Strictly Macro

A four-pillar steady state for Latin America

April 4, 2019

TABLE OF CONTENTS

Lower G-10 yields are good news for LatAm, right?

The risk of a deep contraction in global economic activity has been increasing steadily since late last year. However, according to our G-10 macro specialists, the probability of a recession remains contained for now. Nevertheless, G-4 central banks have recently abandoned plans to keep normalizing interest rates and instead signaled intentions to keep their unconventional policy approach and thus deploy further liquidity to markets. In the meantime, a combination of three factors has pushed 10-year yields decisively lower across developed economies, namely: (i) high geopolitical uncertainty, particularly associated with the potential for a hard Brexit event; (ii) an unfavorable trade deal between the US and China; and (iii) negative surprises in key activity indicators, mostly forward-looking PMIs. Bear in mind that the first two factors are more complicated to forecast but still could generate negative effects on global growth. True, a global environment characterized by persistently loose financial market conditions could fuel demand for risky assets, including the LatAm asset class, in the short term. However, absent both productivity-enhancing reforms and renewed fiscal stimulus across major economies, interest rates at floor levels typically precede disinflation followed by a halt in global growth. For investors, this means increasing challenges to engage in assets that could be trading with a "bubble" syndrome while detecting the best timing to enter or exit positions as they digest a slowing growth stance.

Past and future GDP growth performance

	2016-18	2019 Fcst.		2020 Fcst.	
	Avg.	Last	3-month ch.	Last	3-month ch.
Latam					
Argentina	1.29	-1.00	0.00	2.30	-0.15
Brazil	-0.37	2.20	-0.30	2.50	0.00
Colombia	2.17	3.20	0.00	3.30	-0.10
Chile	2.32	3.30	-0.10	3.20	0.01
Mexico	2.10	1.68	-0.27	1.90	-0.10
Peru	3.49	3.94	0.04	3.79	0.11
Uruguay	2.12	1.70	-0.10	2.50	0.00
Region*	1.15	1.94	-0.21	2.47	-0.04
DM					
US	2.90	2.40	-0.10	1.90	0.00
China	6.60	6.20	0.00	6.00	0.00
EU	1.80	1.20	-0.20	1.40	-0.10

Notes: * Weighted average using 6 countries. Source: Economic forecasts compiled by Bloomberg.

Martin Mansur*
Economist, Argentina
cmansur@santanderrio.com.ar
(54)11 4341-1096

Jankiel Santos*
Economist, Brazil
jankiel.santos@santander.com.br
(55) 11 3012-5726

Juan Pablo Cabrera*
Economist, Chile
jcabrera@santander.cl
(56) 2 2320-3778

Diana Ayala
Economist, Colombia & Peru
diana.ayala@santander.us
1 (212) 407-0979

Guillermo Aboumrad*
Economist, Mexico
gjaboumrad@santander.com.mx
(52) 55 5257-8170

Marcela Bensión*
Economist, Uruguay
mbension@santander.com.uy
(59) 8 1747-6805

David Franco*
Macro, Rates & FX Strategy
david.franco@santandercib.co.uk
(44) 207 756-6633

So far the negative impact on activity resulting from the three factors we listed above has not triggered large downgrade revisions to the 2020 growth scenario, according to analyst consensus (see table on page 1). This is consistent with our view that G-4 monetary stimulus will help to counter the damage linked to higher tariffs and slower private spending amid global uncertainty. We also believe that a major global policy mistake will be avoided, so a moderate slowdown seems more likely than a recession. For the LatAm region in general, we are keeping a constructive view based on four pillars, which we think should provide support to local asset prices this year. The first three pillars – low inflation, low volatility, and fiscal tightening – should yield some further improvement in local macro fundamentals, in our view, while the last one is our G-10 forecast calling for softer (but not collapsing) global demand in 2020 based on looser for longer financial conditions across the G-4 pack.

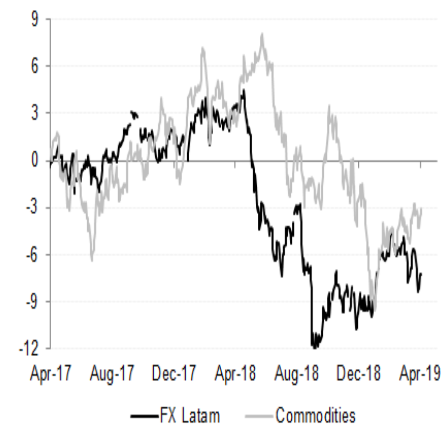
LatAm binary events: we side with momentum over fear

The fact that we are navigating an unparalleled longer yet slower global expansion means a less synchronized and deeper growth deceleration is less predictable, and, if realized, the negative repercussions for LatAm assets and thus activity would be considerable, in our view. Given the region's trade links, a deteriorating outlook for US growth could hit Mexico and Colombia hardest, while China's deleveraging and resulting slower credit expansion are more problematic for the likes of Brazil and the other southern cone countries. This environment demands a close monitoring of global activity indicators as well as of LatAm's crucial binary risk events ahead, particularly in Brazil, Mexico, and Argentina. A good barometer to track these developments will be the FX market. We note USD strength is below its recent peak (late 2018) but is still about 8% above the lows registered during 1Q18, mainly reflecting US activity supremacy over Europe more than interest rate differentials. A relatively buoyant USD also means LatAm FX valuations are relatively cheap and are trading in sync with commodities. Meanwhile, LatAm interest rates, another key FX component, are also reflecting historically low inflation levels (excluding Argentina). Speaking to fundamentals, we see the improvement in the current account balances for most LatAm countries since end-2015, right when the Fed hiking cycle began (see side charts) as a positive development, though this also reflects generous capital inflows from the G-4 QE experiment.

Overall, the recovery we project for LatAm GDP growth to 2% this year, up from a disappointing 1.2% average for the previous three years, incorporates an improvement in confidence and investment in the second half of the year triggered by lower uncertainty. Growth-enhancing macro and micro policy should yield a 2.7% cyclical expansion in 2020 led by Brazil. Consistent with this forecast, we also anticipate that policymakers in LatAm will avoid the temptations of unsustainable policies to fuel activity (i.e., subsidized credit boom) or other self-inflected harm regarding the critical underlying risks in each country. Specifically, we believe Brazil will avoid falling into a debt trap by approving pension reform (PR), which in turn improves the prospects for privatizations, deregulation, and trade opening, in our view. We expect the PR to be approved in 3Q19 after tough negotiations in Congress, thus bringing fiscal savings of around BRL600 bn over 10 years. For Mexico, the imminent risks are high with respect to the energy sector, and we expect the fiscal consolidation effort to continue, with the public debt-to-GDP ratio steady near the current 45% level and the government providing extraordinary financial support to Pemex so as to avoid a downgrade to high-yield. On the other structurally sensitive risk, the new trilateral trade deal (USMCA), we expect implementation next year after each Congress ratifies it later this year (benefits could be diluted if the US keeps 25% tariffs on steel and aluminum on top of new tougher rules for the auto sector). We think a decent US-China trade deal should point to a less protectionist US policy going forward.

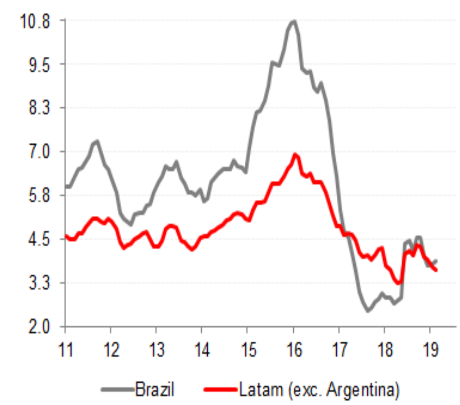
Finally, Argentina's presidential elections (October 27) will be competitive, with FX and inflation the critical factors determining President Macri's reelection, in our view. So far, the aggressive policy tightening as per the IMF deal is not eroding government's core support. However, we believe this macro story remains quite vulnerable, with sinking activity in need of a boost to confidence through both local policy (deregulation, ease of business conditions, trade opening) and external

LatAm FX still looks cheap in sync with commodities



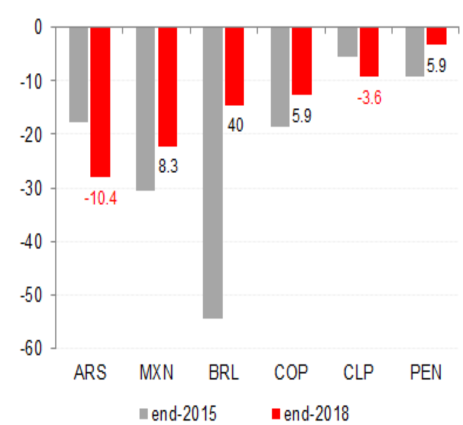
Notes: % change. Normalized from Apr-2017. Sources: Bloomberg and Santander.

LatAm inflation is near record low levels, with lots of help from Brazil



Notes: Weighted average CPI excluding Argentina. Sources: Bloomberg and Santander.

Despite Fed hikes and tepid global growth, CA has improved in general



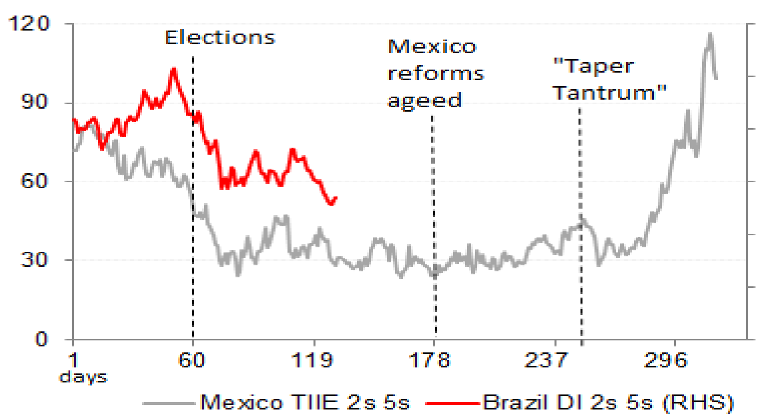
Notes: CA,12-m sum. # is change between periods. Sources: CB in each country and Santander.

drivers (i.e., a spillover from Brazil's expansion). Our less bearish than consensus macro outlook rests on activity already hitting bottom and a faster recovery.

Can LatAm central banks take comfort from dovish G-4 peers?

The evolution of economic activity in the US and China is key for the LatAm outlook going forward, given the region's large exposure to trade and financing flows but also considering the tail risk of no US-China trade deal. Meanwhile, the dovish shift led by the Fed effectively removes pressure on LatAm central banks. However, we highlight two elements regarding the prospects for monetary stimulus across the region. First, USD strength has not abated despite the dovish Fed influence, while LatAm FX is down nearly 10% from its late 2017 peak. Moreover, the fact that LatAm FX is displaying higher correlation with EM capital flows compared to commodities, equities (US and China), or US interest rates also suggests that in the event of much slower US growth, LatAm FX is likely to weaken further from today's relative cheap levels, in our view. Second, LatAm central banks are facing a distinctive combination of underlying risks, output gap-unemployment levels, and inflation divergence from each country's target. The only common factor among monetary officials is the pledge to make progress on the structural reform agenda as the best strategy to cope with slower global growth. We believe most LatAm central banks will take this opportunity to adjust their 2020 rate scenario lower but will remain on the sidelines in the coming months so as to carefully evaluate the trade-off of adjusting policy rates in either direction.

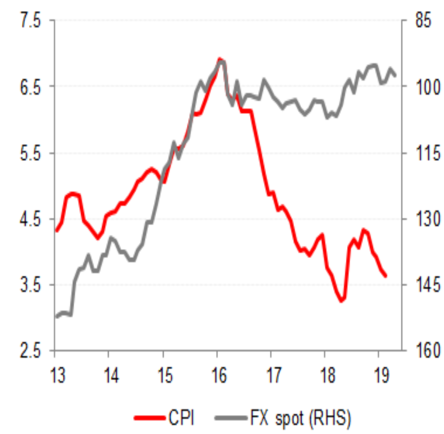
Bullish impact of reforms on the yield curve: Brazil now vs. Mexico before



Notes: Date count starts 3 months before each country presidential elections, or April 2012 for Mexico and July 2018 for Brazil. For Mexico, the mark for reforms agreed relate to the Pact for Mexico deal among political parties (exc. Morena). Sources: Bloomberg and Santander.

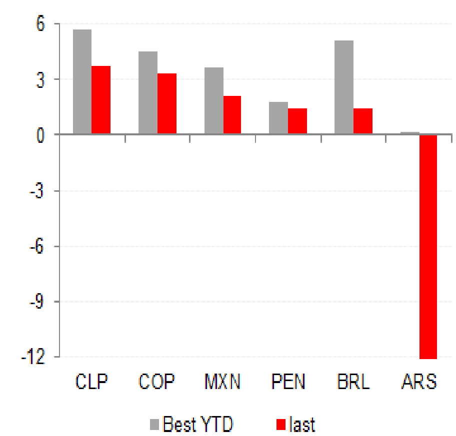
In this scenario, the generalized spread compression in risk premia between the two largest economies in LatAm is unprecedented. Early this year, market-based (longer-term) inflation expectations actually converged around the 4.5% level, and while other risk elements are factored into this price, this development shed light on the positioning around the general outlook divergence (sovereign rating convergence). On the latter, we find it useful to see Mexico from the rear view mirror back to late 2012, when the market made a full pricing of more than ten structural reforms approved by the last government, which produced a considerable flattening of the yield curve. Comparing this to Brazil currently, we are of the view that a considerable part of the reform story is already priced in. Finally, another lesson for LatAm central banks is that even though the sensitive FX pass-through component in their reaction function is much lower currently, LatAm currencies have weakened from their best performance YTD, as we think investors are likely incorporating some risk premia associated with a recessionary scenario (see side charts).

