Strictly Macro

Improving External Conditions, Less So at Home

July 13, 2017

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Benign external conditions mask growth underperformance

When we wrote our annual report in December 2016, uncertainties over a possible shift to a more protectionist landscape in developed markets and tightening financial conditions, mainly in the U.S., were looming over the horizon and threatening LatAm economies, particularly Mexico. However, many of these concerns did not materialize; on the contrary, external conditions, in terms of both growth and financial conditions, have proved more benign than expected. Parliamentary elections in the Netherlands in 1Q17 and presidential elections in France in 2Q17 helped contain the fear that protectionism was spreading across Europe. On the financial conditions side, the decline in U.S. rates and in the U.S. dollar – after the expectations for reflationary policies from the new U.S. administration were tempered somewhat – has led to an easing in financial conditions in the U.S. that has crossed borders into LatAm.

Between December and the end of June, financial conditions have been easing and moving into expansive territory, more remarkably in the U.S. and the U.K., as evidenced by Bloomberg's financial conditions indices (chart on page 2). While still on the tight side in Europe, they have been improving in the last few months. The flattening in U.S. rates coupled with a 6.3% depreciation of the U.S. dollar in multilateral terms has translated into stronger currencies in EM and LatAm (with the exceptions of the ARS, BRL, and COP) and lower rates both in local and foreign currency throughout Latin America. In terms of local rates, the median performance of major LatAm local bond markets is +7% YTD vs. +5% in the broad EM local bond benchmark. This outperformance of local rates markets is due in many cases to an idiosyncratic worsening of the local growth outlook in the countries under our coverage, which we will discuss later. This worsening has allowed expectations of monetary policy accommodation to be maintained and increased in some cases. On the external side, the improvement in external conditions has also been accompanied by a widespread reduction in the risk premium across LatAm external bond markets as evidenced by the movement in 5yr CDS in 1H17. Mexico has seen the largest compression in risk premium after the 28% reduction in its 5yr CDS, while Argentina, Chile, and Peru saw a reduction that was slightly higher than 20%. The recent developments on the political side prevented Brazil from seeing a similar risk-premium reduction, but still 5yr CDS compressed 14% throughout 1H17.

In developed markets, the aforementioned benign scenario has translated into an improving GDP outlook, while in LatAm – with the exceptions of Mexico and Uruguay – that has not been the case. As a consequence, growth forecasts have been revised to the downside. Since December last year, GDP forecasts for 2017 have consistently improved in the Eurozone and Japan, as evidenced by the 0.3-pp and 0.4-pp upward revisions in their forecasts to 1.7% and 1.2%. In the case of the U.S., the 2017 GDP forecast trajectory has been less steady, with consensus growth for this year moving from 2.1% in December 2016 to 2.3% in March 2017 before edging downward to 2.2% in June. All in all, with a 0.1-pp upward revision in Chinese growth between December and June to 6.5%, prospects for global growth inched

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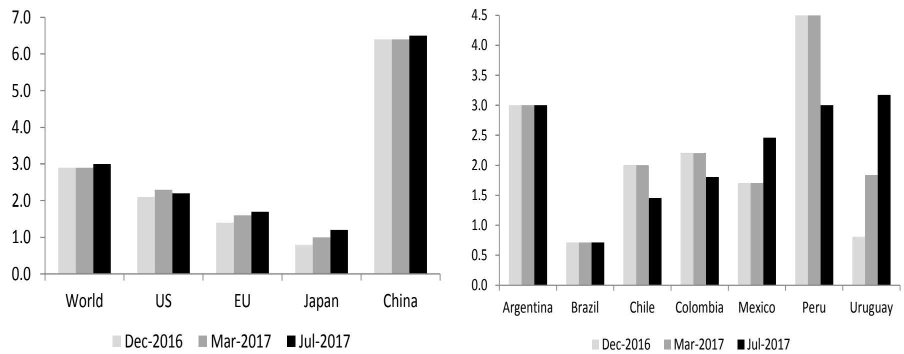
upward by 0.1 pp to 3.0% during 1H17. However, when we turn to LatAm – with the exceptions of Mexico and Uruguay – the picture is less positive.

Growth outlook: better abroad than at home



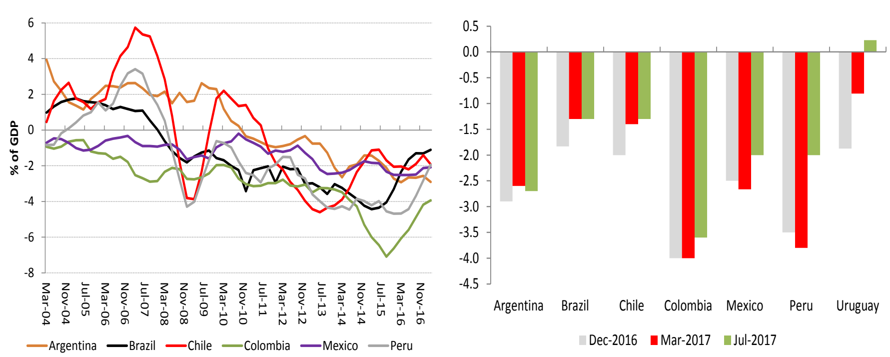
Evolution of 2017 GDP growth by country/region. Sources: Focus Economics and Santander.

The good and the bad: low-growth environment but better external resiliency

In terms of the growth dynamics, high-frequency activity indicators support the idea of an economic deceleration in Latin America at the aggregate level. When the standard deviation of growth rates (in annual terms) is observed through time, there is a sharp and clear reduction in growth variance after 1Q16 and aggregate measures of growth (median average and GDP-weighted, which diverged significantly during the Brazilian recession) both show convergence to a median 0.0-0.5% growth in 1H17, suggesting that economies are losing steam. While the individual factors behind the deceleration differ, the breakdown of GDP components shows, with the exception of Mexico and Uruguay, a consistently low and weak contribution of domestic demand to GDP growth. This, coupled with confidence levels that are below historical norms across countries, supports the argument that the causes of the activity deceleration come from the domestic environment and not from abroad.

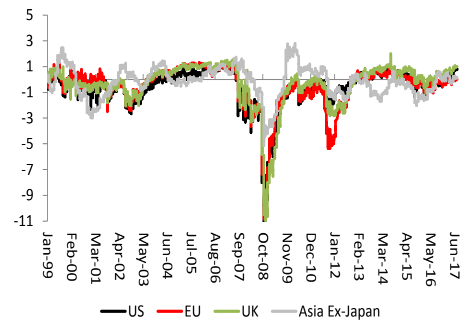
On the external front, the better picture in global financial conditions alongside improved growth prospects for DM and China have been consistent with either an improvement or maintenance of the status quo of terms of trade in the region. A GDP-weighted measure for LatAm's terms of trade (including Argentina, Brazil, Chile, Colombia, Mexico, and Peru) showed a 12.8% YoY advance in 1Q17, up from 8.3% in 4Q16 and 4.3% in 3Q16. The combination of weak domestic demand (more on this below) with a resilient external sector has led to an across-the-board improvement in current account balances, not only in levels but also in expected trajectories (see chart below). The synchronized improvement in the external balances since the beginning of 2016 has led to a reduction in LatAm's median CA deficit of almost 1 pp to 2.0% of GDP, something that has undoubtedly helped shield the region from a weak growth outlook and the forthcoming normalization in developed markets' monetary policy on asset prices.

Current account dynamics: building resiliency for the times ahead



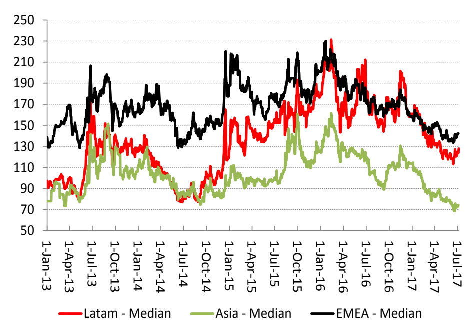
Left-hand chart shows the CA balance as % of GDP. Right-hand chart shows the evolution of CA balance (% of GDP) for 2017. Sources: Bloomberg and Santander.

Improving financial conditions (1): Developed markets



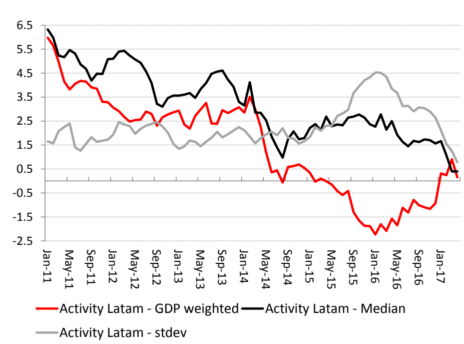
Financial conditions indices. Sources: Bloomberg and Santander.

Improving financial conditions (2): Lower risk premiums



Median of 5yr CDS by region. Sources: Bloomberg and Santander.

Synchronized activity deceleration



Activity Latam – GDP weighted is the GDP weighted of monthly economic activity indicators. Activity Latam – stdev is the standard deviation of annual growth rates per country. Sources: Bloomberg, central banks, and Santander.

Reducing external vulnerabilities but going uphill in terms of activity

While growth and external accounts at the aggregate level are telling a fairly consistent story, the landscape in each country shows important differentiation.

In **Argentina**, the economic recovery has been a bit slower than expected, having been held back by the impact of the macroeconomic rebalancing, political uncertainty, and the economic and political crisis in Brazil. While we keep our 2017 GDP growth forecast unchanged at 3% y/y, we have lowered our 2018 growth forecast from 4.5% y/y to 3.5%. Monetary policy should be a bit tighter than initially expected, in our view, as inflation continues to run above target. With October's mid-term elections a main concern of investors, we expect a rebound in growth in 2H 17 to come just in time to help support official candidates. In neighboring **Uruguay,** the near-term growth outlook has improved, and our team has revised upward their 2017 GDP estimate to 3.2% y/y from 2.0% previously.

Brazil has seen its fair share of local political volatility this year, but our team believes the main negative impact will be on the fiscal side, as they keep their growth, inflation, and monetary policy forecasts for 2017 either unchanged or with signs of improvement. However, even though high expected real rates provide a cushion, our local team believes that it is time to brace for a period of heightened political uncertainty going into the 2018 presidential election.

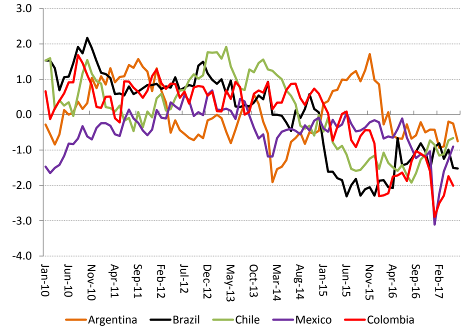
In **Chile,** there was a clear deceleration in 1Q17, with growth of only 0.1% y/y. Copper production declines are largely to blame, but subdued core price inflation suggests that there is a risk of a continuation of a more broad-based deceleration, in our view. We downgrade our 2017 growth forecast from 2.0% y/y to 1.5% and take down 2017 from 2.7% y/y to 2.2%. Thus, we perceive downside risks to our monetary policy forecast of rates on hold at 2.50% for the remainder of the 2017. In addition, in this report our local team dissects the outlook for this year's election as well as examining the risks and challenges facing whomever is elected.

In **Colombia**, the first quarter started off with a capitulation in consumer sentiment, with the consumer confidence index falling to its worst level in history on the back of higher taxes, an unpopular administration, and the accumulated effect of a third year of economic deceleration. While the outlook is challenging, financing conditions have thus far remained accommodative, and the COP has not been overly punished. BanRep has reacted to the deterioration in growth and cut rates aggressively even though inflation is expected to end the year above target for the third year in a row. We see BanRep going on hold in 2H17 in hopes of being able to cut rates more deeply in 2018 and achieve a stimulative real policy rate.

In **Mexico**, our economics team is upgrading their growth outlook on the back of resilient household consumption and better than expected export performance. Households have been able to weather the negative impact on real income from higher inflation, as labor demand and remittances remain firm. All in all, they have upgraded 2017 GDP to 2.5% y/y from 1.7% previously and 2018 to 2.7% y/y from 2.2% previously. They see Banxico on hold at 7% for the rest of 2017 and providing 50 bps of cuts in 2018. Our economists also expect that both energy reform and NAFTA renegotiations will gain steam in 2H17, as the current administration attempts to shield the country from a possible left-of-center AMLO administration.

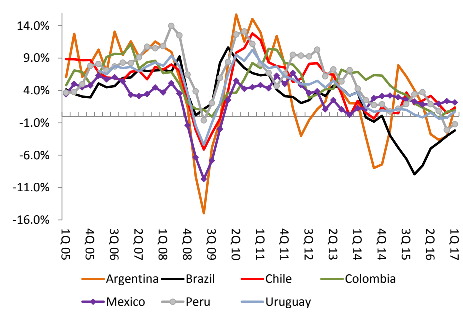
Peru also shared in a deceleration driven by local factors, with heightened political noise, strong weather distortions, and reduced public sector investment pulling down growth in spite of strong export performance. We see asymmetric risks to economic activity and reduce our 2017 GDP growth estimate to 3.0% from 4.5% y/y. Despite these local plot twists, a favorable global economic environment should keep the impact to a minimum, in our view, and with the help of a weaker PEN, we see growth improving to 4% in 2018.

A matter of trust: (lack of) consumer confidence



Z-score of consumer confidence indices. Sources: Adimark, FGV, Fedesarrollo, Inegi, UTDT and Santander.

Domestic demand: contribution to GDP growth



Sources: Central banks, National Statistics Offices, and Santander.

