

Fixed Income & Economics Daily

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FX & RATES STRATEGY RESEARCH

Diana Ayala

212-407-0979
diana.ayala@santander.us

Juan Miguel Arranz*

+5411-4341-1065
jarranz@santanderrio.com.ar

Luciano Sobral*

+5511 3553 3753
lusobral@santander.com.br

Maurício Molan*

+5511 3012 5724
mmolan@santander.com.br

Grzegorz Ogonek*

+4822-534-1923
grzegorz.ogonek@bzwbk.pl

STRATEGY

- **COLOMBIA: Legislative Elections**
- **ARGENTINA: Central Bank intervention since March 5th is aimed at capping FX at around ARS20.40/USD**

ECONOMICS

- **BRAZIL: Low Inflation Paving the Way for Another Rate Cut**
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COLOMBIA: Legislative Elections

- On Sunday, March 11th, Colombia will hold Legislative Elections for 102 senators and 167 House representatives elected for 4-year terms.
- Additionally, Center-Right and Left parties will hold primary elections to select their candidates.
- On the Center-Right, Ivan Duque (from Uribe's party, Centro Democratico), Marta Lucia Ramirez and Alejandro Ordonez will dispute the candidacy.
- On the Left, Gustavo Petro (former mayor of Bogota and former M-19 member) and Carlos Caicedo will dispute the candidacy. Gustavo Petro is expected to win the candidacy of the left, as he is currently leading the presidential election polls with approximately 21% of Vote Intentions.
- For the Congressional election, overall, political analysts expect the Right Wing Block to win more seats, in part because the leftist parties are currently divided. Analysts believe that Petro's movement, called "la lista de la decencia" could take away votes from the traditional leftist parties such as Polo Democratico.
- Regardless of the number of votes, FARC will have 5 seats in the Senate and 5 seats in the House of Representatives.
- Moreover, one seat in the senate will subsequently be assigned to the presidential runner-up candidate and one seat in the House will be assigned to its running Vice President.
- Markets will be eyeing the legislative election results in order to assess the presidential candidates and their parties' ability to win the presidency.
- Thus after March 11th, there could be important changes to the candidates' support, and polls after this election could

provide a better picture of voting preferences for the first round Presidential election, which will take place on May 27th.

ARGENTINA: Central Bank intervention since March 5th is aimed at capping FX at around ARS20.40/USD

- The government's decision is to maintain sporadic interventions until abundant exports of corn and soybeans will make Central Bank interventions completely redundant – i.e., 2Q18.
- We expect the dollar quote in a clear downward trend this month; however, we foresee it returning to a range of ARS19.40 to ARS 19.90/USD in April.
- In 2016, the dollar quote appreciated 5% on average between March and July, while last year, a similar downward trend was abruptly interrupted by mid-May, impacted first by Brazilian political turmoil involving President Temer and, later on, by Cristina Kirchner's announcement that she would run for a seat in the Senate.

2016-17 March-July ARS/USD Index



Source: BCRA and Santander.

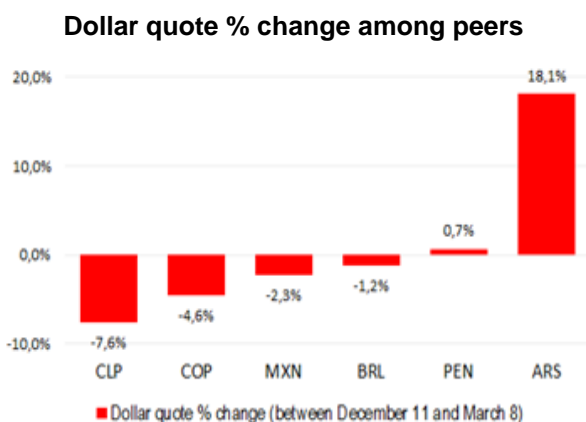
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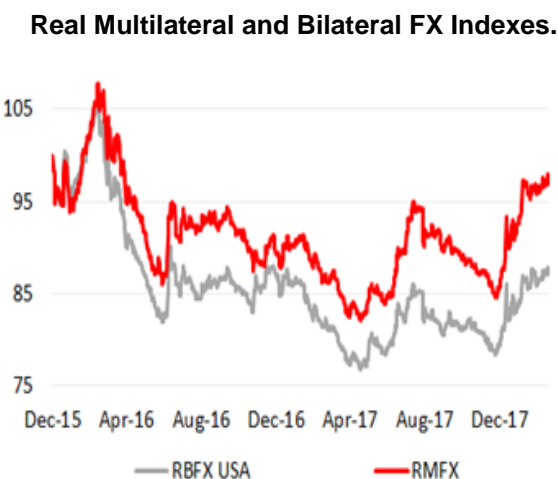


- In addition to the seasonal impact from grain and oilseed export sales, we believe our dollar quote forecast will be also supported by the peso's nominal depreciation since mid-December.



