# Strictly Macro

## 2019 Latin America Macro Outlook

December 19, 2018

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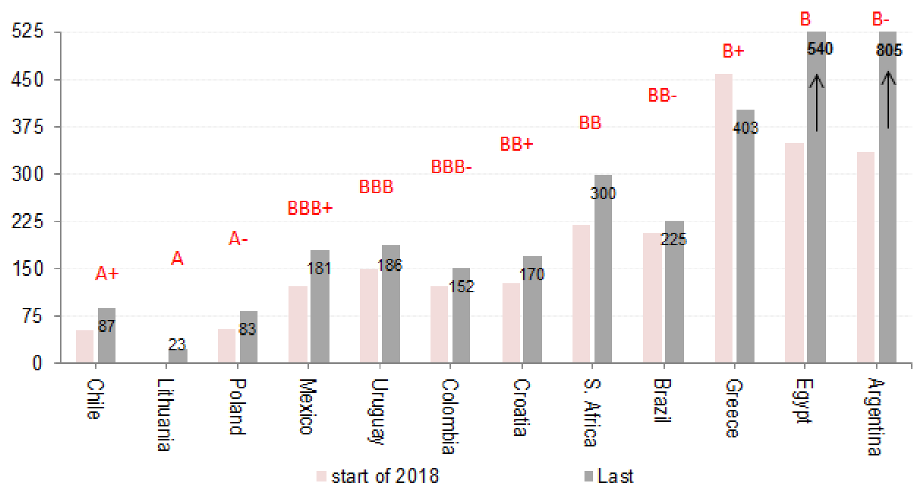
### Another challenging year ahead for LatAm

The performance of assets across our LatAm countries in 2019 will remain highly conditional upon external and domestic catalysts. Regarding the two crucial external drivers – Fed hikes and global trade tensions – that we estimate would impose the biggest downside to riskier assets in general, the recent tentative signals are supportive, in our opinion. However, it is too early to conclude that these developments could produce a longer-term favorable impact. First, we believe vulnerability indicators across LatAm remain weak and investors' concerns will start to dissipate after the Fed halts its hiking cycle. Our G-10 fixed income team expects Fed tightening to come to a halt during 2H19. If this occurs, it should remove significant tightening pressure on LatAm central banks, in our view, thus allowing a healthier macro rebalancing and giving the needed boost to fuel a cyclical recovery in most LatAm countries. Second, we think an eventual US-China trade deal should also help remove concerns about global growth deceleration. For the US economy, a combination of stronger productivity growth with steady wage inflation will be key to keeping EM downside risks relatively contained. Meanwhile, the trade negotiations between the two largest global economies are likely to prove a contentious process, and here the recent modernization of NAFTA offers important lessons for markets.

**Bond performance vs. sovereign ratings**




Notes: Z-spreads on 10-year bonds in hard-FX or equivalent. Sovereign ratings using S&P. Last is December 18, 2018. Sources: Bloomberg and Santander.

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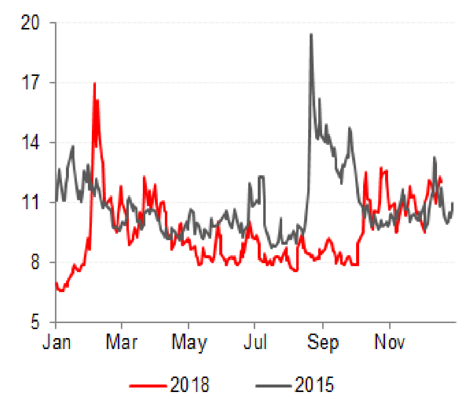
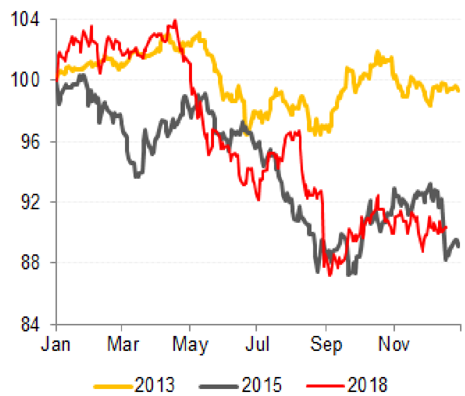
During the first part of 2019, we expect LatAm assets to experience headwinds from Fed normalization and the corresponding USD momentum, in addition to China growth dynamics and Euro-politics uncertainties (Brexit and the Italian budget). The evolution of specific underlying risks in each LatAm country could help mitigate or amplify the impact from external drivers, in our view. As shown in the chart above, the tightening of US financial conditions during most of 2018 (witness the uptrend in real interest rates) drained EM liquidity with a corresponding widening in sovereign bond spreads (in hard currency) in most cases. While we believe net inflows into LatAm will remain constrained in the coming months, we expect growth performance across the region to improve during the second part of 2019, driven by outperformance in Brazil, thus allowing positive returns. This inflection point is also expected to coincide with the aforementioned lessening in external headwinds. Yet, we also see a high risk that the outlook for LatAm economies will begin to diverge in response to idiosyncratic factors. On balance, LatAm economies will continue to face fundamental challenges in 2019; however, we believe the region as a whole is likely to generate growth that is more synchronized and close to potential. The chart on the previous page also confirms that investor sentiment toward LatAm countries has undergone a significant shift, leading to a relative repricing of underlying risks since the start of 4Q18, particularly in the case of Mexico and Argentina, where prices are already consistent with a two-notch downgrade by rating agencies.

As we head into 2019, we also find it important to consider the level of conviction among investors toward risky assets in general, as well as market positioning. Here we highlight that LatAm assets appear to be headed for a rather disappointing 2018, with assets posting negative returns across the board (including FX, bonds, and equities) making this another losing year and the worst since 2015 (see charts below).

**High volatility in key global assets[1] . . .**




**. . . puts pressure on LatAm assets[2]**




[1]Notes: Average volatility of US equities (VIX), US Treasuries (10-yr Note) and EM FX.
[2]Notes: FX carry total return, cumulative. 100 is Jan 1 for each year.
Sources for both charts: Bloomberg and Santander.

LatAm vulnerability to external shocks also depends on price stabilization in commodities and the contribution of pro-business initiatives by governments toward boosting foreign investment. We note that downward revisions to growth forecasts remain closely correlated with capital outflows, which explains investors' need to hedge against further FX weakness (top table at right). Looking forward, we believed the rate of change in local fundamentals needs to become decisively positive to enable local assets to break the current negative trend. We are of the opinion that growth developments and fiscal dynamics will remain at the top of global investors' concerns in the months to come, although we also recognize that LatAm FX valuation in general already looks cheaper than the levels implied by capital flows (middle chart).

**New governments in Brazil and Mexico face a decisive test**

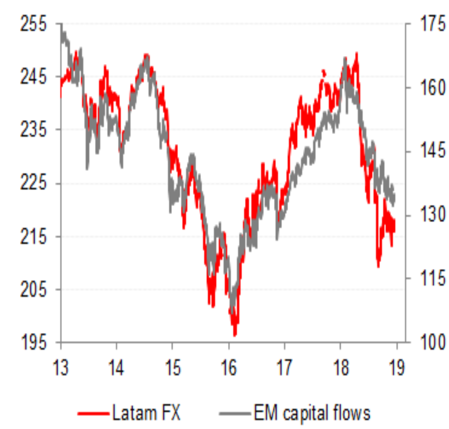
We expect the macro divergence within the LatAm region and particularly between the two largest economies to increase in 2019. In the case of Brazil, we think the stage is set for above-potential growth, and our out-of-consensus forecast sees

**Growth projections vs. FX anxiety**

| | GDP forecast end-19 | | FX anxiety | |
|---|---|---|---|---|
| | Last | ch vs jan-18 | Last | Avg last 12m |
| Argentina | -0.6 | -3.9 | 6.4 | 6.2 |
| Brazil | 2.3 | -0.5 | 2.3 | 2.7 |
| Chile | 3.2 | 0.2 | 1.7 | 1.6 |
| Colombia | 3.4 | 0.4 | 1.6 | 1.3 |
| Mexico | 2.1 | -0.2 | 2.7 | 2.2 |
| Peru | 3.9 | -0.1 | 1.6 | 1.5 |
| Uruguay | 2.0 | -1.5 | na | na |

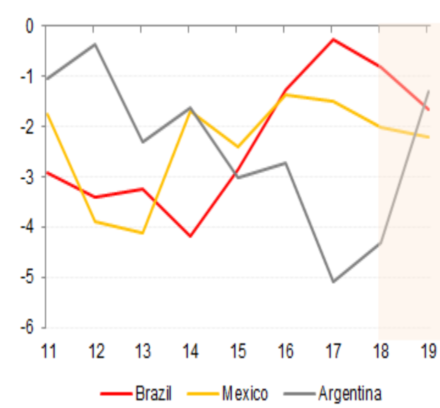
Notes: GDP forecasts are Bloomberg consensus. FX anxiety gauge is 3-month 25-delta Risk Reversal versus USD for all FX crosses. Sources: Bloomberg and Santander.

**LatAm FX already weaker vs. the levels implied by EM capital flows**




Notes: LatAm FX is carry return. EM capital flow proxy. Sources: Bloomberg and Santander.

**External imbalances for the 3 big LatAm countries look less problematic**




Notes: CA deficit as % of GDP. Shaded area is Santander forecast. Sources: Bloomberg and Santander.

GDP advancing 3% in the following two years after lackluster growth in the previous two years (1.2% on average). Our bullish outlook is based on a strong contribution from consumption and investment, as both growth engines are expected to benefit from benign inflation and renewed confidence against a background of deleveraging. The pro-business agenda set forth by President-elect Bolsonaro features a comprehensive set of structural reforms and privatizations, in addition to tax simplification and elimination of subsidies, targeting fiscal sustainability and renewed competition. Nevertheless, uncertainty surrounds the ability of the new government to use its political capital efficiently to secure the passage of awaited reforms in Congress followed by successful implementation. Solving Brazil's debt overhang problem, which is primarily associated with the pension system, will be crucial for capping gross debt to GDP at around the 80% level in the coming years, in our view. Another fundamental challenge down the road is to improve current poor productivity growth and to open the economy.

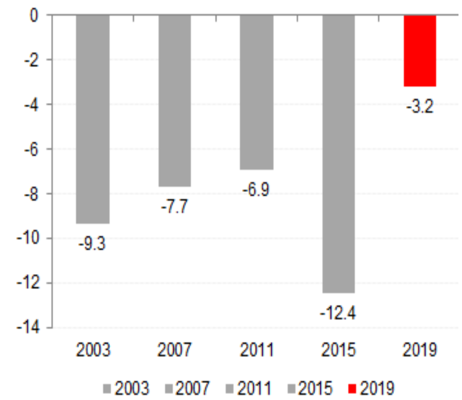
Meanwhile, Mexico's weak structural fiscal stance (witness the sharp buildup in general government debt to 45% of GDP compared to 29% before the 2008 global crisis) will remain unchanged in our baseline scenario. However, the outlook in general faces a twofold risk: First, President Lopez Obrador plans to put on hold or even reverse some of the structural reforms he inherited (without political cost to him). His new macro strategy will be under scrutiny, particularly regarding the energy sector (liberalized back in 2013), which on average subtracted 0.6 pp of GDP growth over the last three years. Second, our G-10 team believes US economic growth has peaked and will decelerate gradually, while the new USMCA (the core trade link between the countries of North America) requires approval by the US Congress. Both factors could keep uncertainty relatively high, thus delaying a needed boost in investment, which has remained sluggish since 2012. However, we also expect the following counterweights to support Mexico's resilience: (i) a narrow external imbalance, (ii) existing counterweights, namely Banxico's ahead-of-the-shock policy (witness real rates at decade highs above 4%) and Supreme Court independence, and (iii) decent (if slowing) US growth. We also note that measures to improve security and fight corruption, which lie at the center of the new political focus, could have positive growth implications if successful.

Historically, new governments in Brazil and Mexico have experienced disappointing growth during their first year in office (relative to their top trade partners – China and the US, respectively), reflecting a combination of a steep learning curve and policy discontinuity. According to our projections, both new governments are not likely to break this negative trend, although we expect Brazil to deliver its best relative performance of the past five administrations (see charts on this page). Meanwhile, we expect Argentina's business cycle to remain weak, albeit with some improvement (our forecast anticipates a sharp reduction in the CA deficit next year) after reaching a bottom in 1Q19. We expect activity to remain burdened by the ongoing significant tightening in both monetary and fiscal policies. Overall, we see a fragile structural status and higher vulnerability to external shocks with limited liquidity centered around the political risks associated with the presidential election (October 27).

Despite the wider macro performance divergence, we forecast the LatAm region will deliver higher growth next year, at 2.5%, which is close to its potential after a mere 1.6% average in the previous two years. Notably, we anticipate average GDP growth to be slightly above potential for the four smaller economies (Colombia, Chile, Peru, and Uruguay), which will continue to experience monetary stimulus despite continued rate hiking, albeit from low levels. Our base scenario for those economies also incorporates healthy dynamics in both investment and private consumption. Nonetheless, the main deceleration risk is associated with a negative terms-of-trade shock amid further decline in commodity prices.

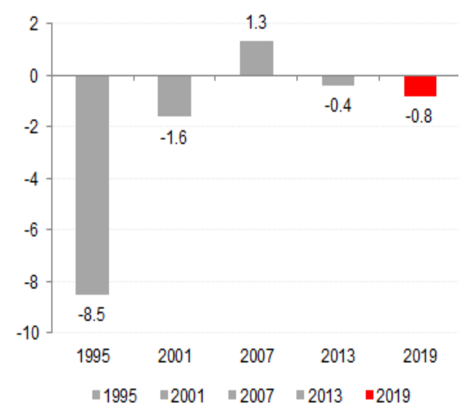
For a detailed description of the main catalysts for each LatAm country including our team's expectations, we have included a calendar on page 36.

**Brazil GDP performance during first year of past 5 new governments (vs. China)**




Notes: Brazil's annual GDP growth relative to China during the first year of new government in Brazil. 2019 forecasts are Santander. Sources: Bloomberg and Santander.

**Mexico GDP performance during first year of past 5 new governments (vs. US)**




Notes: Mexico's annual GDP growth relative to the US during the first year of new government in Mexico. 2019 are Santander forecast. Sources: Bloomberg and Santander.

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# FORECAST SUMMARY TABLES

## KEY MACRO INDICATORS

| GDP growth | 2017 | 2018F | 1Q19F | 2Q19F | 3Q19F | 4Q19F | 2019F | 2020F | Nom GDP '18 | Nom GDP '19 |
|---|---|---|---|---|---|---|---|---|---|---|
| Argentina | 2.9 | -2.4 | 3.9 | -4.2 | -3.5 | -5.6 | 0.5 | 2.8 | 459 | 397 |
| Brazil | 1.0 | 1.3 | 2.4 | 2.8 | 3.2 | 3.6 | 3.0 | 3.0 | 1,914 | 1,985 |
| Chile | 1.5 | 4.0 | 3.0 | 2.7 | 4.2 | 3.9 | 3.5 | 3.2 | 300 | 305 |
| Colombia | 1.8 | 2.7 | 2.2 | 2.8 | 2.9 | 3.0 | 3.3 | 3.5 | 334 | 340 |
| Mexico | 2.0 | 2.1 | 2.2 | 0.9 | 1.8 | 2.4 | 1.8 | 2.0 | 1,215 | 1,199 |
| Peru | 2.5 | 4.0 | 4.0 | 3.0 | 5.2 | 4.0 | 4.0 | 4.0 | 222 | 231 |
| Uruguay | 2.7 | 1.8 | 0.6 | 1.8 | 1.0 | 1.8 | 1.4 | 2.0 | 61 | 61 |
| **LatAm-7** | **1.7** | **1.6** | **2.6** | **1.5** | **2.2** | **2.3** | **2.5** | **2.8** | **1,216** | **1,235** |

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 | Priv Cons | | | Pub Cons | | | Investment | | | Exports | | | Imports | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Components | '17 | '18F | '19F | '17 | '18F | '19F | '17 | '18F | '19F | '17 | '18F | '19F | '17 | '18F | '19F |
| Argentina | 3.5 | -1.1 | 0.1 | 1.9 | -1.8 | -2.0 | 11.3 | -1.5 | 3.2 | 0.4 | -0.3 | 12.7 | 14.7 | 2.8 | 5.9 |
| Brazil | 1.0 | 2.0 | 3.0 | -0.6 | 0.1 | -0.3 | -1.8 | 4.3 | 8.0 | 5.2 | 2.5 | 2.8 | 5.0 | 8.2 | 4.2 |
| Chile | 2.4 | 4.0 | 3.8 | 4.0 | 2.7 | 2.6 | -1.1 | 5.9 | 5.6 | -0.9 | 4.8 | 3.2 | 4.7 | 7.8 | 4.9 |
| Colombia | 1.8 | 2.7 | 4.7 | 4.0 | 4.7 | 3.6 | 0.6 | 1.1 | 2.7 | -0.7 | 1.5 | 1.9 | 0.3 | 3.9 | 4.6 |
| Mexico | 3.0 | 2.8 | 2.6 | 0.1 | 2.0 | -1.0 | -1.5 | 2.5 | -0.2 | 3.8 | 4.7 | 4.2 | 6.4 | 5.8 | 5.2 |
| Peru | 2.5 | 3.8 | 4.1 | -0.2 | 2.6 | 3.8 | -0.3 | 5.4 | 6.9 | 7.8 | 3.1 | 4.1 | 4.1 | 5.2 | 5.0 |
| Uruguay | 4.4 | 2.2 | 1.0 | -1.3 | 0.4 | 0.0 | -13.8 | 14.3 | 4.8 | 7.6 | -5.3 | 4.0 | -0.4 | -2.0 | 4.3 |
| **LatAm-7** | **2.1** | **2.2** | **2.8** | **0.5** | **1.1** | **0.0** | **-0.1** | **3.0** | **4.4** | **3.6** | **2.9** | **4.3** | **6.0** | **6.3** | **4.8** |

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 | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2017* | 2018F* | Jan-19F | Feb-19F | Mar-19F | 2019F* | 2020F* | 2018F | 2019F | 2020F |
| Argentina | 24.8 | 47.5 | 47.8 | 47.1 | 47.6 | 26.0 | 15.0 | 47.8 | 26.8 | 15.7 |
| Brazil | 2.9 | 3.8 | 3.9 | 4.0 | 4.2 | 3.7 | 4.2 | 3.2 | 3.5 | 3.5 |
| Chile | 2.3 | 2.7 | 2.5 | 2.6 | 2.8 | 2.8 | 3.0 | 2.3 | 2.9 | 3.0 |
| Colombia | 4.1 | 3.2 | 3.5 | 3.5 | 3.8 | 3.6 | 3.1 | 3.5 | 3.5 | 3.0 |
| Mexico | 6.8 | 4.8 | 4.4 | 4.3 | 4.3 | 4.0 | 4.0 | 3.7 | 3.7 | 3.7 |
| Peru | 1.4 | 2.2 | 2.3 | 2.3 | 2.4 | 2.5 | 2.2 | 2.4 | 2.5 | 2.5 |
| Uruguay | 6.6 | 7.9 | 7.2 | 7.3 | 7.7 | 7.8 | 7.5 | 8.0 | 7.8 | 7.5 |
| **LatAm-7** | **6.5** | **8.6** | **8.4** | **8.3** | **8.5** | **6.0** | **5.0** | **8.1** | **5.9** | **4.7** |

*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 | 2017 | -6.1 | -7.8 | -2.8 | -3.6 | -1.1 | -3.1 | -3.5 |
| | | 2018F | -6.5 | -7.0 | -1.8 | -3.1 | -2.0 | -2.9 | -3.9 |
| | | 2019F | -3.8 | -6.3 | -1.7 | -2.4 | -2.0 | -2.7 | -3.8 |
| | | 2020F | -2.6 | -6.1 | -1.6 | -2.2 | -2.5 | -1.9 | -3.7 |
| Public debt | % of GDP | 2017 | 26.6 | 51.6 | 14.0 | 44.4 | 46.0 | 24.9 | 32.3 |
| (Net terms in ARS, BRL, CLP) | | 2018F | 52.0 | 54.0 | 15.0 | 47.8 | 45.3 | 25.7 | 33.7 |
| | | 2019F | 45.0 | 57.2 | 16.0 | 47.3 | 45.3 | 26.9 | 36.7 |
| | | 2020F | 41.5 | 57.4 | 16.7 | 47.0 | 45.8 | 26.0 | 38.1 |
| Current account | % of GDP | 2017 | -4.8 | -0.5 | -1.5 | -3.3 | -1.7 | -1.1 | 1.6 |
| | | 2018F | -4.3 | -0.8 | -2.0 | -3.4 | -1.7 | -1.6 | -1.1 |
| | | 2019F | -1.3 | -1.6 | -2.5 | -3.6 | -1.8 | -1.5 | -1.7 |
| | | 2020F | -1.7 | -2.8 | -3.0 | -3.6 | -1.9 | -1.4 | -2.6 |
| Trade balance | US$ bn | 2017 | -8.5 | 67.0 | 7.9 | -4.6 | -11.0 | 6.6 | 3.6 |
| | | 2018F | -6.1 | 59.6 | 2.5 | -3.9 | -11.9 | 8.0 | 2.5 |
| | | 2019F | 4.8 | 44.3 | 1.8 | -6.0 | -13.0 | 6.0 | 2.3 |
| | | 2020F | 6.7 | 22.8 | 0.0 | -5.8 | -14.0 | 4.0 | 1.8 |
| Unemployment | % of workforce | 2017 | 7.2 | 11.8 | 6.7 | 8.6 | 3.4 | 6.5 | 8.8 |
| | | 2018F | 9.4 | 11.2 | 6.8 | 8.4 | 3.3 | 6.2 | 8.6 |
| | | 2019F | 9.0 | 10.6 | 6.6 | 8.0 | 3.5 | 6.0 | 8.6 |
| | | 2020F | 8.4 | 10.0 | 6.5 | 8.0 | 3.6 | 6.0 | 8.2 |

Source: Santander.