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FORECAST SUMMARY TABLES

KEY MACRO INDICATORS

GDP growth	2015	2016	1Q17	2Q17	3Q17	4Q17	2017F	2018F	Last Review '17	Nom GDP '17
Argentina	**2.6**	**-2.3**	0.3	2.7	5.0	3.7	**3.0**	**3.5**	Down	616
Brazil	**-3.8**	**-3.6**	-0.4	0.2	1.0	2.1	**0.7**	**3.0**	Down	2,011
Chile	**2.0**	**1.6**	0.1	1.0	2.1	2.6	**1.5**	**2.2**	Down	262
Colombia	**3.1**	**2.0**	1.1	1.4	2.3	2.2	**1.8**	**2.6**	Down	290
Mexico	**2.6**	**2.3**	2.8	1.2	2.6	3.2	**2.5**	**2.7**	Up	1,146
Peru	**3.0**	**3.9**	2.1	2.0	3.5	4.0	**3.0**	**4.0**	Down	205
Uruguay	**0.4**	**1.5**	4.3	0.7	4.6	3.3	**3.2**	**3.0**	Up	61
LatAm-7	-0.2	-0.9	0.8	1.0	2.3	2.7	**1.7**	**3.0**		

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

GDP Components	Priv Cons '15	Priv Cons '16	Priv Cons '17	Pub Cons '15	Pub Cons '16	Pub Cons '17	Investment '15	Investment '16	Investment '17	Exports '15	Exports '16	Exports '17	Imports '15	Imports '16	Imports '17
Argentina	3.5	-1.4	2.2	6.8	0.3	2.7	3.8	-5.5	7.7	-0.6	3.7	6.5	5.7	5.4	9.2
Brazil	-3.9	-4.2	0.3	-1.0	-0.6	-0.6	-13.9	-10.2	1.3	6.4	1.9	3.4	-13.9	-10.3	5.0
Chile	2.0	2.4	2.1	4.5	5.1	4.6	-0.8	-0.8	-0.9	-1.8	-0.1	0.7	-2.7	-1.6	3.5
Colombia	4.0	2.1	1.6	2.8	1.9	2.2	2.8	-4.5	0.5	-0.6	-0.9	2.0	4.0	-6.1	0.0
Mexico	2.3	2.7	2.4	2.3	1.2	0.5	4.3	0.1	1.0	10.4	1.2	7.6	8.6	1.1	5.3
Peru	3.4	3.4	3.0	9.8	-0.5	-5.0	-0.7	-4.5	-1.0	3.5	9.4	6.0	2.5	-2.2	-1.5
Uruguay	-0.5	0.7	2.6	2.2	1.6	1.7	-9.0	0.7	2.2	-0.6	-1.4	4.2	-7.3	-2.9	2.0
LatAm-7	-0.1	-0.9	1.4	1.9	0.5	0.4	-4.6	-5.7	1.8	5.3	2.0	4.7	-3.0	-4.1	4.9

Annual changes in %. na: Not available. Sources: National central banks, finance ministries, and Santander.

Inflation	Headline CPI (YoY)							Core measure		
	2015*	2016*	Jul-17F	Aug-17F	Sep-17F	2017F*	2018F*	2016F	2017F	2018F
Argentina	**26.9**	**37.7**	21.3	22.9	23.2	**22.0**	**15.0**	**32.1**	**18.6**	**13.9**
Brazil	**10.7**	**6.3**	2.8	2.7	3.1	**4.2**	**4.2**	**6.2**	**4.2**	**4.2**
Chile	**4.4**	**3.0**	1.9	2.1	2.3	**2.7**	**3.0**	**2.8**	**2.5**	**2.8**
Colombia	**6.8**	**5.8**	3.8	4.2	4.4	**4.3**	**3.4**	**5.1**	**4.7**	**3.5**
Mexico	**2.4**	**3.3**	6.7	6.2	5.9	**5.6**	**3.8**	**3.4**	**4.9**	**3.8**
Peru	**4.4**	**3.2**	3.0	2.9	2.9	**2.8**	**2.5**	**3.0**	**2.5**	**2.5**
Uruguay	**9.4**	**8.1**	5.9	5.9	6.1	**6.6**	**7.2**	**8.2**	**6.8**	**7.2**
LatAm-7	**9.9**	**9.4**	**6.3**	**6.4**	**6.6**	**6.8**	**5.4**	**8.6**	**6.2**	**5.2**

*Year-end levels, YoY. Core measure as per national definitions. Santander estimates denoted by F. Sources: National central banks, finance ministries, and Santander.

Macro Miscellanea			ARS	BRL	CLP	COP	MXN	PEN	UYU
Fiscal balance	% of GDP	2016	-5.9	-10.3	-2.7	-3.9	-2.6	-2.1	-3.9
		2017F	-6.2	-8.9	-3.0	-3.7	-1.3	-3.0	-3.4
		2018F	-5.2	-6.7	-2.7	-3.1	-2.0	-2.8	-3.2
Public debt	% of GDP	2016	26.0	36.0	9.9	44.0	50.2	23.3	30.8
(Net terms in ARS, BRL, CLP)		2017F	27.0	45.9	12.0	43.0	48.0	27.0	23.9
		2018F	29.3	50.0	13.6	44.0	48.0	26.5	22.5
Current account	% of GDP	2016	-2.6	-3.3	-1.4	-4.5	-2.1	-4.4	-0.2
		2017F	-2.7	-1.3	-1.3	-3.6	-2.0	-2.0	0.2
		2018F	-2.8	-1.8	-1.9	-3.1	-2.0	-2.5	-0.2
Trade balance	US$ bn	2016	2.1	17.7	3.5	-10.0	-13.1	-1.6	0.3
		2017F	-3.6	47.7	4.9	-7.5	-12.0	0.5	0.3
		2018F	-4.5	40.7	6.0	-5.7	-11.1	0.2	0.1
External debt	% of GDP	2016	7.6	9.0	6.5	9.2	3.7	6.7	7.8
(Total public and private)		2017F	7.2	12.3	6.8	9.6	3.4	7.5	7.9
		2018F	6.8	10.9	6.5	10.0	3.4	6.0	7.9
Unemployment	% of workforce	2016	-5.9	-10.3	-2.7	-3.9	-2.6	-2.1	-3.9
		2017F	-6.2	-8.9	-3.0	-3.7	-1.3	-3.0	-3.4
		2018F	-5.2	-6.7	-2.7	-3.1	-2.0	-2.8	-3.2

Source: Santander.

MONETARY POLICY MONITOR

	Current	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
ARGENTINA	26.25	24.50	23.00	20.75	18.75	16.50	14.25
		-175	-150	-225	-200	-225	-225
BRAZIL	10.25	9.00	8.50	8.50	8.50	8.50	8.50
		-125	-50	0	0	0	0
CHILE	2.50	2.50	2.50	2.50	2.75	3.00	3.00
		0	0	0	25	25	0
COLOMBIA	5.75	5.25	5.25	5.25	5.00	4.75	4.75
		-50	0	0	-25	-25	0
MEXICO	7.00	7.00	7.00	7.00	6.75	6.50	6.50
		0	0	0	-25	-25	0
PERU	4.00	4.00	3.50	3.50	3.50	3.50	3.50
		0	-50	0	0	0	0

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

- **<u>Easing in Argentina, Brazil and Colombia</u>: With 350 bps worth of cuts in 1H17, we expect BCB to deliver an extra dose of 125 bps in 3Q17 and 4Q17 before ending the easing cycle with a terminal Selic rate of 8.5%. After the unexpected hike of 150 bps in April and with regulated inflation cooling down, the BCRA should resume its cutting cycle in 3Q17 and send the policy rate to 23% this year. In Colombia, Banrep continued delivering some surprises along the road, and, after another 50 bps in cuts likely to be delivered in 3Q17, we would expect the board to reassess the inflationary outlook before embarking on the next leg of the easing cycle.**
- **<u>Staying put in Mexico and Chile (for now)</u>: The (400-bp) hiking cycle in Mexico has come to an end, in our view. With inflation likely to peak in 3Q17 and long-term expectations being anchored, we think Banxico should feel comfortable staying put until 1H18 before delivering 50 bps of cuts in 2018. Soft activity and inflation surprising to the downside could favor another cut from the monetary authority in Chile. However, our base case is that the cycle has come to an end and that we can expect 50 bps of hikes in 2018.**

FOREIGN EXCHANGE RATES

	BRL	MXN	CLP	COP	ARS	PEN	UYU
Jun-17	3.32	18.12	665	3000	16.63	3.25	28.30
Sep-17	3.41	18.06	675	3000	17.37	3.26	29.10
Dec-17	3.50	17.70	670	3200	17.70	3.27	29.50
Mar-18	3.63	18.00	640	3300	18.25	3.40	30.22
Jun-18	3.72	18.90	650	3400	18.81	3.48	30.96
Sep-18	3.80	18.50	665	3300	19.40	3.57	31.72
Dec-18	3.84	18.00	675	3200	20.00	3.67	32.50

End-of-period levels. Sources: Bloomberg and Santander.

- **LatAm FX – with the exception of the Mexican peso – has been under pressure in 2Q17. Developed markets' talks on policy normalization could translate into further pressure in the short term, but if the U.S. dollar manages to stay range-bound, we believe the weakening of LatAm FX should be more contained. Across the region we see further weakening (except in Mexico).**
- **The BRL has been affected by political developments, and we believe markets will continue to follow those closely, as well as the outlook for reforms. As we are cautious on both prospects, we see the BRL moving toward USD/BRL 3.5 by year-end. The improvement in fundamentals and the reduction in the risk premium should continue to build resiliency in the MXN, in our view, and we have an out-of-consensus call for a peso trading at USD/MXN 17.70 by year-end.**
- **Oil prices edging downward have proved to be a factor pressuring the COP, which is not expensive by historical standards but still has a lot of work to do on closing the current account. We see the COP reaching 3200 by year-end. The adjustment in the ARS is a positive event given an overvalued currency but the speed of the depreciation could threaten the inflation outlook, as the BCRA is battling to control inflation. In the CLP and PEN space, we see stability throughout 2H17.**

ARGENTINA

MOUNTING UNCERTAINTY AND HIGHER VOLATILITY AHEAD OF KEY MID-TERM ELECTIONS

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- **Growth continues gaining strength slowly, propelled by agriculture and public works, although we think the recovery looks weaker and more heterogeneous than previously thought.**
- **With still higher than expected inflation readings and inflation expectations well above the target, we anticipate more cautious policy rate-cutting going forward.**
- **With the candidates chosen, the campaign for the October mid-terms has already begun, which will likely translate into higher volatility in the exchange rate, in our view.**

Economic activity

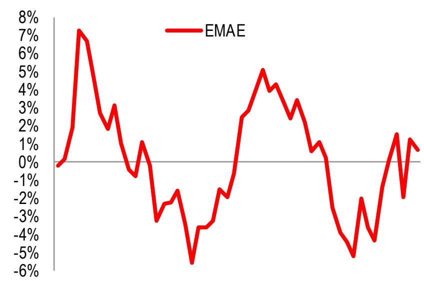
Since the beginning of 2017, the government has been increasingly stimulating public works growth, which we expected to be one of the key drivers throughout the year. Between January and May, asphalt sales (closely related to road and street construction) have shot up, expanding 80% vs. the same period in 2016. Meanwhile, cement consumption grew 12.4% y/y in March-May. This is translating into accelerating activity for construction, which was one of the hardest-hit sectors last year (-11%). In the coming months we expect activity to continue gathering pace as we approach the mid-term elections, propelling investment expenditures. As mentioned in previous issues of *Strictly Macro*, agriculture (the sector that most benefits from tax reductions) and some related sectors (such as transport) are spearheading the GDP pickup. Agriculture and transport expanded 4.3% y/y and 3.7% y/y in 1Q17. Also, most services sectors (with the exception of commerce and hotels) are expanding at the margin (+0.3% m/m sa in the last three months to April). Industry has been the lagging sector, although it is showing signs of recovery of late. In May it posted the first annual growth (+2.7% y/y) since January 2016, suggesting that the sector may finally be starting to recover. Nevertheless, this recovery is one of the weakest of the period following the global financial crisis. Through April, the annualized rate of GDP expansion stood at 3.2%, below the 5% average observed in other post-recessionary periods. This is related to three main factors: the macroeconomic rebalancing's impact on activity, investors' uncertainty on the political front (with crucial mid-term elections approaching), and the noise from Brazil (main trading partner), whose slow pickup is weighing on local growth, mostly in the industrial sector.

The economic activity recovery is also seen in fiscal numbers. Since April, VAT collection has been expanding in real terms (+6.9% y/y on average in 2Q17), which is a sign of overall consumption growth. In June total tax collection expanded 30.5% y/y, above inflation (around 23% y/y), which is starting to help fiscal consolidation (i.e., primary deficit reduction) by means of improving revenue in real terms. Also, the government has been working on expenses, substantially reducing economic subsidies (which expanded only 0.5% y/y in January-May), although other items such as pensions (+41.9% y/y) and social subsidies (+40.3% y/y) are still growing above inflation in the run-up to the mid-term elections.

Inflation and monetary policy

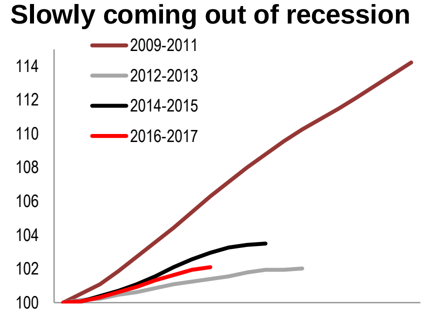
Inflation measures at the national level showed an acceleration starting in February, mostly as a result of utility rates adjustments taking place since that month. Our measure of national core inflation increased to 2.8% m/m in March, up from 1.4% m/m in December, before falling again to 1.7% in May. INDEC's core CPI (restricted to metropolitan Buenos Aires) peaked at 2.3% monthly in April, and has started to show a decelerating trend since then. The inflationary spike in February-April was higher than previously expected, which prompted the Central Bank to tighten, raising the seven-day repo rate to 26.25% p.a. from 24.75% p.a. in mid-April. The authorities acknowledged that the move to ease monetary policy (begun in November) was implemented too early. Also, while the June inflation print is expected to come in at 1.4% m/m (a tad above May's 1.3% m/m), in July more regulated price increases (fuels, health care) should add 0.25 pp to inflation, which we forecast at 1.6% m/m.

Volatile GDP growth



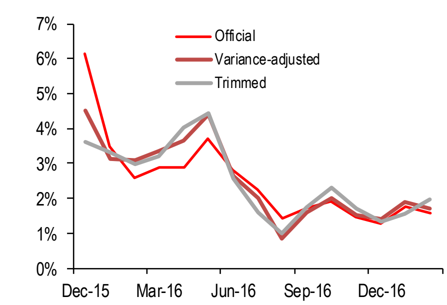
Notes: Economic Activity Monthly Estimator annual growth. Sources: INDEC and Santander.

