to widen in 2019, as we expect imports to accelerate faster in line with the recovery. At the same time, we notice that portfolio inflows have been decelerating at a faster pace than the increase in FDI. According to BanRep, the FX accumulation program may last two years, and although there is no specific target and it is not aiming to fully cover the FCL, we consider that the accumulation of $4 billion could lead to a more adequate level. In sum, we see the news of this program as positive, given that the external environment is less favorable and remains uncertain and the external position is likely to deteriorate at the margin.

Fiscal policy in the spotlight again

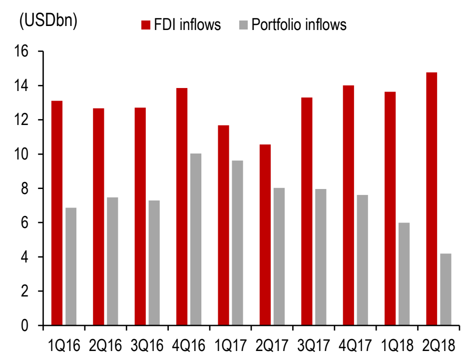
The fiscal budget for 2019 continues to be discussed in Congress. The Ministry of Finance estimates that there is a COP14 trillion gap in the budget that will have to be covered in order to be compliant with the fiscal rule and decrease the fiscal deficit of 2.4% (-0.7 ppts vs. 2018). In an effort to reduce this gap, the government approved a local swap debt, where the government swaped 2018 and 2019 bonds for bonds due between 2025 and 2035. With this, the government decreases amortizations by COP6.5 trillion in 2019 and by COP5.8 trillion in 2018. Additionally, the government issued US$2 billion of USD bonds and bought back US$1 billion (COP3 trillion) worth of debt in 2019. *Ceteris paribus*, we think 2019's fiscal adjustment is achievable, with oil revenue estimated to close 0.5 p.p. of the gap. However, medium-term fiscal consolidation remains a concern, given the rigidities on the expenditure side, in particular pension obligations, which account for ~28% of total expenditures. The Ministry of Finance is expected to present a fiscal reform proposal this year that will aim to alleviate the tax burden on corporates and increase the tax base. Fitch has stated that the reform has to be net positive in order to ensure that the government meets its fiscal target; however, we believe the fiscal reform will prove to be neutral at best. The main reason, in our view, is that although the corporate income tax contribution is higher in Colombia than in the region overall, VAT collection is more in line, and the initial proposal for aggressive increases in the tax base has received significant pushback in Congress, leaving once again the need for pension reform to address structural rigidities and ensure fiscal consolidation in the medium term.

FX reserves as % ARA metric



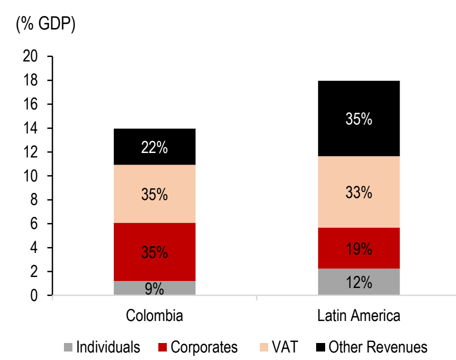
Note: ARA Metric is a weighted average of export revenue (5%) broad money (5%), short-term debt (30%) and other liabilities (15%). Sources: IMF and Santander

FDI inflows increasing, while portfolio inflows slowing down (4q-sum)



Sources: BanRep and Santander

Central government tax revenue breakdown



Note: 2016 Data. Sources: OECD and Santander.

COLOMBIA

	% GDP	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		8.9	4.7	4.9	1.8	4.0	4.6	3.5
Private Consumption (Δ% y/y)	61.1	6.1	11.8	-1.2	0.3	0.6	0.4	1.5
Public Consumption (Δ% y/y)	16.1	4.7	-0.3	1.7	-1.4	-0.7	1.5	3.1
Investment (Δ% y/y)	23.7	7.4	7.8	-1.1	-4.0	0.3	3.8	4.8
Exports (Δ% y/y)	18.9	382	381	293	283	314	338	338
Imports (Δ% y/y)	19.8	8.9	4.7	4.9	1.8	4.0	4.6	3.5
GDP (US$ bn)		6.1	11.8	-1.2	0.3	0.6	0.4	1.5
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		1.9	3.7	6.8	5.8	4.1	3.3	3.2
Core inflation (Dec Cumulative)		2.8	3.3	5.2	5.1	5.0	3.7	3.5
US$ Exchange Rate (Average)		1869	2400	2740	3050	2952	2916	3100
Central bank reference Rate (eop)		3.25	4.50	5.75	7.50	4.75	4.25	5.25
Bank lending to the private sector (% chg YoY, Dec)		14	14.0	12.0	9.0	10.0	12.0	12.0
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-2.4	-2.4	-3.0	-4.0	-3.6	-3.1	-2.4
Primary Balance, % of GDP		0.0	-0.2	-0.5	-1.1	-0.8	-0.2	0.5
Balance of Payments								
Trade Balance (% of GDP)		-0.7	-3.0	-4.7	-3.3	-1.5	-1.0	-1.0
Current Account (% of GDP)		-3.3	-6.6	-6.4	-4.3	-3.3	-3.0	-3.4
Debt Profile								
Central Bank International Reserves (US$ bn)		43.6	47.3	46.7	46.7	47.3	47.6	50.1
Total Public Debt (gross, % of GDP)		31.6	38.3	37.0	44.0	45.0	45.0	44.0
Of which: Foreign-currency denominated (% of GDP)		8.5	11.0	14.0	16.0	16.0	15.0	15.0
Labor Markets								
Unemployment Rate Avg. (year-end % of EAP)		8.4	8.7	8.6	8.7	8.6	8.4	8.0

E = Santander estimate. F = Santander forecast. Sources: Finance Ministry, Budget Office, Central Bank, and Santander.