# MONETARY POLICY MONITOR

| | Current | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 |
|---|---|---|---|---|---|---|---|---|---|---|
| ARGENTINA | 59.00 | 53.20 | 47.90 | 42.60 | 37.30 | 32.00 | 28.50 | 25.00 | 21.50 | 18.00 |
| | | -580 | -530 | -530 | -530 | -530 | -350 | -350 | -350 | -350 |
| BRAZIL | 6.50 | 6.50 | 6.50 | 6.50 | 6.50 | 6.50 | 7.00 | 7.50 | 8.00 | 8.50 |
| | | 0 | 0 | 0 | 0 | 0 | 50 | 50 | 50 | 50 |
| CHILE | 2.75 | 2.75 | 3.00 | 3.25 | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 | 3.50 |
| | | 0 | 25 | 25 | 25 | 0 | 0 | 0 | 0 | 0 |
| COLOMBIA | 4.25 | 4.25 | 4.50 | 4.75 | 5.00 | 5.25 | 5.25 | 5.25 | 5.25 | 5.25 |
| | | 0 | 25 | 25 | 25 | 25 | 0 | 0 | 0 | 0 |
| MEXICO | 8.00 | 8.25 | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 | 8.50 |
| | | 25 | 25 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| PERU | 2.75 | 2.75 | 2.75 | 3.00 | 3.25 | 3.50 | 3.75 | 3.75 | 3.75 | 3.75 |
| | | 0 | 0 | 25 | 25 | 25 | 25 | 0 | 0 | 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 with a relatively stable exchange rate and persistently negative output gap, inflation will end 2019 at 3.7% y/y, below the 4.5% inflation target. Under this scenario, we consider that Copom will remain on hold in 2019.**
- **Lower interest rates in Argentina: Since authorities adopted direct control of monetary aggregates as the new monetary policy, inflation expectations have declined, giving the central bank space to eliminate the 60% floor for the monetary policy rate, which edged down to slightly above 59%. Going forward, we expect interest rates to continue to decline but at a slow pace, as the MPC stated that it will keep a cautionary stance.**
- **Mexico expected to hike more: We expect Banxico to hike 25 bps both at the December 20 meeting and in March 2019, ending 2019 at 8.50%. We see this as increasingly likely, given that one member voted for a 50-bps hike at the November meeting, and another voted for the announcement of the objective for the reference rate at levels higher than those foreseen recently.**
- **Higher interest rates in the Andean region: In Colombia, we expect BanRep to hike 100 bps in 2010, bringing the interest rate to neutral. We believe Peru will hike in 2Q19 as the output gap closes and inflation remains above the target. In Chile, we expect the BCCh to continue to hike in 2019 as the MPC considers that monetary policy is currently "highly expansionary," but expect it to interrupt the cycle before reaching the neutral rate.**

# FOREIGN EXCHANGE RATES

| | BRL | MXN | CLP | COP | ARS | PEN | UYU |
|---|---|---|---|---|---|---|---|
| Last* | 3.89 | 20.0 | 689 | 3215 | 38.3 | 3.35 | 32.2 |
| **Dec-18** | **3.80** | **20.5** | **680** | **3200** | **41.0** | **3.38** | **32.2** |
| Mar-19 | 3.80 | 20.5 | 690 | 3300 | 43.6 | 3.44 | 32.9 |
| Jun-19 | 3.85 | 20.4 | 670 | 3250 | 46.2 | 3.49 | 33.6 |
| Sep-19 | 3.90 | 20.8 | 680 | 3350 | 48.7 | 3.53 | 34.3 |
| **Dec-19** | **4.00** | **21.0** | **687** | **3400** | **51.3** | **3.57** | **35.0** |
| Mar-20 | 4.08 | 21.1 | 680 | 3400 | 53.2 | 3.57 | 35.6 |
| Jun-20 | 4.15 | 21.0 | 670 | 3300 | 55.1 | 3.60 | 36.2 |
| Sep-20 | 4.25 | 21.4 | 665 | 3200 | 57.0 | 3.50 | 36.9 |
| **Dec-20** | **4.30** | **21.4** | **660** | **3300** | **58.9** | **3.60** | **37.5** |

End-of-period levels. * December 18 2018 Sources: Bloomberg and Santander.

- **Year-to-date, LatAm currencies have depreciated, reflecting in part a less favorable external environment, with higher US rates, a stronger USD, increasing trade tensions between the US and China, and lower prices for oil and metals. In the case of the BRL, MXN, and ARS, idiosyncratic factors also added pressure during the year, 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. Policy decisions by the new governments in Brazil and Mexico should play a key role for asset prices in 2019, in our view. In Argentina, the presidential election race will be an important market mover, in our opinion, while in Chile, Colombia, and Peru, we expect international commodity prices to remain important drivers for FX performance.**

# *REGIONAL RISKS: UPSIDE AND DOWNSIDE RISKS FOR LATAM IN 2019*

In this section we present our economists' assessments of idiosyncratic upside and downside risks that could affect the various countries in Latin America in 2019, separate from the external drivers that could affect the region as a whole.

| Country | Upside Risks | Downside Risks |
|---|---|---|
| Argentina | • Better climatic conditions may lead to higher than expected crop production, which could help GDP bounce back at a stronger pace than we currently forecast.<br>• A swifter than expected slowdown in inflation due to the current stringent Central Bank stance and lower FX volatility could result in faster monetary policy loosening and rebound in loan growth.<br>• Improving economic and financial conditions (higher growth, lower inflation and interest rates, low FX volatility) could lead to a strong recovery in government approval ratings, leading to lower probability of a political U-turn. | • A deeper and more protracted recession and/or stubborn inflation could continue denting government approval ratings, endangering the chances of political continuity, opening the possibility of a more unpredictable administration taking office in December 2019.<br>• Additional rounds in the trade war between the US and China, mounting geopolitical tensions, and/or tighter credit conditions for EM could lead to higher exchange rate volatility and lower growth.<br>• The impact of a GDP slowdown on tax collection could jeopardize the accomplishment of primary fiscal targets, forcing the government to reduce expenditures further. |
| Brazil | • Starting from a low base and boosted by business confidence, investment may surprise to the upside and add some growth to our baseline scenario.<br>• External accounts, although deteriorating at the margin, still look resilient, especially considering strong expected FDI inflows.<br>• Inflation is low and well-anchored; the Central Bank can continue to use loose monetary policy to stimulate the economy. | • Positive market expectations rely on the approval of effective pension reform in 2019; failure to deliver could trigger deterioration in confidence and growth prospects.<br>• Even under optimistic assumptions regarding pension reform, fiscal consolidation will require persistent efforts to cut government spending, which could undermine government popularity and ability to implement productivity-enhancing reforms.<br>• Attempting to meet the mandatory spending cap could create tensions between the government and markets or interest groups. |
| Chile | • Investment growth: large-scale projects are expected to kick off early next year.<br>• Inflation may surprise on the downside, if the recent decline in oil prices lasts over time and if second-round effects prove to be larger than anticipated.<br>• Although the Central Bank signaled that rates will rise to 4% by 2020, the hiking cycle may end well below that threshold, based on local and external factors. | • The current account deficit may hit 4% of GDP in 2019 if copper prices remain below US$3.00/lb and import growth remains in double-digit territory.<br>• The so-called "trade war," mainly involving the U.S. and China: Increasing tensions may lead to a decline in copper prices and in external demand, with negative implications for external and fiscal accounts.<br>• The goal of reducing the fiscal deficit may be jeopardized by stronger political pressures to increase spending and by sluggish revenue. |
| Colombia | • The continuation of infrastructure projects, a stronger recovery in the construction sector, and an increase in non-commodity exports represent upside risks to the near-term growth outlook.<br>• FX, consumer sentiment, and external imbalances are likely to be sensitive to oil price changes in the short term.<br>• The possibility of continuing low and stable inflation could allow BanRep to keep low interest rates for longer, which would continue to boost growth and aid a recovery in consumer and business sentiment.<br>• The government is expected to push ahead with structural fiscal reforms. | • Risks to activity include less government spending, higher taxes, a drop in employment, slashed investment budgets, and energy rationing.<br>• Risks for higher inflation include stronger than expected effects from El Niño, further depreciation of the COP leading to higher pass-through, and a higher than expected minimum wage increase.<br>• Risks to external balances include escalation of the trade war between the US and China, risk-off EM sentiment, a stronger US dollar, and a weaker oil price.<br>• On the fiscal front, lower than estimated resources from the financing law, lower oil prices, and growth below 3% could lead to a downward revision by the rating agencies. |

| Country | Upside Risks | Downside Risks |
|---|---|---|
| Mexico | • AMLO is able to achieve all the savings he is proposing with his austerity measures and from eradicating corruption and is able to run government as a much slimmer operation.<br>• Increases in real terms in the minimum wage and other wages, along with higher social programs expenditures, boost private consumption to the point that it offsets a grim outlook for private investment and the typical slow start of a new government. | • A credit rating downgrade for Pemex due to a change in the business model to reduce oil-generating US dollar exports and refine more gasoline locally, selling it in pesos with substantial currency risk, as Pemex's debt service is mainly in hard currency.<br>• An even more negative oil situation, due to either lower output from Pemex or lower prices or both. This would mean further fiscal stress and lead us to downgrade our growth estimates.<br>• A US economic recession, which would drag down Mexico's growth while also causing significant financial stress.<br>• Opposition in the US Congress to proceeding with the USMCA agreement as negotiated. |
| Peru | • Faster than expected growth pace in public investment in infrastructure projects.<br>• A resolution in the trade war between the US and China that leads to a pickup in copper prices and other metal prices.<br>• Government coordination that continues to approve large infrastructure projects and structural reforms. | • Risks to activity include increase in political risks that causes deterioration in business and consumer confidence.<br>• Risks for higher inflation include stronger than expected effects from El Niño and further depreciation of the PEN, leading to higher pass-through.<br>• Risks to external balances include continued escalation of the trade war between the US and China, lower copper prices, a risk-off event in EM, and a stronger US dollar. |
| Uruguay | • Infrastructure works on railways, highways, and ports that Finnish firm UPM insisted that authorities put forward in 2019-20 as a condition for building its second pulp mill could partially reverse current negative business sentiment and investment.<br>• A stronger than expected UYU could keep inflation low, pushing household consumption above expected levels, particularly for imported-durable goods. | • High public sector spending continues to pose risks in terms of persistently escalating debt ratios and potentially higher tax increases that would add to those already implemented in 2017.<br>• Potential credit risk downgrades driven by a weaker fiscal position.<br>• Higher than expected unemployment if rigid wage increases continue to weigh negatively on production costs (e.g., decline below the rate of inflation). |

# ARGENTINA

## HERE WE GO AGAIN

- **We believe 4Q18 has marked the lowest point in terms of declining activity and rising inflation; we expect the recession to bottom out in 1Q19; high-frequency data suggest inflation is slowing faster than expected.**
- **Implementation of the second SBA is yielding successful results, as ARS devaluation expectations were anchored, and policy interest rates have started to decrease slowly.**
- **While economic conditions may improve in the next few months, we think political uncertainty will be the predominant factor influencing asset prices ahead of a likely highly contested presidential race.**


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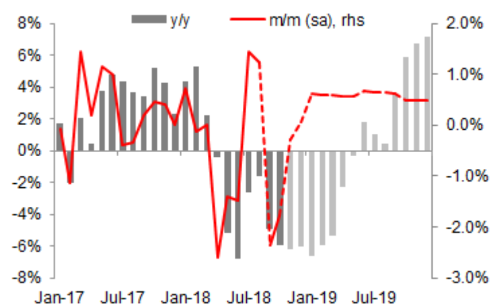
### Good-bye FX shock, hello political uncertainty

A year ago, macroeconomic and financial conditions for Argentina seemed to be stable, although the country remained vulnerable to eventual capital flow reversals, a scenario which finally materialized. The year 2018 has proved tough and extremely volatile. The generous second stand-by arrangement (SBA) with the IMF has so far proved successful in reducing volatility and anchoring expectations. While exchange rate volatility has decreased significantly of late and interest rates are gradually being reduced, inflation has soared, and we believe activity numbers are likely to continue disappointing in the next releases. In our view, we may be in the worst phase in terms of high inflation and plunging activity, which should start to change in the next few months. Although expectations for the speed or pattern of GDP recovery and inflation slowdown differ among analysts, there is consensus about the trend. However, uncertainty lingers, mostly related to the political dimension. The Cambiemos government's likelihood of remaining in office is highly dependent on the economic cycle throughout 2019, and at the moment the race for the presidency looks competitive. As a result, monitoring high-frequency activity, employment, and inflation data will be crucial for gauging their impact on the political arena.

### Activity

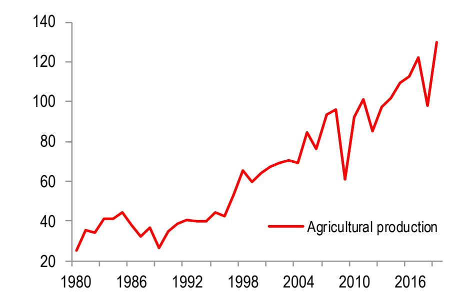
Activity has endured several shocks during 2018. The drought that affected crop yields in the last Southern Hemisphere summer explained almost all of the 4.2% fall in GDP in 2Q18. While the decline was milder in 3Q18 (-3.5% y/y), the sharp peso devaluation in August-September and the subsequent inflationary surge will likely result in a GDP decline of 5.6% y/y in 4Q18, according to our estimates. Recent sector activity data point in that direction. Construction dropped 6.4% during October, while industrial sector output fell 6.8% in the same month. Deeply negative prints for several sectors are likely to be the norm going into year-end 2018, in our view. On the demand side, we expect consumption to contract significantly as inflation-adjusted wages plummet. We estimate real salaries declined 10.5% annually during October, well below the -0.6% y/y growth observed in March, before the string of FX shocks struck the economy. The weakness will probably persist during the January-March period, in our view, but starting in 2Q19, we expect that GDP should begin to rebound (in annual terms). The coincident and leading activity indicator data for October suggest that the recession trough has not yet been reached. During the last three recessions, this indicator was, on average, in recessionary territory for 10 months. Assuming a similar pattern going forward, we would expect a recovery to take place sometime between March and May, which is consistent with a recession trough around 1Q19. The expectation of much better agricultural production next year is one of the main catalysts for a GDP recovery taking place in 2Q19. We currently estimate that the total harvest in the 2018-19 season will reach 130 million tons (+33%). For that to materialize, it is crucial that summer weather conditions remain normal to favorable. This seems likely,

**Recovery expected for 2Q19**



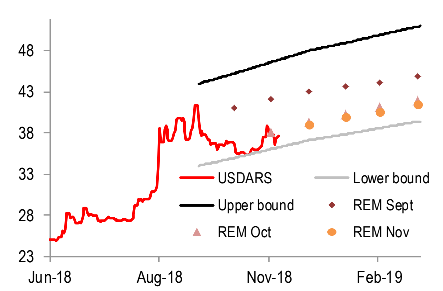

GDP seasonally adjusted monthly growth (right axis) and annual growth (dotted line and lighter grey bars are forecasts). Sources: INDEC and Santander.

**Waiting for a bumper crop, if weather allows**




Total agricultural production. Last point is forecasted. Sources: Secretary of Agriculture and Santander.

**Fenced in**




USDARS exchange rate, no-intervention zone bounds and exchange rate expectations. Sources: Bloomberg, Central Bank and Santander.

in our view, as the US National Oceanic and Atmospheric Administration puts the probability of an El Niño phenomenon at 80% for next summer. El Niño is typically associated with better than normal conditions in most of the Argentine crop area, which suggests that the likelihood of another drought remains low. We maintain a relatively more bullish view on GDP expansion for next year, as we forecast GDP will edge up 0.5%, compared to the -1.2% expected by the market (Central Bank poll). There is a significant dispersion among analysts' forecasts, and average 2019 growth depends crucially on when the recession trough occurs and how fast GDP picks up thereafter.

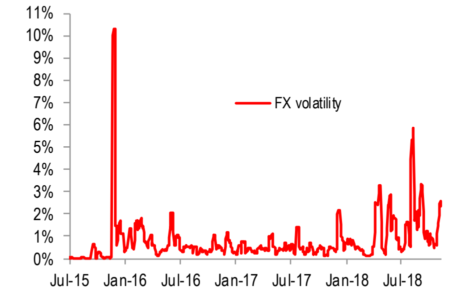
## FX and external sector

The government's ultimate objective, pursued with the second SBA, of anchoring devaluation expectations seems to have been successfully accomplished, in our view. At the end of November, FX volatility had declined to a fifth of the maximum reached in September, although of late it has increased somewhat, in line with other LatAm currencies. The introduction of the non-intervention zone mechanism and the relatively high level reached by the REER contributed to appease US dollar demand. External asset formation (chiefly, retail investors' USD purchases) declined to USD 1.1 bn in October, a fourth of last May's peak, reaching a level close to the historical average since 2003 (subtracting the capital controls period). While the exchange rate came close to piercing the lower bound of the free floating zone (it stood only 0.1% above it on November 11), it thereafter moved higher, suggesting that the usual self-equilibrating dynamics are at work and that the Central Bank is effectively rebuilding some credibility. The no-intervention zone lower bound was set 5% above the REER 1996-2018 average and 5% below the 2003-2018 average. Although the currency purchases to maintain the USD quotation close to this bound are optional, this suggests authorities have the will to keep a relatively undervalued peso in order to generate external surpluses. This will be key in order to stabilize and eventually bring down the indebtedness ratio (see "Debt sustainability" section). While the REER reached a significantly undervalued level in September (the result of a 51% exchange rate jump between the end of July and September 30), the subsequent FX stabilization and the rise in inflation led to a 14% strengthening in the last three months. However, the REER level is approximately similar to that observed in August 2011, and we estimate that the peso is mildly undervalued compared to the USD, based on a simple PPP trend comparison (we calculate the peso is currently 11% weaker than its neutral level). We forecast that due to the real depreciation seen this year (and also to the expected recovery in grain production noted above), next year's trade balance will total a USD 6 bn surplus from a USD 5.8 bn deficit in 2018. This should help drive the current account deficit to 1.3% of GDP, down from 4.8% of GDP in 2017, according to our projections.

## Monetary policy and inflation

The November Central Bank poll of economic forecasters showed the second consecutive decline in 12-month mean inflation expectations: they dropped 3.3 pp to 28.6% between September and November, allowing the Central Bank to eliminate the 60% floor for the monetary policy rate, which edged down to slightly above 59% on December 6. However, the monetary authority stated that it will keep a cautionary stance before moving to a sharper reduction in interest rates. So far the Central Bank has over-accomplished the quantitative targets agreed upon with the IMF in the second SBA. Recall that starting in October, a quantitative target policy was implemented with the objective of 0% growth in the seasonally adjusted monetary base. In October and November the average monetary base stood ARS 19 bn and ARS 15 bn below the target, respectively. While in December the target increases 6.3% due to seasonal growth in money demand, the Central Bank has stated that this month the monetary base will be lower than the target by "at least" ARS 16 bn. As expected, the impact of the peso devaluation on inflation was significant, with CPI jumping 6.5% m/m and 5.4% m/m in September and October, respectively. The November print stood at 3.2% m/m, while we expect the December increase to be around 2.5% m/m (+47.5% in annual terms). However, higher-frequency data collected by local consultants are pointing to a likely sharper slowdown in inflation during

**Receding volatility**

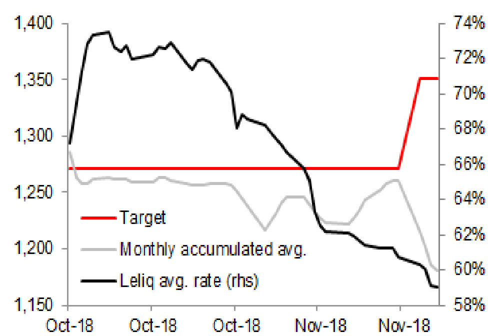



USDARS daily growth 5-day standard deviation. Sources: Bloomberg and Santander.

**A mildly undervalued ARS**

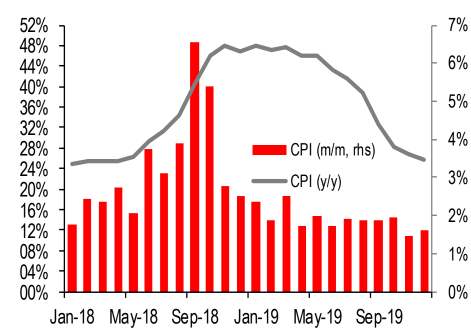

Estimated exchange rate misalignment. Sources: Bloomberg and Santander.

**Meeting monetary target**




Monetary base target and monthly average monetary base level (in ARS million); average Leliq rate (right axis). Sources: Central Bank and Santander.

**Gradually coming down**




Annual and monthly inflation (estimated since November 2018). Sources: INDEC and Santander.

December. The stringent monetary policy seems to be bearing fruit in terms of receding inflation. We currently calculate that inflation by end-2019 will stand at 25.6% (vs. a 27.5% mean market expectation), but we think the decrease could be sharper if the Central Bank sticks to the 0% monetary base growth target until June (which we think is highly likely, given the commitment recently expressed by its authorities).