Slowly coming out of recession



Notes: GDP trend after recessions. Sources: INDEC and Santander.

Core inflation, still above 1.5% m/m

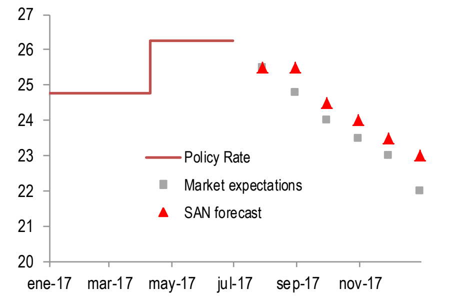


Notes: measures of monthly national core inflation. Sources: INDEC, Province of San Luis, Province of Cordoba, City of Buenos Aires, and Santander.

Inflation expectations for year-end 2017 (as measured by the Central Bank's poll of economic forecasters) stand at 21.6%, well above the current year's monetary authority maximum target (17%), which looks extremely challenging to meet, in our view. We believe the authorities may begin to set policy in order to accomplish next year's target (12% maximum), given the lag with which the monetary policy operates (from 9 months onward).

As a result, going forward we may see the Central Bank being more cautious in resuming the easing cycle. We believe the CB will likely wait until the signs of significantly lower inflation are well established. Also, we believe that the monetary authority has a wider scope to maintain a hawkish bias, given that economic activity is already gathering pace, which helps dampen criticism of the effect on GDP recovery of the stringent monetary stance. Although the repo rate market's expectations (as measured by the Central Bank poll of economic forecasters) for year-end stand at 22% for December, we expect the cutting pace to be slower, reaching 23% by then.

Cautious going forward

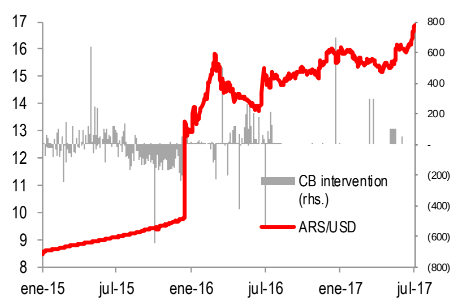


Notes: Average 7-day repo rate and expectations. Sources: Central Bank and Santander.

External sector and exchange rate

After a seemingly long period of subdued FX volatility (sporadically interrupted by exogenous shocks, the last being the latest political crisis in Brazil), the exchange rate has depreciated substantially of late, this time due to local factors. Between the end of May and July 5, the peso shed 6.7% as supply faded and demand built up (in part stimulated by uncertainty regarding the electoral process). Agricultural exporters' sales, the main source of non-financial hard currency supply, declined 34% in June's second fortnight to only USD 79 mn per day, probably, in our view, because exporters were waiting for better prices in order to resume selling. Although we were expecting stronger depreciative pressures on the exchange rate for 2H17, as most of the bond placements were already closed and U.S. dollar demand from imports began to increase (*pari passu* GDP pickup), the last move surprised market observers for its speed. Going forward, we maintain our expectation of mounting FX volatility (the ARS/USD quote should be highly influenced by election polls). Despite the recent FX surge, we are not changing our year-end forecast (currently at ARS/USD 17.70), which stands only a tad below the mean market expectations (ARS/USD 17.80).

Leaving the fear of floating behind

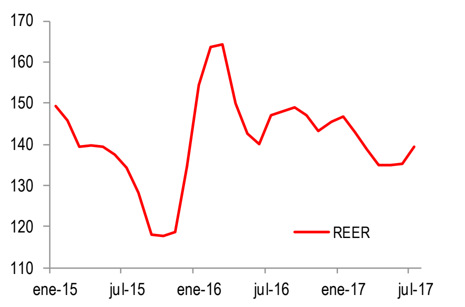


Notes: ARS/USD exchange rate and Central Bank intervention in FX market (USD million, rhs). Sources: Central Bank, Bloomberg, and Santander.

Politics

The upcoming mid-term elections in October are the most important event already influencing the economy. Some months ago, the governing coalition seemed, in our view, to be relying on an economic activity pickup and employment recovery as the main elements buttressing voter approval. However, as we noted above, GDP growth has taken longer to materialize, and although employment is expanding, it is just now reaching the levels of December 2015. We expect that as we approach the elections, activity growth will become stronger, which, together with lower inflation levels, should help build voters' support for the official candidates. However, that effect may turn out to be somewhat weak and come too late to significantly influence undecided voters, in our view. This may have affected the government's strategy, as its message has shifted from the positive effects of its economic policy toward topics centered in non-economic issues, such as transparency. We believe the fact that the powerful Peronist party is split into three main candidacies for these elections will help consolidate support for the official candidates. (Cristina Kirchner, leading the Unidad Ciudadana coalition, which is formally different from the traditional Peronist party, Florencio Randazzo, an ex-transport minister from the previous administration, and Sergio Massa of the Frente Renovador party are all competing for an upper house seat from the Province of Buenos Aires.) However, it is too early to draw conclusions, as there are still many weeks before the elections, and we lack polling data.

Stabilizing real exchange rate



Notes: REER. Base Dec 2001 = 100. Sources: Central Bank, INDEC, Bloomberg, and Santander.

The mandatory primary elections (scheduled for August 13) will act as a broad survey of voting intentions and will likely help polarize the preferences for the October mid-terms, in our opinion. The mid-term elections are seen by the market as a referendum on the government's track record in economic delivery and are key to gauging the relative strength we may see in investment growth going forward. So far the perception of political observers is that the government could add some legislators in the lower house (where half of the seats are up for grabs), but that it is far from approaching a majority. Currently the Cambiemos coalition has 86 representatives in the lower house (129 needed for an outright majority). As a result, we believe the most likely outcome is that the relative forces within Congress will not change significantly, leaving the official coalition with the need to continue engaging in negotiations to approve laws.

ARGENTINA

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (Δ% y/y)		2.3	-2.56	2.6	-2.3	3	3.5
Private Consumption (Δ% y/y)	72.1	4.64	-5.19	3.5	-1.4	2.2	3.2
Public Consumption (Δ% y/y)	13.4	5.32	2.95	6.8	0.3	2.7	1
Investment (Δ% y/y)	19.5	3.91	-7.6	3.8	-5.5	7.7	13
Exports (Δ% y/y Local Currency)	19.2	-3.52	-6.98	-0.6	3.7	6.5	9
Imports (Δ% y/y Local Currency)	24.7	3.88	-11.48	5.7	5.4	9.2	12.2
GDP (US$ bn)		614.2	567.5	631.89	545.1	616.8	630
Monetary and Exchange Rate Indicators							
*CPI Inflation (Dec Cumulative)		10.5	24.9	26.9	37.7	22	15
*CPI core Inflation (Dec Cumulative)		10	24.1	25.7	32.1	18.6	13.9
US$ Exchange Rate (Average)		5.5	8.1	9.26	14.78	16.53	18.92
Central Bank Reference Rate (eop)		21.6	20.4	33	24.75	23	14.25
Private sector credit (% of GDP)		12.7	12.5	13.8	13.2	13.4	15.2
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-2.9	-4.3	-4.6	-5.9	-6.2	-5.2
**Primary Balance, % of GDP		-1.7	-2.7	-4.9	-4.3	-4.4	-3.5
Balance of Payments							
Trade Balance, % of GDP		0.2	0.5	-0.5	0.4	-0.6	-0.7
Current Account, % of GDP		-0.9	-1.4	-2.7	-2.6	-2.7	-2.8
Debt Profile							
Central Bank International Reserves (US$ bn)		30.1	31.4	25.6	38.8	49	52
Total Public Debt (net of public sector holdings, % of GDP)		18.1%	17.6%	16.0%	25.0%	27.0%	29.3%
Of which: Foreign-currency denominated (% of GDP)		18.3	13	13.6	20.3%	22.0%	24.0%
Labor Markets							
Unemployment Rate (% eop)		6.4	6.9	5.9	7.6	7.2	6.8

Sources: Economy Ministry, Central Bank, and Santander estimates.

BRAZIL
BACK TO POLITICAL UNCERTAINTY

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- **Rising political uncertainty has reduced significantly the likelihood of success for the structural reform agenda, in our view, and may put a strain on fiscal accounts.**
- **Improved fundamentals and falling inflation are helping keep markets relatively stable, in our view.**
- **The ongoing political crisis highlights the crucial importance of the 2018 presidential race, in our opinion.**

A challenge to fiscal consolidation

A little more than a year after Brazil's lower house voted to impeach President Dilma Rousseff, political shockwaves hit the country's economy and financial markets once again. Although the spike in asset prices' volatility was short-lived (more on this below), the entrance of President Temer and his inner circle into survival mode is having prolonged and important consequences for the medium term. First, markets reduced drastically the implied likelihood of approval of comprehensive social security reform, in our view one of the most important steps Brazil could take to assure its debt sustainability and, consequently, reduce risk premiums and long-term interest rates. Before the latest scandal, the government was, according to the local press and political consultants, around 30 votes short of the two-thirds majority needed to get the reform through the lower house, and it seemed a matter of time and negotiation for Temer's allies to close that gap. Now, even the most optimistic observers believe that only minimal reform can be approved in 2H17, with diminishing likelihood as the 2018 general elections approach.

These developments led us to revise substantially our estimates for gross debt/GDP. In our view, if social security reform were enacted in 2017, the ratio would peak at 83% in 2020, falling to 76% in 2023. Currently, given the transformed outlook, we believe this metric will continue to grow until 2022, peaking at 87%. This perception of a deteriorating outlook seems to be shared with the main credit rating agencies: S&P Global placed Brazil's debt on credit watch with negative implications on May 22; Moody's changed Brazil's outlook from "stable" to "negative" four days later.

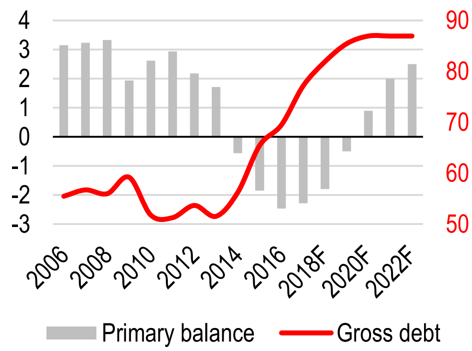
The political crisis also has short-term fiscal implications, in our view, in addition to a possible inability to raise tax revenue given lower than expected growth. First, with eroded support, the government may find it difficult to raise taxes that depend on congressional approval. Second, President Temer's weakening bargaining power may translate into more concessions in response to representatives' demands for more spending and public bank lending. We recently revised our primary deficit (as share of GDP) estimates for 2018 and 2019 to 1.8% and 0.5%, respectively (from 1.3% and 0.1%). Finally, it will be harder for the government to adhere to the spending cap added to the Constitution last December, a theme we explored at length in our report *2019: Time to Bite the Bullet*, June 27, 2017.

Markets remain calm though

As an aftershock to last year's major political earthquake, this time political turmoil hit financial markets with much less intensity. FX volatility surged momentarily, but it is already back to a single-digit handle (in realized/historical terms), and the BRL's mild weakening against the USD (around 6%) should have negligible consequences for inflation, in our view. Five-year USD and inflation-linked sovereign bond spreads widened by around 30 bps and 60 bps, respectively – hardly a major shock to funding costs.

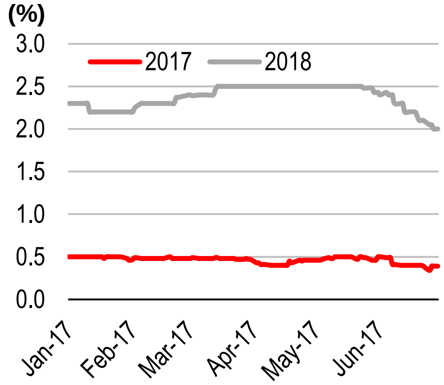
This can be explained partially by a higher global risk appetite, but domestic fundamentals have also markedly improved (see the table for the evolution of some key indicators). Moreover, continuously falling inflation and regained credibility now allow monetary policy to act counter-cyclically: although Brazil's Central Bank recently signaled a slowing in the pace of rate cuts (partially blaming the lack of progress in the structural reform process), the ongoing cycle is still compatible with our year-end forecast of 8.5% for the overnight rate. According to our projections, rolling 12-month CPI inflation should dip below 3% in July and August and finish the year around 4%, meaning that, in real terms, the policy rate will stay relatively high.

Primary balance and gross debt (% of GDP)



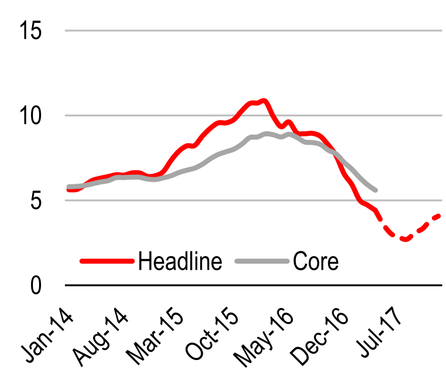
Sources: Brazil Central Bank and Santander.

GDP growth, median market forecasts (%)



Source: Brazil Central Bank Focus survey.

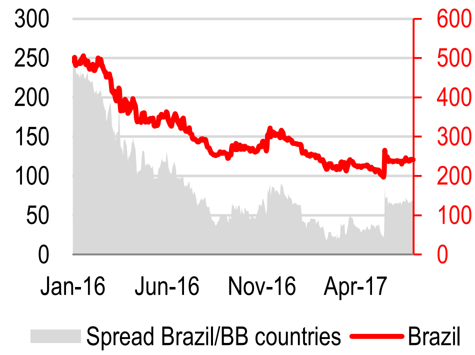
12-month CPI inflation (%)



Notes: points in the dashed line are Santander forecasts.
Sources: IBGE and Santander.

We think this will maintain some dry powder in case economic activity resumes its slowdown (so far, our 0.7% forecast for 2017 GDP growth remains achievable, although now carrying a negative bias – GDP should stay flat in the second quarter, not repeating the strong performance of the previous period) and assure the sustainability of the terminal rate in the eyes of market players.