Source: Bloomberg and Santander.

- However, the peso depreciation strongly contrasts with the appreciation of LatAm currency peers since mid-December.
- The more than 18% depreciation of the local currency recorded in the last 90 days has resulted in a Real Multilateral Exchange rate level not seen since April 2016, which was one of the highest dollar quotes during the Macri era.



Source: BCRA and Santander.

- Meanwhile, the Real Bilateral dollar rate has improved less than the Real Multilateral dollar rate, causing some concern among journalists and economists.
- The Central Bank's decision to intervene in the FX market also received support from Treasury Minister Nicolás Dujovne in an interview published by *La Nación* on Tuesday.



LATAM ECONOMICS

Brazil Macro Compass

Low Inflation Paving the Way for Another Rate Cut

Luciano Sobral*

lusobral@santander.com.br
+5511 3553 3753

What's New: Yet Another Low Inflation Release

February CPI inflation came in at 0.32% m/m, slightly above our estimate (0.29%) but still comfortably low. It was the lowest February monthly inflation since 2000. Twelve-month inflation, at 2.84%, is still comfortably below the target lower bound, and core inflation continued to decelerate (from 2.96% in January to 2.89%, according to the measure that excludes foodstuff and regulated prices). **Year to date, measured inflation is 39 bps lower than what the Central Bank (BCB) forecasted in its December Quarterly Inflation Report.** That and a more favorable outlook for the remainder of the year (BCB official forecast for year-end 12-month inflation is 4.1%; we project 3.5%) leads us to believe that BCB can deliver another rate cut in March 21, bringing the Selic rate to 6.5%. That should come with a revision in its forecasts, in our view, to be detailed in this year's first *Quarterly Inflation Report* (to be published on March 29).

Industrial production fell 2.4% m/m in January, in-line with our expectations. This negative reading offsets an extraordinary December performance (revised this month from +2.8% m/m to +3.1% m/m), smoothing out a positive trajectory in a wider period: compared with January 2017, the index is 5.7% higher. Our estimated diffusion index shows 65% of around 100 manufacturing segments expanding production, compared with only 30% a year ago. We expect industry to grow 4.7% in 2018.

U.S. steel and aluminum tariffs: Brazil is the second largest exporter of steel to the United States and, so far, the producer most affected by the new tariffs, since Canada was exempted in last Thursday's announcement. Despite the immediate hit to a struggling industry, the first-order macro impact to Brazil should be almost negligible, even assuming a very steep demand curve for the commodity. The average value of yearly steel exports to the U.S. between 2013 and 2017 was little more than USD 3 billion (almost exactly the value exported in 2017, from USD 2.2 billion in 2016), compared with yearly average exports (in the same period) of USD 212 billion. Brazil aluminum exports to the U.S. in 2016 and 2017 were only USD 144 million and USD 119 million, respectively.

Upcoming Data: A Light Schedule Ahead

Next week's only relevant releases are two pieces of economic activity data from January. We expect core retail sales to have grown 0.7% in the month, while the volume of services should fall 0.3% in the same period, in our view. Those results, along with the industrial production figures mentioned in the previous section, would point to a 2.4% monthly contraction in BCB's monthly GDP proxy (IBC-Br), to be released in the following week.