MEXICO

AMLO Has an Opportunity to Jump-Start the Economy

- **The trilateral trade agreement was a significant positive macro event for Mexico, in our view.**
- **Three years of uncertainty regarding the trade outlook for Mexico, the US, and Canada came to an end.**
- **We believe AMLO has an opportunity to jump-start the economy, as there is a significant lag in both private and public investment.**
- **Inflation is still a challenge in the short-term; we see Banxico with a hawkish bias given concerns about the complex global environment.**

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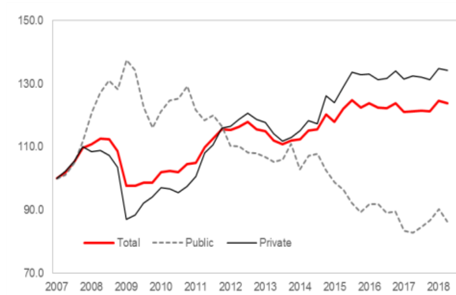
Trilateral Trade Agreement, USMCA, ends three years of uncertainty

On September 30, the US, Canada, and Mexico reached a trilateral trade agreement to replace NAFTA. The agreement, to be known as the US-Mexico-Canada Agreement, or USMCA, was a major macro event for Mexico. The outcome was made possible by a last-minute understanding between the US and Canada making the agreement trilateral instead of bilateral (US-Mexico), just before the midnight deadline of September 30 to present the written document to the US Congress. Up until the deadline, the understanding was that both Mexico and the US would present the bilateral agreement reached a month earlier to their respective legislatures, with the risk that the US Congress would not approve it, as, according to most press accounts, they preferred a trilateral agreement that included Canada. Over that weekend, however, intensive negotiations brought Canada back to the table, and with a surprise reversal, we now have a trilateral pact.

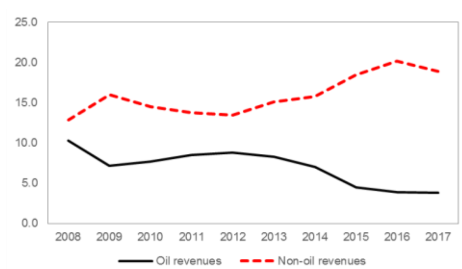
Fixed investment (1Q2007=100 S.A.)



Sources: INEGI and Santander.

The implications for the Mexican economy are substantial, because for the last three years, private investment has suffered from uncertainty regarding the fate of the trade agreement. Since Donald Trump was a presidential candidate in 2016, and later, since he became president, he has threatened to withdraw the US from NAFTA and terminate the deal. That threat created a cloud of uncertainty that, together with Mexican presidential election jitters last year and this one, made the private sector more cautious about investing in the Mexican economy. Adding these factors to the fiscal constraints that have forced the current administration to cut public investment, the overall outlook for total investment has been grim at best. The current Peña Nieto administration faced a collapse of fiscal oil revenue of around 5.0% of GDP, pressures from pension expenditures, and a substantial depreciation of the peso, among other negative factors. The policy response was to increase tax revenue, and the remaining deficit was accommodated by increasing public debt as a percentage of GDP and by cuts in expenditures, mainly on investment projects. According to the current administration, it hoped that the private sector, within the framework of the structural reforms, would be able to offset these expenditure cuts with private investment.

Public sector revenue (% of GDP)



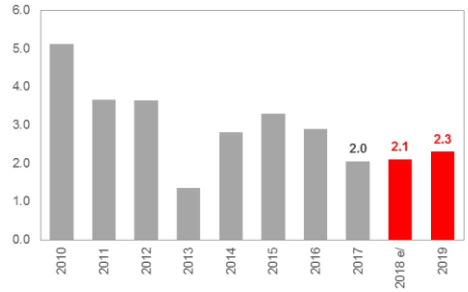
Sources: Ministry of Finance and Santander.

The incoming administration of Andrés Manuel López Obrador (AMLO), who will take office in December, has an opportunity to jump-start investment, in our view, as there is a significant lag in infrastructure projects, and the structural reforms are in place, passed by the current administration. AMLO's team has pledged to foster private sector investment, or even public investment projects with private capital. With the uncertainty around relations with the US out of the way, we expect total investment to rebound and have a positive impact on growth in the coming years. We believe that in order to appeal to the private sector, AMLO's administration will have to create a more stable environment for investors and understand the fiscal constraints. In our view, a good start could be investments in the Mexico City Airport, better yet if the government offered concessions to private investors. So far, AMLO's team has been careful to send reassuring signals to the market. An example was the recent appointment of a private economist, Jonathan Heath, to the board of governors of the Central Bank, replacing Manuel Ramos Francia at the end of the year when his term expires. Mr. Heath is independent and has no affiliation with AMLO's political party. His appointment was well received by the market.