5-year CDS spreads (bps)



Notes: BB countries include Croatia, Bulgaria, Indonesia, Portugal, Russia, and Turkey. Sources: Bloomberg and Santander.

Brazil, key vulnerability indicators

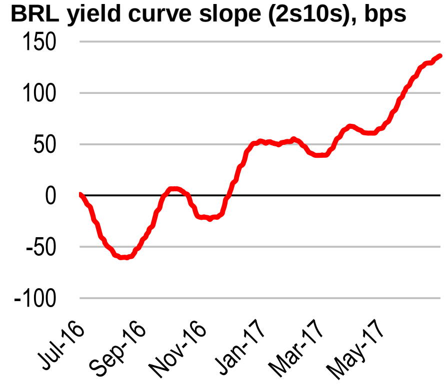
	May-16	May-17
12-month rolling primary deficit (% GDP)*	2.25	2.34
Sovereign 5-year CDS (bps)	365	238
Petrobras 5-year CDS (bps)	780	318
Petrobras net debt/EBITDA**	14.5	4.3
International reserves, net of FX swaps (USD bn)	313	359
CPI, 12-month % change	9.3	3.5
Ex-ante real overnight (Selic) rate (%)	7.8	6.3
12-month rolling current account deficit (% GDP)***	-1.9	-1.1

*Up to March. **2Q figures. ***Up to April. Sources: Bloomberg, Anbima, and Brazil Central Bank.

2018: the big reset

In our view, in one possible desirable scenario after Dilma Rousseff's impeachment, the combination of a capable team of technocrats and an already unpopular government, with no intention of getting reelected and backed by a large coalition in Congress, would have been able to deliver a bold structural reform agenda. We believe this would have reduced interest rates structurally, improved the business environment, and spurred sustained growth, perhaps leading to the election of a candidate also identified with pro-market reforms in 2018 (or at least weakening the appeal of candidates running on a platform of economic populism).

BRL yield curve slope (2s10s), bps



Note: 21-day moving average. Sources: Anbima and Santander.

In our opinion, markets should now brace for a period of increasing political uncertainty that will peak, at best, close to the October 2018 general elections. The reform agenda should remain paralyzed in Congress at least until the criminal charges against President Temer are resolved in Congress and in the judicial system, which may take most of the rest of this year. The likelihood of unpopular reforms (especially pension reform) getting through Congress will, in our view, continue to decrease with time, as the vote gets closer and politicians who are seeking reelection fear to be associated with such reforms. In the meantime, we believe Brazil's fragile fiscal position should leave the country exposed to swings in the mood of global investors and possible credit rating downgrades.

The sitting economic team (especially at the Central Bank and the Ministry of Finance), its credibility, and rigid fiscal responsibility laws should continue to keep the country away from populist experiments until the end of the current presidential term, in our view. Conversely, politicians are likely to be restrained from trying to expand public spending, considering the risk of triggering a collective resignation of officials and a negative market reaction. Unlike the final days of Mrs. Rousseff, we now see the likelihood of financial repression policies (forcing markets to roll over public debt at very low or negative real interest rates) and accelerating inflation as quite low. However, we find many reasons for concern in a presidential race taking place amid high-profile corruption investigations, high unemployment, and falling confidence in established political parties[1]. Whoever is elected will face challenging economic problems, and a lack of consensus among potential candidates regarding the fundamentals of macroeconomic management could be problematic for asset prices, in our view.

[1] See, for example, Forças armadas lideram confiança da população; Congresso tem descrédito. Folha de S. Paulo, June 24, 2017.

BRAZIL

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (∆% y/y)		2.7	0.5	-3.8	-3.6	0.7	3.0
Private Consumption (∆% y/y)	62.8	2.9	2.3	-3.9	-4.2	0.3	2.5
Public Consumption (∆% y/y)	20.8	2.2	0.8	-1.0	-0.6	-0.6	1.4
Investment (∆% y/y)	16.5	6.1	-4.2	-13.9	-10.2	2.7	6.0
Exports (∆% y/y Local Currency)	11.3	2.1	-1.1	6.4	1.9	3.4	2.5
Imports (∆% y/y Local Currency)	-11.4	7.6	-1.9	-13.9	-10.3	5.0	2.2
GDP (US$ bn)		2,246	2,455	1,801	1,796	2,011	1,923
Monetary and Exchange Rate Indicators							
IPCA-IBGE Inflation (Dec Cumulative) (%)		5.9	6.4	10.7	6.4	4.2	4.2
IGP-M Inflation (Dec Cumulative) (%)		5.5	3.7	10.5	7.0	1.6	4.5
US$ Exchange Rate (Average)		2.2	2.4	3.3	3.5	3.3	3.7
Central Bank Reference Rate (eop)		10	11.75	14.3	13.8	8.5	8.5
Stock of Credit To Nonfinancial Private Sector (% of GDP)		56.5	58.9	54.5	50.5	48.2	47.7
Fiscal Policy Indicators							
Public Sector Fiscal Balance (harmonized) (% of GDP)		-3.1	-6.0	-10.2	-8.9	-6.7	-6.7
Primary Balance (% of GDP)		1.77	-0.56	-1.85	-2.5	-2.3	-1.8
Balance of Payments							
Trade Balance, % of GDP		2.6	-3.9	1.0	2.7	2.0	2.3
Current Account, % of GDP		-3.04	-4.24	-3.27	-1.30	-1.83	-1.77
Debt Profile							
International Reserves (US$ bn)		358.8	363.6	356.5	365.0	358.7	369.5
Total Public Debt (net of public sector holdings, % of GDP)		30.6	32.6	35.6	45.9	50.0	55.9
Of which: Foreign-currency denominated (% of GDP)		-10.2	-10.3	-10.5	-10.5	-10	-9.8
Labor Markets							
Unemployment Rate (% eop)		6.2	6.5	9	12.0	12.3	10.9

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

CHILE
A QUESTION OF ANIMAL SPIRITS

- **We expect the economy to accelerate somewhat for the rest of the year, after a dismal beginning: above 2% in 2H17, vs. only 0.5% in 1H17.**
- **Presidential elections take place in 4Q17; we believe the next administration's main challenge will be reinvigorating animal spirits to boost investment and keep fiscal accounts in check.**
- **External conditions, mainly copper prices and demand from trading partners, are expected to improve gradually, in our view, which means a better outlook for exports, especially in 2018.**

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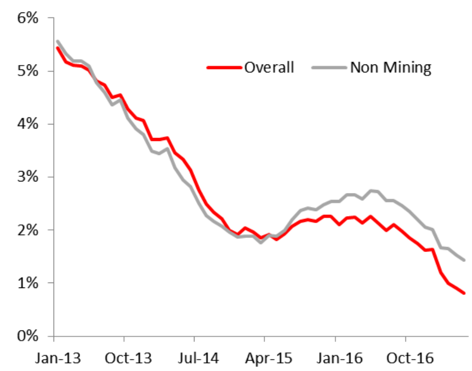
On November 19, presidential elections will take place, with a second-round vote likely on December 17, according to the latest polls (as of June). We believe the contenders with the best chance of winning the presidency are the center-right candidate, former President Sebastián Piñera (with 30% of vote intentions) or the center-left candidate, ruling Nueva Mayoría coalition candidate Alejandro Guillier (around 15% in the polls). According to the programs set forth by the contenders, a Guillier administration would maintain the guidelines of the current policy approach, in which social reforms (education, health, labor market) and income distribution issues remain at the top of the agenda. In contrast, a Piñera administration would focus on growth, as seen in his previous term in 2010-2014, although against a less favorable external backdrop.

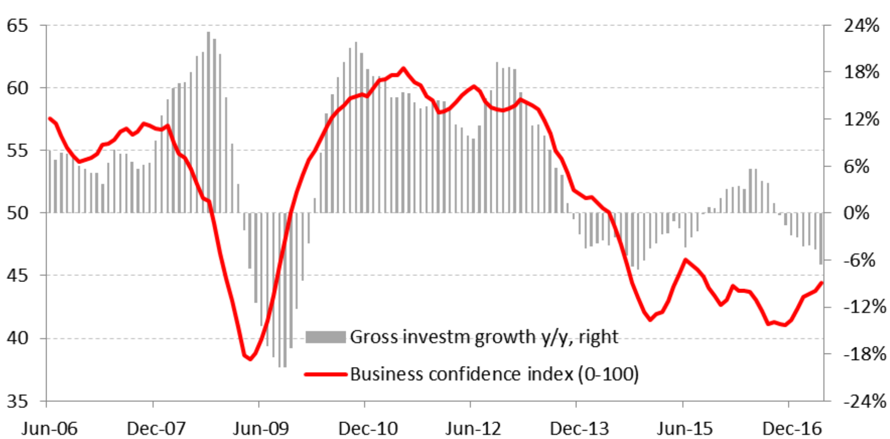
Whoever wins in the final vote, we believe the key challenge of the next administration is likely to be the reinvigoration of business and consumer confidence. Gross fixed investment is the GDP component most heavily affected by the ongoing slowdown, at least vs. the trend prevailing until 2013, which means that the normalization of growth conditions necessarily requires a rebound in capital formation.

IMACEC growth by sector



Last 6 month average of y/y changes. Sources: Central Bank and Santander.

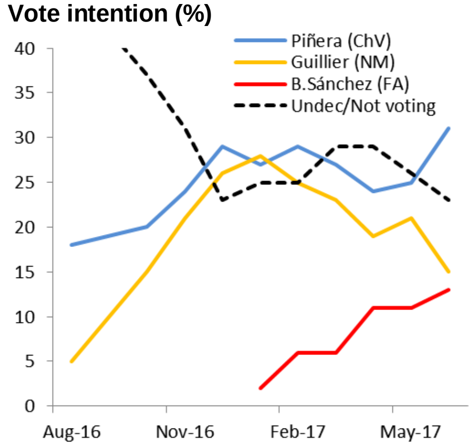
Business confidence and the investment cycle



Synthetic gross fixed investment indicator (based on imports of capital goods, and construction sector data). Last 6 month averages. Sources: Central Bank, and Santander.

In this context, the outlook for the mining sector and copper prices is important, as this sector accounts for roughly 20-25% of overall investment. Even more significantly, the expectations channel is, in our view, crucial to foster private investment growth in the non-mining sector. According to our estimates, the history of the last 15 years indicates that business confidence (as per the IMCE index by ICARE) needs to be around the 55-60 level in order to see gross investment grow by around 10% annually with a lag of four months (the 50 threshold is considered neutral). Compared with the current 40-45 levels, it turns out that if business confidence simply returns to neutral on a permanent basis, investment could grow by around 3% y/y after a lag, which means a 5.5-pp improvement vs. the -2.4% y/y recorded in 1Q17. As investment now accounts for 20% of GDP, this potential rebound could imply a 100-120-bp acceleration in GDP growth, according to our estimates.

Vote intention (%)



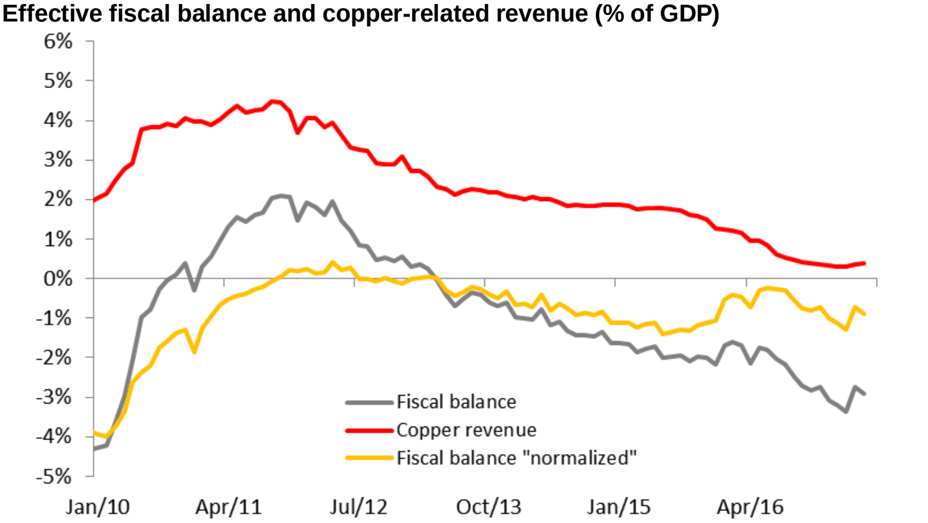
Through June 2017. Source: Adimark.

On the external side, copper prices have stabilized at around US$2.60/lb, implying a 20% y/y increase and significant relief for local producers in terms of profits. The effects on real growth, however, will not be evident in 2017, in our view, as strikes and technical problems have caused a sharp hit on mining sector output (-10% y/y, year to date), and investment is likely to recover only gradually, in tandem with international prices. As a result, this better outlook in the local mining sector is not reflected until 2018, when our GDP growth forecast is 2.2%. Likewise, Chile's main trading partners in non-mining products (mainly South American neighbors, the U.S., and Europe) should grow a bit faster, implying better conditions for Chile's real exports (we estimate growth here at 0.5% and 2.0% in 2017 and 2018, respectively).

The change in administration implies no risks to monetary policy, as BCCh independence is guaranteed by the constitution. In this sense, the easing cycle of 100 bps implemented since January, to the current policy rate (MPR) of 2.50%, reflects the deterioration of the growth outlook in recent months and the relatively comfortable inflationary context. In the last IPoM report, the BCCh signaled that further easing in the near future is unlikely, projecting a rebound in inflation in 2H17 (from 2.2% in June to 2.7% in December), and also an improvement in growth (+1.4% for the whole year, vs. +0.4% recorded year to date). That said, we think June's very low inflation reading and the persistence of low growth conditions imply that dovish risks are on the rise. As a result, we do not rule out further downside revisions of 2017 GDP, and therefore, additional monetary easing by the BCCh, although this is not our base-case scenario.

