Strictly Macro

Weathering Risks

July 13, 2018

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The search for the least vulnerable

Latin America braces for heightened uncertainty as we head into the second half of 2018, reflecting a challenging external backdrop compounded by internal vulnerabilities. The beginning of 2Q18 saw a fast and furious depreciation in LatAm FX (13 pp decline from peak to trough), underperforming EM FX, as global investors liquidated their positions in risky assets in response to: (i) higher financing costs, as DM central banks led by the Fed continued to shift away from QE and into QT; (ii) increased global trade protectionism; and (iii) a stronger USD, which reflected the dominance of US activity, wider US interest rate spreads vs. other DM economies and geopolitical tensions (e.g., euro periphery). Broadly speaking, the idiosyncratic themes in Latin America have not improved above the levels required to keep the risk-reward balance attractive, in our view. Against this backdrop, we believe the typical search for yield has been replaced by a search for the least vulnerable economies across EM.

EM vulnerability scoreboard for 2018

	Gross PS Debt	Primary fiscal bal.	Current account	Reserves
Argentina	54.1	-3.5	-5.1	7.9
Brazil	87.3	-2.3	-1.6	17.8
Chile	23.8	-0.5	-1.8	13.7
Colombia	49.3	0.1	-2.6	14.7
Hungary	67.4	0.0	2.5	18.0
India	68.9	-1.7	-2.3	14.7
Indonesia	29.6	-0.9	-1.9	12.2
Mexico	53.5	1.0	-1.9	14.3
Philippines	37.3	1.4	-0.5	22.8
Poland	50.8	-0.2	-0.9	20.6
South Africa	54.9	-0.5	-2.9	9.7
Turkey	27.8	-1.3	-5.4	12.2

Green indicates stronger fundamentals. Red shows weaker fundamentals.

All data is % of GDP. Source: IMF and Bloomberg. Estimates are 2018, except Reserves, which are 2017.

In our opinion, LatAm local assets' performance in coming months will remain highly sensitive to the following drivers: (i) the rate of change in fundamentals from what we judge is a still decent position currently (growth rate near potential, inflation below average, and so-called twin deficits with no major imbalances); (ii) business cycle synchronization and the net impact of a potential global economic slowdown; and (iii) economic policy.

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Big LatAm countries are more exposed

The table on the previous page shows the heat map for selected EM countries (using IMF calculations to allow easier comparisons), including those factors that in our view will be closely scrutinized by global investors going forward. Our first conclusion here is that the bigger LatAm EM economies (i.e.,, Brazil, Mexico, and Argentina) look more prone to another sudden repricing considering the structural nature of risks involved. Indeed, the ability to service public service debt amid political uncertainty remains center stage. Among the large LatAm trio, Argentina is undergoing a set of critical macro adjustments as per the IMF's shock therapy guidelines to correct its twin deficit position. Moreover, the country has more than two-thirds of public debt denominated in hard currency and thus remains the economy most exposed to a worsening in external conditions. Despite Argentina's exceptionally high rates in real terms (top chart at right), poor liquidity conditions across assets reveal a precarious market and highlight the critical task for Argentine authorities to regain investor confidence.