Increasing productivity, easing inflationary pressures, and boosting consumption

For the past several years, we think it is possible that weak investment reduced the potential growth of the Mexican economy, and Banxico has expressed concern that the tight labor market could be inflationary. In our view, a surge in investment projects is what the economy needs to boost GDP, easing inflationary pressures by enabling real wage increases to be matched by productivity gains. With USMCA in effect, the proposal of the incoming AMLO administration to increase the minimum wage can be better absorbed by the economy, in our opinion, reducing its inflationary impact somewhat and contributing more to private consumption and GDP growth. In this scenario, we underscore that economic growth could accelerate to 2.3% in 2019 from our 2.1% forecast for this year. We anticipate that accelerating growth is likely to become more obvious in the second half of 2019 once the new administration has had time to settle in.

GDP growth (%)

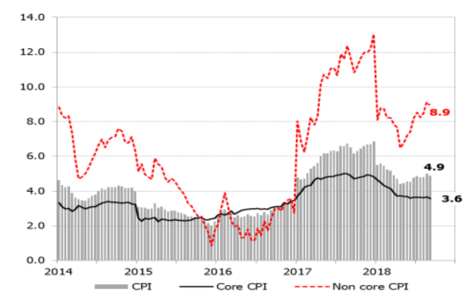


Sources: INEGI and Santander.

Inflation still a challenge in the short term; we see Banxico with a hawkish bias

On October 4, in a move widely anticipated by the market and by us, the board of governors of the Central Bank left the policy rate unchanged at 7.75%. Going into the meeting, we expected a stay in the policy rate, but we changed that call after we learned that Canada had joined the USMCA on the night of September 30. In this context, aside from the positives of the agreement, we expected a 25-bps hike, taking the policy rate to 8.0%. The relevant point is that we still envisioned a heated debate, and in fact, one member of the board dissented and voted for a hike. Thus, we view the communique as hawkish, and looking at the details, we think the USMCA might have tilted the balance toward a stay in the policy rate.

CPI (YoY %)



Sources: INEGI and Santander.

With respect to inflation, the board took a wait-and-see attitude. The board still characterizes the energy price shock as temporary, although larger than previously thought. They are not altering their expectation that core inflation will continue in a descending trend, even though they now see the new trade agreement contributing to reduce the negative bias to GDP growth that they saw in the last meeting. Previously, this negative bias to growth was expected to help moderate core inflation. The board also underscored that the new trade agreement could have positive effects on the exchange rate and on inflation down the road – another factor in which the trade pact may have tilted the balance toward a stay. However, we believe the decision to hold was based more on a wait-and-see attitude, and we note that the board stressed that the balance of risks for inflation is still to the upside.

In our view, the communique by no means closes the door to more hikes in the future. Banxico expressed concerns about the complex global economic environment, in particular the Fed's tightening policy, and more so after the warning by Fed Chairman Jerome Powell on October 2 that the Fed might hike rates above the neutral level. Nevertheless, Banxico's board underscored the reduction in uncertainty resulting from the new trade agreement, which in our view may have tilted the balance in favor of a stay in policy. At any rate, a "stay" should not be confused with the end of the tightening cycle, as the board still sees an adverse external environment. At this point we do not expect a hike in our base scenario, but believe the bias is still on the hawkish side. The communique did not omit the line from previous statements that the board will follow the relative monetary approach taken by Mexico and the US.

MEXICO

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		1.4	2.8	3.3	2.9	2.0	2.1	2.3
Private Consumption (Δ% y/y)	73.9	1.8	2.1	3.4	3.7	3.0	2.8	3.0
Public Consumption (Δ% y/y)	10.9	0.5	2.9	1.9	2.4	0.1	2.0	0.5
Investment (Δ% y/y)	20.9	-3.4	3.1	5.0	1.1	-1.5	2.5	2.2
Exports (Δ% y/y Local Currency)	17	1.4	7.0	8.4	3.5	3.8	4.7	4.5
Imports (Δ% y/y Local Currency)	21.5	2.1	5.9	5.9	2.9	6.4	5.8	5.2
GDP (US$ bn)		1,275	1,313	1,170	1,077	1,154	1,217	1,244
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		4.0	4.1	2.1	3.3	6.8	4.5	3.9
CPI core Inflation (Dec Cumulative)		2.8	3.2	2.4	3.4	4.9	3.7	3.7
US$ Exchange Rate (Average)		12.8	13.3	15.9	18.7	18.7	19.0	18.7
Central Bank Reference Rate (eop)		3.50	3.00	3.25	5.75	7.25	7.75	7.25
Bank Lending to Private Sector (% of GDP)		14.7	14.8	16	16.9	17.5	18.5	19.0
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-2.3	-3.2	-3.5	-2.6	-1.1	-2.0	-2.0
Primary Balance, % of GDP		-0.4	-1.1	-1.1	-0.1	1.4	0.9	0.9
Balance of Payments								
Trade Balance		-0.1	-0.2	-1.3	-1.2	-1.0	-1.0	-1.0
Current Account, % of GDP		-2.4	-1.8	-2.5	-2.2	-1.7	-1.6	-1.6
Debt Profile								
Central Bank International Reserves (US$ bn)		176.5	193.2	176.7	176.5	172.8	175.0	178.0
Total Public Debt (gross, % of GDP)		40.4	43.2	47.3	48.7	46.0	45.3	44.8
Of which: Foreign-currency denominated (% of GDP)		10.2	11.9	14.6	18.3	15.7	15.1	14.7
Labor Markets								
Unemployment Rate (year-end, % of EAP)		4.9	4.8	4.3	3.9	3.4	3.3	3.4