We see FX pass-through much lower across LatAm (ex Argentina)



Notes: CPI is % ch, y/y. FX is index, spot average. Sources: Bloomberg and Santander.

LatAm FX spot performance



Notes: % change using nominal indices normalized with Jan 1 2019=100. Sources: Bloomberg and Santander.

David Franco*
Macro, Rates & FX Strategy
david.franco@santandercib.co.uk
(44) 207 756-6633

FORECAST SUMMARY TABLES

KEY MACRO INDICATORS

GDP growth	2017	2018	1Q19F	2Q19F	3Q19F	4Q19F	2019F	2020F	Last Review' 19	Nom GDP '19
Argentina	2.7	-2.5	-6.8	-0.9	1.6	4.4	-0.5	2.8	Down	491
Brazil	1.1	1.1	1.6	2.0	2.5	2.9	2.3	3.0	Down	1,836
Chile	1.5	4.0	2.5	3.6	4.4	3.4	3.5	3.2	Unchanged	305
Colombia	1.4	2.7	3.2	3.0	3.4	3.4	3.3	3.6	Unchanged	323
Mexico	2.1	2.0	1.8	0.6	1.4	1.9	1.5	1.8	Down	1,257
Peru	1.6	4.0	3.6	4.7	3.6	5.0	4.2	4.0	Up	233
Uruguay	2.6	1.6	-1.5	0.5	0.6	2.0	0.7	1.8	Down	60
LatAm-7	**1.7**	**1.4**	**1.1**	**1.6**	**2.3**	**2.9**	**2.0**	**2.7**		**1,203**

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	'18	'19F	'17	'18	'19F	'17	'18	'19F	'17	'18	'19F	'17	'18	'19F
Argentina	4.0	-2.4	-1.8	2.7	-3.3	-3.2	12.2	-5.8	-7.4	1.7	0.0	13.3	15.4	-5.1	-3.6
Brazil	1.0	1.9	2.2	-0.6	0.0	-0.2	-1.8	4.1	4.5	5.2	4.1	2.7	5.0	8.5	3.5
Chile	2.4	4.0	3.6	4.0	2.2	2.6	-1.1	4.7	5.6	-0.9	5.0	3.2	4.7	7.6	5.0
Colombia	2.1	3.5	4.7	3.8	5.9	6.4	-3.2	3.5	6.0	2.5	1.2	1.4	8.0	11.3	12.2
Mexico	3.1	2.2	2.3	1.0	1.4	-2.0	-1.6	0.6	-1.0	3.9	5.7	5.0	6.2	6.2	4.5
Peru	2.5	3.8	3.8	0.5	2.0	1.1	-0.3	5.2	4.5	7.8	2.5	1.9	4.1	3.4	5.5
Uruguay	4.6	1.5	0.4	-0.7	0.8	0.5	-13.0	7.3	3.4	6.9	-4.8	4.0	0.5	-2.0	4.5
LatAm-7	**2.2**	**1.9**	**2.2**	**0.9**	**0.8**	**-0.2**	**-0.3**	**2.1**	**1.8**	**4.0**	**3.8**	**4.3**	**6.7**	**6.2**	**4.0**

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

Inflation	Headline CPI (YoY)							Core measure		
	2017*	2018*	Apr-19F	May-19F	Jun-19F	2019F*	2020F*	2018	2019F	2020F
Argentina	24.8	47.6	55.1	56.5	54.7	37.3	21.7	47.7	35.6	21.1
Brazil	2.9	3.7	4.6	4.6	3.6	3.5	4.0	2.8	3.1	4.0
Chile	2.3	2..6	1.8	1.9	1.9	2.5	3.0	1.8	2.5	2.7
Colombia	4.1	3.2	3.1	3.2	3.2	3.2	3.1	3.5	3.2	3.0
Mexico	6.8	4.8	4.5	4.4	4.3	4.0	3.8	3.7	3.7	3.6
Peru	1.4	2.2	2.3	2.4	2.2	2.2	2.2	2.4	2.5	2.5
Uruguay	6.6	8.0	8.2	7.7	7.1	7.6	7.5	7.5	7.8	7.5
LatAm-7	**6.5**	**8.6**	**9.4**	**9.5**	**8.9**	**7.0**	**5.5**	**7.9**	**6.6**	**5.4**

*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
		2018	-5.0	-7.1	-1.7	-3.1	-2.1	-2.5	-4.0
		2019F	-4.0	-6.6	-2.0	-2.7	-2.0	-2.3	-4.5
		2020F	-2.8	-6.8	-1.7	-2.3	-2.5	-1.8	-4.3
Public debt	% of GDP	2017	30.9	51.6	14.0	44.8	45.8	24.9	32.1
(Net terms in ARS, BRL, CLP)		2018	52.2	53.8	14.4	48.6	44.8	25.5	35.9
		2019F	53.9	56.9	15.5	50.0	45.3	26.0	39.7
		2020F	50.1	57.4	16.3	52.0	46.0	26.0	39.6
Current account	% of GDP	2017	-4.9	-0.4	-1.5	-3.3	-1.7	-1.1	0.7
		2018	-5.6	-0.8	-3.1	-3.8	-1.8	-1.5	-1.2
		2019F	-2.0	-1.7	-2.8	-4.0	-2.0	-1.6	-1.8
		2020F	-2.5	-2.4	-2.8	-4.5	-2.0	-1.7	-2.6
Trade balance	US$ bn	2017	-8.3	67.0	7.9	-4.6	-11.0	6.2	3.6
		2018	-3.8	58.7	4.7	-5.3	-13.7	6.9	2.5
		2019F	6.4	44.3	3.8	-7.4	-15.3	6.8	2.3
		2020F	5.0	33.0	3.4	-9.0	-16.1	6.7	1.8
Unemployment	% of workforce	2017	7.2	11.8	6.7	8.6	3.4	6.5	7.9
		2018	9.1	11.6	7.0	9.7	3.3	5.7	8.4
		2019F	9.2	10.6	6.8	10.0	3.9	6.0	8.1
		2020F	8.8	9.1	6.7	9.7	3.8	6.0	7.9

Source: Santander.

MONETARY POLICY MONITOR

	Current	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
ARGENTINA	66.93	53.80	45.50	37.10	34.10	31.10	28.00	25.00
		-1313	-830	-840	-300	-300	-310	-300
BRAZIL	6.50	6.50	6.50	6.50	6.50	6.50	6.50	6.50
		0	0	0	0	0	0	0
CHILE	3.00	3.00	3.00	3.25	3.25	3.50	3.75	3.75
		0	0	25	0	25	25	0
COLOMBIA	4.25	4.25	4.25	4.50	4.75	5.00	5.25	5.25
		0	0	25	25	25	25	0
MEXICO	8.25	8.25	8.25	8.25	8.00	7.75	7.75	7.75
		0	0	0	-25	-25	0	0
PERU	2.75	2.75	3.00	3.25	3.50	3.75	3.75	3.75
		0	25	25	25	25	0	0

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

- **<u>Brazil expected to remain on hold for longer</u>: In Brazil, in the scenario of a slower than anticipated recovery, and inflation expected to converge to the targets, we consider that Copom will hold the interest for longer and expect it to keep the interest rate at 6.50%, not only in 2019, but also in 2020.**
- **<u>Lower interest rates in Argentina</u>: The Central Bank completely backtracked from the (premature) monetary policy loosening it undertook in the first fortnight of February and adopted more rigorous monetary base targets to curb increasing inflation. Going forward, we expect interest rates to continue to decline but at a slow pace, as the MPC will keep a cautionary stance.**
- **<u>Mexico expected to hold</u>: We expect Banxico to remain on hold for the rest of the year, as inflation is not falling fast enough to follow Banxico's inflation forecasted path. While the market is pricing 100 bps in cuts in the next two years, we think we are more likely to see cuts between 50-75 as a compromise between Banxico and the market. We think such a move would be undertaken to relieve some pressure from the current high real rates, possibly in the first quarter of 2020 (our base case).**
- **<u>Higher interest rates in the Andean region</u>: In Colombia, we expect BanRep to hike 100 bps by YE2020, bringing the interest rate to neutral. We believe Peru will hike in 3Q19 as the output gap closes and inflation remains above the target. In Chile, we now expect 75 bps of hikes in the next 24 months, vs. the previous guidance of 125 bps in the next 18 months, as the BCCh became more dovish in the latest IPOM.**

FOREIGN EXCHANGE RATES

	BRL	MXN	CLP	COP	ARS	PEN	UYU
Last*	3.87	19.2	667	3129	42.9	3.30	33.8
Jun-19	3.85	19.6	675	3200	42.8	3.35	33.5
Sep-19	3.85	20.3	665	3250	45.5	3.36	33.8
Dec-19	**4.00**	**20.5**	**660**	**3300**	**48.5**	**3.37**	**34.0**
Mar-20	4.10	20.5	660	3250	50.8	3.40	34.5
Jun-20	4.20	20.7	660	3300	53.1	3.37	35.0
Sep-20	4.30	20.9	650	3250	55.6	3.39	35.5
Dec-20	**4.30**	**21.0**	**650**	**3300**	**58.2**	**3.40**	**36.0**

End-of-period levels. * April 3 2019 Sources: Bloomberg and Santander.

- **Year to date, LatAm currencies (ex ARS) have appreciated, benefiting in part from the EM asset rally observed in the first three months of the year, as a result of a less adverse external environment, a more dovish Fed, and a rebound in oil and metal prices. In general, we see more pressures in the FX markets in the coming quarters due to continued concerns on the global economy and the uncertainty regarding the trade talks between the US and China. Additionally, policy decisions in Brazil and Mexico should continue to play a key role for asset prices in 2019, in our view. In Argentina, the presidential election race will soon become 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.**

STANDING AT THE CROSSROADS

- **We see signs of recovering economic activity, although inflation remains stubbornly high and may only start to decrease more noticeably by mid-year, in our view.**
- **Taming FX volatility through highly restrictive monetary policy remains the main government objective in the short run, while agricultural exporters' currency supply is expected to increase in the coming weeks.**
- **If the incipient economic recovery gathers some pace and inflation slows down more materially, the government may recover in the polls; however, we expect a competitive presidential race, with a polarization scenario likely to favor the incumbent.**

Martin Mansur*
(5411) 4341-1096

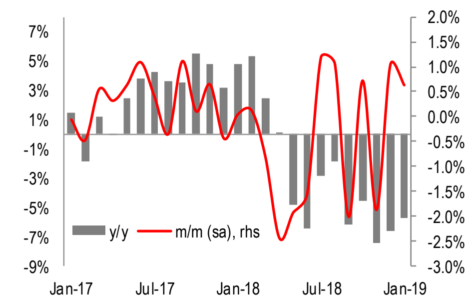
Activity: A turning point?

The latest economic activity numbers have predictably shown sharp decreases in annual terms. While the EMAE contracted 5.7% y/y in January, industrial production and construction indicators plummeted 10.8% y/y and 15.7% y/y in the same month. However, as mentioned in our publication *Incipient (Though Still Weak) Signs of Economic Recovery* (March 21, 2019), we find some early signs that economic activity may have bottomed and is starting to recover, although the strength of the subsequent pickup remains uncertain. Our leading and coincident indicators suggest that economic activity has been slowly gathering pace in the last month. Based on this, we estimate that economic activity continued expanding in February, after the 1.7% increase observed in the seasonally adjusted Monthly Economic Activity Estimator between January and November. According to our current estimates, GDP may expand 0.6% in seasonally adjusted terms during 1Q19, slightly above the 0% mean market expectation. Again, we think the farming sector will prove the most important factor favoring a recovery in activity in the short run (mostly in 2Q19), given the good season after last year's drought. Total soybean and corn production is expected to amount to 101 million tons, 45% above 2018, following USDA estimates. This improvement, however, may be limited to some related sectors like transport, commerce, and certain industrial clusters linked to farming (food processing) and will likely be more apparent in the small to medium-sized towns, in our view, rather than in major metropolitan areas, of greater electoral relevance. Two other factors may also hinder the expected recovery in GDP: (i) the stringent Central Bank monetary stance, and (ii) the risk of stronger than expected portfolio dollarization, which increases FX volatility and uncertainty. We maintain our GDP forecast at -0.5% for 2019, although we acknowledge that the rigorous monetary policy stance may result in a more lackluster recovery than initially expected, giving a downward bias to our estimate.

FX and external sector: Waiting for agro-dollars to reach the market

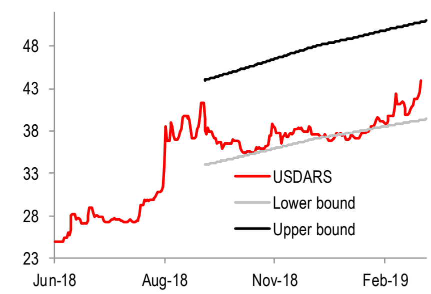
Securing a low level of FX volatility remains the main short-term government objective at the moment. Higher uncertainty could trigger stronger portfolio dollarization, which eventually could cause a sharp upward movement in the exchange rate, with negative consequences on the inflation front. In our view, such a contingency could prove a game-changer for the presidential race, hence the government's concern. The main hurdle is that, due to the IMF accord provisions, the Central Bank has limited instruments to directly intervene in the FX market to tame volatility, and it prefers to do so indirectly (through monetary policy regulation, as discussed below, and limited FX futures positioning). For the moment, given the low level of market liquidity (approximately USD500 million per day), the exchange rate remains highly susceptible to external factors and financial flows reversals (mostly foreign investors unwinding long ARS debt positions). We expected the relief to come, again, from the agricultural sector. During the main harvest season (April-June), farmers tend to sell their stock to cover running expenses and the wheat sowing outlays (June), though they tend to save in stored grain. We estimate the daily average currency supply from the agricultural sector could rise to USD130

Activity recovering at the margin



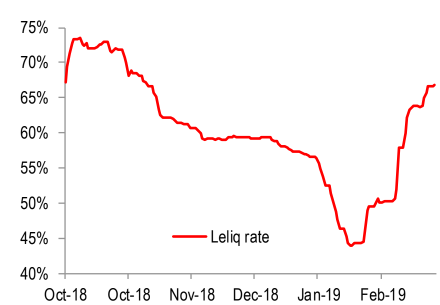
Monthly Economic Activity Estimator growth (annual and monthly, seasonally adjusted). Sources: INDEC and Santander.