In-Depth Research: Food Prices Dynamics

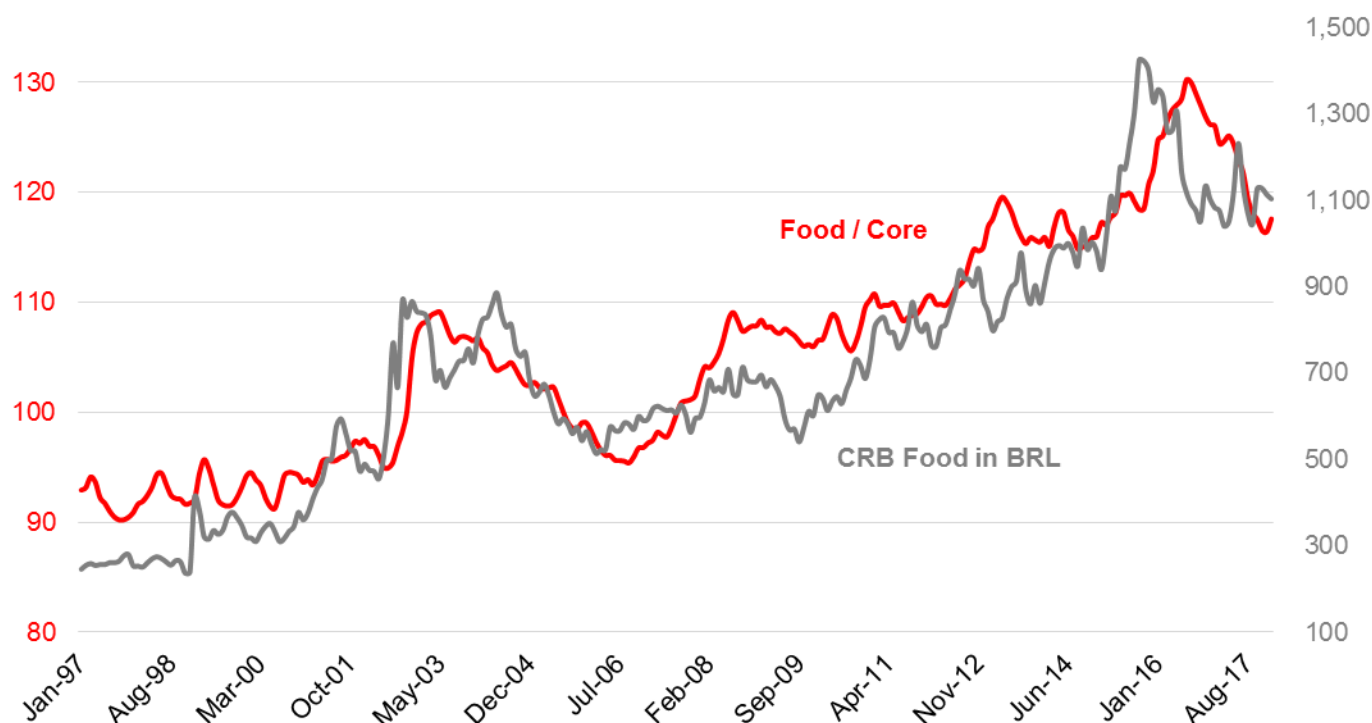
In our March 7, 2018 report, *Food (Inflation) for Thought: Relative Prices*, we offer an analysis of food prices relative to "core" prices in Brazil's main consumer price index. We show that relative food prices are highly correlated with the CRB Food index in BRL (see the Chart of the Week below) and that currently there is no significant divergence between the two measures, suggesting that there is no repressed adjustment to be unloaded. Food inflation is highly seasonal, concentrated in the first and fourth quarters of the year, in Brazil, and low readings so far this year (probably only 0.2% between January and March) should, in our view, continue to drag down inflation expectations.

Chart of the Week: CRB Food Strongly Associated with Relative Food Prices

Over the last 20 years, food prices in Brazil relative to CPI core components (excluding food and regulated prices from the consumption basket) have been following closely international food prices converted to BRL, as measured by the CRB Food index. (See the previous section.)



Brazil—Food/Core Relative Prices (Jan '96 = 100) vs. CRB Food in BRL (Jan '67 = 100)



Sources: IBGE, Bloomberg, Santander.

Political Agenda: A New Presidential Poll

A new presidential election poll (by MDA Pesquisa) was released this week, showing no major changes relative to the latest Datafolha poll (from January 31). Main points, in our view, all suggest a very open race so far:

- In first round scenarios that don't include former president Lula (who has 33% of total votes in the only simulation he was included), the sum of the shares of undecided voters and voters who would vote blank or null jumps from 25% to something between 39% and 42%, which means that about half of the electors that would like to vote for Lula still did not decide for another candidate.
- Jair Bolsonaro leads in all scenarios that don't include Lula, with a minimum of 20% of total votes. Marina Silva is the runner-up in all such scenarios, polling between 13% and 14%. PSDB's Geraldo Alckmin comes third when included, with around 9%.
- In the only scenario he was included, President Michel Temer has 1.3% vote intention, less than former president Fernando Collor (2.1%).
- Run-off simulations without Lula have a very high share of undecided/blank or null votes, none less than 36%. Bolsonaro has a tight lead (less than three percentage points) over both Alckmin and Marina. Marina would beat Alckmin by less than two percentage points.
- In terms of rejection rates (share of people who would not vote to the candidate under any circumstance), Michel Temer has 88%, whereas Alckmin and Bolsonaro have very similar rates (50.7% and 50.4%, respectively). Marina is rejected by 54% of those polled.