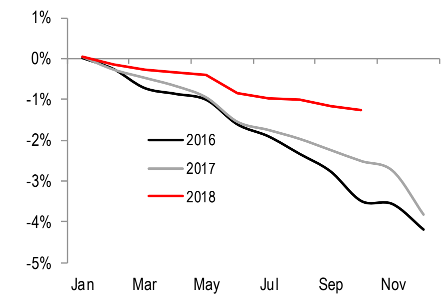
### Fiscal policy

The government has consistently met its fiscal targets during the last two years, and we project it will likely reach a primary deficit in line with the current objective for year-end 2018 (2.7% of GDP). Year to October, fiscal discipline has been observed on the expenditure side, where virtually all items grew below the inflation level: capital expenditure declined 30.7% in real terms, while transfers to provinces fell 21% (also adjusted by inflation). Salaries, social benefits, and economic subsidies fell 9.5% y/y, 2.3% y/y, and 4.4% y/y, respectively, during the first 10 months of 2018 (also in real terms). However, in the same period, revenues grew barely below the inflation rate, edging down 0.9% in real terms, leading the primary deficit to decline to 1.1% of GDP in 3Q18, 0.8 pp of GDP lower than the same quarter of 2017. However, tax collection data for November began to show the impact on revenues of the decline in economic activity, as revenues increased only 33.7% annually, compared to an estimated inflation rate of 47.9% y/y (-9.6% y/y in real terms). For the next few months, we expect the collection numbers to continue showing signs of weakness in a context of economic cycle contraction. The public sector's most representative taxes, such as VAT, social security, and the income tax (which represent almost 70% of total tax revenues), are all being hit. On the other hand, the tax on exports of goods has been reestablished, which helps buttress public accounts. We estimate that taxes collected from these duties will offset 40% of the other taxes lost due to the recession. In our view, the recent approval of the budget law for 2019 is a good first step toward meeting next year's primary deficit target of 0% of GDP. In our baseline scenario, we expect the government to reach this target in the context of continued fiscal discipline on the expenditures side, the recovery of tax collection in 2H19 (in line with a stronger activity cycle), and due to the contribution of export levies.

### Debt sustainability

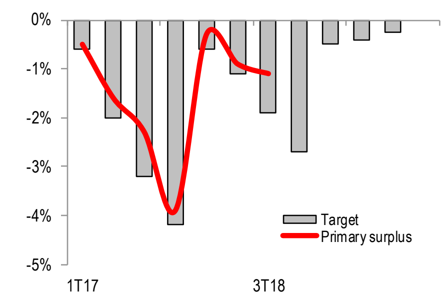
Apart from soaring inflation and declining activity, the FX shock resulted in a sharp increase in the gross-debt-to-GDP ratio, which we project will reach 87% by year-end (taking into account the end-of-period exchange rate), some 30 pp above last year's mark of 57%. The jump is mostly related to the high level of debt denominated in external currency, which stood at 70% of the total before the crisis. In our base-case scenario, the indebtedness ratio will decline to 65% in 2022, assuming that GDP expands 10% in 2019-2022 (and we see a mild REER strengthening). These debt levels are high, even by Argentine standards, as the ratio has been higher than 70% only 7% of the time since 1922. In a scenario of lower GDP growth (say, 5% accumulated between 2019 and 2022), the ratio would increase 3 pp to 68% by the end of the period. Also, assuming that the government cannot reach fiscal targets and the primary deficit remains stuck at 1% of GDP for the whole period, the ratio would climb 5 pp to 70% by 2022 (other things held constant). Finally, a 1% weaker REER would result in an additional 0.6 pp in the debt-to-GDP ratio by the end of the period. As such, setting the conditions for GDP to recover strength, ensuring a fiscal adjustment, and avoiding further external shocks remains key to achieving a decline in the debt-to-GDP ratio and thus improving credit risk.

**The fiscal effort**



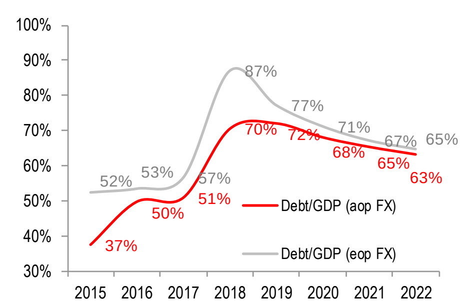

Primary surplus (as % of GDP). Sources: Ministry of Economy and Santander.

**Primary deficit in line with objectives**




Primary surplus (as % of GDP) and primary surplus target. Sources: Ministry of Economy and Santander.

**High public indebtedness**




Gross debt to GDP. Sources: Ministry of Economy, Secretary of Finance, INDEC, Central Bank and Santander estimates.

# ARGENTINA

| | GDP % | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|
| **National Accounts & Activity Indicators** | | | | | | | | |
| Real GDP (Δ% y/y) | | -2.5 | 2.6 | -1.8 | 2.9 | -2.4 | 0.5 | 2.8 |
| Private Consumption (Δ% y/y) | 74.1 | -4.4 | 3.5 | -1.0 | 3.5 | -1.1 | 0.1 | 2.4 |
| Public Consumption (Δ% y/y) | 12.6 | 2.9 | 6.8 | 0.3 | 1.9 | -1.8 | -2.0 | 1.1 |
| Investment (Δ% y/y) | 19.5 | -6.8 | 3.8 | -4.9 | 11.3 | -1.5 | 3.2 | 9.7 |
| Exports (Δ% y/y Local Currency) | 18.8 | -7.0 | -0.6 | 5.3 | 0.4 | -0.3 | 12.7 | 9.0 |
| Imports (Δ% y/y Local Currency) | 26.5 | -11.5 | 5.7 | 5.7 | 14.7 | 2.8 | 5.9 | 9.7 |
| GDP (US$ bn) | | 563 | 634 | 545 | 620 | 459 | 397 | 412 |
| **Monetary and Exchange Rate Indicators** | | | | | | | | |
| CPI Inflation (Dec Cumulative)* | | 40.7 | 27.2 | 37.7 | 24.8 | 47.5 | 26.0 | 15.0 |
| CPI core Inflation (Dec Cumulative)* | | 37.9 | 28.2 | 32.4 | 21.1 | 47.8 | 26.8 | 15.7 |
| US$ Exchange Rate (Average) | | 8.1 | 9.2 | 14.7 | 16.6 | 29.6 | 46.4 | 55.3 |
| Central Bank Reference Rate (eop) | | 26.90 | 33.00 | 24.80 | 28.75 | 53.20 | 32.00 | 18.00 |
| Private sector credit (% of GDP) | | 12.7 | 13.7 | 12.9 | 15.3 | 16.2 | 16.3 | 17.1 |
| **Fiscal Policy Indicators** | | | | | | | | |
| Fiscal Balance, % of GDP | | -5.0 | -6.1 | -5.9 | -6.1 | -6.5 | -3.8 | -2.6 |
| Primary Balance, % of GDP | | -3.4 | -4.0 | -4.3 | -3.9 | -2.7 | 0.0 | 1.0 |
| **Balance of Payments** | | | | | | | | |
| Trade Balance | | 0.4 | -0.6 | 0.3 | -1.4 | -1.3 | 1.2 | 1.6 |
| Current Account, % of GDP | | -0.9 | -1.5 | -2.4 | -4.8 | -4.3 | -1.3 | -1.7 |
| **Debt Profile** | | | | | | | | |
| Central Bank International Reserves (US$ bn) | | 31.4 | 25.5 | 38.7 | 55.0 | 64.0 | 69.0 | 73.0 |
| Total Public Debt (net of public sector holdings, % of GDP) | | 18.4 | 22.8 | 26.7 | 26.6 | 52.0 | 45.0 | 41.5 |
| Of which: Foreign-currency denominated (% of GDP) | | 11.9 | 15.3 | 18.2 | 18.1 | 36.4 | 31.5 | 29.05 |
| **Labor Markets** | | | | | | | | |
| Unemployment Rate (year-end, % of EAP) | | 6.9 | 5.8 | 7.6 | 7.2 | 9.4 | 9.0 | 8.4 |

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

# BRAZIL

## A YEAR IN THE SWEET SPOT?

- **We believe Brazil is likely to enter 2019 with the possibility of a combination of relatively strong (above potential) GDP growth, based on a cyclical recovery, and historically low inflation and interest rates – at least while the negative output gap persists.**
- **We expect private consumption to lead to 3.0% GDP growth in both 2019 and 2020. A strengthening labor market and growing credit concessions should be the main pillars of this recovery, in our view.**
- **Starting 2019 with current inflation considerably lower than the target midpoint and no demand pressures should contribute, in our view, to a benign inflation scenario in 2019. We expect 2019 year-end CPI inflation at 3.7% y/y.**
- **We believe this inflation outlook is compatible with a stable Selic rate throughout 2019.**
- **In our opinion, fiscal accounts will continue to be Brazil's main economic vulnerability. The progress (or lack thereof) of pension reform negotiations will be a key market driver on 1Q19, in our view.**

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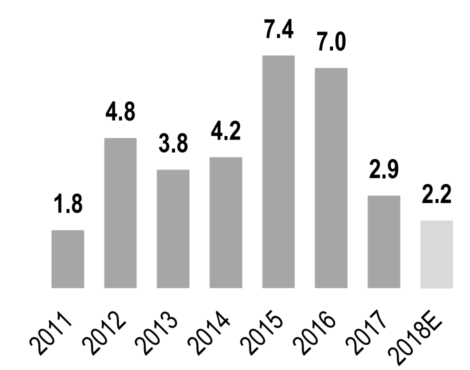
### A year in the sweet spot?

After a long period of macroeconomic adjustment, Brazil is, in our view, on the verge of a stronger cyclical recovery in economic growth. As the country has been slowly coming out of a deep recession, economic slack (especially a still-high unemployment rate) should help to contain inflationary pressures, in our opinion, allowing the Central Bank to maintain an expansionary monetary policy, with overnight rates at historical lows. This, in our view, should provide a temporary "sweet spot" for corporate profits – even more so considering the substantial private sector deleveraging that took place over the past three years.

For that optimistic scenario to unfold, however, we need to assume relative stability in financial markets, which will depend on external conditions and on how investors assess Brazil's debt sustainability. Despite recent efforts to achieve fiscal consolidation, we believe the time bomb of social security still needs to be dismantled – a task that the newly elected government will have to prove it can accomplish.

**Ibovespa net debt/EBITDA**

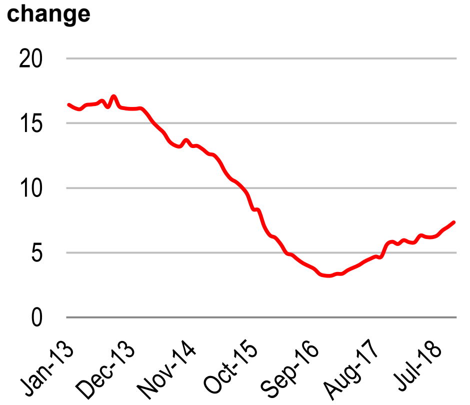



Source: Bloomberg.

### Economic activity: finally a cyclical recovery?

The surge in confidence indicators after the results of the October elections, the widening scope of the economic recovery as shown in high-frequency indicators, and the prospect of low interest rates for some time into the future have led us to anticipate an accelerating rate of GDP growth from 2019. The disappointment of 2018 (with realized growth likely at 1.3%, in our view, 170 bps lower than our initial forecast) is, in our view, more related to external shocks (the truckers' strike in May, Argentina slipping into recession, and higher electoral uncertainty than expected, among other factors) than to underlying economic weaknesses. The two pillars for a household consumption-based recovery are, in our view, still quite solid: a recovering job market (despite persistently high unemployment, real aggregate wages are growing at around 2% for the second year in a row; we expect this growth rate to accelerate to 3% next year) and growing credit concessions (outstanding credit to individuals is growing at 7.4% y/y, the fastest pace since November 2015).

**Outstanding credit to individuals, y/y % change**




Source: Brazil Central Bank.

We now expect GDP growth at 3.0% in 2019 (20 bps below our previous forecast, mostly because of a smaller carry-over effect from 2018). We expect private consumption to contribute about two thirds of headline growth, with the remaining one third coming from investment (public consumption and net exports should have marginal changes, netting each other out). At this pace of growth, we expect the output gap, currently estimated at around 3.5% of GDP, to persist until around 2H20.

**Inflation and monetary policy: expect smooth sailing**

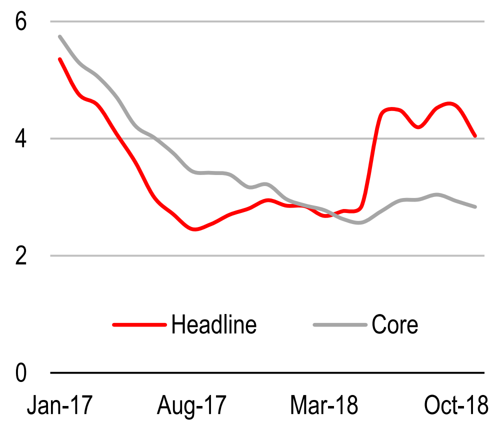
The recent dynamics of core inflation suggest that the still-wide output gap continues to be a major disinflationary force in Brazil. Yearly core inflation slowed to 2.8% from 3.2% throughout 2018, with an even steeper decline in service prices inflation (from 4.5% in December 2017 to 3.3% this past November). Moreover, the behavior of tradable prices throughout 2018 suggests to us that the exchange rate pass-through has been remarkably low, also probably because of the still-weak economy leading to diminished pricing power of importers.

Under our hypotheses of a relatively stable exchange rate and persistently negative output gap, we see 2019 year-end inflation at 3.7% y/y. Yearly inflation should fall to close to 3.0% by June next year, as the extraordinarily high June 2018 monthly inflation is dropped from the series, and should inch higher following the narrowing output gap, in our view.

With the prospect of another year of inflation below the target midpoint, we believe that the Central Bank will keep its benchmark overnight rate (Selic) at 6.5% for all of next year. With marginal GDP growth above potential and a weakening exchange rate (more on this below), we do not see the scope for further easing. However, the reaction function of the incoming CB governor is still unknown – a Central Bank more reactive to market volatility may deliver premature rate hikes in episodes of deteriorating external conditions.

We expect the next hiking cycle to start in 2020, with the Selic rate ending that year at 8.5% – the level we believe is compatible with a neutral real rate of around 4% and inflation converging to the target midpoint.

**12-month CPI inflation (%)**



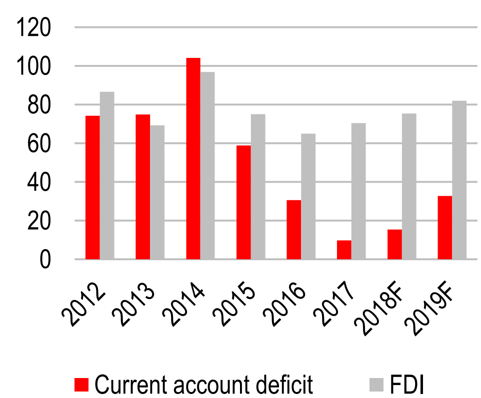

Sources: IBGE and Santander.

**External accounts and FX: Deteriorating current account, still strong FDI**

An accelerating economic recovery based on consumption and investment should, in our view, imply deterioration in external accounts. We believe imports will rise strongly for the third straight year, up 13% from 2018. We expect the trade balance surplus to narrow to USD 44 billion in 2019, doubling the current account deficit as a share of GDP to 1.6% (from 0.8% this year). On the other hand, we expect another strong year for foreign direct investment: we forecast USD 82 billion of inflows in 2019. With that, Brazil would maintain a comfortable position in terms of external financing needs, with an excess of USD 49 billion of FDI over the current account deficit.

As in the recent past, we believe that the external environment and its impact on portfolio inflows will be the main driver for the BRL. The combination of a more challenging global liquidity environment and relatively low interest rate differentials should keep the BRL on a weakening path, in our view, with the excess FDI mentioned above and a strong international reserve position acting to prevent a stronger and sharper depreciation. We forecast the BRL/USD rate at 4.00 and 4.30 for YE2019 and YE2020, respectively.

**Current account deficit and FDI (USD bn)**




Sources: Brazil Central Bank and Santander.

**Fiscal accounts: Brazil's main vulnerability**

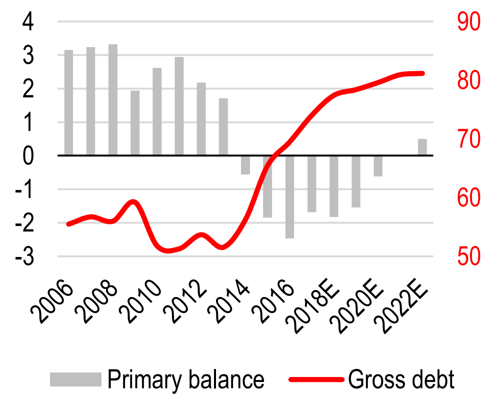
Brazil's fiscal accounts will, in our view, continue to be the main point of concern among the main macro variables. Despite recent efforts that stabilized the structural primary deficit[1] at around 2% of GDP and eliminated future contributors to the deficit (such as subsidized loans through BNDES), debt/GDP will, in our view, continue in an upward trajectory, even taking into account the expected effects of the approval of pension reform (more on this below). At our expected combination of real interest rates and GDP growth, a 1.5% primary surplus would be required to stabilize the debt/GDP ratio, which means that a large fiscal effort (>3% of GDP) in the short term is still necessary, in our opinion.

[1] Defined as discounting one-off revenue and expenditures and the effect of the output gap.

In the short term, part of this adjustment can continue to be done relying on non-recurring revenues, such as privatizations and concessions. For 2019, we believe it is even plausible to expect a balanced primary budget if the auctions related to the transfer of oil exploration rights are successful – expected revenue could more than offset our estimate for the primary budget deficit (1.5% of GDP). This approach, however, has several limitations: it depends on Congress's approval, it taps a limited supply of government assets, and of course, it does not solve the growing spending problem – it could even aggravate it, since, especially at the subnational level, one-off revenue is often treated as permanent and converted to recurring spending.

The constitutional spending cap also makes explicit the limitations of this "balance sheet approach," as the government risks a shutdown if it does not limit spending growth to past inflation. The spending cap will force the new government to make hard decisions, either fighting in Congress to remove earmarks from spending to allow for cuts or having to deal with the consequences (such as freezes on hiring and wage increases for public servants) of breaching the spending limits. There are still few details available about the incoming government's fiscal consolidation plan, which limits our ability to assess the outlook.

**Primary balance and gross debt (% of GDP)**




Sources: Brazil Central Bank and Santander.

**Where economics meets politics: the reform agenda**

We subscribe to the view that pension reform is a necessary step for Brazil to achieve long-term debt sustainability. Without pension reform that substantially increases the average retirement age, any short-term fiscal effort would eventually be undermined by a rapid demographic transition that would require unrealistic productivity gains to keep the system solvent.

Despite the failed attempt of the current government to pass reform through Congress, the effort, in our view, created awareness of the problem and brought the discussion to the forefront of any discussion about the economic outlook for the country. Although it is inherently difficult to approve this kind of reform in any economy, we believe that the newly elected government could succeed if it presents a feasible reform plan (i.e., one that could survive being watered down in Congress without losing most its effectiveness) and makes that its top priority early in the next presidential term.

Perceptions about the likelihood of that happening are likely to be the main domestic market driver in 1Q19 (February and March are key, since the Congress will be in recess during January). Some important events to monitor are the elections for the leadership of the two houses of Congress (in early February) and the presentation of the government's reform proposal. It will be important to monitor whether the next speakers of the Lower House and Senate agree with the fiscal consolidation agenda and are aligned with the government's priorities. On pension reform itself, we believe that taking a fast-track approach – submitting the Temer reform to a vote in the Lower House and amending it in the Senate – would be the most effective path, although there are other possible options.

Although execution risks are far from negligible, we believe the next government will come from a good starting point and will have significant incentives to complete reforms that would support a reasonably strong cyclical economic recovery. We believe that removing the risk of fiscal insolvency would be likely to unleash investment decisions that should contribute to higher economic growth under stable market conditions, a powerful motivator to anyone considering running for reelection in the next electoral cycle. Rationality will not be the only force in play in this process, but we believe it will be a strong enough factor to justify our reasonably bullish outlook.

# BRAZIL

| | GDP % | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|
| **National Accounts & Activity Indicators** | | | | | | | | |
| Real GDP (Δ% y/y) | | 0.5 | -3.8 | -3.6 | 1.0 | 1.3 | 3.0 | 3.0 |
| Private Consumption (Δ% y/y) | 62.8 | 2.3 | -3.2 | -4.2 | 1.0 | 2.0 | 3.0 | 3.0 |
| Public Consumption (Δ% y/y) | 20.8 | 0.8 | -1.4 | -0.1 | -0.6 | 0.1 | -0.3 | 2.0 |
| Investment (Δ% y/y) | 16.5 | -4.2 | -14.0 | -10.2 | -1.8 | 4.3 | 8.0 | 4.0 |
| Exports (Δ% y/y Local Currency) | 11.3 | -1.1 | 6.9 | 1.9 | 5.2 | 2.5 | 2.8 | 3.0 |
| Imports (Δ% y/y Local Currency) | -11.4 | -1.9 | -14.0 | -10.3 | 5.0 | 8.2 | 4.2 | 3.0 |
| GDP (US$ bn) | | 2,455 | 1,801 | 1,796 | 2,055 | 1,914 | 1,985 | 1,970 |
| **Monetary and Exchange Rate Indicators** | | | | | | | | |
| IPCA-IBGE Inflation (Dec Cumulative) (%) | | 6.4 | 10.7 | 6.3 | 2.9 | 3.8 | 3.7 | 4.2 |
| IGP-M Inflation (Dec Cumulative) (%) | | 3.7 | 10.5 | 7.2 | -0.5 | 9.1 | 4.5 | 4.0 |
| US$ Exchange Rate (Average) | | 2.35 | 3.33 | 3.49 | 3.19 | 3.64 | 3.75 | 4.20 |
| Central Bank Reference Rate (eop) | | 11.75 | 14.25 | 13.75 | 7.00 | 6.50 | 6.50 | 8.50 |
| Stock of Credit To Nonfinancial Private Sector (% of GDP) | | 52.21 | 53.65 | 49.55 | 47.13 | 46.2 | 46.0 | 46.5 |
| **Fiscal Policy Indicators** | | | | | | | | |
| Public Sector Fiscal Balance (harmonized) (% of GDP) | | -6.0 | -10.2 | -8.9 | -7.8 | -7.0 | -6.3 | -6.1 |
| Primary Balance (% of GDP) | | -0.6 | -1.9 | -2.5 | -1.7 | -1.8 | -1.5 | -0.6 |
| **Balance of Payments** | | | | | | | | |
| Trade Balance, % of GDP | | -0.3 | 1.0 | 2.7 | 3.3 | 3.1 | 2.2 | 1.2 |
| Current Account, % of GDP | | -4.2 | -3.3 | -1.3 | -0.5 | -0.8 | -1.6 | -2.8 |
| **Debt Profile** | | | | | | | | |
| International Reserves (US$ bn) | | 363.6 | 356.5 | 365.0 | 381.1 | 375.0 | 380.6 | 392.0 |
| Total Public Debt (net of public sector holdings, % of GDP) | | 32.6 | 35.6 | 45.9 | 51.6 | 54.0 | 57.2 | 57.4 |
| Of which: Foreign-currency denominated (% of GDP) | | -10.3 | -10.5 | -10.5 | -10.0 | -9.8 | -9.8 | -9.8 |
| **Labor Markets** | | | | | | | | |
| Unemployment Rate (% eop) | | 6.5 | 9.0 | 12.0 | 11.8 | 11.2 | 10.6 | 10.0 |

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

# CHILE

## A THREATENED RECOVERY

- **Growth: We keep our 2019 estimate at 3.5%, slightly above potential, reflecting normal conditions in consumption and real exports and some acceleration in investment, mainly due to large-scale projects.**
- **Owing to plunging oil prices, we do not expect inflation to be a major concern in 2019, hovering below the 3% target.**
- **Policy mix to remain slightly contractionary: we believe both monetary and fiscal policy should continue tightening after four years of relaxation.**

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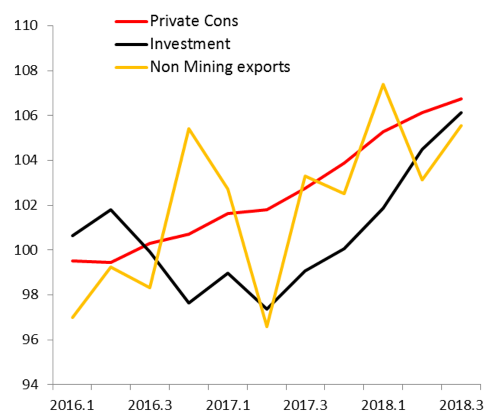
Market sentiment regarding growth is closing 2018 on a relatively negative note. We estimate GDP growth will close the year at 4%, vs. the poor 1.7% average of 2013-17. However, expected growth for 2019 fell 20 bps to 3.6% in recent months (as per the BCCh survey), reflecting a more somber outlook for the global economy and some deceleration in Chile since June. Business sentiment has improved vs. 2017, but failed to soar as many expected it would after President Piñera took office in March. Private consumption and retail sales are expanding at a steady pace (3.5%), but they are far from surging, in the context of relatively slow job creation.