A weaker peso . . .



USDARS exchange rate, and non-intervention zone. Sources: Bloomberg, Central Bank, and Santander.

. . . despite increasing rates



Leliq rate. Sources: Central Bank and Santander.

million in April from USD65 million in February. However, if current FX upward pressure continues (the peso lost 6.2% against the USD in the week to March 28), farmers and exporters may stay on the sidelines, until peso devaluation expectations become anchored. The wide non-intervention-zone (currently ranging from USD/ARS39.29 to USD/ARS50.84) agreed upon with the IMF is seen as the Achilles' heel in the economic policy context, given the disruptive effect that a sharp jump in the exchange rate could have on expectations and, eventually, on the current government's likelihood of remaining in power.

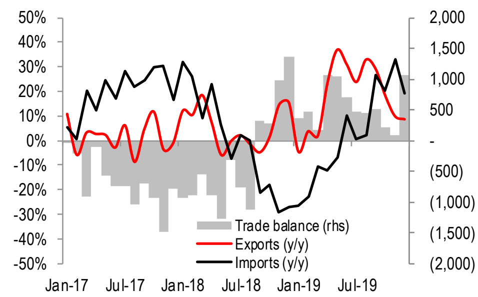
Monetary policy: High rates expected to avert FX volatility; lower inflation still not in sight

In a context of reduced capacity to intervene in the FX market and mounting pressure on the peso, the Central Bank completely backtracked from the (premature) monetary policy loosening it undertook in the first fortnight of February. As a result of this more stringent policy stance, the rate resulting from daily Leliq auctions reached 68.35% on March 28 (similar to early November levels), up from the minimum of 43.94% on February 14. The Central Bank president recently announced a series of modifications to the original monetary program (eliminating seasonal increases in the monetary base target, bringing down its monthly growth during 2H19 to 0% from 1%, and announcing that it will seek to preserve the over-accomplishment seen in February, of ARS41 bn below target, for the remainder of the year), in effect resulting in a more rigorous monetary position. Moreover, we estimate that the monetary base monthly average stands at ARS ~33 bn below the (reduced) target, and the Central Bank will maintain this strictness as long as FX volatility does not recede materially and inflation decelerates. Monetary policy has not yet yielded the expected results in terms of inflation reduction. CPI data has consistently been higher than market expectations in recent months (in January and February, CPI monthly increase stood on average 0.4 p.p. above the mean of market expectations). The same pattern could be apparent in March-April, in our view. We currently estimate that the CPI will grow 4.0% m/m in March and 3.6% m/m in April (current market expectations at +3% m/m and +2.7% m/m, respectively), given the strong carryover effects on core inflation and the impact of utility rate hikes. As a result, we are increasing our end-2019 inflation forecast to 37.3% from the previous 30.5%.

Politics: Gradual economic improvement and polarization may help the government before the vote

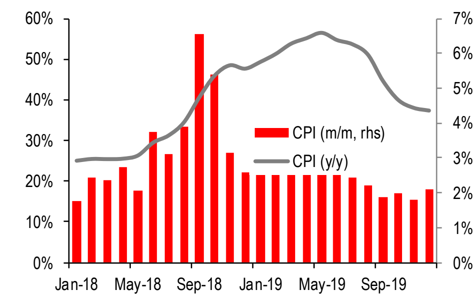
The combination of a steep economic decline, soaring inflation, and an eroding labor market has deeply affected popular confidence in the current administration. In March, the Government Confidence Index was at its lowest level since November 2014 (during Cristina Kirchner's term). Although we expect economic activity to pick up and inflation to gradually decrease going forward, we think the potential increase in voting intentions favoring the current administration will not be enough to significantly ease political uncertainty. As a result, the electoral race will likely be tight, in our view. A recent poll conducted by Isonomía during March puts the first-round election voting intention for CFK (34%) slightly ahead of President Macri (32%), with Lavagna (a potential candidate from the non-Kirchnerist Peronism sector) coming in third (19%). Compared to the survey conducted by the same consultant during February, both Macri's and CFK's voting intentions increased ~3 pp, while Lavagna's declined 1 pp, suggesting increasing polarization around the two political heavyweights. However, until candidacies are defined (June 22), we note that: (i) survey results may vary widely among pollsters; and (ii) survey data will be scant (we currently lack other reliable data for comparison, since no new polls have been released recently). If CFK decides to run and enters the final round, we believe this could potentially split the Peronist vote and help polarize preferences between two antagonists' worldviews, suggesting a still-tight race. According to Isonomía, a potential run-off between Macri and CFK would be slightly favorable for the latter, but the difference (1 pp) falls within the statistical error range. Alternatively, if CFK decides not to run, we think this could hurt the Macri campaign, especially if the economy is not doing well and the chosen candidate from the Peronist camp is able to attract moderate voters disappointed with Cambiemos' performance at the helm.

Export growth likely to recover earlier than import growth



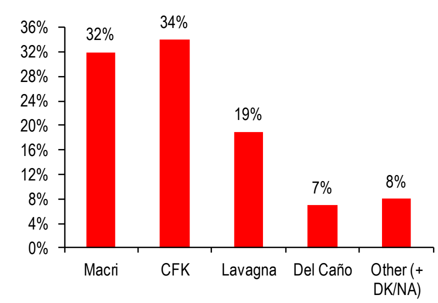
Exports and imports annual growth and trade balance (in USD million, right axis). Sources: INDEC and Santander estimates.

Annual inflation expected to peak by May



Annual and monthly inflation rate. Sources: INDEC and Santander estimates.

Polls: Head to head



Voting intention for first round presidential elections. Sources: Isonomía Consultores and Santander.

ARGENTINA

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		-2.5	2.6	-1.8	2.7	-2.5	-0.5	2.8
Private Consumption (Δ% y/y)	74.1	-4.4	3.5	-1.0	4.0	-2.4	-1.8	2.0
Public Consumption (Δ% y/y)	12.6	2.9	6.8	0.3	2.7	-3.3	-3.2	1.1
Investment (Δ% y/y)	19.5	-6.8	3.8	-4.9	12.2	-1.5	-7.4	9.8
Exports (Δ% y/y Local Currency)	18.8	-7.0	-0.6	5.3	1.7	0.0	13.3	9.0
Imports (Δ% y/y Local Currency)	26.5	-11.5	5.7	5.7	15.4	-5.1	-3.6	9.8
GDP (US$ bn)		563	634	545	642.6	498	491	513
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)*		40.7	27.2	37.7	24.8	47.6	37.3	21.7
CPI core Inflation (Dec Cumulative)*		37.9	28.2	32.4	21.1	47.7	35.6	21.1
US$ Exchange Rate (Average)		8.1	9.2	14.7	16.6	29.3	43.4	53.6
Central Bank Reference Rate (eop)		26.90	33.00	24.80	28.75	59.25	37.10	25.00
Private sector credit (% of GDP)		12.7	13.7	12.9	14.7	14.8	12.6	13.7
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-5.0	-6.1	-5.9	-6.1	-5.0	-4.0	-2.8
Primary Balance, % of GDP		-3.4	-4.0	-4.3	-3.9	-2.3	-0.3	0.7
Balance of Payments								
Trade Balance		0.4	-0.6	0.3	-1.3	-0.8	1.3	1.0
Current Account, % of GDP		-0.9	-1.5	-2.4	-4.9	-5.6	-2.0	-2.5
Debt Profile								
Central Bank International Reserves (US$ bn)		31.4	25.5	38.7	55.0	65.8	68.3	69.3
Total Public Debt (net of public sector holdings, % of GDP)		18.4	22.8	26.7	30.9	52.2	53.9	50.1
Of which: Foreign-currency denominated (% of GDP)		11.9	15.3	18.2	18.1	36.5	37.7	35.1
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.9	5.8	7.6	7.2	9.1	9.2	8.8

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

LOW FOR (MUCH?) LONGER

Jankiel Santos*
+55 11 3012-5726

- **Despite the recovery in confidence indicators and the continued credit expansion, we think the lack of improvement in labor market conditions has weighed on the economic recovery, which remains sluggish.**
- **Given this disappointment, as current price dynamics have fared far better than previously expected and inflation expectations for 2019 have receded, arguments in favor of further monetary stimuli have arisen of late – especially in the absence of elbow room for fiscal incentives.**
- **Despite admitting that economic activity has been running slower than anticipated and that the balance of risks for inflation has improved lately, the Brazilian monetary authority is not yet confident that it has leeway for further easing, as its inflation projections continue to point toward convergence to the targeted levels over the medium term.**
- **Hence, the Brazilian Central Bank (BCB) indicated at the last Copom meeting that it intends to keep the base interest rate unchanged while it assesses whether the impact of prior shocks in the economy is preventing economic activity from delivering a more encouraging performance. Additionally, the BCB has pointed out that a clear assessment is unlikely to materialize in the short term.**
- **Therefore, instead of making (possibly unnecessary) further cuts in the Selic target rate and risking being forced to reverse them soon, we believe the Brazilian monetary authority is more inclined to leave the base interest rate at its (hitherto) lowest level for a longer period of time than previously anticipated – especially as the BCB deems the current stance of the interest rate as already accommodative.**

What else do we need?

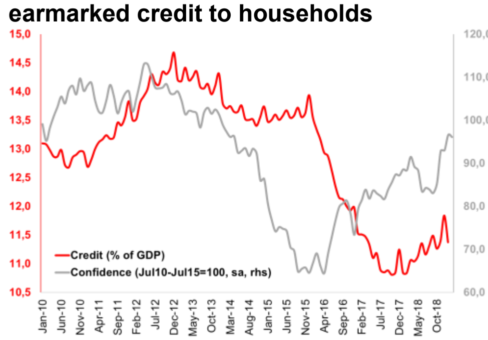
The rapid recovery registered by confidence indicators following the presidential election – which implied a reversal of the negative impact of the truckers' strike and the heated political climate during the election – in tandem with the maintenance of the base interest rate at its historical low reached in March 2018 gave us the impression that the Brazilian economy would finally gain momentum.

The combination of a rising level of confidence – a trend that started in mid-2016 – and cheaper borrowing costs led credit to households as a percentage of Brazilian GDP to register an increase for the first time since 2015. This benefited retail sales of items sensitive to credit conditions, whose annual growth rate more than doubled in 2018 compared to 2017 (9.9% vs. 4.4%).

Unfortunately, though, we have not seen the same pattern materializing for sales of goods sensitive to income, as their annual expansion rate remained nearly stable (3.3% last year vs. 2.9% in 2017). A possible cause for this lackluster performance may be linked to the marginal improvement observed in labor market conditions, with the unemployment rate having declined only about 100 bps from its peak in early 2017 (13.1% in seasonally adjusted terms). That is a reading far above what we assess as the Brazilian "natural unemployment rate" – something between 7% and 8% of the economically active population.

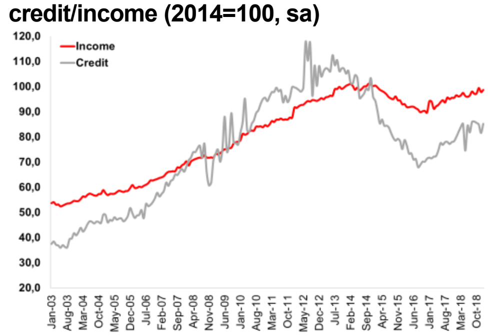
Therefore, we do not find it surprising that households' income also remained nearly unchanged last year (+0.6%, according to BCB's income gauge), a circumstance that may have thwarted the ability of private consumption to register a substantially faster pace in 2018 – household purchases increased 1.9% last year vs. 1.4% in 2017. As the labor market has not yet delivered signs that it is likely to gain substantial traction anytime soon, proposals for the additional use of the monetary policy lever to bolster economic activity have resurfaced.

Consumer confidence vs. non-earmarked credit to households



Sources: Banco Central do Brasil and FGV.

Retail sales – breakdown by sensitivity to credit/income (2014=100, sa)



Sources: IBGE, elaborated by Santander.

Inflation environment adds to pressure on the Brazilian Central Bank

In line with the frustration about the pace of the economic recovery, market participants have also been surprised on the downside by the behavior of price indices, especially those linked to the services group – the most sensitive to economic activity conditions. Price indices' behavior has provoked a substantial revision in market participants' inflation forecasts for 2019, whose median has run below the targeted level set for this year (4.25%).

In addition, such downside surprises have also served to firmly anchor expectations for the years ahead, thus reinforcing the general perception that significant inflationary shocks are not likely in the medium term. Moreover, these downward changes in short-term inflation forecasts, as well as the convergence of medium-term inflation projections, have occurred in tandem with shifts in the expected conduct of monetary policy toward a more accommodative stance rather than the reverse.

Therefore, we think market participants are signaling to the Brazilian Central Bank their belief that there is room for a looser grip on monetary policy, without jeopardizing the convergence of current inflation toward targeted levels for the relevant time horizon – which, in our view, would explain the bull-flattening of the Brazilian domestic yield curve since late last year.

What messages is the Brazilian Central Bank sending?

In its last Copom meeting, held on March 20, the Brazilian Central Bank board – which is now headed by the newly installed governor Roberto Campos Neto – chose to keep the base interest rate unchanged at 6.50% pa, as it considered that to be a level compatible with the convergence of the targeted level of inflation for the coming years. It is true that the Brazilian monetary authority projected inflation to stay slightly below its goal in 2019 (4.1% versus 4.25%) in its baseline scenario – which assumes stability of the FX rate and the Selic target rate at BRL3.85/USD and 6.50% pa, respectively, for the foreseeable future.