Until April 7, the window for seating representatives to change parties freely remains open, so the negotiations and announcements should continue to dominate the legislative agenda, in our view.



Number of the Week

1/3

Almost one-third of the income of Brazil's judges and public prosecutors is exempt from income tax, mainly because of housing stipends and other bonuses (data from the Revenue Service). A Supreme Court vote, scheduled for March 22, should decide on the legality of housing stipends for federal judges.

Quote of the Week

[Protectionism] is something negative to everyone involved, including to the American industry and consumer, since inputs get more expensive.

Finance Minister Henrique Meirelles, quoted by *Valor* newspaper online.

What We've Been Reading

- *Fear Not, Says Brazilian Candidate Aiming to Tax the Rich*, by Bruce Douglas (Bloomberg). An interview with presidential precandidate Ciro Gomes.
- "Emerging Markets Under Pressure as Debt Mounts," by Jonathan Wheatley (*Financial Times*). Most emerging countries increased leverage significantly, especially in local currency, after the global financial crisis. Monetary policy in the developed world turning hawkish might spoil the party.
- *Brazil's Federal Intervention in Rio's Drug Wars Has an Authoritarian Feel—and Could Backfire*, by Benjamin Lessing (Monkey Cage). A University of Chicago professor compares the intervention in Rio with the battle declared by Felipe Calderón on Mexican cartels in 2006, and argues that such demonstrations of "abnormal politics" may end up eroding democracy.
- *The Convergence in Emerging Market Inflation*, by Kevin Daly and Loughlan O'Doherty (VoxEU). According to the authors, increased monetary policy credibility and improvements in emerging countries' balance sheets are behind the convergence in inflation rates since the 1990s.
- *Emprego e Crescimento: a Agenda da Produtividade* (World Bank). A comprehensive assessment of Brazil's (lack of) economic productivity. So far only available in Portuguese.
- "36 Hours in São Paulo," by Seth Kugel (*The New York Times*). Nice and up-to-date tips for the accidental tourist in Brazil's main financial center.

Recent Publications (Available on Our Website)

- *Food (Inflation) for Thought: Relative Prices* (March 7, 2018)
- *One-Off Is Not Enough* (February 20, 2018)
- *Even Better Than the Real Thing* (February 15, 2018)
- *Social Security Reform: Same Proposal. Different Probability?* (February 8, 2018)
- *Why Has the BRL Weakened in 2017?* (January 8, 2018)



LATAM ECONOMICS

BRAZIL

ECONOMICS

Food (Inflation) for Thought (2): Forecasts

Maurício Molan*

+5511 3012 5724

mmolan@santander.com.br

- We recently discussed the importance of commodities prices (denominated in BRL) to the dynamic of food-to-core relative prices: *Food (Inflation) for Thought: Relative Prices*, March 7, 2018.
- One important conclusion is that the recent performance of the CRB Food index, measured in BRL, suggests food inflation will likely be close to core inflation in the short term.
- In this report, we summarize the outcome of our econometric models aimed at estimating the future path of the food-to-core ratio based on a set of hypotheses for the evolution of specific commodities prices, as well as for the BRL.
- In our view, the food deflation experienced since 2017 has been mostly related to drastic price reductions in important commodities such as soybeans (-4.8%), corn (-15.4%), sugar (-23%), orange juice (-28%), coffee (-12%), cocoa (-16%) and beans (-27%).
- We expect most of those prices to recover some ground in 2018 due to still-strong demand worldwide, as well as adverse weather at the beginning of the year in the U.S. and Argentina.
- The following chart and table illustrate expected dynamics for the prices of specific commodities, as well as the impact on our forecast for relative prices.
- Although it may be tempting to extrapolate the first quarter's very low food inflation (likely around 0.2%) to the following periods, we believe it may be more helpful to focus on the expected evolution of fundamentals.
- We forecast non-negligible price increases of corn, wheat and beans, as well as moderate (but still positive) variations for soybeans, sugar and coffee. This would likely lead to food inflation at around 4% in 2018.
- Our forecast for the IPCA in 2018 is 3.5%, in spite of ongoing favorable readings for food inflation.