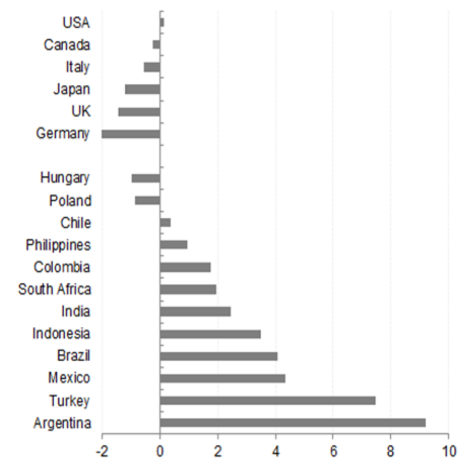
Despite its firm external stance, Brazil's vulnerability is more fiscal in nature, so we believe its prospects depend on approving a major overhaul (including pension reform, public expenditure and wages and tax simplification) to secure fiscal sustainability. The effectiveness of such fiscal reform will depend on the new government's priorities and its political power (control of Congress). Note that Brazil's government has the second largest footprint in the region next to Argentina (middle chart). The upcoming elections (October) could fuel political uncertainty, which could run in parallel with tougher financial conditions abroad, thus leading to additional weakness in local assets, in our view. At face value, fundamental indicators halted the improvement trend seen in 2H17 (slower growth and higher inflation), which in turn increases the pressure for authorities to intervene further in local markets. Among the largest countries, we believe the least vulnerable is Mexico, which recently had its biggest election in history with a seismic reshuffling of power. A leftist government will make its debut with the strongest political position since 1997 after securing a simple majority in Congress. Here the risk-reward looks more balanced, in our opinion, once allowing for high real rates, fiscal consolidation under way, and a resilient economy with cheap FX in real terms (bottom chart). However, from a medium-term perspective, a slower implementation of reforms (mainly energy) and the ambitious social agenda are challenging, in our view, given limited fiscal latitude for such measures. Moreover, we see the pending potential overhaul of NAFTA as another source of legitimate concern.

	GDP			Current Account		Fiscal Balance		Weight
	Last 18yrs	Potential	Next 2yrs	Last 8yrs	Next 2yrs	Last 6yrs	Next 2yrs	
Brazil	2.5	2.0	2.6	-2.8	-0.9	-6.4	-5.6	43
Mexico	2.2	2.5	2.5	-1.7	-1.6	-2.5	-2.0	25
Argentina	2.6	3.0	1.5	-2.3	-2.8	-5.3	-3.0	13
Colombia	3.9	3.3	2.8	-4.0	-3.0	-2.9	-2.8	7
Chile	3.9	3.3	3.7	-1.9	-1.6	-1.5	-2.0	6
Peru	5.0	3.8	3.8	-3.1	-2.3	-0.8	-3.3	5
Uruguay	2.9	3.0	2.4	-1.3	-0.5	-3.2	-3.7	1

GDP is %y/y, Current Account and Fiscal Balance are % of GDP. Region weight using 7 countries.
Source: Santander Research using official figures. All forecast are Santander

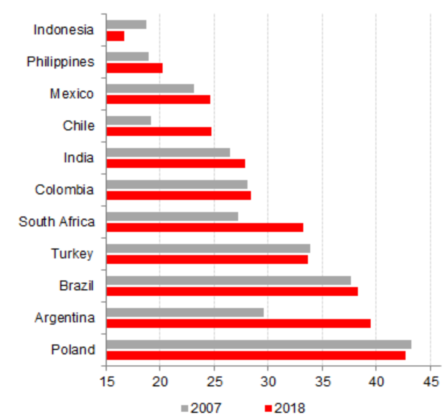
Meanwhile, for the rest of the countries in our LatAm coverage, the limited level of political risk is the first important element of contrast. Growth dynamics in Chile, Colombia, Peru, and Uruguay are benefiting from a combination of healthy consumer and business confidence and supportive commodity prices. Of course, these economies remain vulnerable to a change for the worse associated with the higher-yielding US environment and the adoption of US protectionist policies (including China's retaliation), which could drive a realignment of commodity prices and take a negative toll on the fiscal and external accounts. Another pending issue among the least-vulnerable smaller

Real rates in selected countries



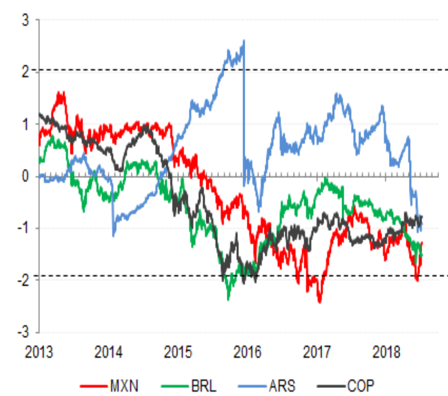
Ex ante using 2yr bond yields deflated with IMF's 2019 CPI forecast. Source: Bloomberg and IMF.