Another key challenge is the improvement of fiscal accounts from a "structural" point of view. Chile's fiscal balance has suffered in the last few years due to the slowdown in the economy, the fall in copper-related revenue, and the ambitious social reform agenda of the Bachelet administration. As a result, the actual fiscal deficit widened to 2.9% in May 2017, from a 0.6% surplus in 2012. More importantly, the cyclically-adjusted fiscal deficit has also increased, to the current 1.4% of GDP from equilibrium in 2013, suggesting to us that there is more than a series of slow years behind the ongoing fiscal slide. In the view of Finance Minister Valdés, the goal of consistently reducing this deficit toward zero by 2020, at a rate of 0.25% of GDP per year, is of paramount importance to defend the current credit rating standards of AA- / A+, the highest in Latin America. In this context, whoever Chile's next president is, we believe fiscal stimulus as a tool to boost domestic demand will simply be unavailable in the next few years. If growth accelerates and copper prices continue to increase, a large portion of this windfall will have to be saved, in our opinion. Alternatively, if the economy and copper prices remain subdued, public spending growth will be close to zero in real terms, which will be challenging in a context of rising social demands for better public services.

Effective fiscal balance and copper-related revenue (% of GDP)

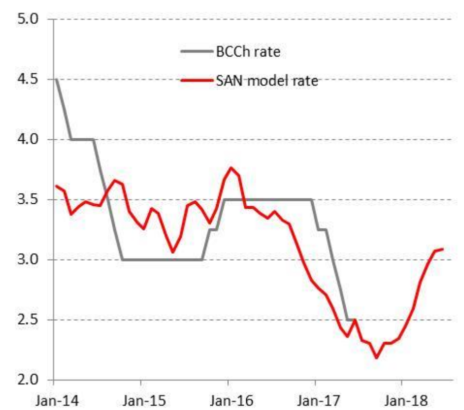


Normalized fiscal balance equals the actual fiscal balance minus the actual amount of copper-related revenue plus the last 10 year average copper revenue (now at 2.4% of GDP). Sources: MinFin and Santander.

Copper prices (in US$/lb and UF)

Copper price in UF terms implies previous conversion into CLP at market FX prices. Sources: Bloomberg and Santander.

BCCh policy rates (%)



Model rate as per our projected Growth-Inflation Balance Index. Sources: BCCh, INE, and Santander.

CHILE

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (∆% y/y)		4.1	1.9	2.3	1.6	1.5	2.2
Private Consumption (∆% y/y)	12	4.2	4.4	1.9	2.4	2.1	2.5
Public Consumption (∆% y/y)	65	5.6	2.2	5.8	5.1	4.6	3.7
Investment (∆% y/y)	28	0.4	-6.1	-1.5	-0.8	-0.8	-0.9
Exports (∆% y/y Local Currency)	39	4.3	0.7	-1.9	-0.1	0.7	2.8
Imports (∆% y/y Local Currency)	39	2.2	-7.0	-2.8	-1.6	3.5	4
GDP (US$ bn)		277	258	241	247	262	274
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		2.9	4.6	4.4	2.7	2.7	3
CPI core Inflation IPCX1 (Dec Cumulative)		2.6	4.6	4.7	3.1	2.6	2.9
US$ Exchange Rate (Average)		525	606	654	678	665	672
Central Bank Reference Rate (eop)		4.5	3.0	3.5	3.5	2.5	3
Private sector credit (% of GDP)		83.2	85.0	88.0	88.2	90.0	90.5
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-0.6	-1.6	-2.1	-3.3	-2.7	-2
**Primary Balance, % of GDP		-0.1	-1.0	-1.4	-2.6	-3.3	-1.4
Balance of Payments							
Trade Balance, % of GDP		0.6	2.5	1.5	2	2.3	1.8
Current Account, % of GDP		-3.7	-1.3	-2	-1.4	-1.3	-1.9
Debt Profile							
Central Bank International Reserves (US$ bn)		41.1	40.5	38.6	40	41	42
Total Public Debt (gross, % of GDP)		12.1	14.1	16.2	20.6	23	24
Of which: Foreign-currency denominated (% of GDP)		1.9	2.5	3.2	3.5	4.5	5.0
Labor Markets							
Unemployment Rate (% eop)		6.0	6.4	6.2	6.5	6.8	6.5

Sources: Central Bank, Servicio de Estudios, and Santander.

COLOMBIA

The Slowdown Continues

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- **Consumer confidence plummeted in the first half of 2017, pulling down household spending, previously the stalwart of the economy. We lowered our growth outlook in spite of BanRep's efforts to bring rates toward neutral. Fiscal policy has felt the strain of lower growth even after the benefits of 2016's tax reform.**
- **BanRep will likely pause their rate cuts in 2H17 after 250 bps of total cuts, in order to monitor inflation developments. In our view, external accounts will also require monitoring so they do not impede a more aggressive cutting cycle.**

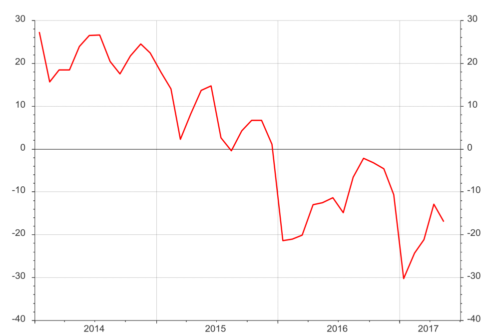
Activity: Tough start to the year; consumer-driven weakness

The weakness in the Colombian economy over the last two years, which brought GDP growth from 4.4% y/y in 2014 to 2.1% y/y in 2016 (and 1.8% this year, according to our forecast), was driven primarily by a slowdown in investment, with sectors such as mining being most affected. Household consumption has managed to grow at or above the total rate of growth of the economy for the last three years, never moving into negative territory as happened with fixed capital formation. This has helped to offset the reduction in investment and government consumption, which have gone from growing at or above the growth rate of the economy, to growing well below it. The strength in household consumption, in turn, was boosted by robust consumer credit growth, continued (albeit moderating) employment growth, and buoyant consumer confidence that the economy was on the right track.

In 2017, however, we believe signs point to a more challenging outlook for the consumer, and these signs have begun to be reflected in both high-frequency data and overall growth metrics. The most striking aspect of the first quarter was the precipitous decline in consumer confidence indices to their lowest level in the history of the current measure. The index, which measures consumers' assessment of their current conditions as well as their outlook for the future, reached a level of -30 in January 2017, meaning that negative responses outnumbered positive responses by 30 pp. In addition to the lagged impact of a weakening macroeconomic environment, several situational factors may have helped cause the large decline in consumer confidence, including a divided political background, with difficult negotiations on the implementation of a peace accord and an administration with low public approval ratings that increased sales taxes from already high levels. In terms of the economic scenario, while real wages have rebounded due to the drop in inflation since August 2016, employment growth is down. In the 12 months through April 2017, the economy produced on average 175,000 new jobs vs. the prior year. However, in the 12 months through April 2016, the economy was creating 343,000 new jobs on average. The labor force is now growing more quickly than employment, reducing the downward pressure on the unemployment rate seen since 2009.

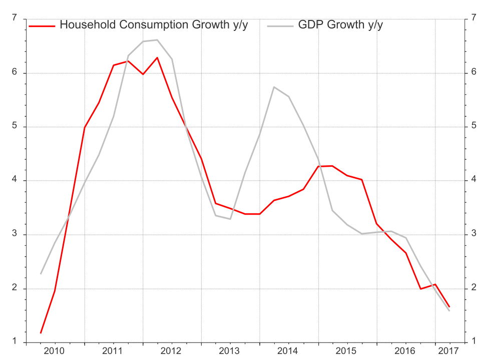
After several years of an environment characterized by high inflation, decelerating GDP per capita growth, and falling employment growth, consumers have shown signs of retrenching in earnest in early 2017, with signs now showing up in household spending. In 1Q17, household spending grew by just 1.1% vs. 2.1% in full-year 2016. Core retail sales, excluding fuel and motor vehicles, went from a +3% annual growth rate in 4Q16 to -1.5% in 1Q17. The weakness in household consumption caused BanRep, at its April policy meeting, to reduce its forecast for 2017 GDP growth to 1.8% y/y from 2.0% previously. This revision occurred before the release of first quarter GDP results, which, at 1.1% y/y, came in slightly below BanRep's forecast of 1.3% y/y growth, causing BanRep to adopt a downward bias to its own forecast at its June policy meeting. In terms of the other components of the economy, there is also room for caution regarding government consumption and investment. Recent scandals involving Brazilian infrastructure companies may have something of a chilling effect on 4G infrastructure project financing, while several projects in both the first and second waves of the 4G projects are currently delayed due to disputes with local communities, environmental issues, or design factors. Going forward, in the absence of some upside surprises from government consumption or spending, or accelerated 4G infrastructure execution, the current outlook does not leave much room for optimism,

Consumer confidence makes a new low



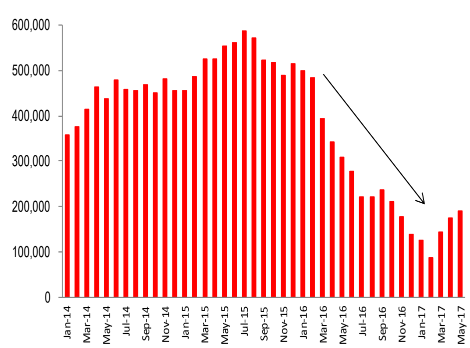
Source: Fedesarrollo

Household consumption weakening



Source: DANE.

Employment growth slowing



Source: DANE.

in our view. We have lowered our own 2017 growth forecast to 1.8% y/y from 2.2% y/y. For 2018, we believe growth will be closer to 2.6% y/y than our previous forecast of 3.0%.

External accounts: Terms of trade improvement slowing

On the external side, the picture in 2017 also presents challenges. While the current account deficit continued to improve in 1Q17, the y/y rate of improvement slowed markedly. Compared with 1Q16, 1Q17's result showed an improvement of US$364 mn, well below the yearly sequential improvements of the last four quarters, which averaged US$1.6 bn. The improvement in the CA deficit in 1Q17 was again driven by a narrowing trade deficit, which contracted by US$1 bn on a y/y basis. The improvement in the trade balance was driven by higher exports, helped along by a 5% y/y increase in Colombia's terms of trade in the first quarter, the first positive yearly growth since the third quarter of 2013. Globally, we see trade volumes growing despite fears regarding a possible outbreak of protectionism, with Panama and the Suez Canal showing an increasing volume of shipments, and the growth rate of world exports moving toward positive territory.

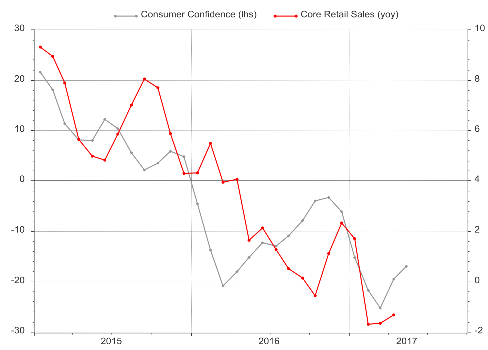
In Colombia's case, going into in 2Q17, the base of comparison for terms of trade is less favorable, and the recent price actions of key commodities such as oil suggest that on a q/q basis, Colombia's terms of trade have fallen in 2Q17. Indeed, the second quarter did not get off to an auspicious start on the external front, as April's trade balance came in worse than expected, with non-commodity exports continuing to be weighed down by weakness in neighboring Venezuela. At 4% of GDP, Colombia's CA deficit remains the widest of the major Latin American economies. Stagnant non-commodity export growth means that as the oil price has wiped out its price increases on a y/y basis in 2Q17, we think continued improvement in the trade balance will likely require lower imports, which is not yet happening – all of which suggests a low probability of additional large improvements in the CA deficit in the rest of the year (our forecast is for a CA deficit of 3.6% in full-year 2017). This leads us to expect that the COP will remain near or above its current level throughout the remainder of 2017. Indeed, its performance on a YTD basis has been stronger than one would have assumed given the weakening in terms of trade. However, the weakening dollar and falling UST rates, amid a reversal in Trump reflation trades, has been a main factor.

Fiscal and monetary policy: Trying to do their part to soften the deceleration

The government recently revised to the upside its projections for the fiscal deficit in 2017 and 2018 to 3.6% and 3.1% of GDP, vs. 3.3% and 2.7% previously. The deterioration vs. last year's projections comes from higher expenditures in the case of 2017, and from a combination of both higher expenditures and lower revenue in 2018. GDP assumptions for both 2017 and 2018 – at 2.3% y/y and 3.5% y/y, respectively – look optimistic, in our view, and could further pressure revenue assumptions, leaving the door open for additional disappointment throughout the year. It is important to note, therefore, that ratings agency S&P has stated that a downgrade could come if the fiscal deficit fails to decline sufficiently and net general government debt rises more than expected due to higher spending or revenue underperformance. S&P also mentioned an increase in external debt, owing to export weakness, as another risk factor. In addition, with investment likely being cut in 2018 in order to reach the deficit target, convergence of the fiscal deficit to the fiscal rule's mandated 1% of GDP by 2022 will imply larger spending cuts in the future, in our view, further pressuring the growth outlook.

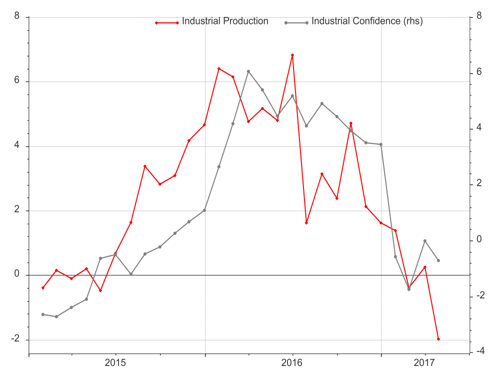
BanRep is responding in kind to the worsening growth outlook, having cut rates by 175 bps this year and 200 bps in total since beginning its cutting cycle. BanRep has leaned in a more dovish direction since Juan Jose Echavarria joined the board, effectively setting aside attainment of the inflation goal in 2017. We expect another 50 bps in cuts this year, before increasing inflation in 2H17 may require BanRep to go on hold in the second half of the year. With these additional cuts, we see the real policy rate ending the year near 1.5%, which corresponds to the long-term average. While we do not rule out completely a move toward a stimulative real rate in the near term despite above-target inflation and the likelihood of a third year in a row of non-compliance with the inflation target, our base case is that high core inflation prevents a more aggressive cutting cycle this year. In 2018, however, we think patience could be rewarded, and if convergence to 3% inflation looks to be assured, by midyear we see room for additional cuts to the overnight policy rate to bring real policy rates into stimulative territory, allowing a rebound in growth vs. 2017.