Figure 1. Relative Prices (Food / Core) and Model Outputs

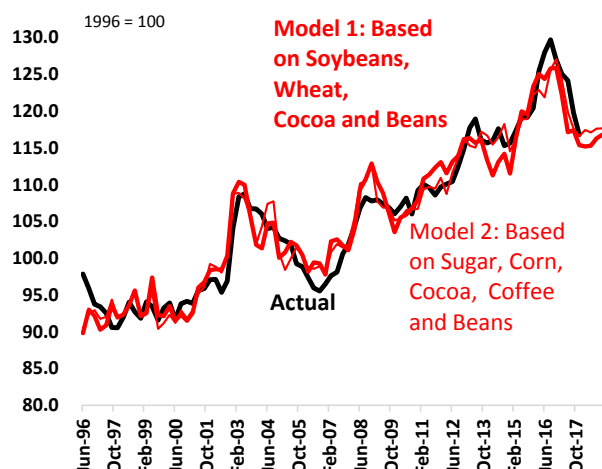


Figure 2. Hypotheses for Main Variables and Model Output

		2016	2017	2018	17/16	18/17
International Prices						
Cocoa	(US\$ per tonn NY)	2,263	1,906	2,100	-15.8%	10.2%
Coffee	(ICE US\$ per lb)	139	122	133	-11.9%	9.1%
Corn	(CBOT US\$ per bushel)	3.50	3.45	4.15	-1.5%	20.4%
Soybeans	(CBOT US\$ per bushel)	10.21	9.72	10.50	-4.8%	8.0%
Sugar	(ICE, US\$ per lb)	19	14	15	-23.4%	4.0%
Wheat	(CBOT USD per bushel)	3.97	4.11	4.75	3.4%	15.6%
Local Prices						
Corn	(BRL / Bag 60kg)	38	32	39	-15.4%	20.0%
Beans	(BRL / Bag 60kg)	153	112	123	-27.0%	10.0%
Output						
Food / Core	Model 1					1.3%
Food / Core	Model 2					1.0%
Food Inflation	Model 1					4.4%
Food Inflation	Model 2					4.0%

Sources: IBGE, Bloomberg and Santander.



The Models

We used two different models to estimate the relative value between food and core prices. The main difference is that the first model includes, as exogenous variables, the international prices of soybeans and wheat, while the second model is based on sugar, corn and coffee. Both models consider the prices of cocoa measured in USD and the BRL; the prices of beans negotiated locally; and the U.S. real exchange rate (USD vis-a-vis a basket of currencies, estimated by the Federal Reserve of St. Louis).

Another important feature of our models is that we used quarterly averages for exogenous variables, with lags of one period. This means that the evolution of food prices for consumers in future quarters depends mostly on readings from the previous quarter.

The Hypothesis

In our previous publication (*Food [Inflation] for Thought: Relative Prices*, March 7, 2018), we discussed the recent performance of food prices, which have returned to negative territory after a moderate recovery at the end of last year and in January 2018. **Although it may be tempting to extrapolate the first quarter's very low food inflation (likely around 0.2%) to the following periods, we believe it may be more helpful to focus on the expected evolution of fundamentals.**

On this issue, it is worthwhile highlighting the following:

- 1) Demand for commodities, in general, is expected to remain strong as global growth continues to accelerate, while supply will likely not be as favorable due to adverse weather in the U.S. and Argentina at the beginning of this year, which may have an impact on the supply of corn and soybeans.
- 2) Prices for the vast majority of agricultural commodities are currently below their five-year moving averages, toward which they tend to converge.
- 3) Specifically in Brazil, the collapse of bean and corn prices last year will lead to smaller harvests in 2018.
- 4) It is already possible to observe delays in corn seeding for the midyear harvest and price increases locally (see Figure 3).
- 5) As for beans, in spite of significant volatility, prices tend to converge toward the mean (Figure 4), which implies stable to positive variations expected for 2018.