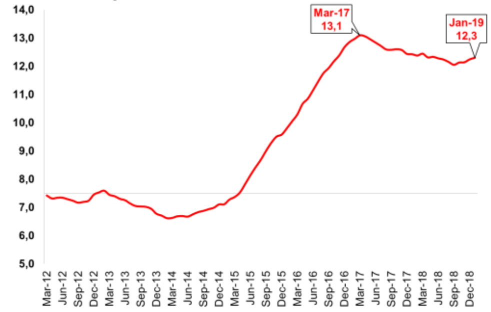
Moreover, under the same assumptions, the BCB's inflation forecast for 2020 points toward 4.0%, which is its target set by the National Monetary Council for the next year. That is, although the BCB reckons that the balance of risks has improved lately – previously the board deemed it tilted toward higher inflation, whereas now it considers the balance to be even – Copom members have not seen their simulations providing projections much lower than the targeted ones, which could allow them to consider trimming the Selic target rate.

Lastly, as far as the rhythm of the economic recovery is concerned, the Brazilian Central Bank also acknowledged that the recovery has been weaker than anticipated – which could be taken as a dovish signal, in our view. Nonetheless, the BCB added a grain of salt to that recognition by stating that negative shocks have hit the Brazilian economy more than once in recent times and that such circumstances may be blurring the real nature of the economic situation. Hence, Copom members preferred to wait for the impact of those negative shocks to wane before deciding on the next steps for monetary policy. Moreover, Copom has pointed out that an accurate assessment of whether these impacts have already faded is likely not possible in the short term.

This clarification from Copom about the time frame to start thinking of changing its monetary policy seemed to us to imply that the current board of the BCB prefers to keep the base interest rate at the historical low for longer in order to see whether the transmission channels of monetary policy are indeed clogged before providing further stimuli – especially as Copom considers the current level of the base interest rate as invigorating for the economy.

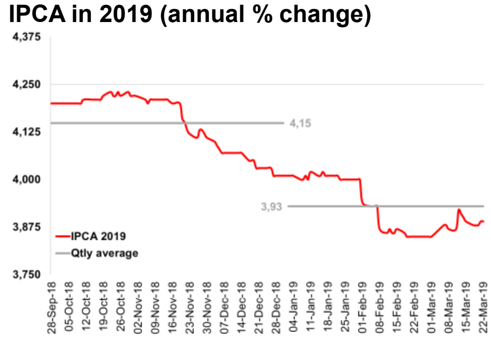
In the absence of clear and rapid progress on institutional reforms – which we believe would translate into a stronger BRL and subsequent deflationary pressure – or further frustration with economic activity, which should also bring inflation forecasts down – we think the BCB is unlikely to shave further points off the Selic target rate. Conversely, under the current circumstances of a gradual recovery and a protracted process for pension system reform in the Brazilian Congress, we think it is likely that the Brazilian monetary authority will extend the period of unchanged interest rates substantially – the record was an eight-Copom meeting string between March 2015 and March 2016.

Unemployment rate (% sa)



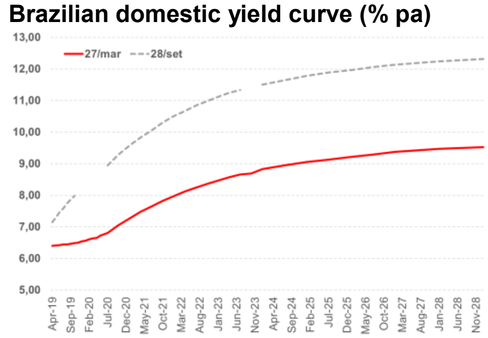
Sources: IBGE, elaborated by Santander.

Market participants' median forecast for IPCA in 2019 (annual % change)



Sources: Banco Central do Brasil, elaborated by Santander.

Brazilian domestic yield curve (% pa)



Source: Bloomberg.

BRAZIL

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		0.5	-3.5	-3.3	1.1	1.1	2.3	3.0
Private Consumption (Δ% y/y)	62.8	2.3	-3.2	-4.3	1.0	1.9	2.2	3.0
Public Consumption (Δ% y/y)	20.8	0.8	-1.4	-0.1	-0.6	0.0	-0.2	0.6
Investment (Δ% y/y)	16.5	-4.2	-13.9	-10.3	-1.8	4.1	4.5	7.0
Exports (Δ% y/y Local Currency)	11.3	-1.1	6.8	1.9	5.2	4.1	2.7	3.2
Imports (Δ% y/y Local Currency)	-11.4	-1.9	-14.2	-10.2	5.0	8.5	3.5	3.7
GDP (US$ bn)		2,455	1,800	1,796	2,053	1,867	1,836	1,860
Monetary and Exchange Rate Indicators								
IPCA-IBGE Inflation (Dec Cumulative) (%)		6.4	10.7	6.3	2.9	3.7	3.5	4.0
IGP-M Inflation (Dec Cumulative) (%)		3.7	10.5	7.2	-0.5	7.5	4.3	4.0
US$ Exchange Rate (Average)		2.35	3.33	3.49	3.19	3.66	3.94	4.15
Central Bank Reference Rate (eop)		11.75	14.25	13.75	7.00	6.50	6.50	6.50
Stock of Credit To Nonfinancial Private Sector (% of GDP)		52.21	53.86	49.72	47.33	47.4	48.5	49.5
Fiscal Policy Indicators								
Public Sector Fiscal Balance (harmonized) (% of GDP)		-6.0	-10.2	-9.0	-7.8	-7.1	-6.6	-6.8
Primary Balance (% of GDP)		-0.6	-1.9	-2.5	-1.7	-1.6	-1.3	-0.6
Balance of Payments								
Trade Balance, % of GDP		-0.2	1.1	2.7	3.3	3.1	2.4	1.8
Current Account, % of GDP		-4.2	-3.3	-1.3	-0.4	-0.8	-1.7	-2.4
Debt Profile								
International Reserves (US$ bn)		374.1	368.7	372.2	382.0	387.0	380.6	392.0
Total Public Debt (net of public sector holdings, % of GDP)		32.6	35.6	46.2	51.6	53.8	56.9	57.4
Of which: Foreign-currency denominated (% of GDP)		-6.8	-11.4	-8.9	-9.4	-10.9	-10.9	-10.9
Labor Markets								
Unemployment Rate (% eop)		6.5	9.0	12.0	11.8	11.6	10.6	9.1

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

CHILE

SUPPLY SHOCK UNDER WAY

- **We adhere to the BCCh view that a supply shock is taking place in the economy, in part generated by large immigration flows: this supports growth, contains inflation, and keeps unit labor costs disciplined.**
- **The demand component of growth, in turn, is failing to accelerate as expected, with consumers a bit frustrated by the soft labor market, and with a rebound in investment still more a hope than a reality, in our view.**
- **We still see GDP growth at 3.5% in 2019 and 3.2% in 2020, but risks are tilting to the negative side.**

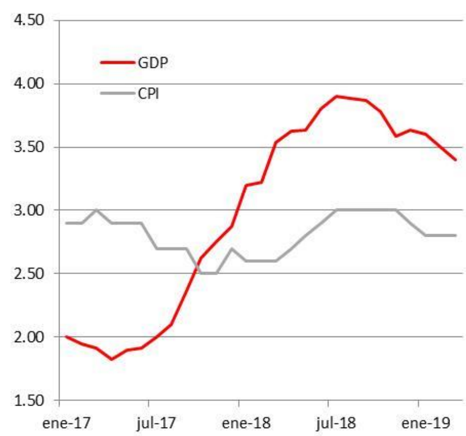
Juan Pablo Cabrera*
(562) 2320-3778

Iván Riveros*
(562) 2320-3421

With the turn of the year, some macro trends have been consolidating in Chile. First, GDP growth remains near potential levels: 3.6% y/y in 4Q18, a bit lower in 1Q19 (around 2.5%, per our estimates), and 3.4% projected for 2019 as per the BCCh survey consensus (Santander's estimate stands at 3.5%). Second, inflation is subdued, at 1.7% (headline) and 2.0% (core), well below the 3% target, with the market discounting 2.3% until 3Q19. Third, the unemployment rate continues to rise gradually, mainly reflecting a sustained increase in the labor force, as a result of large immigration flows in the last few years. Fourth, unit labor costs in the economy, as per our estimates, fell by 3% y/y in 2H18, after four years of steady increases, reflecting a sizable rebound in labor productivity.

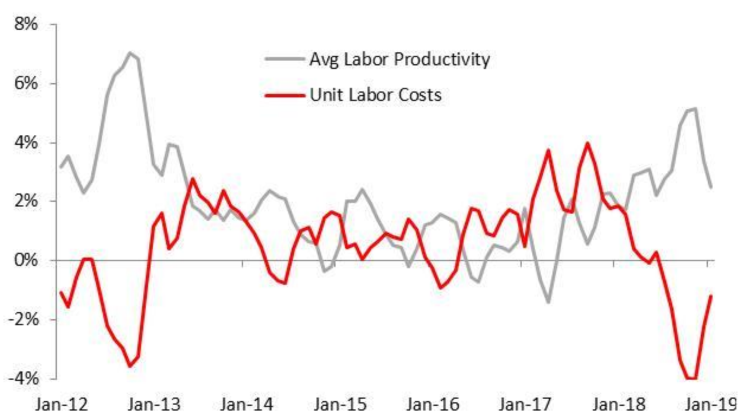
Taking these factors together, we think the Chilean economy could be facing a sort of supply shock, which is sustaining growth and pushing inflation down at the expense of relatively frustrated consumers (salaries and employment are not soaring). We believe it is too early to tell if this shock is temporary or has more permanent roots, but the missing element of this recovery cycle is the demand component, and this will likely be the key issue behind Chile's growth story in 2019-2020, in our view.

GDP and inflation – 12M ahead



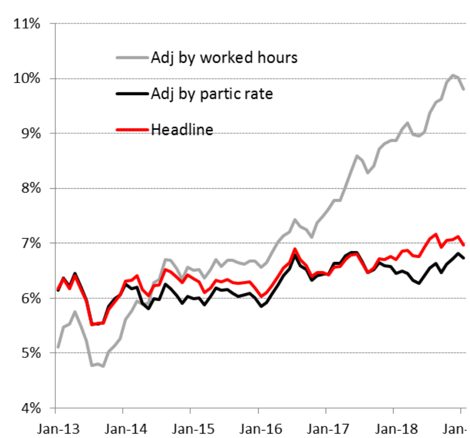
As per BCCh expectations survey. Sources: BCCH and Santander.

Average labor productivity and unit labor costs (y/y chg, last 3M)



Based on IMACEC, worked hours, and real salaries data. Sources: INE, BCCH and Santander

Unemployment rate (%)



Seasonally adjusted series. Sources: INE and Santander.

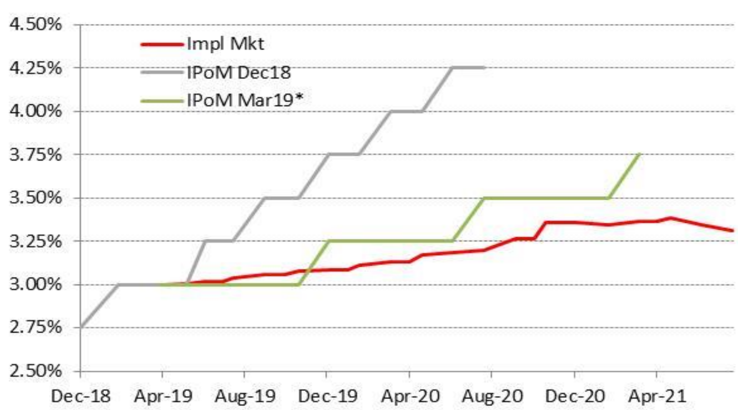
On the consumption side, a sense of frustration has been evident among big retail sector players and consumers. Retail sales grew 3.8% in 2018, in line with GDP, but closed the year on a soft note (2.8% y/y in 4Q18; approximately 0% in January 2019), especially due to the remarkable deceleration seen in durables. After booming by 25% y/y as of mid-2018, new car sales slowed to a more normal, single-digit pace in 4Q18, while electronics sales continue to miss the large inflow of Argentine tourists that packed stores until 1Q18. Non-durable sales are naturally more stable, but growth here also slowed to 1.5% y/y in 4Q18, from 3% in 2Q18. Slow growth in nominal salaries and the soft labor market justify these trends, but we think there will come a time when the extra foreign workers entering the market eventually push consumption up. As we expect a pickup in job creation and a slight decline in unemployment, we see consumption gaining some traction in 2019, with estimated growth at 3.6% in 2019 and 3.5% in 2020, vs. 4.0% last year.

As regards investment, the pipeline remains attractive, in our view, with several large-scale projects kicking in this year (especially in mining and infrastructure). However, data as of January suggests no material acceleration so far, especially in the construction sector (still growing by a modest 1% y/y), with business confidence in general staying in positive territory but not at spectacular levels (between 50-54). Given the relative stability of consumption, we believe that this year, investment will be the GDP component that makes the difference (or not) in terms of growth: Santander's official estimate for investment growth is 5.6% in 2019 and 4.8% in 2020, vs. the 4.7% observed in 2018.

The inflation front continues to be benign, with February CPI posting a low 1.7% y/y reading. Here the outlook changed abruptly in just a few months, as in September, CPI prices were running as high as 2.9% y/y. From then on, gasoline prices started to fall sharply, and in January a new CPI basket was released, which all else equal reduced the y/y rate by 40 bps. The new methodology also exerts downward pressure on the overall CPI, as it is more sensitive to deflation trends in the telecom sector, for example. Regarding underlying trends, immigration is keeping nominal salaries disciplined, while the FX rate has ceased to be a source of upward pressure. In such a context, we think inflation is likely to be a non-issue in the coming months.