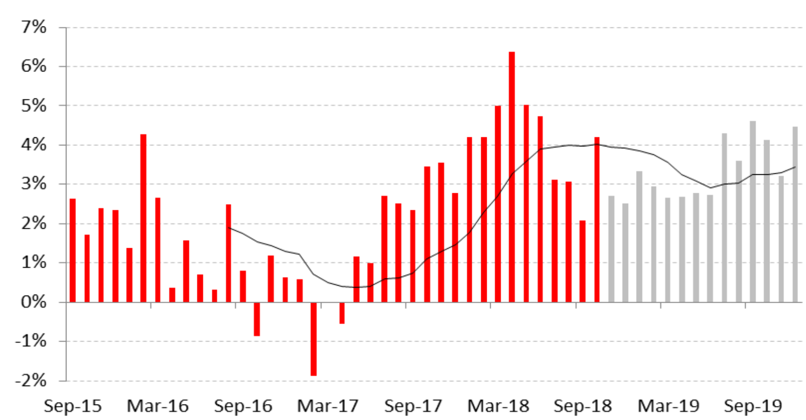
Our call for 2019 GDP growth stands at 3.5%, in line with consensus, but we do not see this pace as disappointing. Potential growth is estimated around 3%, and the output gap is close to zero for the Central Bank, so there are no large idle resources on which to leverage growth. Meanwhile, we expect the policy mix (monetary plus fiscal) to remain slightly contractionary, as real rates rise and the fiscal deficit falls, while external demand from neighboring countries is far from buoyant. In this context, we think a 3.5% expansion looks reasonable, amid a rebound in productivity, mild inflationary pressures, and led by investment.

**GDP components, 100=2016, s.a.**



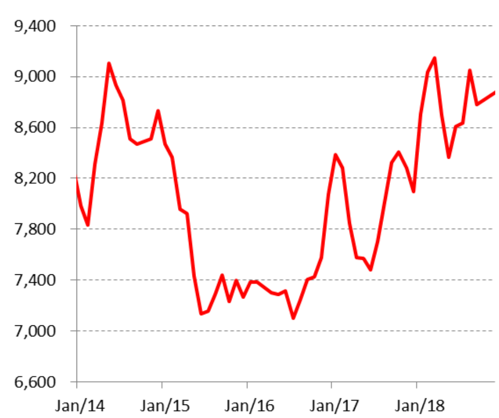

Sources: Central Bank, Santander.

**IMACEC, y/y change & 12M average – 2015-19F**




Sources: BCCH and Santander.

**Non-mining exports**

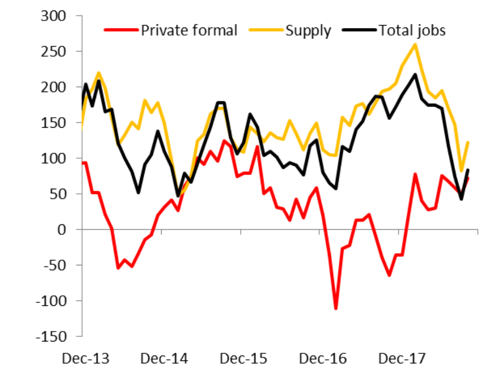



Manufacturing and agricultural exports. Seasonally adjusted. Last-three-month sums. US$ million. Sources: Central Bank, Santander.

Private consumption has been showing two faces in recent quarters. On the non-durables side, growth has been low at 2.0-2.5% annually. As consumption was the most resilient component of GDP during the low-growth years of 2014-2017, we see little room for a big rebound now. In contrast, durables consumption soared 9.0-9.5% annually, mainly in the auto segment. The so-called “Uber effect” and new anti-pollution regulations in the major cities is encouraging consumers to replace cars older than six years old, but it is also true that auto financing remains abundant at low interest rates. Looking ahead, we expect some convergence in consumption, with durables decelerating from unsustainable levels and non-durables gaining some momentum.

As Chile is a small, open economy, negative risks stemming from the so-called “trade war” are important for the country. Apart from the obvious impact on copper prices, the key indicator to measure risks to growth are non-mining exports, but so far there are no signs of a slowdown here: agricultural and manufacturing exports grew 12% y/y (in the August-October quarter), and in seasonally adjusted terms they stand at one of the highest levels in four years. Salmon, wood, pulp & paper, and chemicals are among the outperforming sectors, reflecting good price and demand dynamics. Although global conditions may change suddenly, we see disruption risks here as distant: we estimate growth in non-mining exports at 8% next year, vs. 12% estimated for 2018.

**Labor market: New jobs vs. labor supply**

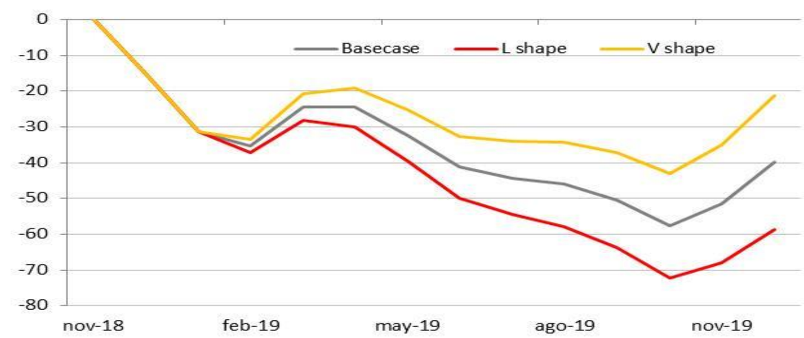



In thousands of persons, last 12 months. Sources: INE and Santander.

Regarding interest rates, the BCCh left the policy reference unchanged at 2.75% this month, after a 25-bp hike in October. Despite this pause, the bank considered that the current stance is “highly expansionary” and expressed an intention to continue adjusting rates in a “gradual and cautious” manner, up to the neutral zone (around 4.25%) in 1H20, which means a pace of 10-20 bps per meeting (or put in another way, two to four hikes every five meetings). In theory, this approach makes sense, but we believe that the global and local conditions to hike rates may disappear as we approach end-2019, so we think it is quite likely that the hiking cycle may be interrupted below neutral by 2Q19 or 3Q19. Santander’s official estimate for BCCh rates is 3.50% for end-2019.

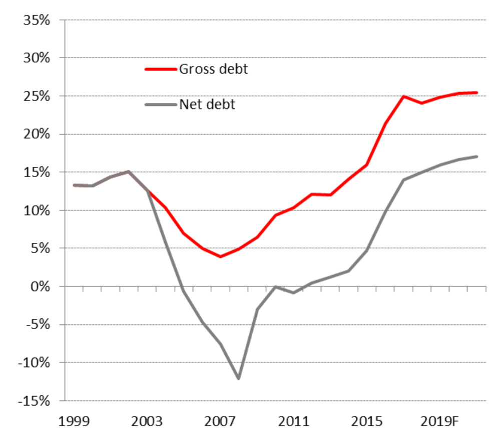
On the inflation side, the recent plunge in global oil prices is a game changer for Chile’s CPI, as local gasoline prices basically follow a lagged function of international prices expressed in CLP. In this context, we foresee significant downward pressure on overall inflation (y/y) in 2019, in a range of 40-70 bps by 3Q19 vs. the current 2.8%, depending on whether oil prices return to previous highs, and at what pace. Another key issue is FX pass-through, which has been mild in recent months, although our call is that a rebound here is likely in 2019. As a result, Santander’s 2019 CPI forecast stands at 2.8%.

**Alternative oil price scenarios – Cumulative effect on CPI y/y (bps)**




L-shape and V shape lines refer to cycle in global oil prices (WTI, US$/b). Sources: INE, Santander

**Public debt as % of GDP**




Sources: Dipres and Santander.

The labor market has been a center of controversy, as the BCCh has recently released a report adjusting employment and salaries by sources other than the official INE survey, on methodology issues. That said, INE data reported 70k new annual jobs in recent months, which is low compared with the 120k new workers entering the market, and has led the unemployment rate to increase gradually, to 7.1% in October (+40 bps vs. a year ago).

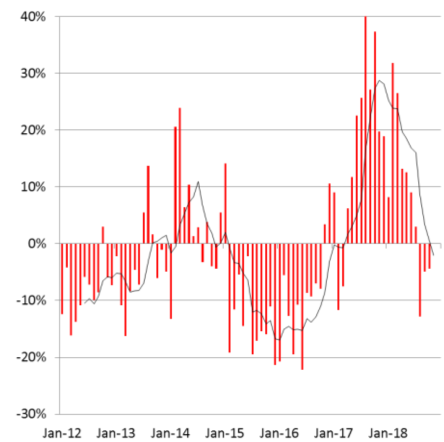
Evidently, the ongoing recovery cycle is proving to be job-poor vs. historical standards, at least considering INE data. However, we also see a positive aspect here: after many years of slowing or even falling average labor productivity (mainly as a result of fast-growing public sector jobs), a turnaround is taking place, with unit labor costs declining 3% annually. This is good for Chile’s competitiveness and the sustainability of the recovery phase, as it implies the absence of material cost pressures on the inflation front.

Immigration is also a key issue in the labor market, as migrant workers’ participation in the labor force practically doubled in less than three years (2015-17), to around 6%. This is in line with disciplined nominal salary growth in the last few years and may have important consequences in terms of the output gap, as a fast-growing labor force tends to lead to higher potential growth. In recent quarters, net migration flows have decelerated, but we expect them to remain positive in the near future, which would require a sustained job creation pace to keep the unemployment rate constant.

We estimate copper prices averaged US$3.00/lb in 2018, +6% vs. 2017. However, indicators are different at the margin: in 2H18 prices fell 10% vs. 1H18 and 6% y/y. Combining output, prices, the FX rate, and domestic prices, real income generated by the mining sector is -6% y/y as of 4Q18, an abrupt reversal vs. +16% in 1H18. With prices at around US$2.85/lb, margins are still decent in the industry, and the global copper market is expected to experience a supply shortfall by 2021, which are good reasons to anticipate an improving investment pipeline in Chile's mining sector: as per CBC data, projected capital spending for 2018-2021 doubled to US$11 billion in the last year.

On the fiscal front, the budget deficit has been falling this year, to 1.9% of GDP in October (last 12 months), from 2.7% in December 2017. This was mainly due to higher mining-related revenue (+0.5%/GDP) and tightly contained primary spending (-0.3%/GDP), in part due to zero growth in capital expenditures. Despite inertia in social spending at an elevated level, the government is close to reaching its 2018 deficit targets, in both actual and structural terms (at 1.8% and 1.9% of GDP, respectively), reflecting a strong commitment to fiscal discipline. We believe declining deficits should eventually lead to a more stable public debt ratio in the next few years, vs. 2018's 24% of GDP (gross) and 15% of GDP (net), up from 12% and 1% five years ago, respectively.

**Mining sector real income**

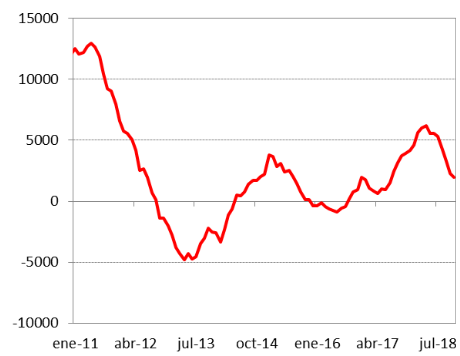



y/y growth, calculated based on exports, output, copper prices, FX rate, and local inflation. Sources: Central Bank, INE, and Santander.

Moving on to external accounts, we estimate that the current account will likely hit a deficit of 2% of GDP in 2018, vs. -1.5% in 2017, reflecting a decline in the trade surplus (mainly due to fast-growing imports), the reversal in copper prices, and rising dividend payments. We see risks in 2019 as skewed toward a larger deficit, if imports continue to grow at 10% annually and copper prices fail to cross the US$3.00/lb threshold. We do not see a 4%-of-GDP current account deficit for Chile as a major concern, as external financing is normally abundant. However, the combination of a considerable CA deficit and tight interest rate differentials vs. the US may impose some downward pressure on the CLP, if net FDI does not offset the potential weakness of net portfolio inflows.

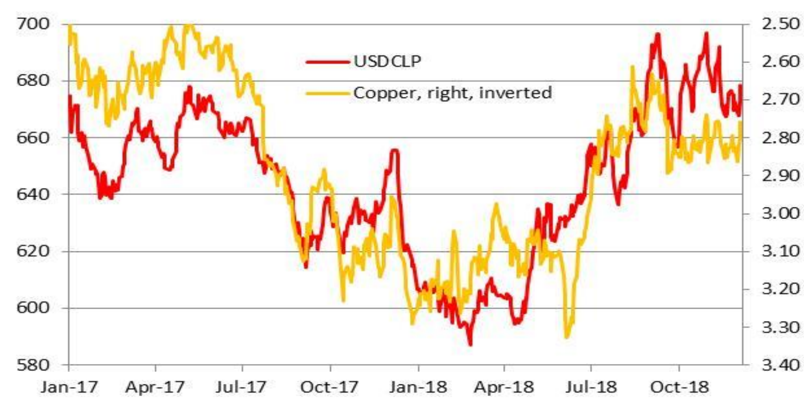
In recent quarters, the exchange rate in Chile has been mainly determined by global forces – i.e., USD levels vs. DM-EM and copper prices (where China plays a large role). The USDCLP rate increased from 595 in February to a 660-700 range since September, despite the pickup in growth and a more hawkish rates outlook. By the same token, our 2019 FX projections mainly hinge on global considerations: we expect a 680 average, but in a wide range, assuming a slightly more expensive USD vs. EM and some rebound in copper prices.

**Trade balance (12M, US$ million)**




Sources: Central Bank and Santander.

**FX rate vs. copper prices, 2017-2018**




Source: Santander

On the political side, President Piñera has had a decent (albeit recently declining) approval rating, near 40%. Regarding his economic agenda, two bills have attracted market attention: the tax modernization project and pension reform. We believe both projects will begin to be discussed in Congress after February, and the ruling coalition's lack of a majority means it will have to negotiate many aspects of the bills. The tax bill, which we believe has a greater likelihood of approval, will likely include a simplification of the corporate income tax regime, new taxes on app services, and measures to reduce tax evasion, always in a context of revenue-neutral reform. On the pension bill, the debate is likely to be fiercer: it would raise employers' contribution to 4% of salaries from 0% and increase the minimum pension paid by the state, for an additional annual cost of US$3.5 billion in five years. The more controversial topic will likely be whether the extra 4% contribution will be managed by existing AFPs, or if new agents are allowed to compete with them.

# CHILE

| | GDP % | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|
| **National Accounts & Activity Indicators** | | | | | | | | |
| Real GDP (Δ% y/y) | | 1.8 | 2.3 | 1.3 | 1.5 | 4.0 | 3.5 | 3.2 |
| Private Consumption (Δ% y/y) | 12 | 2.7 | 2.1 | 2.2 | 2.4 | 4.0 | 3.8 | 3.4 |
| Public Consumption (Δ% y/y) | 65 | 3.8 | 4.8 | 6.3 | 4.0 | 2.7 | 2.6 | 2.3 |
| Investment (Δ% y/y) | 28.4 | -4.8 | -0.3 | -0.7 | -1.1 | 5.9 | 5.6 | 6.0 |
| Exports (Δ% y/y Local Currency) | 39 | 0.3 | -1.7 | -0.1 | -0.9 | 4.8 | 3.2 | 2.9 |
| Imports (Δ% y/y Local Currency) | 39 | -6.5 | -1.1 | 0.2 | 4.7 | 7.8 | 4.9 | 4.4 |
| GDP (US$ bn) | | 261 | 244 | 250 | 277 | 300 | 305 | 324 |
| **Monetary and Exchange Rate Indicators** | | | | | | | | |
| CPI Inflation (Dec Cumulative) | | 4.6 | 4.4 | 2.7 | 2.3 | 2.7 | 2.8 | 3.0 |
| CPI core Inflation IPCX1 (Dec Cumulative) | | 5.1 | 4.7 | 2.9 | 1.9 | 2.3 | 2.9 | 3.0 |
| US$ Exchange Rate (Average) | | 570 | 654 | 677 | 649 | 641 | 683 | 675 |
| Central Bank Reference Rate (eop) | | 3.00 | 3.50 | 3.50 | 2.50 | 2.75 | 3.50 | 3.50 |
| Private sector credit (% of GDP) | | 85.0 | 88.0 | 88.2 | 90.0 | 88.0 | 89.5 | 90.0 |
| **Fiscal Policy Indicators** | | | | | | | | |
| **Fiscal Balance, % of GDP | | -1.6 | -2.1 | -2.7 | -2.8 | -1.8 | -1.7 | -1.6 |
| **Primary Balance, % of GDP | | -1.0 | -1.4 | -2.0 | -2.0 | -1.4 | -1.0 | -0.9 |
| **Balance of Payments** | | | | | | | | |
| Trade Balance, % of GDP | | 2.5 | 1.4 | 2.2 | 2.8 | 0.9 | 0.6 | 0.0 |
| Current Account, % of GDP | | -1.7 | -2.3 | -1.4 | -1.5 | -2.0 | -2.5 | -3.0 |
| **Debt Profile** | | | | | | | | |
| Central Bank International Reserves (US$ bn) | | 40.5 | 38.6 | 40.0 | 40.0 | 40.0 | 40.0 | 40.0 |
| Total Public Debt (gross, % of GDP) | | 14.1 | 16.2 | 21.5 | 25.5 | 24.1 | 24.8 | 25.3 |
| Of which: Foreign-currency denominated (% of GDP) | | 2.5 | 3.2 | 3.5 | 4.0 | 4.5 | 4.5 | 4.5 |
| **Labor Markets** | | | | | | | | |
| Unemployment Rate (% eop) | | 6.4 | 6.2 | 6.5 | 6.7 | 6.8 | 6.6 | 6.5 |

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

## COLOMBIA

# Moderate Recovery Expected to Continue

- **We maintain our forecast of GDP +2.7% for 2018, as leading indicators point to stronger activity in 4Q18. We see the economy maintaining its dynamism in 2019 and expect it to grow at its potential level, 3.3% y/y.**
- **We believe BanRep is in no rush to hike, yet inflationary risks remain to the upside, and the MPC could deliver its first hike in March 2019.**
- **We expect a deterioration in the external account, mainly as a result of lower oil prices. We estimate the current account deficit will widen to 3.6% of GDP after remaining stable at 3.4% in 2018.**
- **Fiscal adjustment in 2019 is feasible, in our view, given the high oil prices posted in 2018. However, concerns about fiscal consolidation in the medium term continue in the absence of structural reforms and given lower oil prices.**

**Diana Ayala**
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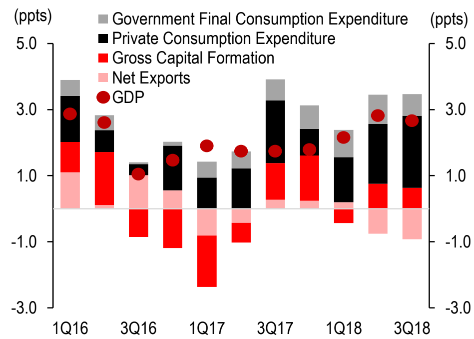
### We expect the economy to reach its potential growth in 2019

Real GDP grew 2.6% y/y in 3Q18, moderating slightly from the 2.7% y/y expansion in 2Q18, but up from 2.5% average growth in 1H18. On the demand side, private consumption continues to be the main driver of growth, contributing 2.2 ppts to annual growth and accelerating at the margin; in 3Q18 it expanded 1.1% q/q (seasonally adjusted) from +1.0% q/q and +0.7% q/q in the previous two quarters. In contrast, investment moderated in 3Q18 after surprising to the upside in 2Q18. Gross fixed investment increased 0.7% y/y, notably lower than the 2.3% y/y increase in 2Q18. However, seasonally adjusted figures suggest that the lower annual growth reflects mainly a more demanding statistical base, as investment expanded a solid 2.4% q/q.