Figure 3. Corn Prices (CBOT in USD / Buschel and Esalque BMF Bovespa USD / Bag 60 kg)

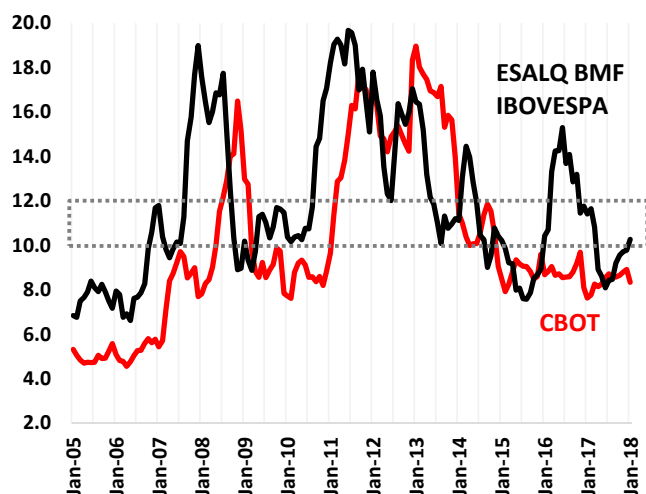
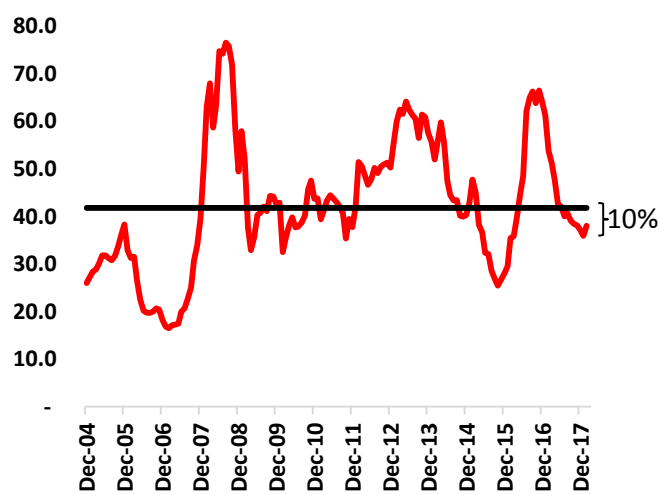


Figure 4. Bean Prices (Locally, USD / Bag 60 kg)



Sources: IPEA, Agrolink, ESALQ (BMF Bovespa) and CBOT.

Conclusion

We see the fundamentals for the main commodities that usually drive Brazilian food prices as biased toward an increase in 2018. Our forecasts for each of them and the translation of those projections into an outlook for food inflation in Brazil are summarized in Figures 1 and 2 (previous page).

We forecast non-negligible price increases for corn, cocoa, wheat and beans, as well as moderate (but still positive) variations for soybeans, sugar and coffee. This would likely lead to food inflation at around 4% in 2018.



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More Evidence of a Tight Labor Market

Grzegorz Ogonek*

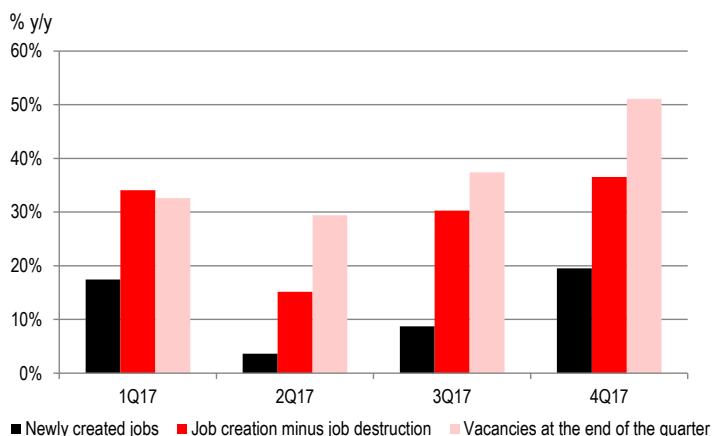
+4822-534-1923

grzegorz.ogonek@bzwbk.pl

The Stats Office released its quarterly report on labor demand, which showed that the problem of labor shortages grew in 4Q17 and that demand for labor continued to increase. The number of unfilled vacancies in 4Q17 was 117.8k, 51.5% higher than in 4Q16. In 3Q17, the growth rate was 37.4% and in 2Q17 it was 29.4%. Among the new job postings in 4Q17, 17.1% remained unfilled at the end of the quarter, similar to 3Q, but higher than in 2Q (15%) and 1Q (12.1%). Job-creation-minus-job-destruction metrics showed a net increase of 80.8k in 4Q, which translated to +36.5% y/y, compared to +30.2% in 3Q and +15.2% in 2Q.