Tracking governments' footprints in EM



Total PS spending as % of GDP. Source: IMF.

FX performance (real terms)



Z-scores calculated since 2010. Source: Bloomberg.

countries is that their strategies to increase potential GDP growth rate are proceeding slowly, which is important given that most of them face mature business cycles.

Collateral toll from trade tensions

The region as a whole features high levels of global trade exposure, although these are particularly elevated in the case of Mexico (manufacturing biased) and Chile (commodity biased), where participation rates in the global supply chains (as share of exports) are above 45%, according to WTO data, compared with a 30-35% range for the rest of the LatAm countries. The collateral impact from a trade war will almost surely cloud the EM outlook, in our view, but mainly for export-dependent economies, where the consequences could be more prolonged as well. The US decision to impose further tariffs on $200bn of imports from China, plus a NAFTA withdrawal, if it occurred, would have an adverse impact on Mexico, which in turn would contaminate the rest of LatAm. Mexico spends 22% of its GDP in US imports compared with 2% in the case of Brazil. From a sectorial view, the auto industry (one of the fastest-growing export markets) is vulnerable given its complex supply chain system, and higher tariffs imply a risk of a loss of competitiveness. Note that NAFTA's total auto production slowed to 17.5mn units last year, while its biggest competitors (China and EU) saw gains (to 29mn and 18.8mn, respectively). Meanwhile, a strategy of tit-for-tat retaliation could prove damaging for Mexico and Canada given their limited global market footprint, in sharp contrast to the US.

It pays to run ahead of shock policies, in our view

At the same time, the region also remains greatly dependent on capital inflows to finance local imbalances and thus is highly sensitive to market volatility (perhaps with the exception of Chile). Of course, a more developed local investor base and higher liquidity can act as important buffers, in our view. Our G-10 research group believes that the risks for global markets associated with the US-China trade conflict and a less gradual Fed rate normalization are being underpriced and thus represent a significant risk for capital flows for our region. Therefore, in the event of renewed global financial instability, those countries with an easier monetary stance relative to the Fed (mainly Brazil and Colombia) could see their FX underperforming. Although Chile fits this category, a key difference lies in its low dependence on foreign capital. At the other extreme of the monetary spectrum lies Mexico, where we believe another potential round of EM outflows may generate a less negative impact given its wider spreads relative to US Treasuries. Behind this is the Mexico Central Bank's strategy to remain ahead of shocks.

Overall, the market environment that LatAm countries will face in coming months also means stronger competition for scarce global flows (both portfolio and FDI). We believe global investors will have a greater preference for liquidity above other considerations, such as valuations and market positioning, and will also focus on the time horizon before allocating investments. Finally, we believe the markets will have a positive bias toward those EM countries running pro-growth strategies (with a subsequent impact on internal productivity and external competitiveness) while implementing coordinated and preemptive monetary and fiscal policies.

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FORECAST SUMMARY TABLES

KEY MACRO INDICATORS

GDP growth	2016	2017	1Q18	2Q18	3Q18	4Q18	2018F	2019F	Last Review '18	Nom GDP '18
Argentina	-1.8	2.9	3.6	-1.3	-0.8	2.6	1.0	2.0	Down	554
Brazil	-3.6	1.0	1.3	2.4	2.9	3.2	2.0	3.2	Down	1,953
Chile	1.3	1.5	4.2	5.1	3.4	3.4	4.0	3.3	Up	310
Colombia	2.0	1.8	2.2	2.3	2.6	3.0	2.5	3.0	Unchanged	346
Mexico	2.9	2.0	1.3	3.0	2.7	2.8	2.4	2.5	Unchanged	1,200
Peru	4.0	2.5	2.5	3.0	3.5	4.5	3.5	4.1	Unchanged	219
Uruguay	1.7	2.7	2.2	3.3	2.6	1.3	2.3	2.5	Down	62
LatAm-7	**-0.3**	**1.7**	**1.9**	**2.4**	**2.4**	**3.0**	**2.2**	**2.9**		**1,235**