E = Santander estimate. F = Santander forecast Sources: Economy Ministry, Central Bank, and Santander estimates.

PERU

Positive Growth Outlook Continues

- **GDP posted a solid expansion in 1H18, driven by private consumption and private investment. In line with this, we have raised our 2018 GDP forecast to 4.0% from 3.5%.**
- **Headline inflation has been slowly rising toward the 2.0% target, as food inflation is normalizing. We expect it to end at 2.3% in 2018.**
- **The Central Bank is on hold, but we expect it to deliver its first hike in December, as inflation reaches the target and the output gap closes.**
- **The government will hold a referendum on December 9 for voters to decide on four constitutional amendments, including the creation of an upper chamber.**

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Solid growth continuing in 2H18

In 2Q18, the economic recovery accelerated more than expected, as real GDP increased 5.4% y/y, posting the highest annual growth since 4Q13. With this, 1H18 growth stands at a solid 4.2% y/y. The acceleration in growth reflects a stronger contribution from private consumption and a notable pickup in private and public investment, while public consumption disappointed. In effect, private consumption increased 4.5% y/y in 2Q18, up from 3.2% y/y and 2.6% y/y in 1Q18 and 4Q17, contributing to almost half of the annual growth. The private consumption recovery has been in line with the pickup in consumer credit as well as the recovery in the labor market, with formal employment in the private sector expanding 5.1% y/y during the quarter, above the 2.0% average increase in 2017.

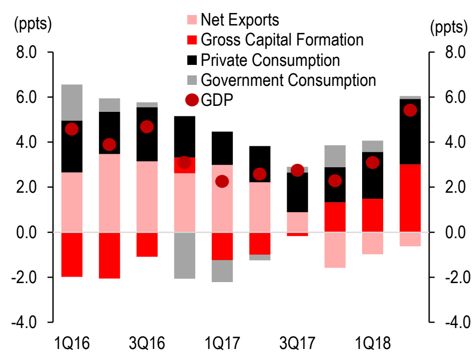
Public and private investment also posted solid results in 2Q18. Public investment growth jumped to 9.0% y/y, from 5.5% in 1Q18 and -4.0% on average in 2017. The pickup in public investment reflects higher investment by local governments related to various infrastructure projects, including the Pan American Games. In terms of private investment, this component also registered a significant acceleration, as it increased 8.5% y/y in 2Q18, above 5.3% y/y in 1Q18 and the 0.2% y/y average in 2017. The pickup in private investment reflects large investment projects in both the mining and non-mining sectors. In general, there are strong investment commitments in the pipeline in both the mining and non-mining sectors, suggesting, in our view, that private investment in general will continue to expand at a solid pace in 2H18 and 2019.

Although the most recent monthly GDP figures point to a moderation (2.3% average in July-August), mainly as a result of lower public investment, we consider that the economy will continue to expand at a solid pace in the coming quarters, driven by strong consumption and private investment. We have raised our GDP forecast for 2018 to 4.0% from 3.5% and anticipate that the economy will continue to expand at a similar pace in 2019.

Inflation on track to reach the 2.0% target

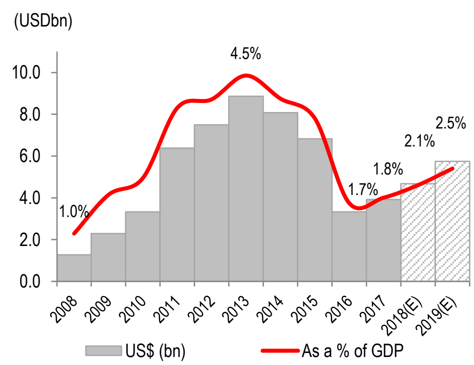
After falling below the target range in March 2018, headline inflation has slowly been rising toward the 2% target. As of September, headline inflation (Lima CPI) stood at 1.28% y/y, up from 1.07% in August. Core measures, however, are higher. Core inflation, for example, which excludes the most volatile items, stood at 2.44% y/y in September, while inflation ex food stood at 2.46% y/y and has remained closer to the high end of the 3% upper band of the target rate for most of the year, suggesting that a great part of the low headline inflation this year is the result of abnormally low food prices, a trend similar to that seen in the other Andean countries. In September, however, there were signs that food inflation is starting to normalize, as food & beverage increased 0.9% m/m in that month, contributing to 84% of the monthly inflation. In general, we expect inflation to continue to move upward, in part due to a less favorable statistical base, but also as we expect food inflation to continue to normalize, while we