In terms of monetary policy, the BCCh became more dovish in this week's IPoM, based on lower inflation forecasts and more benign supply conditions. BCCh guidance now states that the policy rate should reach neutral levels by March 2021, with the next hike coming by 4Q19-1Q20. A key element here is that the BCCh promised new estimates on the neutral rate in June's IPoM, from the current 4.0-4.5% range. We would not be surprised by a 50-bps cut here, so in our view the new official guidance means 75 bps of hikes in the next 24 months, vs. the previous guidance of 125 bps in the following 18 months. Santander's official policy rate estimate is 3.25% for end-2019 and 3.50% for December 2020.

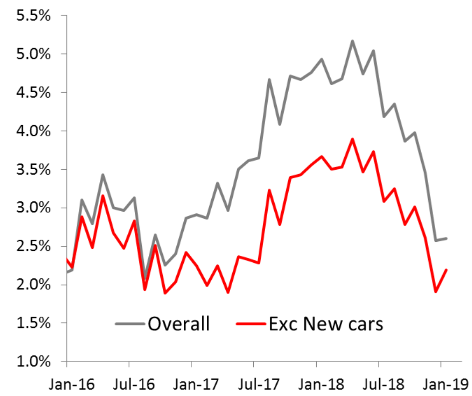
BCCh policy rate – Market implied path vs. IPoM indications



*IPoM March 2019 assumes neutral rate at 3.75%. Sources: BCCH and Santander

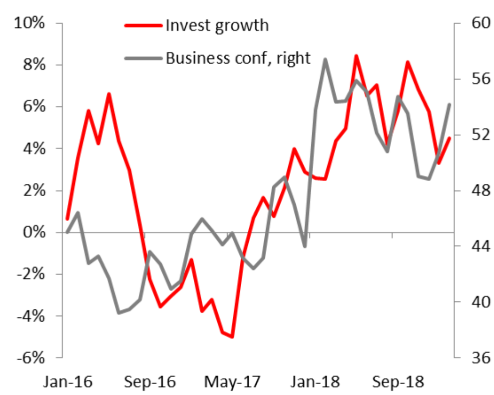
Moving on to external accounts, the current account hit a deficit of 3.1% of GDP in 2018, vs. -2.1% in 2017. This deterioration reflects a decline in the trade surplus (mainly due to fast-growing imports), the reversal in copper prices, and rising dividend payments. We see risks in 2019 as skewed toward a larger deficit, especially if imports continue to grow at 10% annually and copper prices remain close to US$3.00/lb. We do not see a 4%/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 be a negative combination for the CLP. Thus, we continue to see currency swings in Chile as much more dependent on global USD trends than on domestic fundamentals. Based on a somewhat weaker USD globally, we expect a 660 exchange rate by year end, vs. 696 in December 2018.

Retail sales (y/y, last 3M)



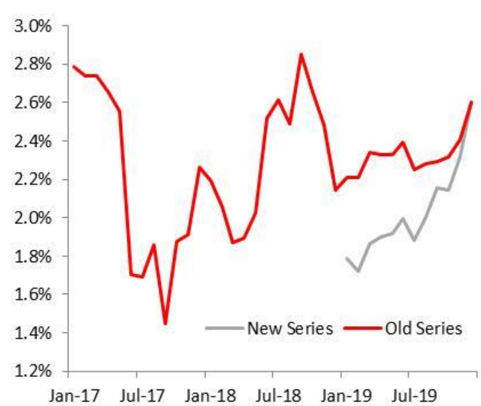
Synthetic Investment growth indicator (last 3M, y/y). Business confidence index (all sectors). Sources: BCCH and Santander.

Investment and business confidence



Synthetic Investment growth indicator (last 3M, y/y). Business confidence index (all sectors). Sources: BCCH and Santander.

CPI inflation (y/y), actual & fwds



Implied levels from forwards market from March 2019 onward. Sources: INE and Santander.

CHILE

	GDP %	2014	2015	2016	2017	2018	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	3.6	3.5
Public Consumption (Δ% y/y)	65	3.8	4.8	6.3	4.0	2.2	2.6	2.5
Investment (Δ% y/y)	28.4	-4.8	-0.3	-0.7	-1.1	4.7	5.6	4.8
Exports (Δ% y/y Local Currency)	39	0.3	-1.7	-0.1	-0.9	5.0	3.2	2.0
Imports (Δ% y/y Local Currency)	39	-6.5	-1.1	0.2	4.7	7.6	5.0	2.6
GDP (US$ bn)		261	244	250	277	299	305	330
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		4.6	4.4	2.7	2.3	2.6	2.5	3.0
CPI core Inflation IPCX1 (Dec Cumulative)		5.1	4.7	2.9	1.9	2.3	2.5	2.7
US$ Exchange Rate (Average)		570	654	677	649	640	670	660
Central Bank Reference Rate (eop)		3.00	3.50	3.50	2.50	2.75	3.25	3.75
Private sector credit (% of GDP)		85.0	88.0	88.2	90.0	88.1	91.0	92.0
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-1.6	-2.1	-2.7	-2.8	-1.7	-2.0	-1.7
**Primary Balance, % of GDP		-1.0	-1.4	-2.0	-2.0	-0.8	-1.2	-0.9
Balance of Payments								
Trade Balance, % of GDP		2.5	1.4	2.2	2.8	1.6	1.2	1.0
Current Account, % of GDP		-1.7	-2.3	-1.4	-1.5	-3.1	-2.8	-2.8
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	23.5	25.6	26.2
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	7.0	6.8	6.7

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

NO IMMEDIATE PRESSURE TO HIKE

- **After expanding 2.7% in 2018, in line with our forecast, we see the economy maintaining its dynamism in 2019, with GDP growth of 3.3% y/y.**
- **Inflation has surprised to the downside, suggesting that there are no material pressures on inflation this year. Although risks remain to the upside, we expect inflation in 2019 to remain close to the 3% target, at 3.2%.**
- **BanRep is under no immediate pressure to adjust the interest rate, and thus we believe it will remain on hold for longer and may not hike until 4Q19.**
- **The Fiscal Rule Committee agreed to adjust the fiscal targets to include the fiscal costs of Venezuelan migration. The fiscal target for 2019 was increased to -2.7% of GDP from -2.4% and for 2020 to 2.3% from -2.2%.**

Diana Ayala
1 (212) 407 0979

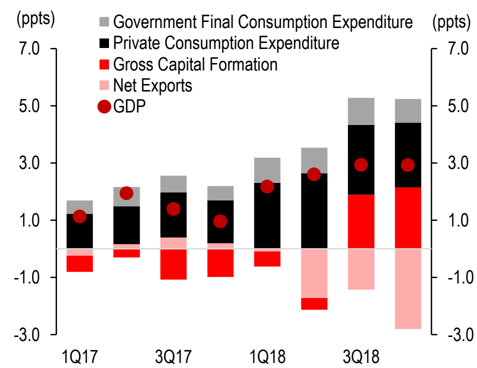
We expect the economy to reach its potential growth in 2019

Real GDP grew 2.9% y/y in 4Q18, growing at the same rate as in 3Q18. On the demand side, similarly to the previous quarter, private consumption continued to be the main driver of growth, contributing 2.3 ppts to annual growth in 4Q18 and maintaining positive growth at the margin, increasing 0.6% q/q, according to the seasonally adjusted figures. Similarly, investment is becoming an important pillar of growth after contracting for eight consecutive quarters. In 4Q18, gross capital formation increased 5.4% y/y, improving from 2.9% y/y growth in 3Q18, and increasing its contribution to 2.1 ppts from 1.9 ppts in 3Q18. The recent improvement in business confidence suggests that investment's contribution will continue to improve in 2019. In contrast to consumption and investment, net exports represented a drag on growth, as imports' 15.6% y/y increase exceeded exports' 3.1% y/y growth in 4Q18. In effect, net exports subtracted 2.8 ppts from growth. We consider that this will continue to be a significant drag on the economy in 2019, as imports should continue to grow at a fast pace, in line with the economic recovery, while exports remain subdued, as we expect average oil prices to remain at similar levels as in the previous year, while external demand continues to slow. On the supply side, services continue to be main driver, growing 3.1% y/y in 4Q18. Secondary activities also continue to support the economy. Among these, construction activity stands out, as it expanded 4.2% y/y, posting its second consecutive quarter of positive growth, after contracting for almost two years. Overall, with 4Q18 growth, GDP expanded 2.7% y/y in 2018, in line with our forecast. For 2019, we consider that the economy will continue to improve, expand 3.3% y/y, driven by consumption but also supported by higher investment. Nevertheless, we see imports expanding at a faster pace, thus capping growth at a level lower than official estimates from BanRep and the government, at 3.5% y/y and 3.6% y/y, respectively.

Inflation under control and in line with the 3% target

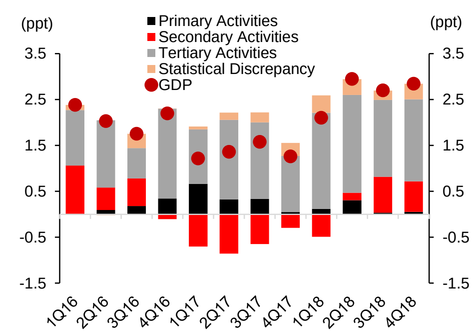
During the first two months of the year, inflation surprised to the downside, decreasing from 3.2% in December to 3.0% in February, reaching BanRep's target. The decline in annual inflation was partially explained by the new methodology, where the weight of food inflation was reduced notably to 24.5% from 28.2%. Additionally, in the first two months of the year, the effect from el Nino has been milder than we expected, reducing the pressure on food prices. In general, although el Nino season is not over yet, risks from this phenomenon seem low, in our view. Core measures have also surprised to the downside, suggesting in general low inflationary pressures in the short term. The average of the four cores fell below the target to 2.81% y/y in February, after averaging 3.5% y/y in 2018. Taking the new weights under consideration, we revised our 2019 headline inflation forecast downward to 3.2% from 3.6% previously, as we estimated that the lower weight of food inflation would offset any possible pressures from this component during the year, while pressures from other

GDP contribution by component



Sources: DANE and Santander

GDP contribution on the supply side



Sources: DANE and Santander.

New CPI weights

CPI Component (New)	Weight	CPI Component (Old)	Weight
Food and non-alcoholic beverages	15.05	Food	28.21
Restaurants and hotels+	9.43		
Accomodation, water, electricity, gas and other fuels	33.12	Housing	30.1
Furniture, hosehold items and it's care	4.19		
Apparel	3.98	Apparel	5.16
Health	1.71	Health	2.43
Education	4.41	Education	5.73
Leisure and cultural activities	3.79	Leisure	3.1
Transportation	12.93	Transportation	15.19
Information and communication	4.33	Communication	3.72
Other goods and services	5.36	Other	6.35
Alcoholic beverages and tabacco	1.7		

Sources: DANE and Santander.

components seem to be in check. However, we do consider that the balance of risks is to the upside, in particular resulting from potential depreciation in the COP, as there is still high uncertainty in the external environment due to lower global growth and the trade talks between the U.S and China.

BanRep: holding for longer

At its March meeting, its second of the year, the Central Bank of Colombia kept the policy rate unchanged at 4.25% for the tenth consecutive month (eighth consecutive meeting), in line with expectations. The decision was again unanimous. In its statement, the board maintained the neutral tone introduced at its January meeting, keeping a positive view on inflation for 2019 while also maintaining a constructive view on growth. On growth, the board has been giving hints of hawkishness, as, in its last communique, the board mentioned that leading indicators point to stronger growth in 1Q19 than in 4Q18 and noted that the technical team's 2019 GDP forecast was revised upward, now at 3.5% vs. 3.4% previously. Moreover, in the press conference, Governor Echavarria stated that BanRep expects the output gap to fully close by end-2020.

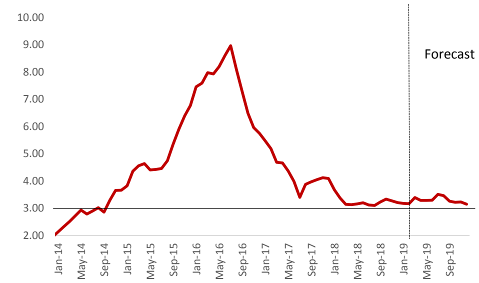
Mr. Echavarria also reiterated that the board will not use monetary policy to correct the current account balance, a question that has been raised among private analysts. In general, we consider that there are no immediate pressures for BanRep to adjust the reference rate in the short term, with inflation low and the more benign external environment, yet we consider that the board will likely bring the interest rate back up to neutral before end-2020, as the output gap closes. The question, in our view, is more on the pace and the level. Governor Echavarria mentioned that his view on rates is similar to that of the market, which expects one hike this year, and he noted that the neutral rate is around 4.55%. While we agree that the hiking cycle will likely start in 4Q19, we estimate the neutral rate is closer to 5.25%, and thus we expect a larger adjustment than Mr. Echavarria suggested.

Finally, BanRep confirmed that the reserve accumulation program, which was introduced in September 2018, will continue. We expect the program to continue until May 2020, when the IMF will hold Colombia's FCL review. So far BanRep has accumulated around US$2.5 billion, including US$1 billion purchased from the Ministry of Finance, and we expect BanRep to continue this process until it accumulates at least US$5 billion, which will bring reserves to a more adequate level.