Retail sales in negative territory . . .



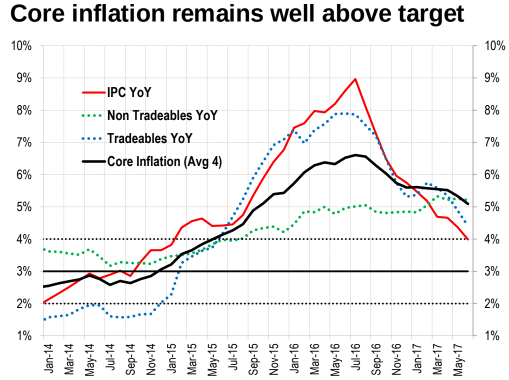
Source: DANE.

. . . along with Industrial production



Source: DANE.

Core inflation remains well above target



Source: DANE.

COLOMBIA

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (∆% y/y)		4.7	4.6	3.1	2.0	1.8	2.6
.0Private Consumption (∆% y/y)	61.1	4.2	4.4	4	2.1	1.6	2.4
Public Consumption (∆% y/y)	16.1	5.8	6.3	2.8	1.9	2.2	2.8
Investment (∆% y/y)	23.7	5.1	11	2.7	-4.5	0.5	3.5
Exports (∆% y/y)	18.9	5.4	-6.7	-0.6	-0.9	2	3
Imports (∆% y/y)	19.8	4.5	8	4.1	-6.1	0	4
GDP (US$ bn)		381.8	378	292	283	290	273
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		1.9	3.7	6.8	5.75	4.3	3.4
CPI core Inflation (Dec Cumulative)		2.8	3.3	5.2	5.14	4.7	3.5
US$ Exchange Rate (Average)		1869.3	2400	2740	3050	3031	3300
Central Bank Reference Rate (eop)		3.25	4.5	5.75	7.5	5.25	4.75
Bank lending to the private sector (% chg y/y, Dec)		14	14	12	11	8	10
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-2.4	-2.4	-3.1	-3.9	-3.7	-3.1
**Primary Balance, % of GDP		-1	-0.5	-0.5	-1.0	-0.7	-0.1
Balance of Payments							
Trade Balance (% of GDP)		-0.7	-3	-6.2	-3.7	-2.6	-2.1
Current Account, % of GDP		-3.3	-6.6	-6.4	-4.5	-3.6	-3.1
Debt Profile							
Central Bank International Reserves (US$ bn)		43.6	47	47	47	47	47
Total Public Debt (gross, % of GDP)		31.6	38.3	37	44	43	44
Of which: Foreign-currency denominated (% of GDP)		8.5	11	14	15	28	29
Labor Markets							
Unemployment Rate (year-end, % of EAP)		9.6	9.1	8.9	9.2	9.6	10

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

MEXICO

UPBEAT FUNDAMENTALS AHEAD OF NAFTA UPGRADE

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- **NAFTA is the epicenter of Mexico's external account vulnerabilities. We expect a decent upgrade outcome from trilateral renegotiations.**
- **The Mexican economy arrives at this juncture in better shape. We are raising our GDP forecast for both 2017 and 2018.**
- **Improvement in external accounts is running in parallel with fiscal consolidation and is supported by a high real policy rate, in our view.**

Better-balanced growth, and more sustainable

We believe the number one characteristic of the Mexican economy is resilience. We note that GDP growth in 1Q17 came in at 0.7% q/q, sa, which was stronger than expected and helped to put to rest concerns about potentially destructive trade policy initiatives by President Trump. Not only did a slowdown in FDI and private spending in general fail to materialize, but Mexican external accounts actually improved further, due to the acceleration in U.S. manufacturing activity. Note that the latter also benefited as factory output across the major global hubs also experienced broad-based momentum, led by China and Europe.

The other positive growth surprise in 1H17 was household consumption, which maintained its stamina as firm labor demand is helping to offset the negative impact on real income from higher inflation. Mexico's sound demographic metrics should also be considered when gauging consumption dynamics, in our view. Last but not least, oil production has been less weak than we feared; monthly data through May puts the full-year 2017 decline consistent with -6% instead of the -9% projected by the government. Taking all this together and incorporating weaker construction input, we now expect GDP growth of 2.5% this year, coming in a bit higher at 2.7% in 2018. If our estimates prove right, growth will still fall short of Mexico's trend-like pace; however, the sector composition of GDP has improved, thus increasing the likelihood of a sustainable expansion. Fixed investment remains weak and pushed down by public capex, but we believe it should improve next year, consistent with less fiscal tightening. Consistent with our new growth scenario, the CA deficit is now expected to shrink this year to 2.0% of GDP (previously 2.3%) and stay at that level next year (previously 2.2%), better than -2.4% in 2015, but still short of the 1.5% average deficit since 2000.

GDP forecast

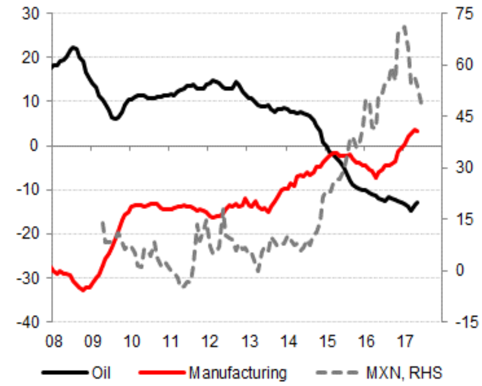
			New		Old	
	Trend*	2016	**2017f**	**2018f**	2017f	2018f
Total	3.2	2.3	**2.5**	**2.7**	2.2	2.2
Services	3.8	3.4	**3.2**	**2.9**	3.1	2.7
Industry	2.3	0.0	**1.1**	**3.4**	0.5	2.1
Manufacturing	4.2	1.3	**3.6**	**4.0**	3.3	3.7
Construction	1.2	1.8	**2.0**	**2.8**	2.4	2.8
Mining	-0.8	-6.4	**-6.7**	**3.0**	-9.4	-3.5
Utilities	4.1	3.3	**1.5**	**1.7**	1.7	2.0
Agriculture	2.1	3.6	**3.9**	**3.8**	3.9	3.8

* Average 2010-2015. Sources: Inegi and Santander.

Mexico is highly NAFTA-sensitive

The resilience of the Mexican economy has a distinctive macro element, which is highly liquid and flexible FX. Indeed, similar to what has happened during severe crises ("Tequila," 1994, GFC-2008), the peso has acted once again as the system's pressure valve, absorbing most of the risk premium while shielding the macro story from an otherwise deeper and longer-lasting toll. During the worst of the NAFTA shock so far (January 20, 2017), the MXN hit an historical low, with losses accelerating to +70% from its April 2013 level, thus allowing a preview of major vulnerabilities linked to external accounts. Although the contribution to growth from net exports (1%) pales in comparison to that from private consumption (67%), its relevance becomes clear when considering that one-third of all jobs lie in manufacturing, while remittances and FDI play a pivotal role in achieving sustainable external accounts.

1. Trade balance: improvement tracks to manufacturing and weak MXN

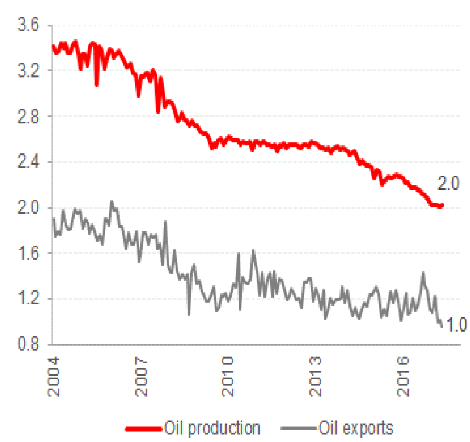


Notes: Trade balance in USD bn, MXN is change versus April 2013. Sources: Inegi, Banxico, and Santander.

2. U.S. manufacturing rebound is key driver of Mexico output

Notes: Mexico and US manufacturing output index, sa 2012=100. Sources: Inegi, Bloomberg, and Santander.

3. Oil is less of a drag currently

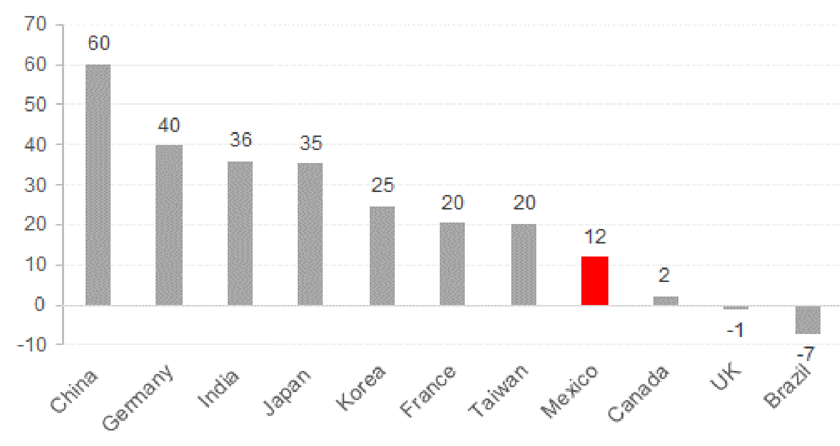


Notes: mnbd. Sources: Pemex and Santander.

Indeed, the financing of the CA deficit through steadier (long-term) sources – that is, FDI plus portfolio inflows – deteriorated amid weakening fundamentals, mainly related to Pemex's dire financial position and a growing fiscal deficit. External imbalances hit bottom in 1Q16 right before the government bailed out Pemex but have continued to heal gradually, based on: (i) a U.S. manufacturing uptrend (chart 2); (ii) strong duration appetite from foreign investors, boosted by a high real policy rate (1yr fwd currently at 3%); (iii) weak currency as highlighted by the +30-pp spread vs. USD index in real terms, the widest since 1995 and compared to the only 5-pp average since 2000 (chart 4); and (iv) fiscal consolidation (witness the primary balance, chart 5).

The upgrading of NAFTA worth $1.1 tn in trade volume per year, is scheduled to kick off next month after the consultation process mandated by U.S. law is completed. While negotiations could go on for several quarters, we think the list of topics up for debate will likely be published soon and provide helpful guidance. The focus should be on: (i) new rules of origin with a U.S. manufacturing bias and consistent with President Trump's "America First" approach; (ii) new rules for services and e-commerce trade; (iii) stricter labor and environmental rules; (iv) an update on intellectual property rights; (v) an update on government procurement; (vi) cross-border investments; (vii) stricter anti-corruption and competition measures; (viii) FX manipulation; (ix) taxes on workers' remittances; and (x) a potential right to raise tariffs in case of "unfair" trade. While the U.S. has substantial leverage (Mexico is the second-largest importer from the U.S. in per capita terms and spends over 22% of its GDP on U.S. goods, while the U.S. spends less than 2% of its GDP to buy Mexican goods), an unfavorable outcome, as priced in January, would disrupt regional supply chains, potentially lowering U.S. firms' competitiveness while increasing goods prices for consumers.

U.S. deficit: the problem lies outside NAFTA partners

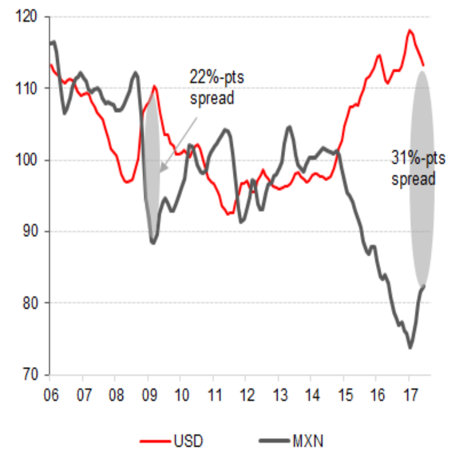


Notes: US trade deficit as share of total bilateral trade with each US partner. Sources: US Census Bureau and Santander.

Reloaded NAFTA to boost competitiveness would be optimum deal, in our view

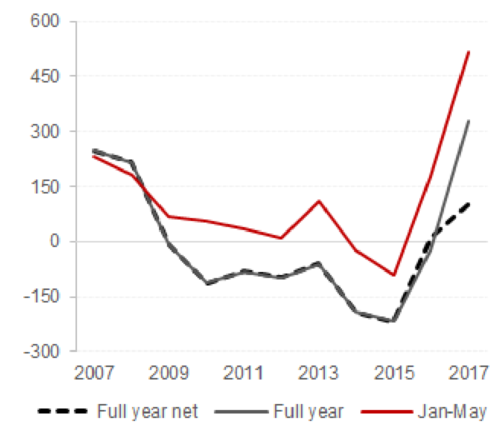
Over 23 years of NAFTA, Mexico's overall convergence has strengthened (witness inflation at +50% in 1995 vs. 3.5% on average in the last five years), and the opening of its energy sector has made it a more competitive global manufacturing hub. Although our base-case scenario is that U.S. officials will agree to an upgrade that essentially keeps tariffs for all goods at the current preferential zero level, their failure to agree would put Mexico in a vulnerable position. Note that Mexico-U.S. bilateral trade under WTO rules means U.S. exporters would end up paying a higher tariff, since Mexico imposes a 7.1% average tariff, or MFN (most favored nation), roughly twice the average U.S. quota. Mexico imposes higher MFN tariffs on the rest of WTO countries compared to the U.S. and Canada (chart 6). Meanwhile, the implementation of energy reform is progressing well despite the low price hurdle and we expect the government to make additional efforts to cement its reformist legacy and shield Mexico from a potential shift to a leftist government. The race for the June 3 presidential election next year has Andres Lopez (known as AMLO) at pole position, and if he is elected, there will be considerable scrutiny of energy land in particular. By the same token, the renegotiation of NAFTA could gain steam, in our view, as both U.S. and Mexican officials would like to prevent negotiations from being obscured by the U.S. mid-term elections and Mexico's election process in 2018.