GDP contribution by component



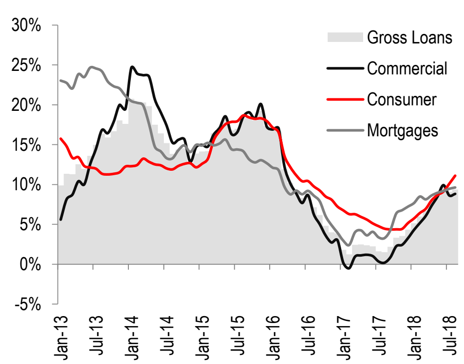
Sources: Central Bank and Santander.

Strong mining investment in the pipeline



Sources: Ministry of Energy and Mining; Santander.

Credit is in expansion mode (y/y %)*



* Nominal terms: Sources: SBS and Santander.

may also start seeing some demand-side pressures by the end of the year, as consumption continues to improve. In all, we also consider that risks remain to the upside, as in addition to the aforementioned factors, the weather association reports that there is a 70% probability of an El Nino event. Although estimates point to a mild El Nino, we may see some pressures associated with this phenomenon.

Central Bank on hold

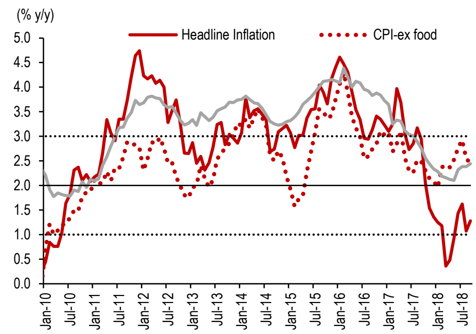
Since June 2018, the Central Bank (BCRP) has kept the reference rate on hold at 2.75%, maintaining an expansionary rate to provide support to the economy. In the latest communiques, the MPC has noted that inflation is within the target range, but has also noted that leading indicators point to temporary moderation and that the economy remains below its potential. On the external front, BCRP members recognize that there is greater risk to global growth and higher volatility due to recent global trade tensions and in the October communique also noted the uncertainty in international markets.

Taking this scenario into consideration, the board continues to see it as fitting to keep the interest rate on hold, as they continue to consider it appropriate to maintain an expansionary policy stance until it is certain that convergence to the target will take place in a scenario of anchored inflation expectations and economic growth close to potential. We maintain our view that this scenario will materialize by the end of 2018, as activity should continue to grow at a solid pace, closing the output gap, and inflation should reach the target in November this year, while inflation expectations in the medium term remain anchored at 2.5%. Under this scenario, we maintain our forecast that the Central Bank will hike 25 bps by the end of this year.

Referendum to fight corruption

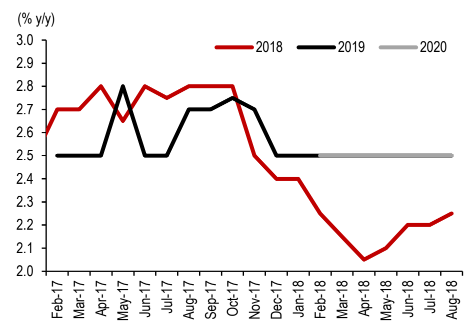
After months of discussion, Peru's Congress approved in October the executive branch's proposal to hold a referendum for voters to decide on four constitutional amendments. The reforms proposed in the referendum would prohibit the immediate reelection of lawmakers, tighten controls over party finances, introduce changes to the election of judges and prosecutors, and make the parliament bicameral again (it was changed to unicameral under Alberto Fujimori's regime in 1992). President Vizcarra proposed the reforms in July this year as a step toward fighting corruption amid exposés of corruption within the judiciary and broad public disapproval of all branches of government. The referendum will take place on December 9, and voters are likely to approve the reforms, according to the latest Ipsos-El Comercio poll (reported on September 16). President Vizcarra recently stated that the executive branch will not support the bicameral reform, as he noted that the approved version removed the gender-parity proposal and changed the rules on vote of confidence in favor of the Congress. In another piece of political news, on October 10 Keiko Fujimori was arrested on allegations of illicit campaign financing stemming from the ongoing Odebrecht probe. Ms. Fujimori is the leader of the Fuerza Popular Party, which in January of this year lost its majority in Congress when her brother Kenji Fujimori and nine other members left the party. Recall that Ms. Fujimori led two attempts to impeach former President Kuczynski, who ultimately decided to resign in March, leaving his former VP Martin Vizcarra to take over the position. In all, the referendum has the potential to change the political dynamics in the country. In the short term, however, we consider that these changes would not affect the country's positive economic outlook, but may actually improve the president's governability, as President Vizcarra's approval rating has improved in part as a result of the referendum discussion.