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

GDP	Priv Cons			Pub Cons			Investment			Exports			Imports		
Components	'16	'17	'18F	'16	'17	'18F	'16	'17	'18F	'16	'17	'18F	'16	'17	'18F
Argentina	-1.0	3.6	0.0	0.3	1.9	-3.4	-4.9	11.3	4.3	5.3	0.4	5.3	5.7	14.7	-0.4
Brazil	-4.3	1.0	3.0	-0.1	-0.6	0.1	-10.2	-1.8	4.5	1.9	5.2	3.3	-10.3	5.0	8.7
Chile	2.4	3.8	3.6	4.0	3.3	3.6	-1.1	5.7	4.9	-0.9	6.8	2.7	4.7	7.5	4.9
Colombia	1.4	1.8	2.7	1.8	4.0	4.6	0.3	0.6	-0.9	-1.4	-0.7	1.8	-4.0	0.3	1.6
Mexico	3.7	3.0	2.8	2.4	0.1	2.0	1.1	-1.5	0.2	3.5	3.8	6.8	2.9	6.4	6.5
Peru	3.3	2.5	3.0	-0.5	1.6	1.0	-3.9	-2.3	4.5	9.5	8.5	6.0	-2.2	4.0	3.0
Uruguay	0.1	4.4	2.6	2.9	-1.3	-0.6	-3.9	-13.8	3.3	-0.2	7.6	2.2	-6.2	-0.4	2.4
LatAm-7	**-0.3**	**2.2**	**2.6**	**1.1**	**0.6**	**0.9**	**-4.5**	**0.2**	**2.8**	**2.7**	**4.0**	**4.5**	**-2.9**	**6.1**	**5.8**

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

Inflation	Headline CPI (YoY)							Core measure		
	2016*	2017*	Jul-18F	Aug-18F	Sep 18F	2018F*	2019F*	2017	2018F	2019F
Argentina	37.7	24.8	30.3	30.4	31.2	29.0	18.0	21.1	26.0	14.0
Brazil	6.3	2.9	4.2	4.0	3.9	3.5	4.0	3.9	3.5	4.0
Chile	2.7	2.2	2.7	2.7	3.0	2.9	2.9	1.9	2.3	2.8
Colombia	5.8	4.1	3.4	3.3	3.4	3.3	3.2	5.0	3.7	3.5
Mexico	3.3	6.8	4.6	4.4	4.3	4.0	3.6	4.9	3.8	3.5
Peru	3.2	1.4	1.6	1.9	2.2	2.5	2.5	1.5	2.5	2.5
Uruguay	8.1	6.6	8.9	8.9	8.8	8.4	7.5	6.6	8.0	7.5
LatAm-7	**8.5**	**6.5**	**7.0**	**6.9**	**6.9**	**6.4**	**5.3**	**6.0**	**6.0**	**4.8**