4. Mexico and U.S. FX trading at its widest spread since the "Tequila crisis"



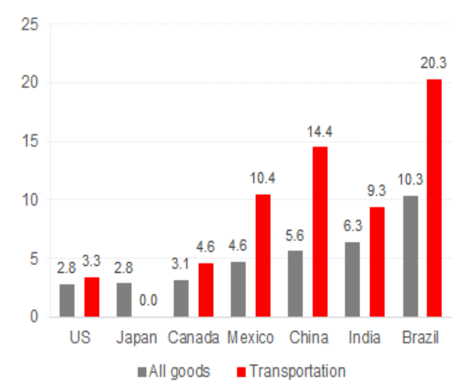
Notes: Indices in real terms, 3mma. Sources: Bloomberg, JPMorgan, and Santander.

5. Fiscal consolidation, a big help right when it's needed



Notes: MX$ bn cumulative. Full 2017 using government target. Full year net is after excluding Banxico's FX surplus. Sources: Ministry of Finance and Santander.

6. Mexico imposes higher MFN tariffs than its NAFTA partners



Notes Average MFN tariffs between country and rest of the world within WTO. Sources: World Bank and Santander.

MEXICO

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (Δ% y/y)		1.4	2.3	2.6	2.3	2.5	2.7
Private Consumption (Δ% y/y)	67.5	2.1	1.8	2.3	2.8	2.4	2.5
Public Consumption (Δ% y/y)	11.1	1.0	2.1	2.3	1.1	0.5	1.2
Investment (Δ% y/y)	21.5	-1.6	3.0	4.2	0.4	1.0	3.7
Exports (Δ% y/y Local Currency)	33.2	2.4	7.0	10.3	1.2	7.6	8.9
Imports (Δ% y/y Local Currency)	-32.9	2.6	6.0	8.6	1.1	5.3	7.9
GDP (US$ bn)		1262.5	1,297	1,151	1,045	1,146	1,224
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		4.0	4.1	2.1	3.3	5.6	3.8
CPI core Inflation (Dec Cumulative)		2.8	3.2	2.4	3.4	4.9	3.8
US$ Exchange Rate (Average)		12.8	13.3	15.9	18.7	18.7	18.5
Central Bank Reference Rate (eop)		3.50	3.00	3.25	5.75	7.00	6.50
Bank Lending to the Private Sector (% of GDP)		14.9	15.0	16.2	17.5	18.0	18.5
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-2.3	-3.2	-3.5	-2.6	-1.3	-2.0
**Primary Balance, % of GDP		-0.4	-1.1	-1.1	-0.1	1.6	0.9
Balance of Payments							
Trade Balance (% of GDP)		-0.1	-0.2	-1.3	-1.3	-1.0	-0.9
Current Account (% of GDP)		-2.5	-2.0	-2.9	-2.7	-2.0	-2.0
Debt Profile							
Central Bank International Reserves (US$ bn)		176.5	193.2	176.7	176.5	178.0	180.0
Total Public Debt (gross, % of GDP)		40.4	43.2	47.3	50.5	48.0	48.0
Of which: Foreign-currency denominated (% of GDP)		10.2	11.9	14.7	15.5	15.2	15.0
Labor Markets							
Unemployment Rate (year-end, % of EAP)		4.9	4.2	4.3	3.7	3.4	3.4

Sources: Economy Ministry, Central Bank, and Santander estimates.

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PERU
PLOT TWIST

- **Our hope that the strengthening of macro fundamentals and the post-election honeymoon could lead to an improved outlook for the Peruvian economy is over.**
- **Regarding the economic activity scenario, the faded hope for reforms and the economic shock led to a plot twist.**
- **Given activity underperformance in 1H17 and the negative impact on business confidence of disputes between the executive branch and Congress, we are lowering our forecast for GDP growth to 3.0% from 4.5%.**
- **We believe the downside risks are asymmetric to economic activity, and thus there is a significant likelihood of additional cuts in the reference rate. Thus, we are revising our call for the YE2017 reference rate to 3.5% p.a. from 4.25% p.a.**
- **On the plus side, downside risks associated with a rise in anti-trade policies globally have not materialized, and we view the international environment as favorable regarding growth, the trade balance, and capital flows.**

Economic activity scenario

Two economic shocks occurred since our last *Strictly Macro* report: political corruption scandals and a coastal El Niño, undermining business confidence, public sector investment capacity, and, consequently, economic growth. The coastal El Niño, which hit the coast of Peru and Ecuador, caused the worst flooding and landslides since 1925. The political scandals have resulted in struggles between the executive branch and Congress; for instance, since the election of President Kuczynski, Congress has voted four ministers out of office. The latest was Alfredo Thorne, former economy minister, who resigned at the end of May after a no-confidence vote in Congress.

The heightened political noise has weakened Kuczynski's ability to govern (his party never had more than 30% of the total seats in Congress) and, consequently, reduced public sector investments planned for 1H17 – thus acting as a drag on infrastructure and reconstruction programs. In 1Q17, real GDP growth was +2.1% y/y. Domestic demand contracted by 1.1% y/y, while exports increased by 12.8% y/y. In 12 months accumulated, real growth cooled down to +3.3% from +3.9% in December 2016, with government consumption falling by 5% and investments declining by 5.9% (private sector investments fell by 5.9% and public sector investments fell by 6%). According to the BCRP, the coastal El Niño also affected the dynamism of the agricultural, mining, and non-primary sectors.

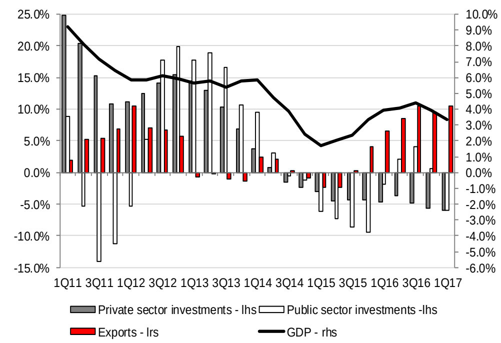
The economic shocks had an unfavorable impact on inflation and fiscal accounts. Inflation picked up to 3.9% y/y in March 2017, with inflation excluding foodstuff falling to 2.8% y/y, while foodstuff and beverage inflation climbed to 5.6% y/y. We believe this was due to the maximum effect of the coastal El Niño being felt in March. Through May, headline inflation fell to 3%, the ceiling of the inflation target, with foodstuff inflation at 3.7% and inflation excluding foodstuff at 2.6%. The fiscal deficit increased to 2.7% of GDP in 12 months accumulated through May (it was 2.6% of GDP in December 2016), as reduced tax collection reflected the lack of economic activity growth.

With the asymmetric risks to economic activity and the reduction of the coastal El Niño's impact on inflation, the BCRP adopted a stance to support activity, cutting the reference rate to 4.0% p.a. from 4.25% p.a. In the last IR (inflation report), the monetary authority stated that they are data dependent for the next decision, but that they could consider additional interest rate cuts depending on inflation.

Forecast changes

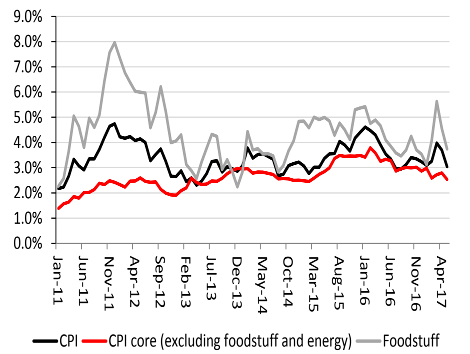
The struggles between the executive branch and Congress will continue, in our opinion. Given the activity underperformance in 1H17 and the negative impact on business confidence of the disputes between the executive and Congress, we are lowering our forecast for GDP growth to 3.0% from 4.5%. We do not expect the

GDP growth breakdown



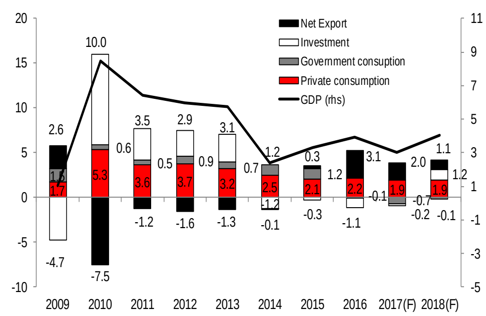
Notes: GDP growth 12 months change. Sources: BCRP and Santander.

Inflation (y/y)



Sources: BCRP and Santander.

GDP growth (contributions) & forecast



Sources: BCRP and Santander.

output gap to close by the end of the year; on the contrary, we see the output gap opening through the end of this year. However, our forecast is still more optimistic than that of the BCRP, which recently revised downward its GDP growth forecast to 2.8%.

We are also revising our forecast for the nominal fiscal deficit. Previously, we expected a narrowing of the fiscal deficit in 2017 and 2018 (2.8% of GDP and 2.5% of GDP). Now, we expect the fiscal deficit in 2017 to be at the same level as 2016, at 3% of GDP, and forecast the fiscal deficit at 2.8% of GDP in 2018, due to reduced tax collection and an increase in public sector investments from 2H17 onward in order to improve economic activity performance.

We see an upward trend for the ratio of public debt to GDP due to the government's countercyclical fiscal policies; we revised the ratio to 27% of GDP for 2017. However, despite the deterioration in the fiscal balance, we still do not see the upward trend of public debt as sufficient to lead to downward revisions for Peru's sovereign credit ratings in 2017.

The consistent growth of advanced economies and the improvement of terms of trade resulted in a greater than expected reduction in the current account deficit. For instance, we forecast Peruvian terms of trade to increase by 5.5% in 2017 (export prices increasing 10.2% and import prices increasing 4.5%). Therefore, we revised the trade deficit to 2.0% of GDP for both 2017 and 2018; previously we expected a deficit of 3.5% of GDP in 2017.

Despite the favorable global growth conditions and their impact on trade volume and capital inflow to emerging countries, we are maintaining our forecast for PEN at 3.4 per U.S. dollar at the end of 2017. We believe that eventually President Kuczynski's difficulty in governing will have a negative impact on asset prices, which will likely cause PEN depreciation.

Regarding the inflation scenario, we are maintaining our call of inflation convergence toward the target range of 1-3%, despite the impact of the coastal El Niño and our expectation of PEN depreciation. We are maintaining our 2017 forecast at 2.8%; mainly, we are not seeing secondary effects from the food supply shock on other prices, and core inflation (excluding food and energy) is still running within the target range, at 2.4% in May.

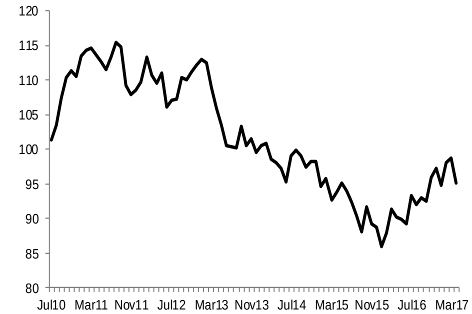
As inflation is converging toward the target while consensus is revising downward economic growth expectations, the BCRP started a monetary easing cycle. Although we do not see the monetary authority as biased toward growth rather than inflation, we believe the downside risks are asymmetric to economic activity, and because of this, there is a significant likelihood of additional cuts in the reference rate. Thus, we are revising our call for the YE2017 reference rate to 3.5% p.a. from 4.25% p.a.

All in all, our hope that the strengthening of macro fundamentals and the post-election honeymoon could lead to an improvement of the prospects for the Peruvian economy is over. Furthermore, our concerns about the impact of an opposition-controlled Congress have proved to be justified. With this, we saw yet another postponement of attempts to tackle the reform agenda: (1) reducing informality; (2) strengthening the ongoing education reform; and (3) laying down a privatization/concession agenda in order to attract investments in transportation, telecoms, energy, water, and sanitation. In terms of the economic activity scenario, the faded hopes for reforms and the economic shock led to a plot twist.

On the positive side, downside risks resulting from a rise in anti-trade policies globally – in particular an increase in protectionism that could be a constraint for emerging countries highly dependent on international trade, such as Peru – have not materialized. We believe the international environment is highly favorable regarding growth, the trade balance, and capital flows, which helps keep volatility in emerging markets under control. Despite all the political turbulence in Peru, Brazil, and other LatAm countries, the volatility of asset prices is not much above its historical levels.

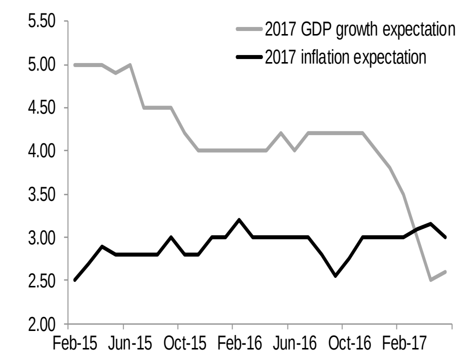
Terms of trade (Index 2007= 100)

Terms of trade index



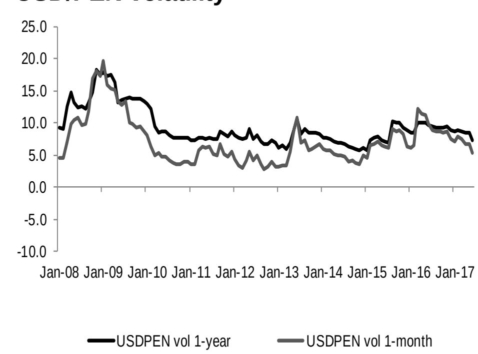
Sources: BCRP and Santander.

Inflation vs. GDP growth expectations



Notes: Economic analysts' expectations. Sources: BCRP and Santander.

USD/PEN volatility



Notes: Economic analysts' expectations. Sources: BCRP and Santander.