CPI moving higher



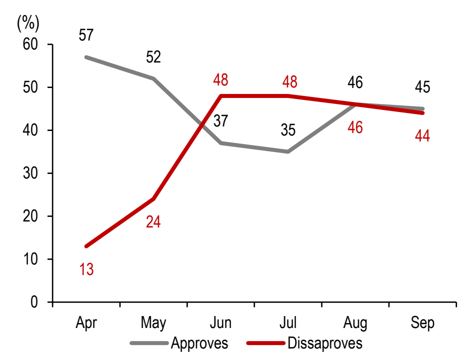
Sources: Central Bank and Santander

Inflation expectations



Source: Central Bank.

President Vizcarra's approval rating recovering



Source: IPSOS-El Comercio.

PERU

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		5.8	2.4	3.3	4.0	2.5	4.0	4.1
Private Consumption (Δ% y/y)	61.4	5.7	3.9	4.0	3.3	2.5	3.5	3.8
Public Consumption (Δ% y/y)	11.2	6.7	6.0	9.8	-0.5	1.6	3.0	3.0
Investment (Δ% y/y)	28.2	11.5	-3.1	-2.8	-3.9	-2.3	6.0	3.0
Exports (Δ% y/y Local Currency)	23.9	-1.3	-0.9	4.0	9.5	8.5	3.5	3.6
Imports (Δ% y/y Local Currency)	24.6	4.2	-1.4	2.4	-2.2	4.0	4.3	4.5
GDP (US$ bn)		198	203	192	197	217	229	244
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		2.9	3.2	4.4	3.2	1.4	2,3	2.5
WPI Inflation (Dec Cumulative)		3.7	3.3	4.1	3.7	2.3	2.5	2.5
US$ Exchange Rate (Average)		2.7	2.8	3.2	3.4	3.2	3.3	3.4
Central Bank Reference Rate (eop)		4.00	3.50	3.75	4.25	3.25	3.00	3.75
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		0.9	-0.3	-2.1	-2.3	-3.1	-3.0	-2.7
**Primary Balance, % of GDP		2.0	0.8	-1.1	-1.3	-1.9	-2.0	-1.5
Balance of Payments								
Trade Balance, % of GDP		0.3	-0.7	-1.5	1.0	2.9	3.5	3.6
Current Account, % of GDP		-4.7	-4.4	-4.8	-2.7	-1.3	-1.3	-1.4
Debt Profile								
Central Bank International Reserves (US$ bn)		65.7	62.3	61.5	61.7	63.6	64.6	65.1
Total Public Debt (gross, % of GDP)		20.0	20.1	23.3	23.8	24.8	25.8	27.5
Of which: Foreign-currency denominated (% of GDP)		9.0	8.7	11.1	10.3	8.7	8.7	8.7
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.5	5.2	6.2	6.7	6.9	6.0	6.0

E = Santander estimate. F = Santander forecast Sources: Economy Ministry, Central Bank, and Santander estimates.

URUGUAY

COLLATERAL DAMAGE

- **While financial links with Argentina have weakened within the past decade or so, we think tourism inflows and retail sales are likely to lose steam. We lowered our 2018 GDP growth estimate to 1.5% from 2.3%.**
- **The UYU remains overvalued with mounting downward risks, particularly as the Central Bank reduces its still-high reserve ammunition. We now expect the peso to close the year at UYU/USD 33.5 (previously UYU/USD 32.0). As a result, we see inflation likely to close at 8.4% y/y.**
- **Fitch (BBB-) revised the country's outlook to negative amid persistent fiscal deficits and a high and rising debt burden.**

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Activity figures are not as strong they appear, excluding the oil refinery effect

Real GDP figures released in mid-September show 2.5% y/y growth for 2Q18, slightly below our 3.3% y/y expectation, as both private investment and exports declined. Moreover, excluding the oil refinery effect, we estimate overall 2Q18 GDP growth near 1% y/y, decelerating from an estimated 1.6% y/y in 1Q18 and 2.2% y/y in 4Q17. State-owned refinery ANCAP was closed for almost all of 2017 due to maintenance and a strike by the workers' union, undermining GDP levels for the year. The opposite is occurring in 2018, as the reopening of the refinery "inflates" GDP readings. Illustrating this, industrial production was announced by the Central Bank to have grown 6.8% y/y in 2Q18, including the oil refinery effect, albeit falling by 1.8% y/y excluding that impact. Agriculture also fell 2.1% y/y, while Transport & Communications (+4.5% y/y) has been the leading growth sector in recent years, though with limited spillover effects in alternative sectors and employment. Retail, restaurant and hotel sales grew 2.3% y/y in 2Q18, decelerating from 4.3% y/y in 1Q18 and, in our view, not yet fully capturing the worsening conditions in Argentina: GDP contraction and significant weakening of the ARS – which implied a 40% real exchange rate depreciation vs. the UYU – is already negatively affecting Uruguay's retail sales. Tourism inflows, of which Argentineans account for more than 60%, fell 11.1% y/y in 2Q18 measured in US dollars. Tourism is the main contagion channel from Argentina, given diminished links between the two countries in merchandise trade and financial services.