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

Macro Miscellanea			ARS	BRL	CLP	COP	MXN	PEN	UYU
Fiscal balance	% of GDP	2016	-5.9	-8.9	-2.7	-4.0	-2.6	-2.3	-3.9
		2017	-6.1	-7.8	-2.8	-3.6	-1.1	-3.0	-3.5
		2018F	-4.6	-5.6	-2.2	-3.1	-2.0	-3.6	-3.8
		2019F	-3.9	-5.6	-1.9	-2.4	-2.0	-3.0	-3.6
Public debt	% of GDP	2016	26.7	46.2	9.6	44.0	48.7	23.8	30.7
(Net terms in ARS, BRL, CLP)		2017	28.0	51.6	13.3	45.0	46.0	24.8	31.6
		2018F	32.0	57.9	15.6	45.0	45.3	27.0	33.3
		2019F	33.0	62.8	17.2	44.0	44.8	28.0	34.9
Current account	% of GDP	2016	-2.4	-1.3	-1.4	-4.3	-2.2	-2.7	0.8
		2017	-4.8	-0.5	-1.5	-3.3	-1.7	-1.3	1.6
		2018F	-3.5	-0.8	-1.4	-3.0	-1.6	-2.0	0.0
		2019F	-3.0	-1.0	-1.8	-3.0	-1.6	-2.5	-1.1
Trade balance	US$ bn	2016	1.9	47.7	5.4	-9.2	-13.1	1.9	2.8
		2017	-8.5	67.0	7.9	-4.8	-11.0	5.6	4.0
		2018F	-12.7	55.5	9.0	-3.3	-11.9	2.0	3.2
		2019F	-8.4	54.5	9.5	-3.5	-12.5	2.0	2.6
Unemployment	% of workforce	2016	7.5	12.0	6.5	8.2	3.9	6.7	7.8
		2017	7.2	11.8	6.7	8.6	3.4	6.9	7.9
		2018F	7.1	11.2	6.6	8.0	3.4	6.0	8.5
		2019F	6.8	10.6	6.5	7.5	3.3	6.0	8.2

Source: Santander.

MONETARY POLICY MONITOR

	Current	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
ARGENTINA	40.00	38.00	36.00	32.00	28.00	26.00	23.45
		-200	-200	-400	-400	-200	-255
BRAZIL	6.50	6.50	6.50	6.50	6.50	6.50	7.50
		0	0	0	0	0	100
CHILE	2.50	2.50	2.75	3.00	3.25	3.50	3.50
		0	25	25	25	25	0
COLOMBIA	4.25	4.25	4.25	4.50	5.00	5.25	5.25
		0	0	25	50	25	0
MEXICO	7.75	7.75	7.50	7.50	7.00	7.00	6.75
		0	-25	0	-50	0	-25
PERU	2.75	2.75	3.00	3.25	3.50	3.75	3.75
		0	25	25	25	25	0

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

- **<u>Brazil expected to keep low rates for an extended period</u>: In Brazil, despite recent pressure on the BRL, the MPC considers that the balance of risks continues to warrant a stimulative monetary policy, with the pass-through of the weaker currency limited by the current economic slack. Under this scenario, our economists expect Copom to remain on hold until 2H19.**
- **<u>Easing cycle expected to begin in Argentina:</u> In Argentina, our economists expect the Central Bank to start a gradual easing cycle in 3Q18 as inflationary pressures moderate. However, with the Central Bank decision to complement the inflation-targeting regime with a close monitoring of monetary aggregates, it is expected that the seven-day repo rate will gradually lose relevance as a tool to gauge the relative bias of monetary policy.**
- **<u>Mexico expected to keep high rates until 4Q18</u>: Banxico delivered a 25-bp hike in June, since it considered that the balance of risks to inflation had deteriorated, as the MXN had reached its lowest level since the US elections. However, we think the MXN's recent appreciation should provide some relief for inflation, allowing it to resume its downward path and possibly, if the currency remains stable, opening space for a cut in 4Q18.**
- **<u>Low interest rates in the Andeans</u>: In Colombia, BanRep maintains a neutral tone, and we expect it to remain on hold at 4.25% for the rest of the year. We believe Peru ended its easing cycle in March with its cut to 2.75%, and we expect the BCRP to remain on hold until 4Q18. In Chile our economists expect the BCCh to remain on hold for most of the year, as the output gap gradually closes and inflation normalizes.**

FOREIGN EXCHANGE RATES

	BRL	MXN	CLP	COP	ARS	PEN	UYU
Last*	3.89	19.0	649	2872	27.4	3.27	31.4
Sep-18	3.80	20.2	635	2820	29.5	3.33	31.9
Dec-18	**3.50**	**18.9**	**625**	**2800**	**31.0**	**3.40**	**32.0**
Mar-19	3.52	18.6	630	2780	32.0	3.44	32.5
Jun-19	3.55	18.5	630	2750	34.0	3.49	33.1
Sep-19	3.57	18.8	635	2720	35.0	3.53	33.7
Dec-19	**3.57**	**18.8**	**635**	**2750**	**36.5**	**3.57**	**34.2**

End-of-period levels. * July 13 2018 Sources: Bloomberg and Santander.