On the supply side, the main improvement was reported in construction activity, which expanded 1.8% y/y in 3Q18 after contracting for almost two consecutive years. The construction improvement was broad-based, with residential and commercial rebounding to +10.9% y/y from -5.1% in 2Q18 and civil works construction increasing 4.4% y/y in 3Q18. We estimate that construction has subtracted around 0.2 p.p. from GDP growth year to date. Investment figures, however, continue to point to some improvement in the sector in the coming quarters, as investment in other building and structures increased 5.0% q/q, adding to the 1.6% q/q expansion in 2Q18, after declining in the past four quarters, thus offsetting somewhat the 4.3% q/q decline in housing investment. In general, we highlight that this is the first time in two years that all sectors posted positive growth, with secondary activities expanding 2.2% in 4Q18, the first positive reading in two years.

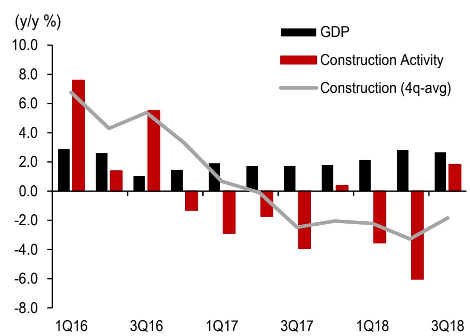
Leading indicators point to a slight pickup in 4Q18. Both retail sales and industrial production surprised to the upside in October, with retail sales expanding a solid 6.5% y/y and industrial production increasing a respectable 5.8%. Given this, we consider that the economy is on track to grow 2.7% in 2018 and 3.3% in 2019, which we estimate as its potential level. In 2019, we expect private consumption to continue to be the main driver of growth. We think the recent decline in consumer confidence is temporary, reflecting in part the public's rejection of the government's initial proposal to expand the VAT base to include staple items, as well as student demonstrations demanding more funding for public universities. At the same time, we expect investment to continue improving in the coming quarters, providing more support to the economy. The downside risks to our scenario are (i) lower investment as a result of lower oil prices and diminished business confidence due to fiscal concerns and a possible sovereign rating revision by Moody's and Fitch, and (ii) lower consumption resulting from persistently low consumer confidence and lower than expected public revenue collection from the financing law. The upside risk is a stronger than expected recovery in investment.

**GDP contribution by component**



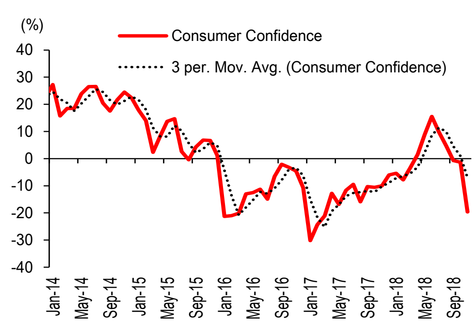

Sources: DANE and Santander.

**Construction activity rebounds in 3Q18**




Sources: DANE and Santander.

**Negative Consumer Confidence Index**




Sources: Fedesarrollo and Santander.

### Inflation risks are to the upside

In general, inflation in 2018 was low and stable, remaining close to the 3% target, aided in great part by lower tradable goods prices and a notable improvement in non-tradable inflation as well as still subdued food prices. In effect, after remaining high and sticky in 2017, in 2018 non-tradable inflation decreased from 5.5% at end-2017 to 4.0% in November 2018, subtracting around 40 ppts from headline inflation. Similarly, tradable inflation dropped from 3.8% y/y at end-2017 to 1.3% in November 2018, subtracting 60 ppts from headline inflation. As mentioned previously, food inflation also remained low, averaging 1.6% y/y in 2018. Despite this, throughout the year we noticed that food inflation started to slowly normalize, adding 35 ppts to the headline since February 2018, which offset some of the positive dynamics from the other two aforementioned components. As of November 2018, headline inflation stood at 3.27% y/y; we estimate inflation at 3.2% by end-2018.

For 2019, we consider that inflationary risks remain to the upside. Admittedly, with the government's initial proposal to increase the VAT tax base being off the table, inflationary risks have moderated. However, a couple of important risks remain, in our view. First, the probability of observing inflationary pressures from El Niño phenomenon has increased. The Minister of Environment stated that El Niño may cut rainfall by 80% in 1Q19, creating significant risks of food inflation in the short term. While we see a low probability of strong pressures similar to those seen in 2015-16, when a very strong El Niño phenomenon occurred, we estimate that a more moderate El Niño would still add around 35-40 ppts to headline inflation. As a result, we now expect inflation to end at 3.6% in 2019, up from our previous forecast of 3.2% y/y.

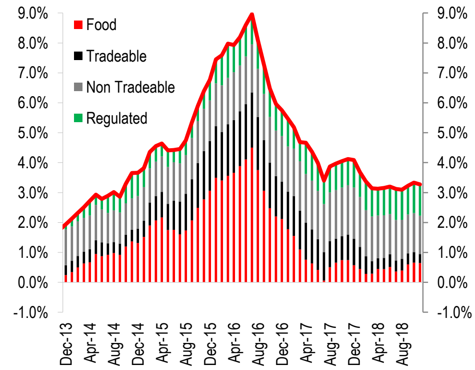
Moreover, the minimum wage revision remains an important upside risk for inflation, in our view. The private sector is proposing a moderate increase of 4.0%, while labor unions are advocating for increase of 10-12%. The minimum wage increased 5.9% in 2018 and 7.0% in 2017, in each case essentially reflecting an increase slightly above the previous year-end inflation. If the next minimum wage increase is above this trend, we may see substantial inflationary pressures given the indexation in the economy. Finally, an abrupt depreciation in the COP, due to higher oil prices or continued volatility in the international financial markets, could create additional inflationary pressures. In contrast, if El Niño effects are milder than anticipated, we could see inflation ending at 3.2%.

### BanRep: to hike or not to hike?

At its October meeting, BanRep kept the interest rate on hold, at 4.25%, for the sixth consecutive month, in line with expectations. In general the MPC maintained a dovish stance, and in its communique it continue to emphasize the weakness of the economy and the uncertainty of the recovery, while noting that observed and expected inflation remains close to target. Moreover, in the 3Q18 quarterly inflation report, BanRep cut its 2019 growth estimate to 3.5% (from 3.7% previously), while maintaining a positive outlook for inflation and still expecting inflation to end at 3.0% in 2019. Finally, during the inflation report presentation, Governor Echavarria gave the impression that the board is still in a wait-and-see mode, as he acknowledged the various upside risks to inflation but noted that inflation expectations remain anchored and that the board will act only if these start to be contaminated by the risks. This supports our view that the MPC is in no rush to hike and that it remains vigilant about inflation expectations in determining when to start the hiking cycle. We maintain our view that the MPC will deliver the first hike by March 2019, when it would have enough information on the inflationary impact of El Niño and the minimum wage increase, as well as 4Q18 GDP data. We believe that if there are no significant pressures from El Niño and if the COP remains somewhat stable, BanRep may start the hiking cycle later. In general we expect BanRep to hike 100 bps during this cycle, taking the rate back to the neutral level.

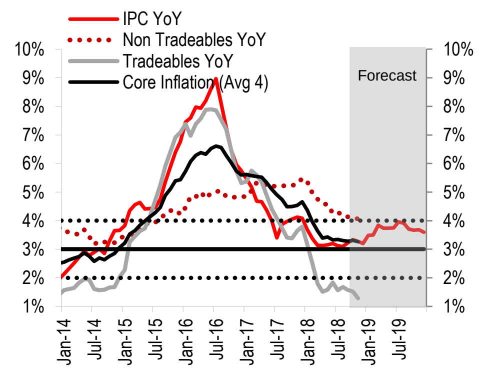
Finally, we expect BanRep to continue its reserve accumulation program in 2019. The program was announced in September 2018, and since its implementation BanRep has accumulated US$400.3 mn. The program was introduced to accumulate international reserves through put options as a preventive measure in case its flexible credit line (FCL) with the IMF of approximately US$11.5 bn is reduced in 2020. If we look at FX reserves as a

**CPI breakdown by component**



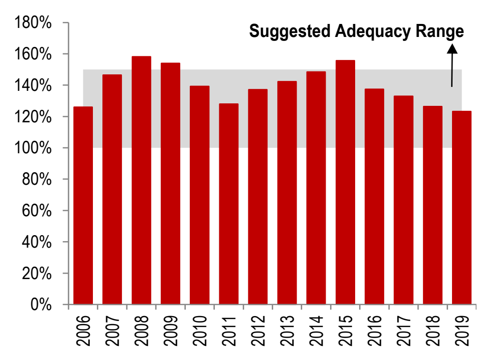

Sources: DANE and Santander.

**El Niño could push inflation to 3.6%**



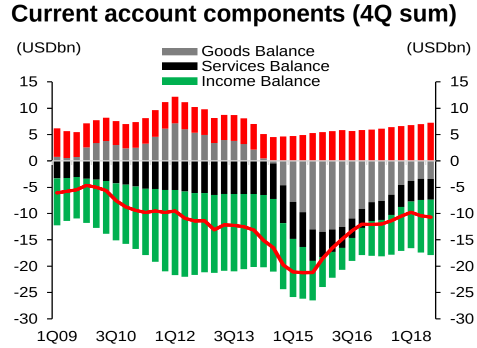

Sources: DANE and Santander.

**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

**Current account components (4Q sum)**




Sources: BanRep and Santander.

percentage of the IMF's ARA metric, we notice that reserves remain within the range of adequacy. However, since 2015 this buffer has been contracting. 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 US$4 bn could lead to a more adequate level.

### Wider current account balance

In 2018, the current account balance continued to improve in the first three quarters of the year, posting a current account deficit of 3.2% of GDP (4Q sum) vs. 3.3% of GDP in 2017. The improvement mainly reflected a small trade deficit, which declined to 1.0% of GDP from 1.5% of GDP in 2017. Despite this improvement, we consider that the current account deficit will end at 3.4% of GDP in 2018, partly as a result of a wider income balance deficit. In effect, we had initially estimated that the current account deficit would moderate to 3.0% of GDP in 2018, given the significant adjustment reported in the trade balance driven by higher oil prices and a moderate recovery in imports. However, the income balance deficit has continuously widened since 2H16, and in 3Q18 it reached 3.2% of GDP, up from -1.5% of GDP in 2Q16 and -2.7% in 2017, offsetting the adjustment in the trade balance. The increase in income outflows mainly reflects higher profits from FDI, with the highest reported in the oil sector.

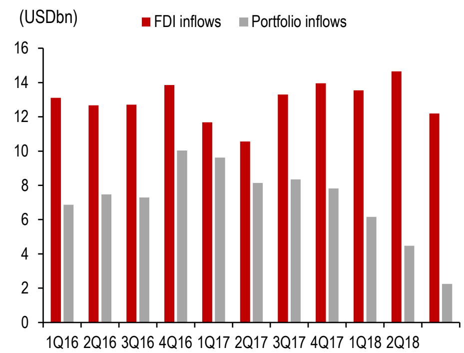
In 2019, we expect the current account deficit to widen to 3.6% of GDP, as we anticipate a higher trade deficit mainly as a result of lower oil prices. In effect, in 2018 terms of trade increased 6.6% as of September 2018, with export prices rising 9.7% during the period, while import prices reported a much more moderate increase of 3.3%. For the last months of the year and in 2019, we expect terms of trade to decrease to reflect the 24% decline in oil prices since September. In addition to lower export prices, we expect imports to continue to pick up in line with the economic recovery.

On the financing side, the 3Q18 report indicated that FDI inflows have declined somewhat vs. 2017 but remain at solid levels, adding up to 3.6% of GDP, down from 4.4% of GDP in 2017 (4Q sum). These investments were allocated primarily among the mining and oil sectors (37%) and financial and business service sectors (22.4%). In contrast, portfolio investments have moderated notably in the past two years, falling to 0.7% of GDP from 2.5% in 2017 and 3.5% in 2016. In the short term, we expect to see a slight increase in inflows as a result of the government's decision to reduce the TES withholding tax to 5% from 14%. In general, we do not expect financing pressures next year, as we expect FDI to remain strong. However, a shift in portfolio inflows into negative territory could create some concerns.

### Fiscal policy: the discussion continues

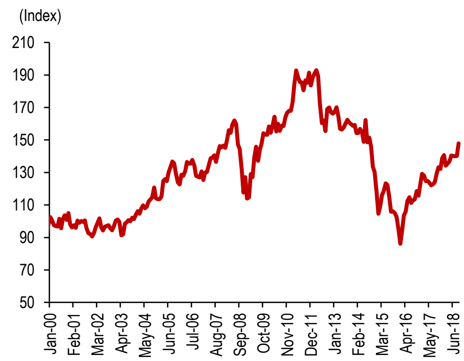
Fiscal concerns remain in the near term. In recent weeks, the government's initial proposal for a financing law was rejected, as its decision to collect COP14 tn, mostly by increasing the VAT tax base, was highly unpopular. In the second version of the law, the government aimed to collect COP7.5 tn, mainly by taxing the wealthy, adding a tax on existing home sales, and increasing taxes on sugary beverages and beer. As of this writing the discussion continues, with legislators tweaking the second version and diluting it. The latest version presented to the Congress for approval estimates a collection of COP7.1 tn, COP0.4 tn less than the second proposal. In general, we believe the financing law falls short in addressing the main fiscal structural issues. While we think 2019's fiscal adjustment is achievable, with oil revenue estimated to close 0.5 p.p. of the gap, the fiscal adjustment in 2020 and beyond will require a more comprehensive reform, as a result of lower projected oil revenue and increasing pressures on the expenditure side. Our concern is the government's ability to deliver political costly reforms, such as pension reform, as its inability to pass a more comprehensive financing law is not a good precedent, in our view. Additionally, the initial financing law proposal, although rejected, did not come without a cost – not only did consumer confidence deteriorate, but President Duque's disapproval rating increased significantly to 64%, according to the latest Gallup poll. If the government is unable to address the structural fiscal issues, we would not rule out the possibility that Moody's and Fitch could downgrade Colombia's sovereign rating by year-end, matching S&P's downgrade of Colombia in 2017 to BBB-, one grade above junk level.

**FDI inflows stable, while portfolio inflows are decelerating (4q-sum)**



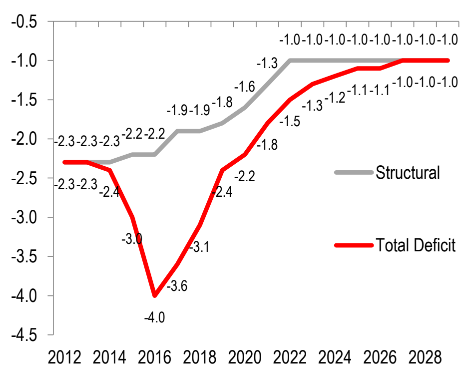

Sources: BanRep and Santander.

**Terms of trade expected to decrease**



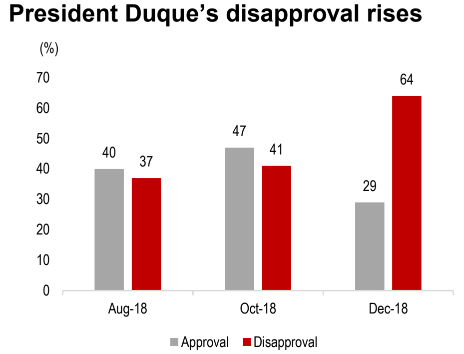

Sources: BanRep and Santander.

**Fiscal targets (% GDP)**




Sources: Ministry of Finance and Santander.

**President Duque's disapproval rises**




Sources: Gallup.

# COLOMBIA

| | % GDP | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|
| **National Accounts & Activity Indicators** | | | | | | | | |
| Real GDP (Δ% y/y) | | 4.7 | 3.0 | 2.0 | 1.8 | 2.7 | 3.3 | 3.5 |
| Private Consumption (Δ% y/y) | 61.1 | 4.6 | 3.1 | 1.4 | 1.8 | 2.7 | 4.7 | 4.4 |
| Public Consumption (Δ% y/y) | 16.1 | 4.7 | 4.9 | 1.8 | 4.0 | 4.7 | 3.6 | 3.3 |
| Investment (Δ% y/y) | 23.7 | 11.8 | -1.2 | 0.3 | 0.6 | 1.1 | 2.7 | 3.1 |
| Exports (Δ% y/y) | 18.9 | -0.3 | 1.7 | -1.4 | -0.7 | 1.5 | 1.9 | 2.0 |
| Imports (Δ% y/y) | 19.8 | 7.8 | -1.1 | -4.0 | 0.3 | 3.9 | 4.6 | 4.5 |
| GDP (US$ bn) | | 381 | 293 | 283 | 314 | 334 | 340 | 351 |
| **Monetary and Exchange Rate Indicators** | | | | | | | | |
| CPI Inflation (Dec Cumulative) | | 3.7 | 6.8 | 5.8 | 4.1 | 3.2 | 3.6 | 3.1 |
| Core inflation (Dec Cumulative) | | 3.3 | 5.2 | 5.1 | 5.0 | 3.5 | 3.5 | 3.0 |
| US$ Exchange Rate (Average) | | 2400 | 2740 | 3050 | 2952 | 2952 | 3325 | 3325 |
| Central bank reference Rate (eop) | | 4.50 | 5.75 | 7.50 | 4.75 | 4.25 | 5.25 | 5.25 |
| Bank lending to the private sector (% chg YoY, Dec) | | 13.6 | 14.6 | 9.2 | 7.3 | 6.5 | 8.0 | 10.0 |
| **Fiscal Policy Indicators** | | | | | | | | |
| Fiscal Balance, % of GDP | | -2.4 | -3.0 | -4.0 | -3.6 | -3.1 | -2.4 | -2.2 |
| Primary Balance, % of GDP | | -0.2 | -0.5 | -1.1 | -0.8 | -0.2 | 0.5 | 0.6 |
| **Balance of Payments** | | | | | | | | |
| Trade Balance (% of GDP) | | -3.0 | -4.7 | -3.3 | -1.5 | -1.2 | -1.8 | -1.7 |
| Current Account (% of GDP) | | -6.6 | -6.4 | -4.3 | -3.3 | -3.4 | -3.6 | -3.6 |
| **Debt Profile** | | | | | | | | |
| Central Bank International Reserves (US$ bn) | | 47.3 | 46.7 | 46.7 | 47.6 | 47.8 | 49.8 | 51.8 |
| Total Public Debt (gross, % of GDP) | | 38.3 | 37.0 | 44.0 | 44.4 | 47.8 | 47.3 | 47.0 |
| Of which: Foreign-currency denominated (% of GDP) | | 11.0 | 14.0 | 16.0 | 16.0 | 15.1 | 15.1 | 15.0 |
| **Labor Markets** | | | | | | | | |
| Unemployment Rate Avg. (year-end % of EAP) | | 8.7 | 8.6 | 8.7 | 8.6 | 8.4 | 8.0 | 8.0 |

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

# MEXICO

## IT'S ALL ABOUT GENERATING CONFIDENCE

- **Mexico is moving closer to finally achieving a new trilateral trade agreement with the US and Canada, pending approval by the US Congress.**
- **The cancellation of the Texcoco airport, based on the results of a public consultation, may have missed an opportunity to jump-start growth, in our view.**
- **We see concern in the markets that the new administration's policies could lead to fiscal laxity.**
- **In the context of increasing inflation expectations, we now expect a 25-bps hike at the December 20 meeting and another in March 2019, ending 2019 at 8.50%.**

**Guillermo Aboumrad***
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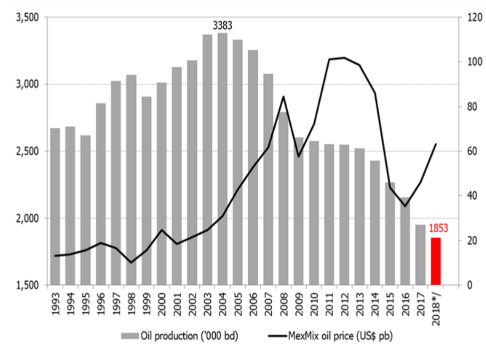
### Did AMLO miss an opportunity to jump-start growth by cancelling Texcoco airport?

On November 30, the US, Canada, and Mexico signed the USMCA agreement, or "NAFTA 2.0," moving closer to a new trilateral trade agreement among the three countries, pending approval by the US Congress. We view the agreement as a major macro event for Mexico, as NAFTA jitters for the last three years, among other factors, including uncertainties around the policies of the incoming administration, have private sector investment projects in a wait-and-see mode. Mexico's new president, Andrés Manuel López Obrador, was enjoying a political honeymoon with the markets from a few weeks before the elections until a few weeks before the cancellation of the Texcoco airport, coinciding with a better outlook for trade relations with the US. It appeared the table was set for luring private investment back into the Mexican economy. However, by cancelling the Texcoco airport based on the results of a public consultation, the next administration missed an opportunity to jump-start growth, in our view.

**Oil production (tbd)**




Sources: Pemex and Santander.

AMLO has underscored the need for private investment, both domestic and foreign, to generate growth above the 2% in which Mexico has been trapped for many years. However, to achieve this goal, we believe the government needs to generate confidence among investors, and so far AMLO has failed to do this, judging by the reaction of the financial markets. AMLO has said that once his policies are in place, the markets will realize their benefits, which will generate the needed confidence, but in the meantime he indicated he would not be held hostage by the markets. Our concern is that he may not be taking into account how quickly confidence can evaporate and how long it can take to regain it.

### Policies and implications

AMLO's policies, as spelled out in his books, during the presidential campaign, and most recently in his inaugural speech, have been consistent in their focus on eradicating corruption and economic abuses of the population and ensuring a bigger role for the public sector to take care of the population's needs. (The new Mexico City airport at Texcoco was a major symbol of corruption, according to AMLO, which is why he believed the project had to be discontinued.) The markets are concerned that this could lead to fiscal laxity and have expressed that concern with a widening of the break-even inflation linkers. We think that higher inflation expectations could lead investors to demand a higher premium at the long end of the yield curve and cause Banxico to increase the policy rate. In our view, AMLO is not opposed to the markets *per se*, but so far, his policies and proposals have made investors uneasy, aside from the appointment of Jonathan Heath to the Central Bank. Jonathan Heath is a true independent economist, with no affiliation with AMLO's Morena party. However, AMLO's second appointment, Gerardo Ezquivel, who worked closely with AMLO in designing the 2019 budget, is a close associate of the president.