Fiscal Rule Committee revises fiscal targets

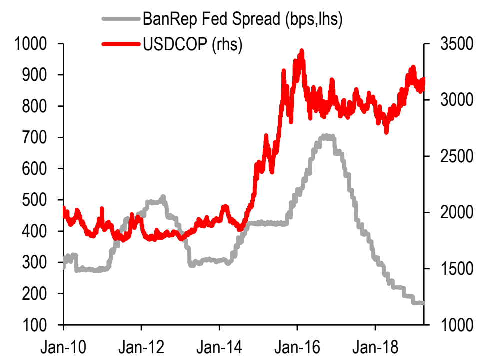
In March, the government met with the Fiscal Rule Committee to present its case for the need to account for the fiscal cost of the Venezuelan migration, which is estimated at around 0.5% of GDP per year, in the fiscal targets. The Committee agreed to take into account this short-term shock and revised the targets in favor of lower adjustment in 2019 and 2020, but plans a faster adjustment to converge to the 1% of GDP structural fiscal deficit. Specifically, the deficit target was revised to 2.7% from 2.4% for 2019, and to 2.3% from 2.2% for 2020, to reach a 1% deficit by 2024 instead of 2027 as previously. During the press conference where the new targets were presented, Mr. Carrasquilla, Minister of Finance, emphasized that the government remains committed to achieving the fiscal targets and that despite the higher deficits in the next three years, the debt should follow a downward trend as previously estimated. If the debt scenario materializes, we believe it would be more likely that Colombia would keep its current rating of BBB. However, despite the fiscal consolidation undertaken by the government in the past two years, the government has failed to stabilize its already high debt, and thus, we believe there is still a high probability that Moody's and Fitch will join S&P's decision to downgrade Colombia's sovereign rating to BBB-, one level above junk, this year. In particular, there is still concern about the government's ability to reach the fiscal target in 2020, when the government is expected to collect lower corporate taxes in line with the Financing Law approved last year. Moreover, Fitch considered that the change in fiscal rule hurts credibility, while Moody's has already expressed its concern about the government's ability to continue with its fiscal consolidation in the medium term in the absence of structural reforms, which we believe might be difficult for it to deliver.

CPI forecast to end 2019 at 3.2%



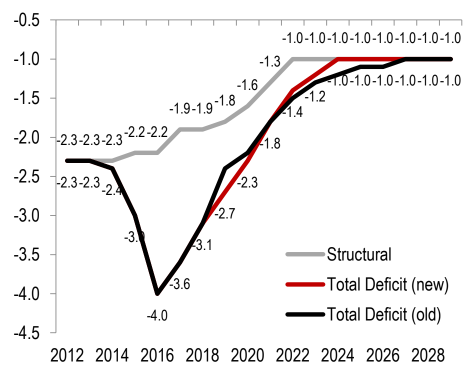
Sources: DANE and Santander.

BanRep on hold



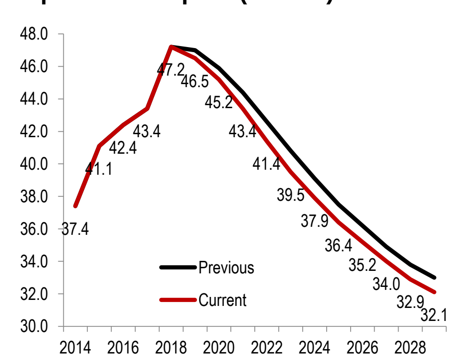
Sources: Bloomberg and Santander.

New fiscal targets



Sources: Ministry of Finance and Santander.

Expected debt path (% GDP)*



Note: General Government Debt. Source: BanRep

COLOMBIA

	% GDP	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		4.7	3.0	2.1	1.4	2.7	3.3	3.6
Private Consumption (Δ% y/y)	61.1	4.6	3.1	1.6	2.1	3.5	4.7	5.5
Public Consumption (Δ% y/y)	16.1	4.7	4.9	1.8	3.8	5.9	6.4	6.0
Investment (Δ% y/y)	23.7	11.8	-1.2	-0.2	-3.2	3.5	6.0	6.5
Exports (Δ% y/y)	18.9	-0.3	1.7	-0.2	2.5	1.2	1.4	1.8
Imports (Δ% y/y)	19.8	7.8	-1.1	-3.5	1.2	8.0	11.3	12.2
GDP (US$ bn)		381	293	283	312	331	323	338
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		3.7	6.8	5.8	4.1	3.2	3.2	3.1
Core inflation (Dec Cumulative)		3.3	5.2	5.1	5.0	3.5	3.2	3.0
US$ Exchange Rate (Average)		2400	2740	3050	2952	2958	3221	3275
Central bank reference Rate (eop)		4.50	5.75	7.50	4.75	4.25	4.50	5.25
Bank lending to the private sector (% chg YoY, Dec)		13.6	14.6	9.2	12.0	4.0	8.0	10.0
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-2.4	-3.0	-4.0	-3.6	-3.1	-2.7	-2.3
Primary Balance, % of GDP		-0.2	-0.5	-1.1	-0.8	-0.3	0.3	0.4
Balance of Payments								
Trade Balance (% of GDP)		-3.0	-4.7	-3.3	-1.5	-1.6	-2.2	-2.7
Current Account (% of GDP)		-6.6	-6.4	-4.3	-3.3	-3.8	-4.0	-4.5
Debt Profile								
Central Bank International Reserves (US$ bn)		47.3	46.7	46.7	47.6	48.4	51.4	52.6
Total Public Debt (gross, % of GDP)		38.3	37.0	43.7	44.8	48.6	50.0	52.0
Of which: Foreign-currency denominated (% of GDP)		11.0	14.0	15.5	15.5	16.8	17.0	18.0
Labor Markets								
Unemployment Rate Avg. (year-end,% of EAP)		8.7	8.6	8.7	8.6	9.7	10.0	9.7

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

MEXICO

The Pledge to Fiscal Discipline and Generate Growth above 2%

- **We think AMLO has the right diagnosis to improve productivity.**
- **The administration's objective not to increase debt to GDP gives little space to public finance.**
- **The previous administration cut the Pemex investment budget, and now the company needs more capex.**
- **The big debate is how to generate growth, make Pemex strong again, and maintain fiscal prudence in a decelerating global economy, all at the same time.**
- **Banxico may cut 50-75 bps, in our view, but is not likely to engage in a cutting cycle, as inflation is not decreasing fast enough to reach the target.**

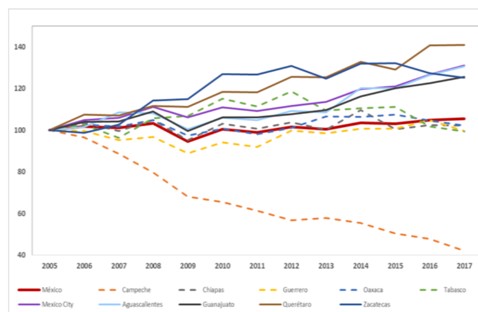
Guillermo Aboumrad*
+52 55 52578170

AMLO has the right diagnosis to improve productivity, in our view

The Mexican economy has been growing at 2.2% on average for the last 10 years. During that time, more than 80% of that growth has been explained by growth in employment, with less than 20% accounted for by productivity growth. In previous administrations numerous actions have been taken to improve the overall productivity of the Mexican economy, among which we highlight: free trade agreements, opening sectors to competition, reducing the informal economy and increasing financial penetration, and investing in infrastructure, to name a few. Challenges remain, however, in the areas of security, impunity from prosecution, corruption, and the rule of law.

One novel approach of this administration is attacking the productivity problem by focusing on those states that are less productive. Although on average the economy has low productivity growth, some industrial states (like Querétaro, Mexico City, Aguascalientes, Guanajuato, and Zacatecas), show high productivity, while some poor states have below-average productivity, mainly in the south of the country (e.g., Oaxaca, Chiapas, and Guerrero). With the decline in oil activity, Campeche and Tabasco, also in the south, have exhibited low productivity growth. As part of addressing the productivity challenge, AMLO's main priority is to reduce corruption and improve security, which is key to improving growth prospects in many states. In this context, AMLO's main infrastructure programs are exactly geared toward the southern states of Mexico: Dos Bocas refinery in Tabasco, the Maya train in the Southeast, and the Trans-isthmus runway running through Oaxaca and Veracruz.

Mexico's productivity, by state

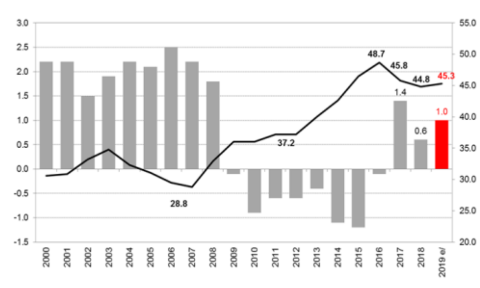


Index 2005=100. Sources: INEGI and Santander.

The administration's objective not to increase debt to GDP gives little space to public finance

Because of higher financial cost to the public sector, in order to maintain this year's debt to GDP at the same level as 2018, the budget exercise for this year required a primary surplus of 1.0% of GDP, higher than the 0.6% observed in 2018. In essence, according to the Federal Expenditure Budget, 2019 total expenditures to GDP are almost 1% lower than those of 2018, once we exclude pension and financial expenses, as well as tax contributions to the states from the Federation. Thus, in order for this year's budget to reach the same percentage of GDP as last year for social programs and physical investment, substantial effort is needed to cut operational expenses, mainly salaries, advisories, and superfluous expenditures, as well as to find savings in government purchases. In this context there is little room in public finance to accommodate more growth-oriented initiatives.

Budget primary balance and total public debt (% of GDP)



Sources: SHCP and Santander.

In addition, as this is the first year of the AMLO administration, the fiscal budget for this year considers only a fraction of the main social programs and infrastructure project costs, because typically there is less spending at the beginning of an administration. In addition, tax revenue was estimated with a GDP growth rate of 2.0%, while the market is now estimating 1.5% for 2019 and 1.8% for 2020 (the same as our own forecast), so a shortfall in tax revenue is likely, in our view. January public finance figures showed lower tax revenue and oil revenue due to declining oil production and also lower expenses compared to the monthly program published by the Ministry of Finance. So, although public finance could miss revenue estimates this year, the government may also spend less as the administration gets off to a slower than anticipated start. In this case we believe it is possible to reach the 1% primary surplus target, but 2020 could be a challenge once the government is up and running and spending fully on programs, with possibly lower revenue if the economy suffers from a worldwide deceleration in that year.

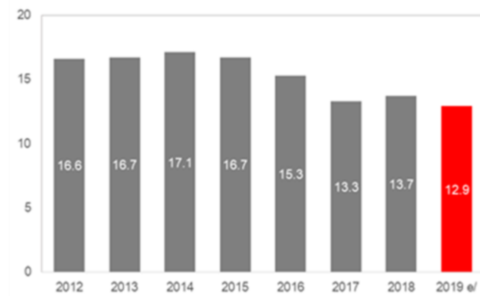
The previous administration cut the Pemex investment budget, and now the company needs more capex to stop the decline in production. During the Peña Nieto administration, debt to GDP increased from 37.2% in 2012 to 48.7% in 2016. After the threat of sovereign downgrades from most of the rating agencies, the administration cut expenses, especially in the Pemex capex budget. The debt to GDP ratio was finally lowered, to 44.8% of GDP, but the company was left with declining oil production and refining capacity, and with a high level of debt. One of the AMLO administration's goals, as mentioned previously, is to recover energy independence by building a new refinery at Dos Bocas and repairing the existing six refineries. Thus, putting more capex into Pemex is not compatible with fiscal prudence. In essence, the discussion so far points to high dependence on the private sector to generate growth through investments and to finance the infrastructure projects proposed by this administration to help the poorer states. In addition, private sector capex is needed in the energy sector, something this administration has not yet considered, although it could do so eventually.

Unfortunately, the private sector has been taking a wait-and-see stance since 2016, first waiting for NAFTA jitters to subside and then for more visibility on AMLO's new policies and attitude toward the private sector. This year private investors most likely will remain on the sidelines, in our view, which would be negative for GDP growth. Regrettably, if in the next year we experience a worldwide deceleration affecting the US economy, that would not be the best environment for private sector investment to flourish. In addition, USMCA still must be approved by the legislature of each signing country, and the relations between Trump and Democrats in the US Congress is causing some jitters regarding the likelihood of the agreement being signed.

The big debate is how to generate growth, make Pemex strong again, and maintain fiscal prudence in a decelerating global economy, all at the same time. We believe that without the active participation of the private sector, it will be difficult to achieve all three, and hence we see risks to public finance. In our view, Banxico is not only concerned about inflation and about inflation expectations not falling faster to its goal of 3.0%, but also about how the debate mentioned will play out. In the event of a deeper US deceleration, the external scenario could work against emerging markets even though it has been benign lately. Moreover, USMCA jitters could erupt again in the second half of this year.

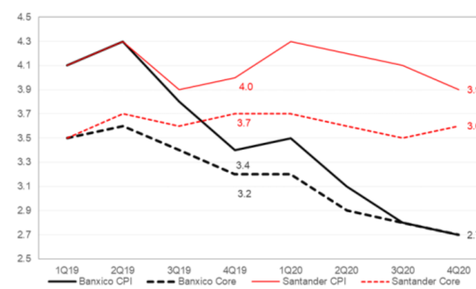
The temptation for the administration to push growth initiatives while facing apathy from the private sector regarding investment is a risk to public finance in 2020, in our view. In addition, Pemex could demand capex funds sooner rather than later. Even though the market is pricing 100 bps in cuts from Banxico for the next two years, we think we are more likely to see cuts between 50-75 as a compromise between Banxico and the market. We think such a move would be to relieve some pressure from the current high real rates, possibly in the first quarter of 2020 (our base case); alternatively, we would not be surprised if that is moved back to 4Q19. Nevertheless, we do not yet foresee a full cutting cycle, because inflation is not decreasing fast enough to reach Banxico's target along its published trajectory. According to that trajectory, Banxico is expecting headline inflation to drop to 3.4% by year end and core inflation to fall to 3.2%. Both forecasts are way below our own forecasts of 4.0% and 3.7%, respectively. We note also that Banxico has said repeatedly that those forecasts are congruent with the current policy rate of 8.25%. Thus, we believe the key for Banxico to cut aggressively is the level of inflation.