- **Year-to-date, LatAm currencies – with the exception of the MXN and COP – have depreciated, reflecting in part a less favorable external environment with higher US rates, a stronger USD, and increasing trade tensions between the US and China. In the case of the BRL and ARS, local events and political noise exacerbated this trend, in our view. Across the region we see diversion in trends for 2H18.**
- **The BRL is a high-beta currency, and we believe that a lower yield premium and political uncertainty should continue to lead to slower inflows and thus a weaker BRL in the short term. In Mexico, the peso may experience some short-term pressure associated with NAFTA negotiations. In Argentina, we expect peso depreciation to continue, but at a slower pace, as Argentina remains the most vulnerable to external shocks. We believe that in Colombia high oil prices will remain supportive of the COP in the coming months. In Chile, the CLP looks slightly undervalued, pressured by lower copper prices, and we expect a slight correction.**

ARGENTINA

INTO A RISK-OFF-DRIVEN MACRO ADJUSTMENT

- **High current account and fiscal deficits left the country badly placed to withstand the worsening external conditions resulting from rising US rates; lack of policy coordination contributed to deepen the shock.**
- **Recent ARS devaluation should lead to increasing inflation, in our view (converging to 29% y/y in December), while activity enters a contracting phase and the current account converges to 4% of GDP.**
- **The IMF agreement covers 72% of the government's total financial needs until December 2019 (of USD 39.1 bn), which reduces the financing risk to be faced in the remainder of Macri's presidential term.**

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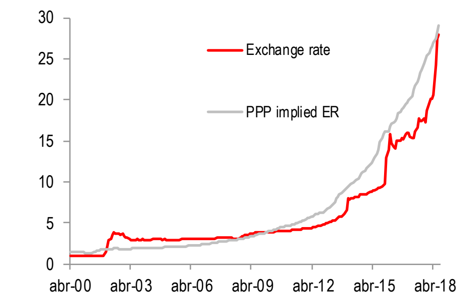
Argentina, more vulnerable to external shocks

Against a worsening international backdrop, a set of more negative fundamentals had a much more severe impact on Argentina than on its regional peers. The magnitude of the sell-off of local assets is mostly apparent in the exchange rate path. While the ARS has depreciated 33% year to date, the Latin American Currency Index has lost only 10%. Last year, the current account deficit reached 4.8% of GDP, well above the 0.9% of GDP average observed in the other important LatAm countries. In 2017 the fiscal deficit stood at 6.1% of GDP (the highest in LatAm bar Brazil), while in 2018 it is expected to decrease slightly, to 4.7% of GDP. Also, as a result of many years of high inflation and local currency rates, 68% of national government debt was denominated in foreign currency (prior to the devaluation), vs. the LatAm average of 9.6%, which leads to a higher risk of exchange rate shocks for Argentina. On top of the exogenous global factors and structural vulnerabilities, some government decisions may have also played a role in the deepening sell-off. The perceived lack of policy coordination by a too-fragmented economic management team has dented market confidence since end-2017. Also, a loosening monetary stance during the first months of 2018 in a context of rising inflation expectations reduced the incentives for short-term capital inflows. Finally, as the tax on financial returns for foreign investors took effect, it acted as a trigger for the sell-off, which began on April 25.