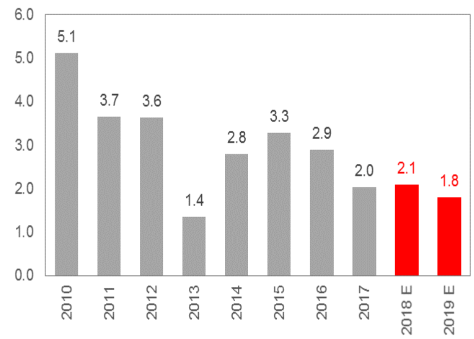
**Mexico 10Y break-even inflation**


Sources: Bloomberg and Santander.

Regarding Pemex, AMLO has said that he believes Pemex should produce more oil and refine more gasoline, with the ultimate goal of selling cheaper gasoline in the local market. However, credit rating agencies such as Moody's have warned against the increased currency risk for the company if it stops exporting oil, which gives it US dollars to service its debt, and starts to refine oil locally by building a new refinery, modernizing the current six refineries, and selling gasoline for pesos. Regarding CFE, the public electricity company, AMLO believes it should produce more electricity, which would be a reversal from the Peña Nieto administration's policy of giving more latitude to the private sector in certain sectors of the economy, given that public money is scarce. For now, AMLO has put on hold for at least three years the next round of energy auctions originally scheduled for February 2019.

Another policy proposal is to centralize more power in the presidency, in contravention of Mexico's tradition of federalism, with the new creation of so-called "superdelegates," who would report directly to the executive branch and control federal resources that go to the states. If enacted, this plan would create competition with the current governors, who have taken a negative view of the proposal. In addition, the new administration has expressed discontent with several industries that AMLO believes are abusing their position in the market, such as the banking sector, mining concessions, and pension funds.

**Mexico GDP growth (%)**

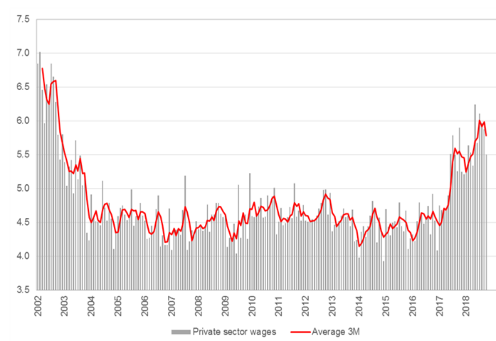



Sources: INEGI and Santander.

### Checks and balances

*The Economist* recently published an article titled "AMLO will be the most powerful Mexican president in decades" (December 1, 2018). So, what are the checks and balances on this administration? AMLO's Morena party has a majority in both chambers of Congress, and the opposition is either highly divided, like the PAN party, greatly diminished, like the PRI, or virtually extinct, like the PRD. Even within his team, we believe AMLO is no longer listening to the conservatives who led investors to believe that this administration would take a centrist approach (such as going forward with the Texcoco airport and following through on energy reform). Thus, in our view, the markets will provide the only check and balance, and they could work to moderate AMLO's ambitious social and infrastructure programs, keeping them within the limits of whatever funds are available. In addition, now that AMLO holds power, he will be politically accountable for his actions and responsible for fulfilling his campaign promises.

**Private sector wage increases (%)**




Sources: Labor Ministry and Santander.

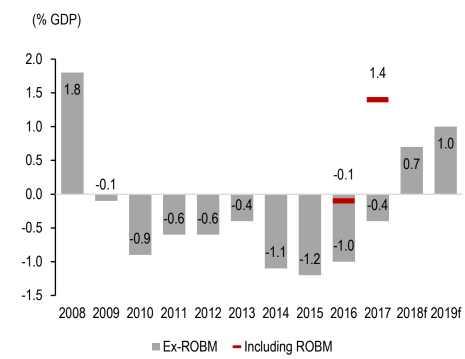
AMLO has stated his willingness to make public consultations legally binding by proposing to Congress some constitutional reforms to Article 35, governing public consultations. Once the reform is in place, AMLO has pledged to hold a referendum on his performance by July 2021, asking voters to cast their ballots on whether they want him to remain president for the rest of his six-year term. In our opinion, that is a highly risky proposition, because Mexico could see a slow GDP growth rate next year (around 1.8%), which is typical during the first year of every new administration and could be more pronounced this time, as AMLO is proposing numerous austerity measures and reducing the size of the government. In 2020, Mexico could also face a US economic deceleration, in our view, so with the pressure of the public consultation to fulfill his campaign promises of improving the standard of living and winning the population to his side, we believe AMLO might be tempted to increase government spending to guarantee victory, thus relaxing the fiscal stance. So far, the market has been pricing this possibility by demanding a higher premium at the long end of the nominal yield curve.

To Mexico watchers, public consultations may seem to be a new political tool, but they are not new to AMLO, as he used them extensively in the past when he was mayor of Mexico City in 2000, and even before that when his registration as a candidate to become mayor of Mexico City was in question when the opposition claimed he was from Tabasco and was not eligible. The PRD held a public consultation that he won with 96% approval, or 400,000 votes. It was organized by the same company that is organizing the consultations today, Rosenblueth Foundation.

### The 2019 fiscal budget

AMLO has an aggressive agenda of new infrastructure projects and new social programs that we believe will require strict austerity measures and the cutting of inefficiencies to achieve the goal of a primary surplus of 1.0% of GDP. In the 2019 budget, AMLO presented reduced costs for the programs for his first year in office, considering that they will not start right away and that for most infrastructure projects, the first year is mostly dedicated to planning. Nevertheless, the 2019 budget proposes to allocate MXN250 bn to the government's 18 priority projects, and if we add the Dos Bocas refinery, Pemex's most important project, we arrive at MXN300 bn. This is still a hefty amount that we believe would require significant cuts elsewhere to close the budget deficit. However, because we think it will take time for the government to settle in, they might not be able to spend the full proposed amount in 2019, so if they are unable find the total savings, the problem will be pushed to 2020 and beyond. We estimate that for 2020, at least another MXN150 bn will be required to fund the full yearly cost of the new programs. We still believe the weakest link is Pemex. In AMLO's 2019 budget, Pemex received no additional funds to invest in production and exploration, and the company urgently needs to turn around 14 years of falling production. In summary, we did not see any significant negative or positive surprises in the budget, compared to what we expected originally.

**Primary fiscal balance**




ROBM= "Remanentes de Operación del Banco de México" Banxico capital transfers to Ministry of Finance
Sources: Ministry of Finance and Santander.

### Banxico keeping close watch on new administration's policies

In the minutes from the November 15 meeting, all board members stated their belief that the balance of risks for inflation had deteriorated with an upward bias. One member noted that some upward risks to inflation have materialized in recent months from both external and domestic factors. Another member was even more hawkish, suggesting that the balance of risks for inflation may be in the process of becoming even more adverse. MXN pressures may continue to be subject to protectionist measures worldwide and other external factors, as well as internal factors such as the deterioration of public finances and wage negotiations that are not consistent with productivity gains. The risk of second-round effects affecting the price formation process continues to rise, in our view.

The minutes also included a discussion on the impact of wage indexation on inflation. This discussion is particularly relevant, as AMLO promised in his inaugural speech that the minimum wage should increase every year at a rate above inflation. He also pledged to increase energy prices zero percent in real terms (in line with inflation), but it is not clear whether he was referring to past or expected inflation. According to the minutes, one member stated that there is ample evidence in the economic history of Mexico and other countries that the implementation of formal or informal indexation mechanisms in the economy increases the risk of losing control of inflation and adversely affecting the target population that such mechanisms seek to protect.

One member considered that if taxes in the border zone with the US were reduced, it would undermine fiscal revenue, generating additional pressures on public finances. This is particularly relevant, as AMLO underscored in his inaugural speech that he plans to introduce into the 2019 budget a plan to strengthen the border cities with the US in order to prevent further immigration to the US; reduce the VAT to 8% from 16% and the income tax to 20% from 35%; equalize the prices of electricity and gasoline with those in the US border cities; and double the minimum wage. Among market observers, estimates are in the range of MXN 100-140 billion for the loss of tax revenue in the 2019 budget resulting from these measures.

In this context, we now expect a 25-bps hike at the December 20 meeting and another for March 2019, ending 2019 at 8.50%. We see this as increasingly likely given that one member voted for a 50-bps hike at the November meeting, and another voted for the announcement of the objective for the reference rate at levels higher than those foreseen recently.

# MEXICO

| | GDP % | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|
| **National Accounts & Activity Indicators** | | | | | | | | |
| Real GDP (Δ% y/y) | | 2.8 | 3.3 | 2.9 | 2.0 | 2.1 | 1.8 | 2.0 |
| Private Consumption (Δ% y/y) | 73.9 | 2.1 | 3.4 | 3.7 | 3.0 | 2.8 | 2.6 | 2.4 |
| Public Consumption (Δ% y/y) | 10.9 | 2.9 | 1.9 | 2.4 | 0.1 | 2.0 | -1.0 | 0.5 |
| Investment (Δ% y/y) | 20.9 | 3.1 | 5.0 | 1.1 | -1.5 | 2.5 | -0.2 | 1.5 |
| Exports (Δ% y/y Local Currency) | 17 | 7.0 | 8.4 | 3.5 | 3.8 | 4.7 | 4.5 | 4.0 |
| Imports (Δ% y/y Local Currency) | 21.5 | 5.9 | 5.9 | 2.9 | 6.4 | 5.8 | 5.2 | 4.8 |
| GDP (US$ bn) | | 1,313 | 1,170 | 1,077 | 1,157 | 1,215 | 1,199 | 1,241 |
| **Monetary and Exchange Rate Indicators** | | | | | | | | |
| CPI Inflation (Dec Cumulative) | | 4.1 | 2.1 | 3.3 | 6.8 | 4.8 | 4.0 | 4.0 |
| CPI core Inflation (Dec Cumulative) | | 3.2 | 2.4 | 3.4 | 4.9 | 3.7 | 3.7 | 3.7 |
| US$ Exchange Rate (Average) | | 13.3 | 15.9 | 18.7 | 18.9 | 19.3 | 20.7 | 21.2 |
| Central Bank Reference Rate (eop) | | 3.00 | 3.25 | 5.75 | 7.25 | 8.25 | 8.50 | 8.50 |
| Bank Lending to Private Sector (% of GDP) | | 14.8 | 16 | 16.9 | 17.5 | 18.5 | 19.0 | 19.5 |
| **Fiscal Policy Indicators** | | | | | | | | |
| Fiscal Balance, % of GDP | | -3.2 | -3.5 | -2.6 | -1.1 | -2.0 | -2.0 | -2.5 |
| Primary Balance, % of GDP | | -1.1 | -1.1 | -0.1 | 1.4 | 0.7 | 1.0 | 0.5 |
| **Balance of Payments** | | | | | | | | |
| Trade Balance | | -0.2 | -1.3 | -1.2 | -1.0 | -1.0 | -1.1 | -1.2 |
| Current Account, % of GDP | | -1.8 | -2.5 | -2.2 | -1.7 | -1.7 | -1.8 | -1.9 |
| **Debt Profile** | | | | | | | | |
| Central Bank International Reserves (US$ bn) | | 193.2 | 176.7 | 176.5 | 172.8 | 175.0 | 178.0 | 180.0 |
| Total Public Debt (gross, % of GDP) | | 43.2 | 47.3 | 48.7 | 46.0 | 45.3 | 45.3 | 45.8 |
| Of which: Foreign-currency denominated (% of GDP) | | 11.9 | 14.6 | 18.3 | 15.7 | 15.1 | 15.4 | 15.6 |
| **Labor Markets** | | | | | | | | |
| Unemployment Rate (year-end, % of EAP) | | 4.8 | 4.3 | 3.9 | 3.4 | 3.2 | 3.5 | 3.6 |

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

## PERU

## REACHING POTENTIAL GROWTH

- **Despite the deceleration in 3Q18, we believe economic activity is on a path to reach its potential growth of 4.0% by end-2018 and maintain that level in 2019.**
- **Headline inflation should remain above the 2.0% target, in our view, as food inflation continues to normalize. We expect headline inflation to end 2019 at 2.5%.**
- **The Central Bank has been on hold, but we consider that it will deliver its first hike in 2Q19 as inflation remains above target and the output gap closes.**
- **Lower copper prices led to a wider current account deficit, yet Peru's external vulnerability remains low in comparison to its peers.**

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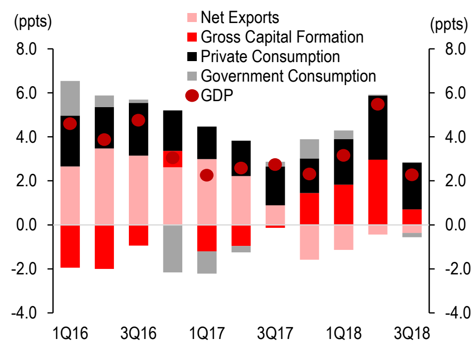
### Growth on a path to reach potential

GDP growth disappointed in 3Q18, decelerating to 2.3% y/y from a strong 5.4% expansion in 2Q18 and solid average growth of 4.3% y/y in the first half of the year. The sudden moderation reflected in particular a contraction in public consumption and public investment. Public consumption contracted 1.8% y/y in 3Q18, falling from low 0.4% growth in 2Q18, while public investment contracted 1.6% y/y after posting a solid 8.4% y/y expansion in 2Q18. In addition to a lower public spending contribution to growth, private investment also moderated in 3Q18 to +1.4% y/y from a high of +8.5% y/y. In contrast, private consumption slowed less noticeably, as it expanded 3.3% y/y in 3Q18 vs. 3.8% average growth in 1H18. Private consumption continues to be the main growth driver, contributing close to 70% of growth this year.

Despite the deceleration observed in 3Q18, leading indicators point to more dynamic economic activity in 4Q18. In effect, the monthly economic activity indicator reports that the economy expanded 4.2% y/y, above the 2.1% y/y growth in September. Moreover, electricity production started to pick up in October, increasing 5.1% y/y from the 3.2% y/y average in 3Q18, and preliminary figures for November point to even stronger production for that month, suggesting that economic activity has accelerated in the last quarter of the year. In addition, central bank governor Julio Velarde noted that public investment surged in 4Q18, increasing around 21%, per CB estimates, and leading to 4.9% y/y GDP growth estimated for 4Q18.

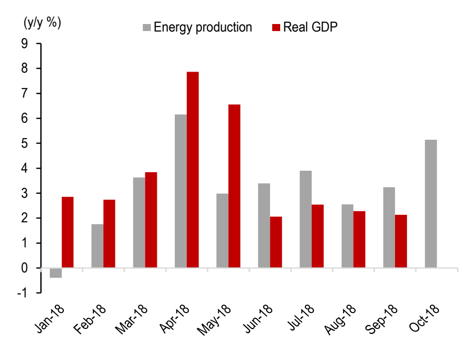
Looking ahead, we consider that the economy is poised to maintain growth at its potential level, 4.0% y/y, in 2019. We consider that private consumption will continue to improve next year, supported by a continuing increase in consumer credit as well as a recovery in formal employment. At the same time, we believe that private investment will remain an important source of growth, as there are strong investment commitments in the pipeline in both the mining and non-mining sector for next year. The BCRP estimates that investment commitments are around US$43.1 bn for next year, which is equivalent to 19% of GDP, with the non-mining sector accounting for almost 90%. Despite this positive outlook, we see important risks to the downside, in particular the possibility of an escalation in the trade war between the US and China, which could lead to even slower global growth than currently expected and to lower metal prices, both with a likely negative effect on exports and possibly investment. Additionally, delays in public investment at the sub-national level could lead to lower GDP growth, in our view. In contrast, better coordination between the executive branch and the Congress, which could lead to the approval of more infrastructure projects and structural reforms, such as labor reform, could improve business confidence and, in turn, could potentially boost investment.

**GDP contribution by component**



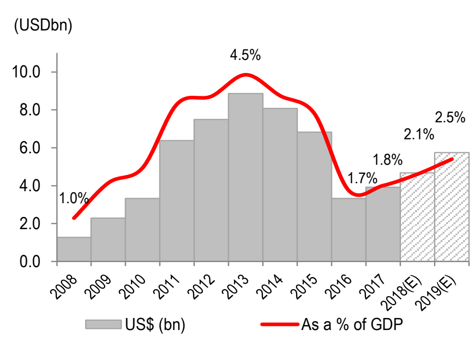

Sources: Central Bank and Santander.

**Electricity production picking up**




Sources: COES, Central Bank, and Santander.

**Strong mining investment in the pipeline**




Sources: Ministry of Energy and Mining; Santander.

## Inflation expected to remain above the 2.0% target

After falling below the target range in March 2018, headline inflation slowly moved up to the 2% target during the year, and in November it jumped to 2.2% y/y from 1.8% in October, posting the first reading above the target since October 2017. Core inflation measures, however, stand at a higher level. Core inflation, which excludes the most volatile items, stood at 2.49% y/y in November, while inflation ex food was 2.42% y/y, with both series fluctuating above the 2% target rate for most of the year, suggesting that a major component of the low headline inflation this year has been abnormally low food prices, a trend similar to that seen in the other Andean countries. Starting in September, however, food inflation resumed its upward trend after a pause in 2Q18, increasing 1.8% y/y in November, up from -1.0% y/y in August, and accounting for 72% of November's monthly inflation.

In general, we expect inflation to continue to move upward and end 2019 at 2.5%, up from our 2.2% end-2018 inflation forecast. This projected increase in inflation is in part due to a less favorable statistical base, but also is based on our expectation that food prices will continue to normalize, while we may also start seeing some demand-side pressures as consumption continues to improve. Finally, we expect tradable inflation to continue to put pressure on the headline, reflecting pass-through from the current and expected depreciation. In contrast, energy prices should remain contained in the first half of 2019, in our view, as international oil prices are likely to remain at current levels.

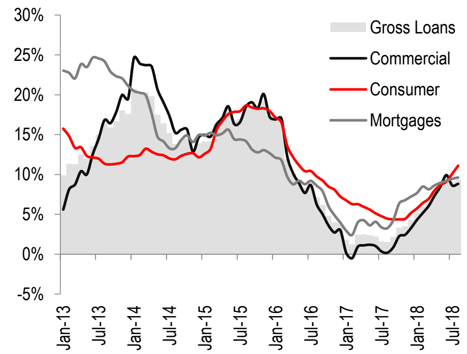
In all, we consider that risks remain to the upside. The main upside risks to our inflation forecast are higher food prices as a result of El Niño. The World Meteorological Organization reported that there is a 75-80% probability of a mild El Niño materializing by February 2019. Moreover, locally the EFEN (Estudio Nacional del Fenomeno "El Niño") reported in December that there is a 58% probability of a weak El Niño, and only a 9% probability of a moderate El Niño. Therefore, our 2019 forecasts do not reflect a significant impact of El Niño on prices. Additionally, a stronger depreciation in the PEN, as a result of lower metal prices, risk-off events in EMs, and/or a stronger US dollar could lead to higher inflationary pressures in 2019, in our opinion. The main downside risks to our forecast are a slower increase in food prices and reduced pressure from domestic demand due to weaker than expected activity.

## We see Central Bank holding stance coming to an end

Since June of 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 its December communique the MPC noted that inflation is within the target range but 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 the uncertainty in international markets.

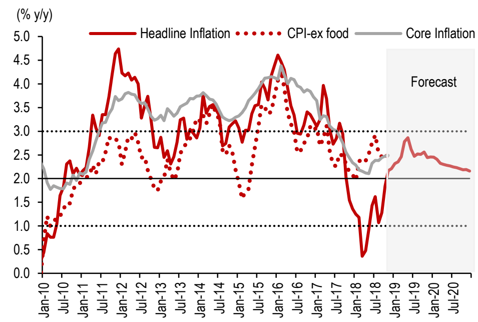
Taking this scenario into consideration, the board kept the reference rate on hold at 2.75%, and said it considered it appropriate to maintain an expansionary policy stance as long as inflation expectations remain anchored and economic activity remains below its potential. Despite these comments, we believe the MPC's holding stance should end soon. We initially expected the central bank to start a hiking cycle at its December meeting; however, given the notable moderation in growth in 3Q18, we see the MPC keeping the interest rate on hold for a bit longer to ensure that the output gap closes before delivering its first hike. We now expect the MPC to deliver its first hike in 2Q19, after 1Q19 activity is reported, as we expect the economy to continue to grow at a solid pace, closing the output gap, while inflation expectations in the medium term should remain anchored at 2.5%. Finally, we consider that BCRP will hike by a total of 75 bps in 2019 and 25 bps in 2020, bringing the interest rate to its neutral level. We anticipate, however, that the pace of the hiking cycle will be slow and with pauses, increasing 25 bps in each quarter. We acknowledge that if growth disappoints in 1Q19, the MPC may opt to start the hiking cycle later.

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



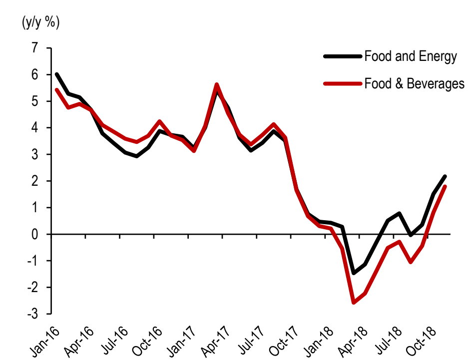

* Nominal terms: Sources: SBS and Santander.

**CPI expected to remain above 2.0%**



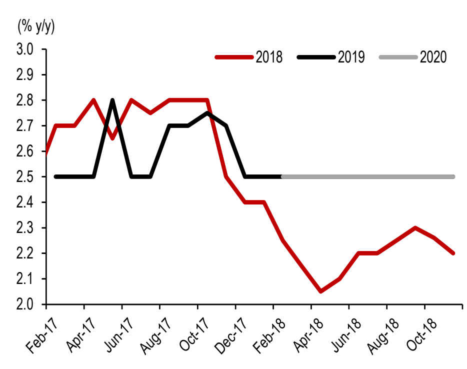

Sources: BCRP, Santander.