We expect this environment to promote the acceleration of wage growth in the private sector from the current +7.3% y/y to approximately +10% toward the end of the year.

Labor Market Statistics



Source: Poland Central Statistics Office, BZ WBK.



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The Inflation Week

Grzegorz Ogonek*

+4822-534-1923

grzegorz.ogonek@bzwbk.pl

This week will be mostly about inflation, with data for February released in Poland, the U.S. and the euro zone. On Monday, we will also get the NBP inflation projection up to 2020.

Poland's February CPI will be calculated using new weightings and the January reading will be revised. This will allow for extraction of core inflation for both months. Our estimates indicate that the CPI basket revision could marginally increase inflation, mostly at the start of the year (by +0.045 pp), but that the effect will be too weak to change the trajectory.

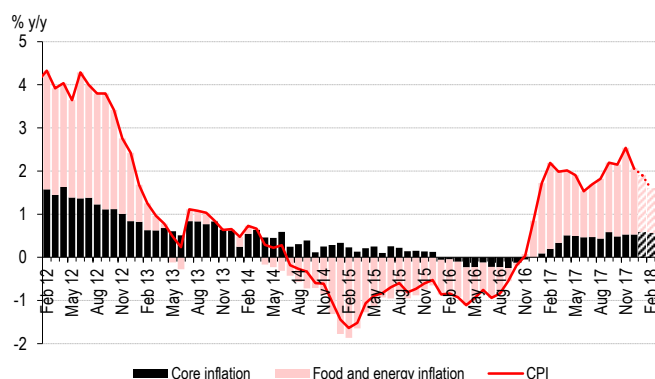
We forecast CPI declining in February from 1.9% y/y to 1.6%, supporting the MPC's rhetoric that there is no reason to consider rate hikes in the foreseeable future. Core inflation could go in the opposite direction, from 0.9% y/y to 1% in February and increasing to c2% at the end of the year.

The inflation report will provide details on the macroeconomic scenario envisaged by the NBP staff supporting the MPC. **We already know that the central CPI path has been lowered** from 2.25% y/y to 2.05% for 2018, and from 2.7% to 2.65% for 2019. 2020 was covered for the first time, projected at 3% – not far enough from the 2.5% target to cause concern for the MPC, as the statement and the press conference have shown.

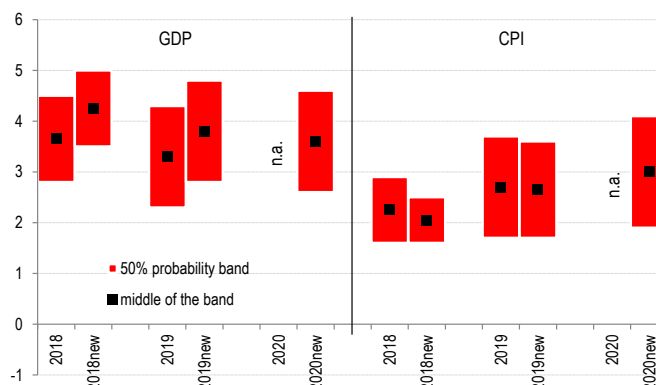
Labor market data are likely to confirm the solid growth of employment (+3.8% y/y) and a further acceleration of wages (to +7.5% y/y from +7.3%) – as the **labor shortages continue to affect Polish companies**.

C/A data for January will be a strong finale at the end of the week. We expect a high surplus of cEUR2.4bn thanks to a substantial improvement in export growth (accelerating from +2.1% y/y to +13% and restoring a trade balance surplus) and sizeable inflows of EU money. This would be the second-highest monthly C/A balance since at least 1990.

Breakdown of annual CPI growth



Update of NBP projections: Nov. 2017 vs. Mar. 2018, 50% probability bands and central path



Sources: Poland Central Statistics Office, NBP, BZ WBK.



CONTACTS / IMPORTANT DISCLOSURES

Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.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	diana.ayala@santander.us	212-350-0979
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537

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
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
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

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