PERU

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (Δ% y/y)		5.8	2.4	3.3	3.9	3	4
Private Consumption (Δ% y/y)	61.4	5.3	4.1	3.4	3.4	3	3
Public Consumption (Δ% y/y)	11.2	6.7	6.4	9.8	-0.5	-5	-1
Investment (Δ% y/y)	28.2	11.5	-7.5	-0.7	-4.9	-1	5
Exports (Δ% y/y Local Currency)	23.9	-3.1	-4.5	3.5	9.7	6	3.5
Imports (Δ% y/y Local Currency)	24.6	2.1	-5.6	2.5	-2.3	-1.5	-0.5
GDP (US$ bn)		202	203	192	195	205	215
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		2.9	3.2	4.4	3.2	2.8	2.5
WPI Inflation (Dec Cumulative)		1.6	1.5	2.6	1.9	1.5	2.0
US$ Exchange Rate (Average)		2.7	2.84	3.19	3.356	3.29	3.57
Central Bank Reference Rate (eop)		4	3.5	3.75	4.25	3.5	4
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		0.9	0.3	-2.1	-2.6	-3	-2.8
**Primary Balance, % of GDP		2	1.2	-1.9	-1.5	-1.5	-1
Balance of Payments							
Trade Balance, % of GDP		0.0%	-0.7%	-1.6%	-0.2%	0.5%	0.4%
Current Account, % of GDP		-4.5	-4	-4.4	-3.8	-2	-2.5
Debt Profile							
Central Bank International Reserves (US$ bn)		65.7	62.4	61.5	61.7	62.9	63.0
Total Public Debt (gross, % of GDP)		20.0	20.0	23.3	23.8	27.0	26.5
Of which: Foreign-currency denominated (% of GDP)		8.99	8.74	11.10	10.30	12.00	12.00
Labor Markets							
Unemployment Rate (year-end, % of EAP)		5.9	5.2	6.2	6.7	7.5	6.0

Sources: Economy Ministry, Central Bank, and Santander estimates.

URUGUAY

GROWTH SURPRISED ON THE UPSIDE IN 1Q17

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- **GDP grew 4.3% y/y in 1Q17, driven by consumption and higher inventories. As a result, we revised our 2017 forecast to +3.2% y/y.**
- **After remaining stubbornly high in 1Q17, UYU yields dropped based on lower inflation and FX that we now forecast at UYU/USD 29.5 for YE2017.**
- **The fiscal deficit remains at 3.6% of GDP, forcing authorities to keep taxes and administered prices high, undermining competitiveness.**

We revised 2017E GDP growth to 3.2% from the previous 2%, based on improved external prospects and a higher than expected 1Q17 reading

1Q17 GDP surprised on the upside with a 4.3% y/y increase, above our 2.8% y/y expectations, with key drivers being household consumption (+4.3% y/y), exports (+4.9%), and inventories (+55%). Household consumption rose due to a declining U.S. dollar that stimulated imported durable goods sales, particularly cars and home appliances. New car sales jumped an impressive 25.1% y/y in real terms in 1Q17, while home appliances increased 16.7% y/y. In this context, we raised our 2017 household consumption forecasts to +2.6% in real terms from the previous +1% y/y, in line with our expectation of payroll evolution. We expect wages to rise an average of 2.6% in real terms in 2017, based on rigid nominal wages (+9% y/y) and lower inflation that we now expect to average 6.4% y/y, down from 9.6% in 2016.

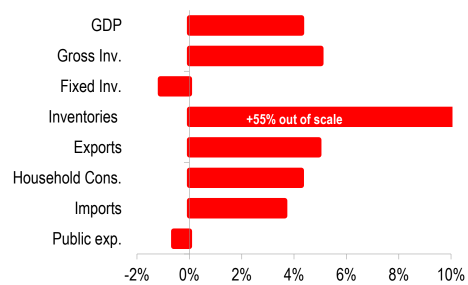
According to own estimates, core industrial production averaged a 1.2% y/y increase in real terms in the first four months of the year. This occurred despite the 2.1% y/y decline in the overall industrial index due to the closing of the state oil refinery for maintenance work, which occurs every five years. Merchandise exports, in turn, grew by 7.7% y/y in the first four months measured in U.S. dollar terms, as key sectors such as soybeans, beef, and dairy picked up. In addition, the summer season was one of the best in years, with a 37% y/y increase in tourism receipts in U.S. dollars, mostly fostered by Argentineans (+44% y/y), which accounted for 70% of total revenue in 1Q17. All in all, exports of both goods and services grew nearly 5% y/y in real terms in 1Q17, positively contributing to activity levels.

Employment, investment, and business sentiment remain subdued

In contrast to robust activity levels, job creation remained negative throughout 1Q17, picking up only modestly in April. As a result, unemployment remained stubbornly high at 8.6% in the moving quarter through April. We expect this situation to prevail in the upcoming months, considering high labor costs and persistent uncertainty regarding improved external conditions, both of which jeopardize job creation. A feeble labor market fed into May Ucudal/Sura consumer sentiment that, after reaching a two-year high of 51.3 in April, receded to a pessimistic level of 47.1, though still above 40.7 a year ago.

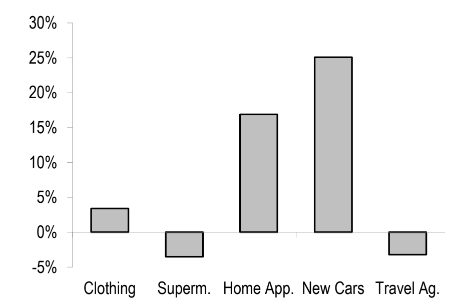
Business sentiment, in turn, picked up in recent months, though still signaling caution regarding future economic conditions. The Deloitte survey conducted in April showed an increase in the percentage of firms expecting better economic conditions in the coming year to 30% from 27% in October 2016, above the percentage of firms expecting worse conditions (14%). Still, a majority (56%) of firms expected no change in economic performance as of April. The industrial survey released in April by the industry chamber showed slightly less optimism. Only 7% of firms expected better economic conditions, up from 4% in October though still substantially below the 26% of firms expecting the economic environment to worsen. Along these lines, private investment stagnated in 1Q17, negatively weighing on activity levels and shedding light on the potential medium-term risks associated with exclusively consumption-driven growth. In our view, political uncertainty in neighbors Argentina and Brazil and undermined competitiveness driven by high labor costs, increased tax pressure, expensive administered prices, and a strong real exchange rate (RER) likely explain low investment and job creation despite a rebound in activity levels.

Strong GDP growth in 1Q17



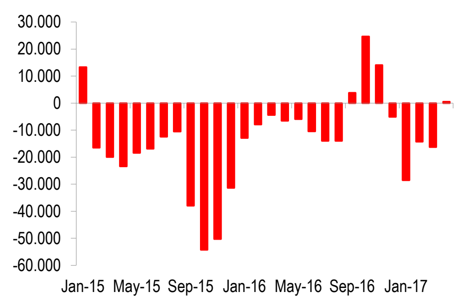
1Q17 GDP growth, % y/y in real terms. Sources: BCU and Santander.

Durable goods rise as the UYU strengthens



1Q17 retail sales % y/y in real terms. Source: Cámara Nacional de Comercio y Servicios.

Job creation remains negative in 2017



Net jobs created y/y in moving quarters (average). Sources: INE and Santander.

UYU rates dropped on the back of lower inflation and peso strength

Despite continued declines in inflation and FX stability since August 2016, UYU yields remained stubbornly high in 1Q17. However, since April, three-month UYU sovereign yields have collapsed from nearly 13% p.a. average as of March to 8.7% p.a. as of July 11. As a result, real yields fell from a high of 5.4% p.a. in 1Q17 to the current 3%. The Treasury took advantage of this decline by issuing the first fixed-rate local currency global bond at a five-year tenor. The bond, issued on June 12, was mostly purchased by institutional investors at a 10% p.a. yield. This occurred amid reaffirmation of Uruguay's sovereign rating at BBB by rating agencies DBRS and S&P; the latter raising its outlook from negative to stable. Successful weathering of recessions in Brazil and Argentina, lower inflation, and a greater focus on fiscal tightening were some of the reasons put forward by the agencies, reducing the likelihood of a credit downgrade in the near future, in our view, despite a stubbornly high fiscal deficit.

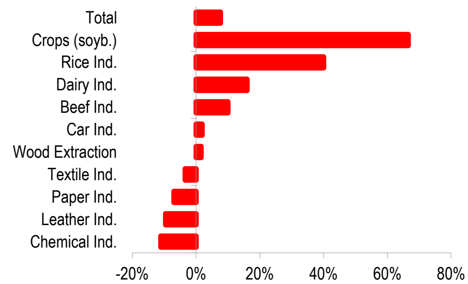
Improved external conditions have resulted in renewed portfolio inflows that are keeping the peso strong against most currencies. The exception is the ARS, which, together with the UYU, remains around 20% overvalued against the U.S. dollar, according to our RER metrics. In our view, this likely explains why the summer tourism season in Uruguay saw record high receipts, which could prevail in 1Q18 if economic policies in Argentina remain unchanged or undergo only minor changes after the October elections. However, material changes in the political and economic scenario in the neighbor country could eventually affect the local exchange rate, similar to past episodes of FX contagion amid strong RER in the region. With such a risk highlighted, our basic assumption is that both external and regional conditions should remain supportive, leading us to revise downward our U.S. dollar forecast to UYU/USD 29.5 from the previous UYU/USD 31.6. Under such a scenario, our models indicate that yields should remain at current levels in upcoming months, with a slight downward bias near 50 bps. Into 2018, however, we expect rates to return to two-digit levels, under the assumption of higher FX depreciation and inflation readings.

Despite higher growth and tax increases, the fiscal deficit remains high

Despite higher taxes in effect since the start of the year – mostly imposed on personal incomes – the fiscal deficit remains stubbornly high at 3.6% of GDP as of April 2017. The primary result remains negative at 0.4% of GDP, way below the 0.9% of GDP we estimate as necessary to stabilize public sector net debt at the current level of 43% of GDP. The high deficit lingers despite cyclical recovery, an estimated increase in revenue of 0.7% of GDP due to fiscal tightening, and a decline in public investment of 1% of GDP during the current administration. The main reason for such worsening is rising current spending amid legal protections for pensions and healthcare, which poses serious threats to reaching the fiscal target of 2.5% of GDP in 2019 without further fiscal measures. Moreover, rising demands from public teachers and from judicial system personnel forced the Ministry of Finance to promote new tax increases for 2018 in the budget bill sent to Congress a few weeks ago. If passed, new taxes will amount to 0.2% of GDP, to be imposed on gambling and imports, clearly contrasting with official language, which has indicated an intention to promote further trade openness.

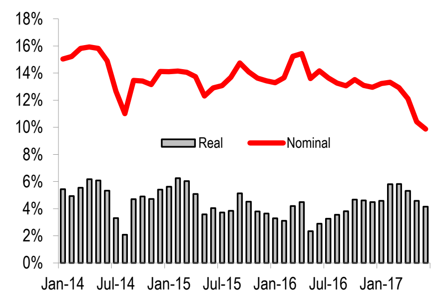
In sum, activity appears to be in much better shape than we anticipated a year ago, driven by improved external prospects that boosted exports and consumption as FX quotes and inflation readings declined. In addition, the likelihood of a credit downgrade in the near term declined considerably, providing relief to authorities. However, underinvestment and low employment shine a light on high labor costs, expensive publicly-administered prices, and a strong RER, which, in our opinion, could weaken medium-term growth prospects and expose the country to potential swings in global sentiment or unexpected regional distress. Furthermore, ongoing rising expenses will likely impose new deficit-reduction measures in upcoming years in order to place public debt dynamics on a firm downward trajectory. Unless authorities undertake firm action on capping public expenses, new fiscal measures are likely to add further strain on the private sector, in our view.

Exports pick up



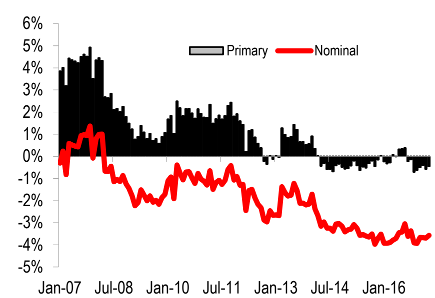
% y/y in US dollar terms. Jan-Apr 2017. Source: BCU.

UYU rates finally dropped



Sovereign 3-month tenor yields. Real rate based on past y/y inflation (June 2017: forecast). Sources: BEVSA and Santander.

Public sector deficit remains high



Primary and nominal public sector result in terms of GDP. Adjusted by exceptional revenues and expenses. Sources: MEF and Santander.

URUGUAY

	GDP %	2013	2014	2015	2016F	2017F	2018F
National Accounts & Activity Indicators							
Real GDP (Δ% y/y)		4.6	3.2	0.4	1.5	3.2	3.0
Private Consumption (Δ% y/y)	66.0	5.5	3.0	-0.5	0.7	2.6	2.8
Public Consumption (Δ% y/y)	13.8	4.9	2.5	2.2	1.6	1.7	1.6
Investment (Δ% y/y)	22.9	4.8	0.0	-9.0	0.7	2.2	4.4
Exports (Δ% y/y Local Currency)	24.0	-0.1	3.5	-0.6	-1.4	4.2	3.0
Imports (Δ% y/y Local Currency)	27.3	2.8	0.8	-7.3	-2.9	2.0	3.0
GDP (US$ bn)		57.6	57.3	53.4	52.5	60.5	62.3
Monetary and Exchange Rate Indicators							
CPI Inflation (Dec Cumulative)		8.5	8.3	9.4	8.1	6.6	7.2
WPI Inflation (Dec Cumulative)		9.2	10.3	10.0	7.7	6.8	7.2
US$ Exchange Rate (Average)		20.5	23.2	27.3	30.1	28.7	31.1
Central Bank Reference Rate (eop)		n/a	n/a	n/a	n/a	n/a	n/a
Monetary Base (Δ% y/y)		16.1	10.7	9.5	6.1	8.0	8.0
Fiscal Policy Indicators							
**Fiscal Balance, % of GDP		-2.3	-3.4	-3.4	-3.9	-3.4	-3.2
**Primary Balance, % of GDP		0.4	-0.6	0.0	-0.6	-0.1	0.2
Balance of Payments							
Trade Balance, % of GDP		-1.4	-0.9	-0.2	0.3	0.3	0.1
Current Account, % of GDP		-2.9	-2.6	-1.1	-0.1	0.1	-0.1
Debt Profile							
Central Bank International Reserves (US$ bn)		16.3	17.6	15.8	13.7	15.3	17.7
Total Public Debt (gross, % of GDP)		55.3	58.5	58.8	63.5	59.7	62.1
Of which: Foreign-currency denominated (% of GDP)		37.7	44.0	54.0	53.0	48.9	50.3
Labor Markets							
Unemployment Rate (year-end, % of EAP)		6.5	6.6	7.5	7.8	8.4	8.1

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

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