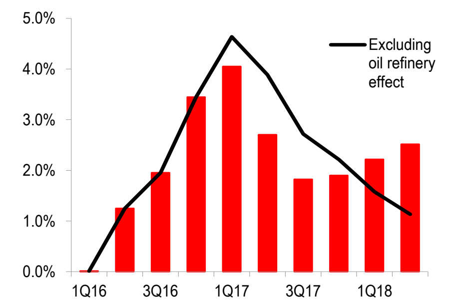
From a demand-side perspective, exports declined 6.7% y/y in real terms, due to lower soybean production and lower tourism inflows, while fixed private investment remains in negative territory with a 2% y/y real decline and a low overall ratio of 16% of GDP. Household consumption grew 2.5% y/y, but this growth partially reflects the abovementioned oil refinery effect (figures not released by the Central Bank). As a result, without this distortive effect, we believe household consumption is likely to have significantly slowed from the 2.8% y/y growth in 1Q18, in line with confidence indicators. In August, the consumer confidence index collapsed 23% y/y, entering strongly pessimistic territory for the first time since it was first compiled by Ucudal in 2007. Regional turmoil, declining employment, and a weaker peso are some of the reasons for such an outcome.

In this context, we have lowered our GDP growth expectation to 1.5% y/y in 2018, but our forecast remains at a modest 0.5% y/y after removing the oil refinery effect. As a result, the country confronts a quasi-recessionary context similar to 2015, when GDP grew 0.4% y/y.

We expect the UYU to close at UYU/USD 33.5 under the assumption of persistent Central Bank intervention and BRL strengthening.

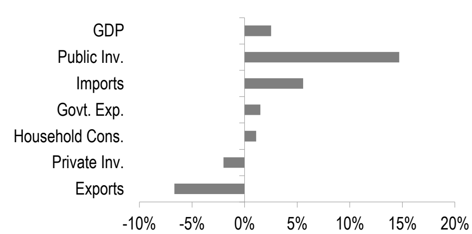
The Central Bank has recently intervened in the FX market at UYU/USD 33.3 levels in an attempt to prevent inflation from escalating above 8.5% y/y, in our

GDP slows excluding oil refinery effect



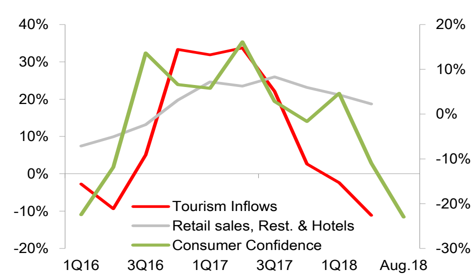
GDP growth, % y/y average change in real terms. Sources: BCU and Santander.

Household consumption rising, though also reflecting the oil refinery effect



2Q18 figures. % y/y change in real terms. Source: BCU.

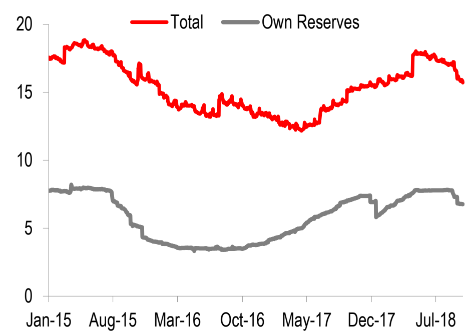
Consumer confidence and tourism inflows decline



% change y/y. Tourism inflows, measured in US dollar terms, Consumer confidence and Retail Sales in real terms. Sources: BCU and Ucudal.

view. CPI stood at 8.3% y/y in September, once again breaching the official target range between 3% and 7%. The main drivers were both tradable and non-tradable goods such as food (+14.5% y/y), a stronger U.S. dollar (+13.8% y/y), and public-owned services (+8.3% y/y). Wages, one of the main production costs in recent years, grew 6.8% y/y, well below the 8-9% levels seen in recent months. This occurred as wage negotiations stagnate in a context of rising inflation, record-high firm bankruptcies since 2002, and declining business profits. As a result, we could witness moderate real wage declines for the first time since 2015 – the only other year of such declines in the past 14 years, a period when real wages have increased by an average 3.5% p.a. Soft wage growth is consistent with rising unemployment, which reached 9% of the economically active population in 2018 as of August. This figure still disguises an even more worrisome reduction in the employment rate since 2014, partially mitigated by the decline in the average participation rate to 62.2% from 64.7%. Had the participation rate remained at 2014 levels, unemployment would have averaged 11.9% in 2018 year-to-August.

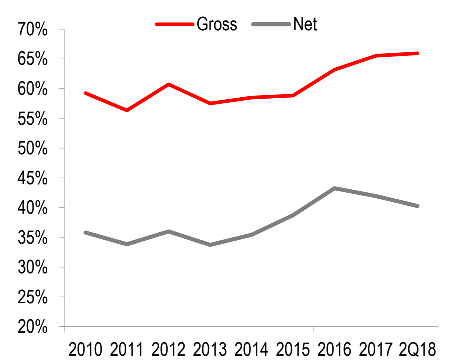
Central Bank reserves fall as the CB contains peso weakening



Total reserves and Central Bank reserves (excluding Treasury liquidity and banks' reserve requirements).In USD billion. Source: BCU.