**Food prices are trending up**




Sources: BCRP and Santander.

**Inflation expectations anchored**




Sources: BCRP, Santander.

## Fiscal consolidation on the way

As of October of this year, the Ministry of Finance registered a deficit of 2.2% of GDP, a notable improvement from the deficit of 3.0% reported during the same period last year. The improvement in the deficit corresponds to the authorities' commitment to start fiscal consolidation in 2018, in order to reach a 1% deficit by 2021, after they revised the path to allow a slower consolidation to provide resources for the reconstruction of the areas affected by El Niño in 2016. We estimate the fiscal deficit in 2018 to have decreased to 2.9% of GDP from 3.1% in 2017, slightly lower than the government's current target of 3.0%, and we expect the authorities to continue with fiscal consolidation and lower the deficit to 2.7% as a percentage of GDP in 2019.

Peru has been running a deficit for the past four years, and as a result, its public debt has increased from 19% of GDP in 2013 to close to 26% of GDP in 2018. We expect the deficit to increase to 27% in 2019 and to start decreasing in 2020. Despite the increase in public debt, Peru remains in a better position than its peers that hold the same sovereign rating, as its debt remains well below the median of debt in this group (41.9%) and is one of the lowest in the region (second to Chile). Overall, we do not see risks of a downward revision of Peru's sovereign credit rating in 2019.

## External accounts in check

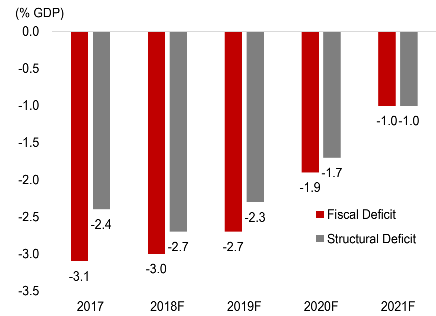
In 3Q18 the current account balance posted a deficit of US$1.1 bn, increasing from the deficits of US$0.7 bn reported in 2Q18 and US$0.3 bn reported in the same period last year. In 4Q sum terms, the current account deficit increased to 1.7% as a percentage of GDP, increasing from the 1.1%-of-GDP deficit reported in 2017. In 3Q18 the deterioration in the current account balance was mainly the result of a lower trade surplus. In effect, the trade surplus declined to US$1.2 bn from US$2 bn in 2Q18 and was lower than the surplus of US$1.8 bn registered during the same period last year. In turn, the lower trade surplus reflects lower terms of trade, which have been declining since February of this year and decreased 10% y/y in October. While import prices continue to increase, due in part to the depreciation of the currency, export prices have fallen notably, due to lower international metal prices, including copper, gold, and zinc, while volume for both exports and imports has remained relatively stable. The latest data suggest that terms of trade have stabilized in 4Q18, and thus, we estimate that the current account will post a deficit of 1.6% of GDP in 2018. Assuming that international metal prices remain relatively stable over the next year, we consider that the current account could post a similar deficit of 1.5% of GDP in 2019.

Despite the deterioration reported in the current account balance, the deficit remains one of the lowest in the region. Moreover, the deficit is well financed, as net FDI flows are more than double the size of the deficit. In effect, FDI has surged in 2018, close to US$6 bn of inflows in 3Q18, almost US$2 bn higher than the inflows reported during the same period last year. Part of this surge is the result of the increase in mining sector investment, which we expect to remain solid in 2019, as reflected by investment commitments.

## Referendum to fight corruption: positive for President Vizcarra?

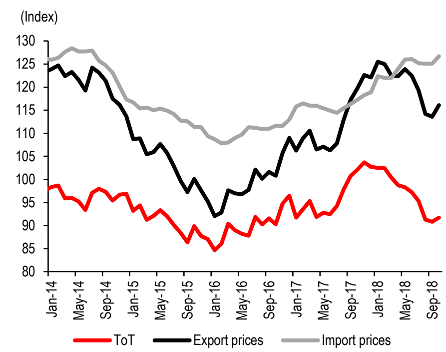
On December 9, Peru held a referendum in which citizens voted on four constitutional reforms that would (i) prohibit the immediate reelection of lawmakers, (ii) tighten controls over party finances, (iii) introduce changes to the election of judges and prosecutors, and (iv) return Parliament to a bicameral structure. The ONPE (Oficina Nacional de Procesos Electorales) reported that the majority of citizens voted against the bicameral proposal but approved the other three reforms. Political analysts consider this a positive result for President Vizcarra, who proposed the reforms in July and whose popularity has increased since then. Following the results, Mr. Vizcarra announced measures to implement the changes. While we do not expect the referendum's outcome to have an impact on the economy, we acknowledge that there are risks to the upside if Mr. Vizcarra uses this win to push for structural reforms, such as labor reform, and/or infrastructure projects, before the next election in July 2021.

**Fiscal consolidation on the way**



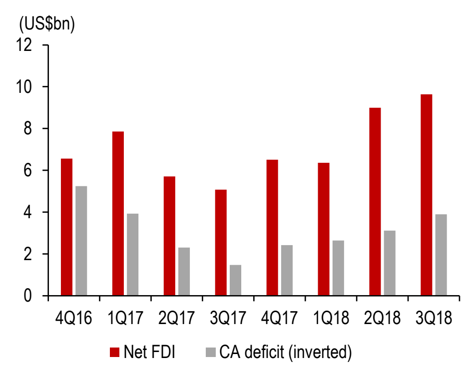

Sources: BCRP and Santander.

**Decreasing terms of trade**



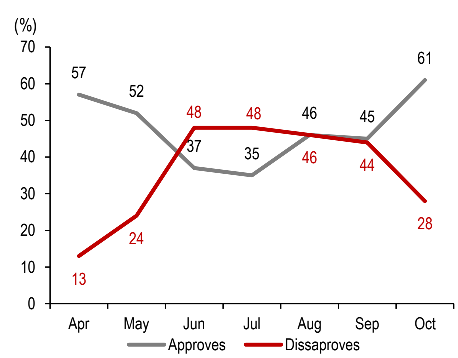

Sources: BCRP, Santander.

**Net FDI above Current Account Deficit***




*Note: 4Q sum. Sources: BCRP and Santander.

**President Vizcarra approval rating recovering**




Sources: IPSOS-El Comercio.

# PERU

| | GDP % | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|
| **National Accounts & Activity Indicators** | | | | | | | | |
| Real GDP (Δ% y/y) | | 2.4 | 3.3 | 4.0 | 2.5 | 4.0 | 4.0 | 4.0 |
| Private Consumption (Δ% y/y) | 61.4 | 3.9 | 4.0 | 3.3 | 2.5 | 3.8 | 4.1 | 3.8 |
| Public Consumption (Δ% y/y) | 11.2 | 6.0 | 9.8 | -0.3 | -0.2 | 2.6 | 3.8 | 3.6 |
| Investment (Δ% y/y) | 28.2 | -3.1 | -2.8 | -4.4 | -0.3 | 5.4 | 6.9 | 6.2 |
| Exports (Δ% y/y Local Currency) | 23.9 | -0.9 | 4.0 | 9.4 | 7.8 | 3.1 | 4.1 | 3.8 |
| Imports (Δ% y/y Local Currency) | 24.6 | -1.4 | 2.4 | -2.2 | 4.1 | 5.2 | 5.0 | 4.8 |
| GDP (US$ bn) | | 203 | 192 | 195 | 214 | 224 | 223 | 231 |
| **Monetary and Exchange Rate Indicators** | | | | | | | | |
| CPI Inflation (Dec Cumulative) | | 3.2 | 4.4 | 3.2 | 1.4 | 2.2 | 2.5 | 2.2 |
| WPI Inflation (Dec Cumulative) | | 3.3 | 4.1 | 3.7 | 2.3 | 2.4 | 2.5 | 2.5 |
| US$ Exchange Rate (Average) | | 2.8 | 3.2 | 3.4 | 3.3 | 3.3 | 3.5 | 3.6 |
| Central Bank Reference Rate (eop) | | 3.50 | 3.75 | 4.25 | 3.25 | 2.75 | 3.50 | 3.75 |
| **Fiscal Policy Indicators** | | | | | | | | |
| **Fiscal Balance, % of GDP | | -0.3 | -2.0 | -2.5 | -3.1 | -2.9 | -2.7 | -1.9 |
| **Primary Balance, % of GDP | | 0.8 | -1.0 | -1.4 | -1.9 | -1.5 | -1.3 | -1.0 |
| **Balance of Payments** | | | | | | | | |
| Trade Balance, % of GDP | | -0.7 | -1.5 | 1.0 | 2.9 | 3.6 | 2.7 | 1.7 |
| Current Account, % of GDP | | -4.4 | -4.8 | -2.7 | -1.1 | -1.6 | -1.5 | -1.4 |
| **Debt Profile** | | | | | | | | |
| Central Bank International Reserves (US$ bn) | | 62.3 | 61.5 | 61.7 | 63.6 | 61.1 | 61.9 | 63.0 |
| Total Public Debt (gross, % of GDP) | | 20.1 | 23.3 | 23.8 | 24.9 | 25.7 | 26.9 | 26.0 |
| Of which: Foreign-currency denominated (% of GDP) | | 8.7 | 11.1 | 10.4 | 8.8 | 9.0 | 9.1 | 9.3 |
| **Labor Markets** | | | | | | | | |
| Unemployment Rate (year-end, % of EAP) | | 5.2 | 6.2 | 6.7 | 6.5 | 6.2 | 6.0 | 6.0 |

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

## URUGUAY

# 2019: UPCOMING PRESIDENTIAL ELECTIONS

- **We expect GDP to grow 1.4% y/y in 2019, a slight recovery from 1.1% y/y expected in 2018, excluding the reopening of the oil refinery.**
- **We expect the UYU to remain overvalued, closing 2019 at UYU35/USD (9% y/y), though with downside risks under alternative external shocks or potential sovereign credit downgrades.**
- **Presidential and congressional elections will take place in October 2019 and could end in a run-off between the ruling Frente Amplio and the opposition Partido Nacional in November, according to most polls.**

**Marcela Bension***
598 1747 6805

### GDP highly dependent on expected FDI inflows

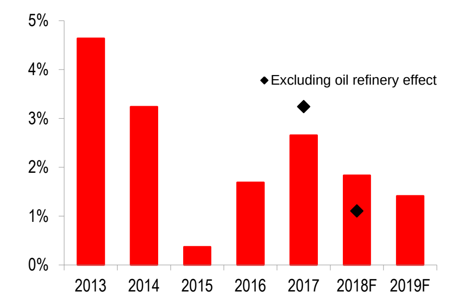
Real GDP growth is expected to average 1.1% y/y in 2018, excluding the oil refinery effect, decelerating from 3.2% y/y in 2017, as per our estimates. State-owned refinery ANCAP was closed for almost all of 2017 due to maintenance and a workers' union strike, undermining GDP levels that year. The opposite has occurred in 2018, as the reopening of the refinery "inflates" GDP growth readings to an expected 1.8% y/y, including the impact of the refinery.

GDP grew a modest 1.2% y/y in 3Q18, excluding the ANCAP refinery, similar to 1.4% y/y in 2Q18, according to Central Bank figures released on December 13˙. Activity results were better than anticipated by key leading indicators, presumably driven by sectors such as communications (+6.1% y/y) that are "over-represented" in the outdated 2005 national accounts methodology used by the Central Bank, while accounting for a low share of areas such as job creation (we believe the methodology is likely to be updated in 2020). In fact, prior to the release of 3Q18 figures, we were seeing considerable similarities between current activity levels and low 0.4% y/y GDP growth in 2015, following global financial turmoil at that time. According to our estimates, core industrial output, excluding large industries such as the state oil refinery, PepsiCo food and beverage production, and UPM pulp mill production, declined 4.2% y/y in real terms in 3Q18, similar to 2015 readings. Our retail sales index, based on data released by the National Chamber of Retail Services (CNCS), signaled a 4.6% y/y decline during 3Q18, in line with 1Q15 minimums (-5.1% y/y), even though Central Bank figures reported a lower 0.9% y/y decline in retail sales. New car sales slumped 16% y/y in 3Q18, with home appliances (+10% y/y), toy stores (+7.1% y/y), and travel agencies (+1.4% y/y) among the few positively performing sectors. Merchandise exports, in turn, fell 14.7% y/y in real terms in 3Q18, driven by collapsing soybean production, which represents roughly 20% of total good exports. Crops fell 65% y/y in 3Q18, due to adverse climatic conditions. All in all, exports of goods and services fell 10.4% y/y, as per Central Bank figures.

As a result, both business and consumer confidence turned negative, following improvement in 2017. The consumer confidence index, according to Ucudal, averaged 41.4 in 3Q18 – the lowest level since the index's August 2007 inception and close to readings that indicate strong pessimism (below 40). Industrial sector business confidence, in turn, has remained strongly negative since 2014, when global conditions started to worsen, -35% in 3Q18, considering that only 2% of surveyed firms expected stronger economic conditions through 2Q19 (6m forward looking), against 37% of firms expecting worse economic conditions. While the index is not as negative as in 3Q16 (-60%), it explains the persistent decline in fixed private investment (-0.4% y/y as of 3Q18).

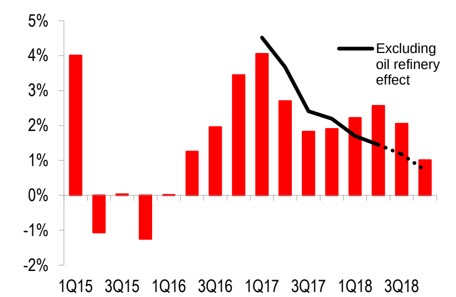
Lower activity appears driven, in our view, by tighter global conditions and undermined competitiveness of local firms, as a result of pressure from high taxes, expensive administered prices such as fuel and electricity, high labor costs, and peso overvaluation.

**GDP expected to grow slightly in 2019 on specific FDI project**



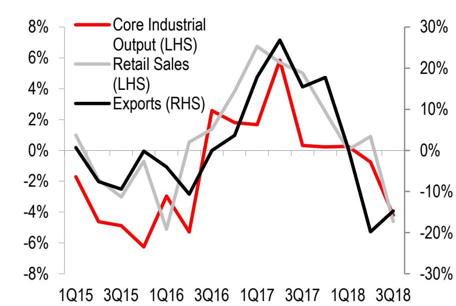

% real y/y change (annual average). Sources: BCU and Santander.

**GDP expected to decelerate further into 3Q18 and 4Q18**




% real y/y change, quarterly data. Sources: BCU and Santander.

**Leading indicators in negative territory, as in 2015**

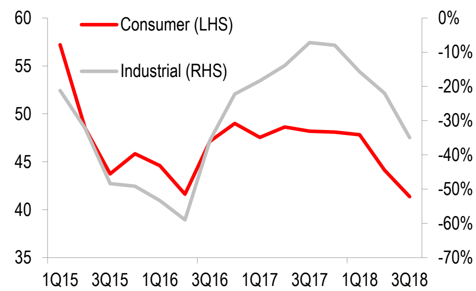



% y/y real change, quarter averages. Sources: INE, CNCS, BCU, and Santander.

Looking at 2019, growth expectations are riding on a recovery of crop exports and the construction of a new 170-mile railway that will join the center of the country to its capital city, Montevideo. The project is a prerequisite from Finnish firm UPM to construct its second pulp mill in 2020-21 at an amount of ~US$1 billion (1.7% of GDP). The concession is currently in the process of being awarded through a PPP.

As a result, we expect fixed investments to rise 5% y/y in real terms in 2019. However, we believe that higher investments are likely to be offset by lower household consumption (+1% y/y) amid job destruction, stagnant real wages, and potential peso weakening that discourages durable goods purchases. Consequently, we expect overall GDP to increase 1.4% y/y in 2019. In 2020, we believe that investments could grow an additional 10-15% y/y, due to the UPM pulp mill construction (US$3 billion, 5% of GDP). While we view favorably the UPM investment, particularly considering that investment ratios have deflated to levels unseen since the aftermath of the severe 2002 financial crisis, authorities had to grant significant benefits to the firm for it to consider building its second pulp mill in the country (a decision to be formally taken by February 2020). Those benefits involve the creation of a free-trade zone for the mill's operations, tax exemptions, compulsory purchases of biomass by the state, and addressing labor market rigidities. (The latter issue is yet to be addressed and particularly refers to strikes and occupation of firms by workers' unions that, being currently legal, have generated complaints from pulp mills already operating in the country). Such beneficial conditions have stimulated political debate on whether local firms deserve equal treatment, a key issue likely to be put forward during the already launched 2019 presidential election campaign.

**Confidence indicators declined as well**

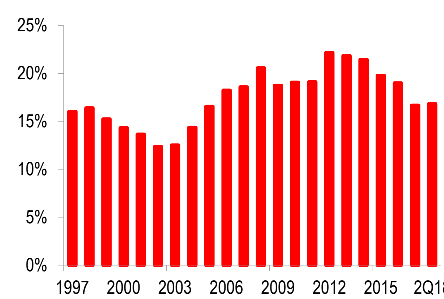



Sources: Ucudal, Sura, and Santander estimates.

**Fiscal tightening: the burden to be inherited by the next administration**

By mid-year, authorities committed to reaching a public sector deficit of 3.3% of GDP in 2018 and 2.8% of GDP in 2019. According to our estimates, the structural fiscal deficit stood at 3.9% of GDP in the moving year to October, adjusted for the cyclical component and one-off effects such as the *cincuentones*, included in fiscal accounts since October. In fact, the Ministry of Finance reports a 2.9% of GDP deficit as of October when incorporating a one-off 1%-of-GDP injection from fully capitalized pension funds corresponding to a group of citizens popularly known as *cincuentones*. This group of workers, currently in their mid-50s, claimed that they had been negatively affected by the 1996 pension reform that migrated from a pay-as-you-go system to a combination of the old system with a fully capitalized regime. The Vazquez administration, whose party holds a majority in Congress, supported this claim and passed a law creating an escrow account that will cumulate proceeds from those workers in the old pay-as-you-go system – that is, fiscal accounts – until they retire. At that time, a new liability will be triggered, higher than assets collected as of October. It is worth mentioning, though, that the economic authorities have made it clear that these funds are not to be freely disposed of and have created new fiscal lines and statements so as to clarify and disclose the impact of this action on fiscal accounts. From a macroeconomic and intergenerational perspective, the *cincuentones* law is quite debatable, in our view, as it benefits a group of workers to the detriment of young workers at a time when a new social security reform is necessary in order to prevent further fiscal worsening. If authorities fail to lower the fiscal deficit as we expect them to in 2019, gross public debt could rise from 67% of GDP in 2018 to 72% in 2021. We estimate that a primary surplus slightly above 1.5% of GDP is necessary to stabilize debt ratios in upcoming years. Considering that the primary result is currently negative at 0.3% of GDP, this implies the need for a near-2% fiscal tightening – a task to be inherited by the next administration, to take office following the presidential elections in the autumn of next year.

**Investment at levels unseen since 2002 crisis aftermath**



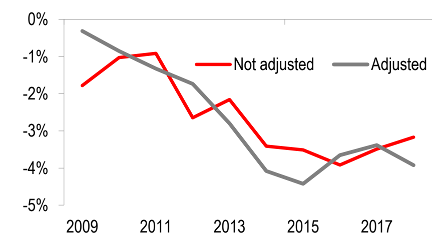

Sources: BCU. Investment as a % of GDP.

A major risk that we expect the country to confront in 2019 is potential credit downgrades, either by Moody's (Baa2, stable) and S&P (BBB, stable) or, in a worst-case scenario, by Fitch (BBB-), as the latter recently revised the country's long-term foreign currency outlook to negative. While this is not our base-case scenario, it cannot be completely ruled out, considering that it is highly dependent on the balance of risks assessed by credit agencies regarding an activity slowdown and worsening fiscals against a long-lasting strong institutional framework, low financing risks, and large expected FDI inflows.

**The UYU could remain overvalued if no major negative shocks occurs**

At current FX of UYU32.2/USD, we estimate that the peso remains overvalued by ~16% vs. historical RER levels. We expect this situation to remain essentially unchanged in 2019, under the assumption that local authorities will not address rising fiscal expenses. Following the Brazilian elections, we now expect the UYU to close 2018 near current levels (vs. previous UYU33.5/USD) and UYU35/USD in 2019 (+9% y/y). Our forecast assumes a 7.8% y/y weakening of the BRL in 2019 – the UYU is strongly correlated with the BRL – and the US 10yr yield at 3.5%. In this context, we expect inflation near 8% y/y in both 2018 and 2019, above the Central Bank's 3-7% y/y indicative range target. Our view is based on the abovementioned UYU weakening and 7.5-8.0% y/y expected increase in both wages and administered prices into 2019. As for rates, we expect 90-day yields to rise slightly to 10% p.a. in nominal terms (currently, 9.5-9.8%) – that is, 2% p.a. in real terms. We expect UI yields to remain slightly above current levels – 3% p.a. and 4% p.a. at 5- and 10-year tenors – under the assumption that sovereign risk premiums rise to 200 bps from the current 180 bps. That said, we cannot completely rule out an alternative worse-case scenario where US rates rise higher than expected or sovereign credit rating downgrades take place, implying greater weakening of the UYU, particularly given its current overvaluation.

**Public sector deficit remains at 4% of GDP when adjusted by one-off effects**

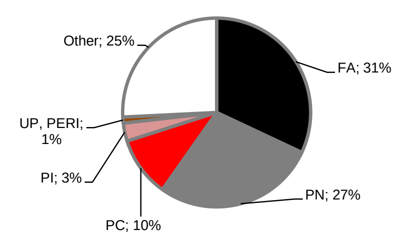



As % of GDP. The adjusted result includes amendments for one-off effects such as the "cincuentones" law as well as for impact of the economic cycle on revenues and expenses. Sources: MEF and Santander.