FX shock impact on the economy in the short term

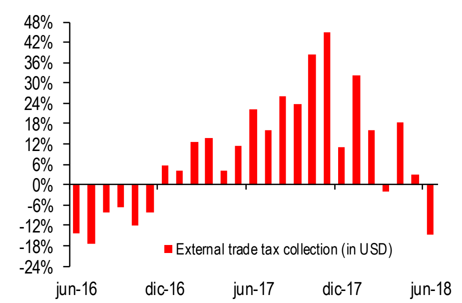
The policy decisions to counter the pressure on the ARS, once taken, rapidly became insufficient and led to another round of measures. The standard FX market intervention and policy rate hikes, coupled with tighter primary deficit targets, gave way to the announcement that the government would resort to the IMF for financial support. Even the latter was not enough to tame FX pressures. Given the restriction outlined in the IMF agreement to intervene in the FX market (see below) and continued ARS weakening, during the last several weeks the government has taken measures to contain USD demand and anchor devaluation expectations (swap of Lebacs for Letes, increase in financial system reserves requirements). The REER weakened almost 30% year to date and is currently slightly above its long-term average. Also, our measure of the PPP exchange rate against the USD suggests that the peso may be roughly at the level consistent with long-term equilibrium. Based on these measures, we think that going forward the pace of ARS depreciation will be slower than seen lately, but we are not yet entirely out of the woods. As a result of the exchange rate increase (40% in the last three months to July 6), we expect inflation to increase substantially during the next few months, given the high pass-through coefficient in the present context (which we estimate at 25% for the four months after the shock). We currently estimate inflation slightly above 3.5% m/m in June, slowing to 3% m/m in July. As a result, during June, inflation likely accumulated more than 15% since last December, surpassing the threshold contained in most of the wage negotiations closed during the first half of the year. Therefore, we expect many labor unions to ask for the reopening of talks with companies in order to renegotiate salary hikes (which we expect will be close to 25% for the whole year) to make up for accelerating inflation.

Closer to equilibrium levels



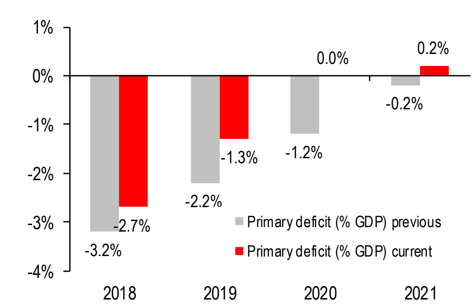
PPP implied exchange rate and market exchange rate (USDARS). Sources: Bloomberg, INDEC, and Santander.

The adjustment is on its way



Annual growth in tax collection related to external trade, in USD. Sources: Ministry of Economy and Santander.

Accelerating the fiscal adjustment



Primary deficit targets (pre and post IMF agreement). Sources: Economy Ministry and Santander.

Nevertheless, new agreements will take time to be closed, which should lead to real wage contraction during the next few months, denting consumption growth. In addition, heightened uncertainty and higher interest rates will likely arrest investment expenditures going forward, in our view. After the 3.6% y/y GDP expansion in 1Q18, we anticipate annual contractions in 2Q18 (due in part to the negative impact of the drought on agricultural production) and 3Q18 of 1.3% y/y and 0.8% y/y, respectively. However, we acknowledge that there are downward revision risks to these estimates. Next year, in a scenario of normal weather conditions, agricultural production could rebound significantly, contributing to the GDP recovery. For 2019 we expect GDP to grow 1.8%.