In a context of rising inflation, the authorities have resolved to prevent sharp peso weakening, even at the expense of rising recession risks. For this reason, in recent weeks, the Central Bank sold roughly USD 1 billion of its reserves since the peak in April (-13%). As of October 5, the monetary authority held USD 15.6 billion of international reserves, of which USD 6.8 billion was its own reserves and USD 8.8 billion was bank reserve requirements and Treasury funds. Based on mid-2015 events, such a level appears strong enough to prevent a sharp weakening of the peso in the coming months. Authorities were then ready to sell approximately USD 4.5 billion of reserves, reaching a minimum of USD 3.5 billion of own reserves during the nine-month duration of the external shock. In early 2016, however, external and regional conditions reversed favorably, allowing the Central Bank to recompose its international reserve assets. In the current scenario, intensification of risks is highly dependent on external conditions and the potential success of Brazil and Argentina in containing negative market sentiment. Considering worsening domestic and regional conditions – as well as domestic constraints – we have revised our year-end FX forecast to UYU/USD 33.5 from our previous UYU/USD 32.0. Our new forecast assumes that the Central Bank continues to make use of its reserve ammunition to prevent sharp peso weakening, that the BRL remains near BRL/USD 3.8-3.9, and that the peso recovers lost ground with regional peers, albeit at a slow pace. As a result, our new forecast falls short of what we estimate as "neutral values" – that is, UYU/USD 36.

Debt ratios stabilize in 2Q18 but are likely to rise in the coming quarters



Uruguay public debt as % of GDP. Sources: BCU and Santander.

Fitch revises outlook to negative, increasing rating risks

Gross public debt stood at 65.9% of GDP as of 2Q18, relatively in line with 2017 year-end levels (65.4% of GDP). Net debt – that is, gross debt minus public-sector assets excluding bank reserve requirements, stood at 40.3% of GDP as per our own estimates, slightly below the 42% of GDP as of 2017. However, we believe debt ratios are likely to increase in the coming quarters in light of softer GDP readings, higher FX rates – which have a negative impact on foreign currency debt – and declining international reserves. In this context, rating agency Fitch revised the country's long-term foreign currency outlook to negative, while reaffirming the rating at BBB-. The revision reflects persistent fiscal deficits – at 4% of GDP as of August – and a rising debt burden that erodes policy space to confront tightening global financing conditions and a challenging macroeconomic environment in the region. Fitch expects gross general government debt to jump to 62.7% of GDP in 2018, from 57.7% in 2017 – noting that this is one of the largest increases since 2013 in the BBB category. As a result, the country's investment-grade status is likely to come under increasing pressure into 2019 despite a strong institutional framework, low financing risks, and large expected direct investments in forestry and the pulp sector in the coming years that have supported the country's rating. Furthermore, we believe the authorities' low confidence regarding structural reforms, coupled with presidential elections next year, is likely to bury all hope of any major fiscal reform before 2020.

URUGUAY

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		4.6	3.2	0.4	1.7	2.7	1.5	1.0
Private Consumption (Δ% y/y)	66.0	5.5	3.0	-0.5	0.1	4.4	2.1	1.0
Public Consumption (Δ% y/y)	13.8	4.9	2.5	2.2	2.9	-1.3	0.0	0.0
Investment (Δ% y/y)	22.9	4.8	0.0	-9.0	-3.9	-13.8	0.6	4.8
Exports (Δ% y/y Local Currency)	24.0	-0.1	3.5	-0.6	-0.2	7.6	-2.5	4.0
Imports (Δ% y/y Local Currency)	27.3	2.8	0.8	-7.3	-6.2	-0.4	-1.9	5.5
GDP (US$ bn)		57.6	57.3	53.4	52.8	59.2	60.7	59.0
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		8.5	8.3	9.4	8.1	6.6	8.4	8.0
WPI Inflation (Dec Cumulative)		9.2	10.3	10.0	7.7	6.6	8.0	7.8
US$ Exchange Rate (Average)		20.5	23.2	27.3	30.1	28.7	30.9	34.9
Central Bank Reference Rate (eop)		n/a	n/a	n/a	n/a	n/a	n/a	n/a
Monetary Base (Δ% y/y)		16.1	10.7	9.5	6.1	12.9	7.2	6.4
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-2.3	-3.4	-3.4	-3.9	-3.5	-4.0	-3.9
**Primary Balance, % of GDP		0.4	-0.6	0.0	-0.6	-0.2	-0.5	-0.2
Balance of Payments								
Trade Balance, % of GDP		1.4	2.8	3.2	5.4	6.8	4.2	3.9
Current Account, % of GDP		-3.4	-3.1	-0.8	0.8	1.6	-1.2	-1.8
Debt Profile								
Central Bank International Reserves (US$ bn)		16.3	17.6	16.0	13.8	16.2	15.8	16.1
Total Public Debt (gross, % of GDP)		57.5	58.5	58.8	63.2	65.4	70.7	77.5
Of which: Foreign-currency denominated (% of GDP)		40.1	44.0	54.0	53.1	41.8	45.3	45.6
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.5	6.6	7.5	7.8	8.8	8.6	8.6

E = Santander estimate. F = Santander forecast Sources: Banco Central de Uruguay, Finance and Economy Ministry, National Statistics Agency (INE), and Santander.

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