**What about the elections?**

After almost 14 years of consecutive rule by the left-wing *Frente Amplio* (FA) while holding majorities in Congress, the political landscape could change in 2019 when presidential elections take place. The first round will occur on October 27, 2019 and also involves elections for all seats in both chambers of Congress. The second round – under a likely run-off vote – will take place on November 24. According to recent polls by Cifra (November 2018), *Frente Amplio* (FA) has nearly 31% of voting intentions, closely followed by center-right Partido Nacional (27%), center-right wing Partido Colorado (10%), and the other center-left parties (7%). As a result, the FA's ability to hold on to office appears threatened, and even if it does retain power, it is unlikely that it will have a majority in Congress, according to these polls. This would suggest that a coalition government may be formed in 2019-20, regardless of which party wins the executive branch. From an economic perspective, issues at stake will be recovering GDP growth amid rising unemployment (near 9%), depressed investment, and low export competitiveness. For all of these to improve, we believe the new administration will need to put forth a new social security reform while addressing alternatives to rising public sector expenses that have translated into a high tax burden and expensive administered prices that are choking private-sector investment and household consumption/savings. Some candidates from the opposition have already stated that they will implement a fiscal rule, extend benefits granted to UPM to all new investments, and forbid the occupation of firms by workers' unions. Conversely, the ruling party has recently formalized its intent to raise income taxes for large firms and wealthier individuals, while potentially decreasing the tax burden on lower-income firms and households. Enhancing the competitiveness of local firms by signing new trade agreements with key partners is also a pending issue that could find new options if Brazil's new "openness approach" to the Mercosur Trade Union is ratified. From a social perspective, citizens are demanding a tougher stance on crime (which has escalated in the past decade), better public education, and a decisive halt to inefficient and opaque management in the public sector that has translated into significant losses at firms like ANCAP.

**Voting polls for 2019 presidential elections**




Sources: Cifra. As of 15-29 November. FA: Frente Amplio; PN: Partido Nacional; PC: Partido Colorado; PI: Partido Independiente; UP: Unidad Popular; Other: null, uncertain.

In sum, a lot appears at stake in 2019's presidential elections, regardless of next year's economic outlook, which could end up being reasonably decent in the absence of negative external shocks. Uruguayans will have to choose between continuing left-wing policies or changing to alternative center-right policies, with uneven prospects for potential GDP growth in the next five years.

# URUGUAY

| | GDP % | 2014 | 2015 | 2016 | 2017 | 2018F | 2019F | 2020F |
|---|---|---|---|---|---|---|---|---|
| **National Accounts & Activity Indicators** | | | | | | | | |
| Real GDP (Δ% y/y) | | 3.2 | 0.4 | 1.7 | 2.7 | 1.8 | 1.4 | 2.0 |
| Private Consumption (Δ% y/y) | 66.0 | 3.0 | -0.5 | 0.1 | 4.4 | 2.2 | 1.0 | 1.8 |
| Public Consumption (Δ% y/y) | 13.8 | 2.5 | 2.2 | 2.9 | -1.3 | 0.4 | 0.0 | -0.5 |
| Investment (Δ% y/y) | 22.9 | 0.0 | -9.0 | -3.9 | -13.8 | 14.3 | 4.8 | 11.4 |
| Exports (Δ% y/y Local Currency) | 24.0 | 3.5 | -0.6 | -0.2 | 7.6 | -5.3 | 4.0 | 3.8 |
| Imports (Δ% y/y Local Currency) | 27.3 | 0.8 | -7.3 | -6.2 | -0.4 | 2.0 | 4.3 | 7.5 |
| GDP (US$ bn) | | 57.3 | 53.4 | 52.8 | 59.2 | 61.4 | 61.4 | 62.5 |
| **Monetary and Exchange Rate Indicators** | | | | | | | | |
| CPI Inflation (Dec Cumulative) | | 8.3 | 9.4 | 8.1 | 6.6 | 7.9 | 7.8 | 7.5 |
| WPI Inflation (Dec Cumulative) | | 10.3 | 10.0 | 7.7 | 6.6 | 8.0 | 7.8 | 7.5 |
| US$ Exchange Rate (Average) | | 23.2 | 27.3 | 30.1 | 28.7 | 30.7 | 33.7 | 36.4 |
| Central Bank Reference Rate (eop) | | n/a | n/a | n/a | n/a | n/a | n/a | n/a |
| Monetary Base (Δ% y/y) | | 10.7 | 9.5 | 6.1 | 12.9 | 7.2 | 6.4 | 8.1 |
| **Fiscal Policy Indicators** | | | | | | | | |
| **Fiscal Balance, % of GDP | | -3.4 | -3.4 | -3.9 | -3.5 | -3.9 | -3.8 | -3.7 |
| **Primary Balance, % of GDP | | -0.6 | 0.0 | -0.6 | -0.2 | -0.5 | -0.4 | -0.2 |
| **Balance of Payments** | | | | | | | | |
| Trade Balance, % of GDP | | 2.8 | 3.2 | 5.4 | 6.8 | 4.1 | 3.7 | 2.9 |
| Current Account, % of GDP | | -3.1 | -0.8 | 0.8 | 1.6 | -1.1 | -1.7 | -2.6 |
| **Debt Profile** | | | | | | | | |
| Central Bank International Reserves (US$ bn) | | 17.6 | 16.0 | 13.8 | 16.2 | 15.8 | 16.1 | 16.4 |
| Total Public Debt (gross, % of GDP) | | 58.5 | 58.8 | 63.2 | 65.4 | 66.7 | 70.0 | 72.1 |
| Of which: Foreign-currency denominated (% of GDP) | | 44.0 | 54.0 | 53.1 | 41.8 | 43.6 | 43.9 | 44.2 |
| **Labor Markets** | | | | | | | | |
| Unemployment Rate (year-end, % of EAP) | | 6.6 | 7.5 | 7.8 | 8.8 | 8.6 | 8.6 | 8.2 |

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

# Main Events Calendar for 2019

| DECEMBER Country | 2018 Date | Event | What to Watch |
|---|---|---|---|
| Mexico | 20-Dec | Banxico monetary policy meeting | We expect Banxico to hike 25 bps. Only four members of the board will attend this meeting, following Mr. Del Cueto's decision to leave the board. This would be also the last meeting for Deputy Governor Ramos Francia. |
| Brazil | 31-Dec | End of government diesel fuel subsidies (decree 847/2018) | Falling crude prices and a stronger currency could smooth out the ending of these subsidies (which are triggered only by certain combinations of international prices and exchange rates; with current market prices, there are no subsidies). The incoming government will have to determine what pricing policy will prevail from 2019 onward. |
| Brazil | 31-Dec | End of federal intervention in Rio de Janeiro state (decree 9288/2018) | President-elect Jair Bolsonaro already stated that the intervention will not be extended. Federal interventions need to be at least temporarily lifted for Congress to vote on proposed constitutional amendments. |
| Brazil | 31-Dec | End of the "financial emergency" period in Rio de Janeiro state | During this period, the state is allowed to temporarily breach debt and payroll spending ceilings imposed by the Fiscal Responsibility Law. The end of the law will further tighten the budget constraints imposed by the Fiscal Recovery Regime, to which the state began adhering in 2017. |
| Colombia | 31-Dec | Deadline to approve minimum wage increase & financing law | Congress would have to approve the final text of the financing law, which seeks to collect an additional COP7.5 tn. Syndicates are advocating a double-digit increase in the minimum wage, which if approved could generate significant inflationary pressures in 2019. |
| Mexico | 31-Dec | Deadline to approve 2019 budget and 1Q19 issuance calendar | The lower house already approved the income law without changes, and we expect the pending laws (spending and indebtedness) to pass before the deadline with minor if any changes. Meanwhile, we expect investors to focus on the new security issuance calendar for 1Q19, which will likely be published in the last days of this year. |
| **JANUARY Country** | **2019 Date** | **Event** | **What to Watch** |
| Brazil | 1-Jan | Jair Bolsonaro's inauguration ceremony in Brasília | The inauguration speech should set the president-elect's priorities and main goals. |
| Mexico | 4-Jan | Mexcat repurchase offer closes | The outcome of bond buyback worth $1.8bn looks binary and will be a timely market test of investors' confidence. |
| Colombia* | 11-Jan | BanRep analysts' expectations survey | Significant revision to inflation expectations would increase the possibility of a hike in January. |
| Peru* | 10-Jan | Monetary Policy Decision | |
| Colombia* | 28-Jan | Monetary Policy Decision | |
| Chile | 30-Jan | First BCCh rate meeting | |
| **FEBRUARY Country** | **Date** | **Event** | **What to Watch** |
| Brazil | 1-Feb | Preparations begin for leadership elections of the Lower House. Parties can gather in blocks to claim seats on the House's board (*mesa diretora*), which are distributed proportionally according to the block sizes. Candidacies for speaker of the Lower House are registered. | The composition of blocks is the initial indication of how parties will align for important votes. It will be important to watch which registered candidate (if any) will be supported by the government. |
| Brazil | 1-Feb | Election of Senate President | An important data point to gauge at this early stage is the new government's influence and the balance of power in the Upper House. Since 2001, all such elections have been won by a candidate from the Brazilian Democratic Movement (MDB), which, despite having lost 7 seats in the 2018 elections, will still be the largest block in the Senate, with 12 senators. |

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|---|---|---|---|
| Brazil | 2-Feb | Election of the Speaker of the Lower House | This will be the most important political event in 1Q19, in our view (perhaps rivaled by the possible presentation of a pension reform proposal). A speaker not aligned with the economic reform agenda would be a troubling sign, in our view. |
| Brazil | 6-Feb | Copom’s first 2019 meeting | Possibly the last Copom meeting with Ilan Goldfajn as governor; in November 2018, he announced that he will stay until Senate approval of the next appointed governor, Roberto Campos Neto. |
| Mexico | 7-Feb | Banxico monetary policy meeting | We expect Banxico to remain on hold. This would be the first meeting with the new board members, Gerardo Esquivel and Jonathan Heath. |
| Peru* | 7-Feb | Monetary Policy Decision | |
| Colombia* | 11-Feb | Quarterly Inflation Report (4Q18) | Possible upward revision to inflation if El Niño effects are stronger than anticipated |
| Chile | 14-Feb | BCCh rate meeting minutes (Jan) | |
| Mexico | 21-Feb | Banxico rate meeting minutes (Feb) | |
| **MARCH** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Brazil | 5-Mar | Carnival’s Fat Tuesday | Common wisdom says the new year in Brazil only starts after Carnival, which is probably more than partially true. Carnival marks the end of the long summer holidays and, in our view, may be the beginning of a period of higher expectations regarding the government’s ability to move forward with its reform agenda. |
| Peru* | 7-Mar | Monetary Policy Decision | |
| Mexico | 11-Mar | AMLO’s 100th day in office | An important date to gauge AMLO’s approval rating. We believe the question of progress on security/corruption issues will be highly sensitive. |
| Brazil | 20-Mar | Copom’s second meeting of 2019 | Possibly the first meeting chaired by Roberto Campos Neto. Markets will be looking for clues about the BCB’s new reaction function. |
| Colombia* | 22-Mar | Monetary Policy Decision | We expect the Central Bank to deliver its first 25-bps hike. |
| Mexico | 28-Mar | Banxico monetary policy meeting | We consider that Banxico could deliver a final 25-bps hike and hold for the rest of the year. |
| Chile | 29-Mar | 2nd BCCh rate meeting | |
| Chile | 30-Mar | IPoM release | |
| Argentina | | Election polls | The first set of significant polls on the presidential election will arrive in March and will be a key market driver, mainly because political coalitions and campaigns will start to develop. Also during this month, Congress will return from its summer break. |
| **APRIL** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Brazil | 11-Apr | Jair Bolsonaro’s 100th day in power | As good a time as any to evaluate the progress of the reform agenda. |
| Mexico | 11-Apr | Banxico rate meeting minutes (Mar) | |
| Peru* | 11-Apr | Monetary Policy Decision | |
| Brazil | 15-Apr | Deadline for the government to submit to Congress the 2019 Budget Guidelines Bill (LDO) | LDO sets the government’s goals and priorities for the following year. At this time, the new government should submit a new proposal for the minimum wage adjustment, replacing the indexation rule that expired on January 1. |
| Chile | 15-Apr | BCCh rate meeting minutes (Mar) | |
| Colombia* | 26-Apr | Monetary Policy Decision | |
| Chile * | 30-Apr | Ministry of Finance announces debt issuance calendar for 2019 | |
| Mexico | | 2020 budget pre-criteria | During April we expect the Finance Minister to provide the macro and fiscal guidelines for the 2020 budget draft. We see this as a key driver for local assets, since investors will remain focused on the government’s plan to maintain the fiscal consolidation effort. |
| Argentina | | Soy crop indicators | The soy crop starts in April and through August, and weather conditions will be important to track a positive crop outcome. This is an important variable for the overall 2019 macro outlook. |
| **MAY** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Brazil | 8-May | Copom’s third meeting of 2019 | We expect Copom to stay on hold (keeping the Selic rate at 6.5%) throughout 2019. |

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|---|---|---|---|
| Chile | 9-May | Third BCCh rate meeting | |
| Peru* | 9-May | Monetary Policy Decision | |
| Chile | 15-May | Financial stability report by BCCh (1H19) | |
| Mexico | 16-May | Banxico monetary policy meeting | |
| Colombia* | 20-May | Quarterly Inflation Report (1Q19) | |
| Chile | 27-May | BCCh rate meeting minutes (May) | |
| Mexico | 29-May | Quarterly Inflation Report (1Q19) | |
| Mexico | 30-May | Banxico rate meeting minutes (May) | |
| **June** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Chile | 1-Jun | "State of the Union" presidential speech in Congress | |
| Peru* | 6-Jun | Monetary Policy Decision | MPC might deliver its first hike, if 1Q19 activity indicates that the output gap has closed. |
| Chile | 7-Jun | Fourth BCCh rate meeting | |
| Chile | 8-Jun | IPoM release | |
| Argentina | 12-Jun | Candidacies for presidential elections – registration deadline | |
| Brazil | 19-Jun | Copom's fourth meeting of 2019 | We expect Copom to stay on hold (keeping the Selic rate at 6.5%) throughout 2019. |
| Chile | 24-Jun | BCCh rate meeting minutes (Jun) | |
| Brazil | 27-Jun | The National Monetary Council (CMN) meets to define the inflation target rate for 2022 | The 2021 target was defined in 2018 at 3.75%, plus/minus 1.5 pp. We expect CMN to continue with the gradual target reduction of the past few years. |
| Mexico | 27-Jun | Banxico monetary policy meeting | |
| Colombia* | 28-Jun | Monetary Policy Decision | We consider that BanRep could deliver its second 25-bps hike. |
| Uruguay | 30-Jun | Internal nominations of presidential candidates by each political party | Most polls indicate favorites in each political party, so this election could be important in case of unexpected results. In addition, each political party's program is likely to become clearer as alternative candidates unite behind the winner. |
| **JULY** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Brazil* | 5-Jul | June CPI inflation (IPCA) release | 12-month inflation up to June is used to adjust the constitutional spending ceiling. Inflation in June 2018 was extraordinarily high because of the truckers' strike in the previous month; the removal of this effect should result in a tighter ceiling for 2020 (we expect 12-month inflation at 3.3% in June 2019). |
| Mexico | 11-Jul | Banxico rate meeting minutes (Jun) | |
| Peru* | 11-Jul | Monetary Policy Decision | |
| Argentina | 12-Jul | Electoral campaign kicks off (for primaries) | |
| Brazil | 17-Jul | Last day of Congress sessions in 1H19 | Activity in Congress starts to slow by mid-June, with the local midwinter celebrations (*Festas Juninas*). |
| Chile | 18-Jul | Fifth BCCh rate meeting | |
| Colombia* | 26-Jul | Monetary Policy Decision | |
| Brazil | 31-Jul | Copom's fifth meeting of 2019 | We expect Copom to stay on hold (keeping the Selic rate at 6.5%) throughout 2019. At this point, 2020 inflation expectations should start to play a bigger role in BCB's reaction function. |
| **AUGUST** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Brazil | 1-Aug | Congress resumes regular sessions after the winter recess. Deadline for the government to submit to Congress its four-year budget plan (PPA) and the 2019 budget bill (LOA). | The PPA sets the public administration investment and spending plan for the following four years, a blueprint for the following annual budgets. LOA sets the "hard" budget for the following year. |
| Chile | 2-Aug | BCCh rate meeting minutes (Jul) | |
| Peru* | 8-Aug | Monetary Policy Decision | |
| Argentina | 11-Aug | Presidential elections primaries (PASO) | |
| Colombia* | 12-Aug | Quarterly Inflation Report (2Q19) | |
| Mexico | 15-Aug | Banxico monetary policy meeting | |

| | | | |
|---|---|---|---|
| Chile | Aug-15-30 | Experts' committees publish long-term estimates on GDP growth and copper prices (inputs to calculate the structural fiscal balance) | |
| Mexico | 28-Aug | Quarterly Inflation Report (2Q19) | |
| Mexico | 29-Aug | Banxico rate meeting minutes (Aug) | |
| **SEPTEMBER** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Chile | 3-Sep | Sixth BCCh meeting | |
| Chile | 9-Apr | IPoM release | |
| Peru* | 12-Sep | Monetary Policy Decision | Central Bank may deliver its second 25-bps hike. |
| Argentina | 13-Sep | Presidential candidates' debate | |
| Mexico | 15-Sep | 2020 Budget submission deadline | The government is scheduled to send the draft budget to Congress |
| Brazil | 18-Sep | Copom's sixth meeting of 2019 | We expect Copom to stay on hold (keeping the Selic rate at 6.5%) throughout 2019. |
| Argentina | 22-Sep | General elections campaign starts | |
| Chile | 23-Sep | BCCh rate meeting minutes (Sep) | |
| Mexico | 26-Sep | Banxico monetary policy meeting | |
| Colombia* | 27-Sep | Monetary Policy Decision | We consider that BanRep could deliver its third 25-bps hike. |
| Chile | 30-Sep | Executive submits 2020 budget bill to Congress | |
| **OCTOBER** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Mexico | 10-Oct | Banxico rate decision minutes (Sep) | |
| Peru* | 10-Oct | Monetary Policy Decision | |
| Chile | 23-Oct | Seventh BCCh rate meeting | |
| Uruguay | 24-Oct | First round of presidential elections in Uruguay | At stake: continuation of government by the left-wing Frente Amplio after 15 years of governing with majorities in Congress or a change to a coalition of center-right parties. |
| Colombia* | 25-Oct | Monetary Policy Decision | |
| Colombia | 27-Oct | Local elections | |
| Argentina | 27-Oct | First round of presidential elections in Argentina | The continuation of Mauricio Macri's pro-market policies is at stake. |
| Brazil | 30-Oct | Copom's seventh meeting of 2019 | We expect Copom to stay on hold (keeping the Selic rate at 6.5%) throughout 2019. |
| Chile* | 30-Oct | Release of Public Finance report by Ministry of Finance | |
| Mexico | 31-Oct | Deadline for approving 2020 income law in Congress | |
| **NOVEMBER** | | | |
| **Country** | **Date** | **Event** | **What to Watch** |
| Chile | 4-Nov | Financial stability report by BCCh (2H19) | |
| Peru* | 7-Nov | Monetary Policy Decision | |
| Chile | 11-Nov | BCCh rate meeting minutes (Oct) | |
| Colombia* | 12-Nov | Quarterly Inflation Report (3Q19) | |
| Mexico | 14-Nov | Banxico monetary policy meeting | |
| Mexico | 15-Nov | Deadline for approving 2020 expenditures law of the budget | |
| Chile | 16-17 Nov | Asia-Pacific Economic Cooperation Forum (APEC) meets in Santiago and other Chilean cities | |
| Argentina | 24-Nov | Argentina's presidential run-off election (if needed) | A run-off will take place if no candidate secures at least 45% of valid votes in the first round, or at least 40% and 10 percentage points over the runner-up. |
| Uruguay | 24-Nov | Uruguay's presidential run-off election (most likely necessary) | A run-off will take place if no candidate secures 50%+1 of valid votes in the first round. |
| Mexico | 27-Nov | Quarterly Inflation Report (3Q19) | |
| Mexico | 28-Nov | Banxico rate meeting minutes (Nov) | |

| DECEMBER<br>Country | Date | Event | What to Watch |
|---|---|---|---|
| Chile | 1-Dec | Deadline for Congressional approval of 2020 budget | |
| Chile | 6-Dec | Eighth BCCh rate meeting | |
| Chile | 7-Dec | IPoM release | |
| Brazil | 11-Dec | Copom's eighth (and final) meeting of 2019 | We expect Copom to stay on hold (keeping the Selic rate at 6.5%) throughout 2019. |
| Peru* | 12-Dec | Monetary Policy Decision | Central Bank may deliver its third 25-bps hike. |
| Mexico | 19-Dec | Banxico monetary policy meeting | |
| Brazil | 20-Dec | Last day of Congress sessions in 2019 | 2020 budget should be approved by this date; otherwise, the recess start could be postponed. |
| Colombia* | 20-Dec | Monetary Policy Decision | We consider that BanRep could end its hiking cycle with a final 25-bps hike. |
| Chile | 23-Dec | BCCh rate meeting minutes (Dec) | |

Note: *Tentative dates based on 2018 calendar.

| Sometime in 2019 (no date settled yet) | |
|---|---|
| Brazil | President-elect Jair Bolsonaro will have to undergo new surgery, possibly in January. |
| Brazil | Brazil will host the 11th BRICS summit, gathering leaders of Russia, India, China, and South Africa. Date and venue are still to be determined. The recently opened São Paulo office of the New Development Bank, BRICS' multilateral lender, should increase the group's footprint in Latin America. The past five summits took place between July and October. |
| Mexico | Morena party is expected to present to Congress a constitutional reform to Article 35, governing public consultations; we see this as a key to the medium-term political outlook. |
| Chile | Congress's discussion of tax modernization bill and pension reform bill (between March and October, tentatively). |
| Uruguay | Fitch scheduled to decide on Uruguay's rating (currently BBB-) following negative economic performance in 2018; we believe this decision could occur between April and June. |

Source: Ministries of Finance, Central Banks, Bloomberg, Santander.

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### Electronic Media

| | |
|---|---|
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