Total expenditures minus financial investments, pension expenses, state participation, and financial costs (% GDP)



Sources: SHCP and Santander.

CPI inflation forecast trajectory (annual % var.)



Annual average Q/Q%. Sources: Banxico and Santander.

MEXICO

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		2.8	3.3	2.9	2.1	2.0	1.5	1.8
Private Consumption (Δ% y/y)	73.9	2.1	2.7	3.8	3.1	2.2	2.3	2.3
Public Consumption (Δ% y/y)	10.9	2.9	1.9	2.6	1.0	1.4	-2.0	0.5
Investment (Δ% y/y)	20.9	3.1	5.0	1.0	-1.6	0.6	-1.0	1.5
Exports (Δ% y/y Local Currency)	17	7.0	8.4	3.7	3.9	5.7	5.0	4.5
Imports (Δ% y/y Local Currency)	21.5	5.9	5.9	2.9	6.2	6.2	4.5	4.8
GDP (US$ bn)		1,313	1,170	1,077	1,162	1,224	1,257	1,271
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		4.1	2.1	3.3	6.8	4.8	4.0	3.8
CPI core Inflation (Dec Cumulative)		3.2	2.4	3.4	4.9	3.7	3.7	3.6
US$ Exchange Rate (Average)		13.3	15.9	18.7	18.9	19.2	19.8	20.7
Central Bank Reference Rate (eop)		3.00	3.25	5.75	7.25	8.25	8.25	7.75
Bank Lending to Private Sector (% of GDP)		14.8	16	16.9	17.5	18.0	18.5	19.0
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-3.2	-3.5	-2.6	-1.1	-2.1	-2.0	-2.5
Primary Balance, % of GDP		-1.1	-1.1	-0.1	1.4	0.6	1.0	0.5
Balance of Payments								
Trade Balance		-0.2	-1.3	-1.2	-0.9	-1.1	-1.2	-1.3
Current Account, % of GDP		-1.8	-2.5	-2.2	-1.7	-1.8	-2.0	-2.0
Debt Profile								
Central Bank International Reserves (US$ bn)		193.2	176.7	176.5	172.8	174.8	178.0	180.0
Total Public Debt (gross, % of GDP)		43.2	47.3	48.7	45.8	44.8	45.3	46.0
Of which: Foreign-currency denominated (% of GDP)		11.9	14.6	18.3	15.7	16.5	16.0	16.0
Labor Markets								
Unemployment Rate (year-end, % of EAP)		4.8	4.3	3.9	3.4	3.3	3.9	3.8

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

Slow Start but We See a Bright Future

- **Despite the slow start in 2019, we believe economic activity will pick up and expand 4.2% in 2019, slightly higher than the 4.0% growth in 2018, which is also the level of potential growth.**
- **Inflationary pressures remain low, and thus we now expect headline inflation to end 2019 at 2.2%, lower than our previous forecast of 2.5%.**
- **The Central Bank has been on hold and has indicated there is no need to hike in the short term, and we consider that it will deliver its first hike in 3Q19 as the output gap narrows.**
- **Fiscal consolidation is on the way, in our view, as the fiscal deficit was 2.5% in 2018, lower than the original target of -3.0% of GDP; fiscal accounts should remain solid in 2019, supporting Peru's BBB+ rating.**

Diana Ayala
1 (212) 407 0979

Slow start in activity, but we expect a pickup

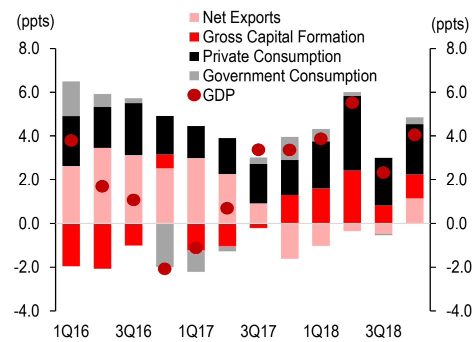
GDP growth picked up in 4Q18, expanding 4.1% y/y after disappointing in 3Q18 at 2.3%. As in previous quarters, growth continues to be mainly supported by private consumption, which increased a solid 3.8% y/y in 4Q18, adding around 2.3 ppts to growth. Additionally, public consumption bounced back after contracting in 3Q18, up 2.2% y/y in 4Q18. Gross fixed capital investment accelerated in the last quarter of the year, with public investment surging to 17% y/y, after falling 1.6% y/y in the previous quarter. Private investment also picked up slightly in comparison to 3Q18, expanding 2.1% y/y. Finally, net exports also turned positive, contributing around 1 ppt to growth after being a drag on growth for a year. In 2019 the economy started at a slower pace. In January, economic activity slowed to 1.6% y/y, driven mainly by lower output in fishing, manufacturing, and mining, which subtracted 22 ppts, 71 ppts, and 17 ppts, respectively, from annual growth. Despite this moderate growth, leading indicators, including electricity production, suggest to us that the economy should rebound in the next few months. Additionally, private consumption remains solid, with credit still expanding in the double digits. The main drag to the economy is public expenditure and investment, as it was recorded that the physical progression of public works declined 13% in the first two months of the year, mainly as a result of a change in subnational governments.

Looking ahead, we consider that the economy is poised to grow 4.2% in 2019, slightly above its potential level of 4.0% y/y, which is the level posted in 2018. We consider that private consumption will continue to be the main driver of growth, supported by a continuing expansion 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 USD43.1 bn for next year, which is equivalent to 19% of GDP, with the non-mining sector accounting for almost 90% of investments.

Inflationary pressures remain low

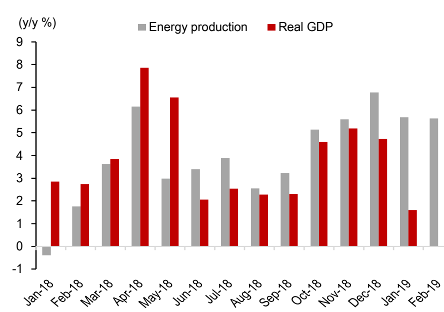
The Consumer Price Index surprised to the upside in March, after coming in below expectations in the first two months of the year. In March, headline inflation in Metropolitan Lima increased 0.73% m/m, notably above consensus of 0.58% m/m and our forecast of 0.60% m/m. With this, headline inflation jumped to 2.25% y/y from 2.00% y/y in February. The higher than expected inflation was mainly explained by seasonal effects related to education, as well as beverages and food. The leisure, cultural activities, and education component increased 2.96% m/m, while the food & beverage component increased 0.43% m/m. These two components alone contributed 64 ppts to monthly inflation. Core inflation (CPI ex food and energy prices) also bounced back to 2.56% from 2.39% in February,

GDP contribution by component



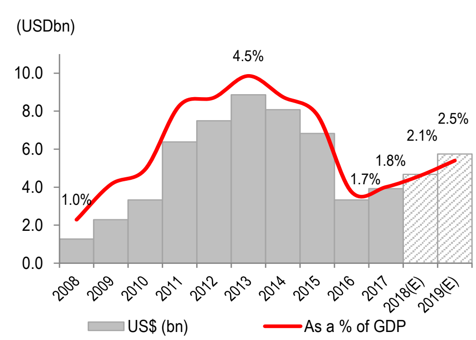
Sources: Central Bank and Santander.

Electricity production picking up



Sources: COES, Central Bank, and Santander.

Strong mining investment in the pipeline



Sources: Ministry of Energy and Mining; Santander remaining above 2.0% for almost a year. In the previous months, food pressures were more moderate than we initially expected, but they also reflected a one-off decline in energy prices as a result of the government's decision to reduce fuel prices as a compromise to end the truckers' strike in February.

In general, we expect inflation to remain above the 2.0% target for the rest of the year. However, we now see inflation ending at 2.2% y/y in 2019 instead of 2.5%, mainly due to lower inflation recorded in the first months of 2019 and artificially lower fuel prices as a result of the government's agreement with truck drivers. We still consider that food prices will continue to normalize and that we may also start seeing some demand-side pressures as consumption continues to improve, and thus still consider that inflation risks are to the upside.

Central Bank on hold in the short term

At its March meeting, the Central Bank of Peru kept the reference rate on hold at 2.75% for the tenth consecutive month, as expected. Similar to the previous months, the MPC maintained a positive view on inflation, as it noted that inflation is within the target range and expects inflation to remain close to the 2.0% target. The MPC also noted that 12-month inflation expectations declined to 2.40% in February from 2.48% in January, also still within the target range.

In terms of growth, the MPC maintained the hint of hawkishness added in February's statement. The MPC noted that leading indicators point to dynamic activity, but, as in previous communiques, it noted that the economy remains below its potential. However, similarly to February, it acknowledged that the economic indicators are pointing to narrowing of the output gap, albeit gradual, while noting that business confidence remains positive.

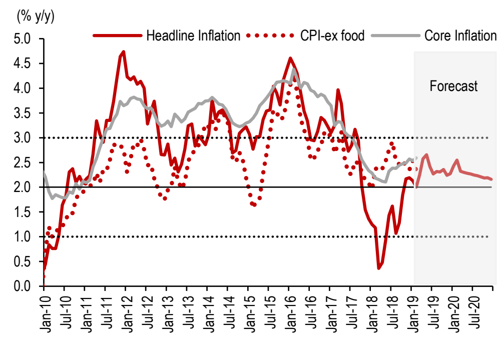
In general the board seems comfortable with its holding stance and still considers it appropriate to maintain an expansionary policy as long as inflation expectations remain anchored and economic activity remains below its potential. This view was reiterated by Governor Velarde, who in the 1Q19 inflation quarterly report stated that he does not see the need to hike in the short term, while adding that there is also no space to cut given that domestic demand remains solid. Overall, we consider that the BCRP will remain on hold in the first half of this year; however, we maintain our view that the Central Bank will deliver its first hike this year, as activity remains robust and the output gap is closing.

Finally, in the 1Q19 inflation quarterly report, Mr. Velarde noted that the BCRP took advantage of the appreciation observed in the PEN in March to increase international reserves, and he announced that the BCRP would like to further increase reserves to USD64.5 mn in 2019 and to USD67.5 mn in 2020 from USD60.1 mn in 2018.

Stronger fiscal consolidation

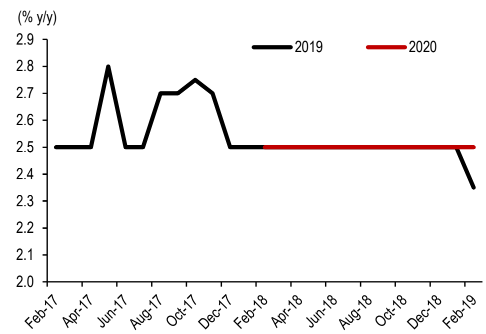
The Ministry of Finance reported that in 2018 the fiscal deficit declined to 2.5% of GDP, a notably better result than the target of -3.0% of GDP. Moreover, the initial fiscal data for the year suggest that the government is poised to reach a 2.3% of GDP deficit in 2019, lower than the current target of 2.7%. In February, the Central Bank reported that the fiscal deficit had decreased to 2.1% of GDP, driven by higher revenue and lower non-financial public expenditure. Additionally, the Ministry of Finance announced it will pursue policies to reduce tax evasion in addition to simplifying the income tax and making changes in the property tax. In all, the government remains committed to continuing its fiscal consolidation and reaching a 1% deficit by 2021 to stabilize debt after it revised the path to allow slower consolidation to provide resources for the reconstruction of the areas affected by El Nino in 2016. In general, we expect the government to continue to meet the fiscal targets, and thus, we see no risks of a downward revision of Peru's sovereign credit rating in 2019.

CPI expected to remain above 2.0%



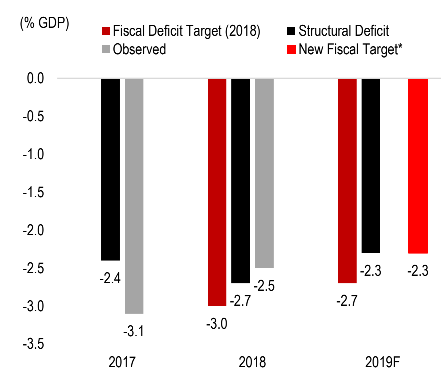
Sources: BCRP, Santander

Inflation expectations anchored



Sources: BCRP, Santander

Stronger fiscal consolidation



Sources: Ministry of Finance and Santander

PERU

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		2.4	4.9	1.0	1.6	4.0	4.2	4.0
Private Consumption (Δ% y/y)	61.4	3.9	4.0	3.3	2.5	3.8	3.8	3.8
Public Consumption (Δ% y/y)	11.2	6.0	9.8	0.3	0.5	2.0	1.1	1.5
Investment (Δ% y/y)	28.2	-2.0	-5.2	-4.4	-0.3	5.2	4.5	6.3
Exports (Δ% y/y Local Currency)	23.9	-0.6	3.9	9.4	7.8	2.5	1.9	3.0
Imports (Δ% y/y Local Currency)	24.6	-1.4	2.4	-2.2	4.1	3.4	5.5	6.8
GDP (US$ bn)		202	192	195	214	224	233	240
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		3.2	4.4	3.2	1.4	2.2	2.2	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	3.4	3.5
Central Bank Reference Rate (eop)		3.50	3.75	4.25	3.25	2.75	3.25	3.75
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-0.3	-2.0	-2.5	-3.1	-2.5	-2.3	-1.8
**Primary Balance, % of GDP		0.8	-1.0	-1.4	-1.9	-1.1	-0.8	-0.5
Balance of Payments								
Trade Balance, % of GDP		-0.7	-1.5	1.0	2.9	3.1	2.9	2.8
Current Account, % of GDP		-4.4	-4.8	-2.7	-1.1	-1.5	-1.6	-1.7
Debt Profile								
Central Bank International Reserves (US$ bn)		62.3	61.5	61.7	63.6	60.1	64.5	67.5
Total Public Debt (gross, % of GDP)		20.1	23.3	23.8	24.9	25.5	26.0	26.0
Of which: Foreign-currency denominated (% of GDP)		8.7	11.1	10.4	8.8	10.3	9.1	9.3
Labor Markets								
Unemployment Rate (year-end, % of EAP)		5.2	6.2	6.7	6.5	5.7	6.0	6.0

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

URUGUAY

UYU WEAKENS AMID ACTIVITY SLOWDOWN AND FISCAL DETERIORATION

- **Real GDP grew 1.6% y/y in 2018 (expected 1.8% y/y), mostly owing to the reopening of the oil refinery. Excluding such impact, GDP grew a modest 0.9%. We lowered our 2019 GDP estimate to 0.7% y/y from the previous 1.4% y/y.**
- **In January 2019, the fiscal result – excluding the *cincuentones* effect – worsened to 4.4% of GDP, as rising expenses outpaced revenue.**
- **At the start of 2019 we lowered our year-end FX forecast to UYU34/USD (from the previous UYU35/USD) based on a more accommodative monetary policy stance in the US. However, recent FX volatility in some EM, coupled with a persistently strong UYU, imposes a downward bias on the currency.**

Marcela Bension*
598 1747 6805

Activity grew 1.6% y/y in 2018, though mainly driven by reopening of the ANCAP oil refinery

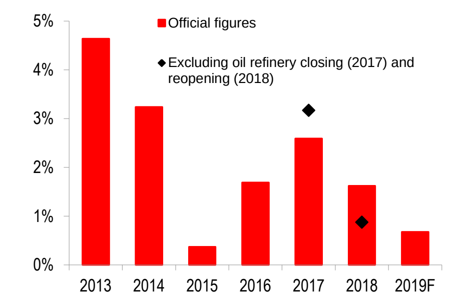
According to official figures, real GDP grew 1.6% y/y in real terms during 2018, slightly below our 1.8% y/y expectation. However, activity performance is gloomier than revealed by recently released data. First, 2018 readings were substantially driven by the oil refinery reopening. State-owned refinery ANCAP was closed for almost all of 2017, mostly due to maintenance works, undermining GDP growth that year. The opposite occurred last year, as the reopening of the refinery "inflated" GDP readings, particularly those for the industrial sector and household consumption. According to our estimates, this effect accounts for 0.7 percentage points of GDP. As a result, excluding the oil refinery effect, GDP grew a bare 0.9%. Moreover, such growth occurred mostly during 1Q18 considering that, excluding the refinery impact, GDP fell 1.2% q/q, 1.1% q/q, and 0.4% q/q in 2Q18, 3Q18, and 4Q18, respectively. Second, GDP readings in recent years have been mostly driven by the communications sector, particularly as data transmission and technological services gain traction. However, that sector has limited spillover effects on other sectors of the economy or even on employment. In addition, communications are overweight in national accounts given that the Central Bank has not recently updated its methodology so as to capture the declining weight of this activity in overall GDP as the costs of its services decline. Excluding the oil refinery effect and communications, "core" GDP would have declined an average 0.1% y/y in 2018, which appears consistent with leading indicators such as the closure of firms (similar to Chapter 11 in the US) and retail sales. In our view, pressure from high taxes, high administered prices such as fuel and electricity, a rigid labor market, and peso overvaluation are substantially undermining business competitiveness.

Private investment shrank 4.2% y/y in real terms during 2018, with total fixed investment standing at a modest 16.6% of GDP. Exports of goods and services, in turn, declined 4.8% y/y, dragged down by collapsing soybean production and weakened tourism inflows, as the latter are highly dependent on Argentina. Household consumption, in turn, grew a modest 1.5%, declining 0.4% y/y as of 4Q18. As a result, we have lowered our 2019 GDP forecast to 0.7% y/y (from the previous 1.4%) based on lower than expected household consumption. We still remain positive, though, based on the expected recovery of soybean exports and a pickup in investment from the construction of a new railway, a condition imposed by Finnish firm UPM to construct its second pulp mill in 2020-21. However, we keep a downward bias considering worsening global prospects and the authorities' lack of scope to implement countercyclical policies under potential unwinding of negative external shocks.

Fiscals continue to worsen due to a persistent rise in rigid expenses

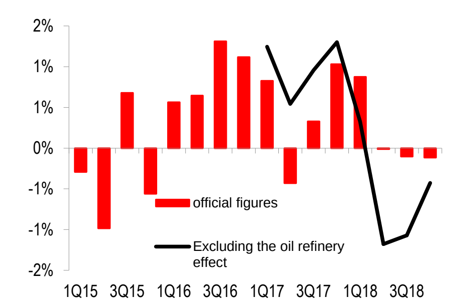
The fiscal result continues to worsen, reaching 4.4% of GDP as of January 2019 as per own estimates adjusted by the *cincuentones* effect incorporated in

GDP grew 0.9% in 2018 excluding the oil refinery impact



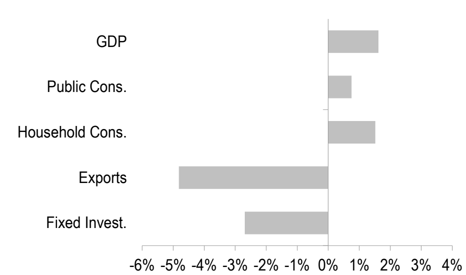
% real y/y change (annual average). Sources: BCU and Santander.

Activity entered *technical* recession in 2Q18 excluding the oil refinery opening



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

2018 GDP by components of demand



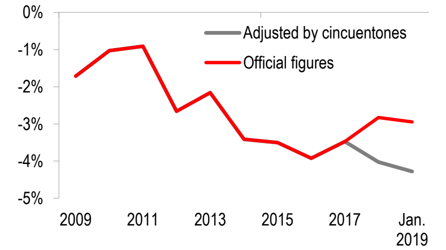
% real y/y change, 2018 average. Source: BCU.

fiscal accounts since October 2018. The latter relates to a group of citizens currently in their mid-50s who have filed a legal claim to detach from the mixed pension system in force since 1996, a combination of a pay-as-you-go and a fully capitalized system. This group of citizens asserted that the regime in place negatively affected their future pensions and appealed to return to the old pay-as-you-go regime under the scope of the public sector. Granting their claim, the current administration passed a bill through Congress requiring pension funds (AFAPs) – operating within the private sector – to transfer all funds associated with this group of workers to the state. The new law thus implies one-off extraordinary fiscal income that will be more than offset by pension liabilities in the coming years once such workers retire, presumably in their early 60s. As a result of this decision, official figures reported an improvement of the fiscal deficit from 3.6% of GDP as of January 2018 to 3% of GDP as of January 2019. However, this figure included 1.4% of GDP of extraordinary income from the *cincuentones* effect held in a specific escrow account and reported separately by the Ministry of Finance. Excluding such income, the fiscal deficit was a negative 4.4% of GDP as of January 2019, a figure that better illustrates the fiscal situation in the medium term, in our view. The 0.8 pp of GDP deterioration in the fiscal accounts within the past year is explained by a worsening of the primary balance (+0.6 pp) throughout all categories of non-discretionary spending, but particularly pensions and transfers, and by a 0.2 pp debt service increase. As a result, we believe the administration that will take office after the presidential elections in October-November will need to tackle structural reforms, particularly related to pensions and inefficient public sector spending. This is easier said than done, considering the unpopularity of such topics, which, for now, is keeping discussion of them out of the political campaign.

While our estimates point to a lower structural fiscal deficit, considering a negative output gap – 4% of GDP as of January adjusted by both one-off and cyclical factors – it is still up from an estimated 3% of GDP the previous year.

In our view, fiscal worsening lies behind the weakened competitiveness of the private sector and raises questions on potential sovereign downgrades, particularly considering Fitch's negative outlook. Mitigating factors against fiscal worsening include low financing risks – amid high liquidity and debt maturity profiles – and large FDI inflows expected toward 2021. Finally, from a timing perspective, we question whether rating agencies would take any rating action prior to the outcome of the presidential election in October-November 2019.

Public sector deficit worsened to 4.4% of GDP when adjusted for one-off effects



As % of GDP. The adjusted result includes amendment for one-off effect from the "cincuentones" law. Sources: MEF and Santander.

Rising expenses offset higher revenue

	Jan. 18	Jan. 19	change
Revenues	**30,0**	**30,4**	**0,4**
Primary Expenses	**30,2**	**31,2**	**1,0**
Wages	5,2	5,4	0,2
Current Exp.	3,7	3,9	0,2
Pensions	10,0	10,4	0,3
Transfers	8,9	9,2	0,3
Investments	2,3	2,3	-0,0
Primary Result	**-0,2**	**-0,9**	**-0,7**
Debt Service	3,3	3,5	0,2
Nominal Result	**-3,6**	**-4,4**	**-0,8**

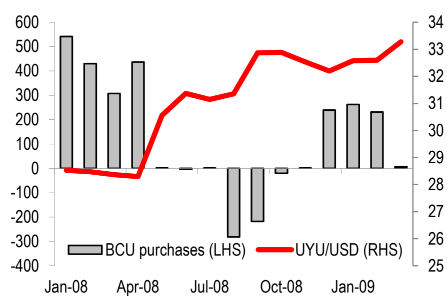
As % of GDP. Fiscal worsening y/y as of January 2019 per item. Adjusted for the "cincuentones" effect. Sources: MEF and Santander.

UYU weakened based on Central Bank intervention and EM volatility

The UYU has weakened 4.1% YTD, above our 2% expectation for the period. While in recent weeks, currency weakening appears to be driven by renewed FX volatility in some EM, particularly in neighbors Brazil and Argentina, at the start of the year, it mostly reflected renewed Central Bank intervention in the local FX market. From December 2018 to February 2019, the monetary authority purchased monthly USD250 million in the market, nearly 50% of total market trading, in our view driven by persistent strengthening of the UYU, particularly since mid-2018. In its 4Q18 monetary report, the monetary authority explicitly recognized a 15% overvaluation of the RER against its economic fundamentals, similar to our own estimates based on historical RER levels.

At the start of the year, we lowered our year-end FX forecast to UYU34/USD (-5% y/y, from our previous UYU35/USD forecast) based on looser monetary conditions in the US and Europe and under the assumption that credit agencies will not downgrade the sovereign rating in 2019. As a result, we assume that the RER will remain strong, a factor we have persistently considered as a macroeconomic weakness, considering its negative spillover effects on activity and potential ignition of sharper UYU weakening if external conditions in EM or domestic indicators continue to worsen. As a result, we keep a downward bias on the UYU.

UYU has weakened 4.1% YTD, driven by BCU purchases and EM FX volatility



Monthly net purchases by the BCU in USD million against UYU/USD average monthly quote. Source: Central Bank (BCU).

URUGUAY

	GDP %	2014	2015	2016	2017	2018	2019F	2020F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		3.2	0.4	1.7	2.6	1.6	0.7	1.8
Private Consumption (Δ% y/y)	74.7	3.0	-0.5	0.1	4.6	1.5	0.4	1.5
Public Consumption (Δ% y/y)	10.3	2.5	2.2	2.9	-0.7	0.8	0.5	-0.5
Investment (Δ% y/y)	17.5	0.0	-9.0	-3.9	-13.0	7.3	3.4	11.1
Exports (Δ% y/y USD)	28.0	3.5	-0.6	-0.2	6.9	-4.8	4.0	3.8
Imports (Δ% y/y USD)	30.5	0.8	-7.3	-6.2	0.5	-2.0	4.5	7.5
GDP (US$ bn)		57.3	53.4	52.8	59.6	59.6	59.6	62.5
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		8.3	9.4	8.1	6.6	8.0	7.6	7.5
WPI Inflation (Dec Cumulative)		10.3	10.0	7.7	6.6	7.5	7.8	7.5
US$ Exchange Rate (Average)		23.2	27.3	30.1	28.7	30.7	33.4	35.1
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	5.8	8.5	9.0
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-3.4	-3.5	-3.9	-3.5	-4.0	-4.5	-4.3
**Primary Balance, % of GDP		-0.6	0.0	-0.6	-0.2	-0.6	-1.1	-0.8
Balance of Payments								
Trade Balance, % of GDP		2.8	3.2	5.2	6.0	4.3	3.8	2.9
Current Account, % of GDP		-3.2	-0.9	0.6	0.7	-1.2	-1.8	-2.6
Debt Profile								
Central Bank International Reserves (US$ bn)		17.6	16.0	13.8	16.2	15.8	16.0	16.4
Total Public Debt (gross, % of GDP)		58.5	58.9	63.2	65.0	68.5	72.7	73.1
Of which: Foreign-currency denominated (% of GDP)		43.9	53.8	52.8	41.5	43.5	43.9	44.2
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.6	7.5	7.8	7.9	8.4	8.4	8.1

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

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Diana Ayala	Economist – Colombia, Peru	diana.ayala@santander.us	212-407-0979
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	598 1747-6805
Fixed Income Research			
Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
David Franco*	Macro, Rates & FX Strategy – Latin America	david.franco@santanderCIB.co.uk	44-207-756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Equity Research			
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Nicolas Schild*	Head, Chile	nschild@santander.cl	5622-336-3361
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Cecilia Jimenez*	Head, Mexico	mcjimenez@santander.com.mx	5255-5269-2228

Electronic Media	
Bloomberg	SIEQ <GO>
Reuters	Pages SISEMA through SISEMZ

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Martin Mansur*, Jankiel Santos*, Juan Pablo Cabrera*, Diana Ayala, Guillermo Aboumrad*, Marcela Bension*, David Franco*, and Iván Riveros*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

Santander
Corporate & Investment Banking