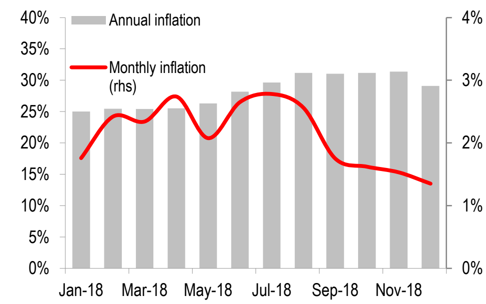
Implications of IMF accord

The stand-by arrangement (SBA) outlines a series of targets that will need to be met in order to access the IMF funding (after the initial USD 15 bn disbursement, the plan anticipates additional optional installments of USD 2.9 bn per quarter from September 2018 until June 2021). On the fiscal front, the IMF requires the government to reach a primary deficit equivalent to 2.7% of GDP in 2018, 1.3% of GDP in 2019, and reach equilibrium in 2020. Also, the Central Bank is required to immediately phase out the monetary transfers to the central government (temporary transfers and profits) and to stop purchasing US dollars from the public sector (proceeds from overseas debt placements). Additionally, the government is required to cancel up to the equivalent of USD 25 bn of non-marketable bonds in the hands of the Central Bank (from a total of approximately USD 48.8 bn) by issuing new debt to the market during the next two years. The proceeds will be used by the Central Bank to repurchase Lebacs, reduce its stock, and reduce the refinancing. We believe that these measures leave the Central Bank in a much stronger position than in the past to effectively fight inflation, once the effect of the ARS devaluation fades. We think that the inflation target set for the end of 2019, at 17% (and contained in the SBA as a consultation target) is reasonably achievable. In addition, the IMF has imposed on the Central Bank a minimum increase in the level of net reserves per quarter; net reserve growth cannot be lower than USD 5.5 bn in the coming quarters. Given that the Central Bank has sold reserves in recent weeks in order to tame ARS depreciation, we estimate that net reserves are close to the minimum required level, which leaves the monetary authority with diminished firepower to intervene in the FX market.

Fiscal accounts and financing needs

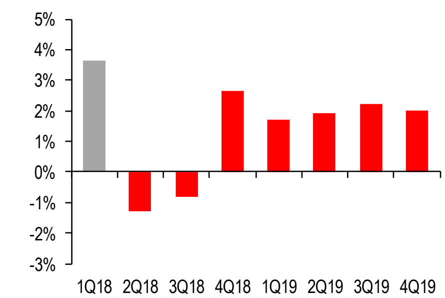
We estimate that the government will easily meet the 2.7% primary deficit target agreed upon with the IMF for 2018. Year to May, revenue grew 24.3% y/y, while expenses expanded 17.5% y/y. In the coming months we anticipate an acceleration of revenue growth linked to the exchange rate (exports and imports duties). On the expenditure side, the government has substantially reduced subsidies and public work expenses: they fell 9.3% y/y and 20.9% y/y year to May. We consider that the 2.7% target for 2018 could even be exceeded, which would leave the government in a better position to reach the committed primary target deficit for 2019 of 1.3% of GDP. For next year, the strategy will be concentrated in reducing expenses in four key items: public works (-0.6% of GDP), subsidies (-0.4% of GDP), transfers to provinces (-0.3% of GDP), and wages (-0.2% of GDP.) The only item that could expand in GDP terms is social security outlays (+0.5% of GDP). Taking into account only the reduction in expenses, we estimate the primary deficit could reach 1.6% of GDP in 2019. To attain the additional 0.3 pp of GDP to meet the target, the government assumes a positive contribution from increasing revenue from a yet undisclosed origin (we believe this additional income could come from a labor amnesty). The SBA targets will need to be included in the budgetary law for 2019; we anticipate that the official coalition legislators will face a difficult task to reach agreements with opposition blocs in order to get this bill through Congress, in a context in which the different factions of the Peronist party are adopting a more confrontational stance in light of the predictable drop in the government's popularity and aiming at the presidential elections due next year. Assuming a stressed scenario in which the government cannot roll over USD amortization in the next 18 months (not the current case), we estimate that the IMF's assistance will be enough to cover up to 72% of the gross USD financing needs.

Increasing inflation due to ARS devaluation



Annual and monthly inflation rates. From June is estimated. Sources: INDEC and Santander.

Contracting activity ahead



Annual GDP growth. Sources: INDEC and Santander.

Financial needs for 2H18 and 2019

Next 18 months	ARS bn	USD bn	Total in USD bn
Primary deficit	522.0	0.0	17.9
Interest payments	210.5	13.5	20.3
Amortizations	96.3	34.6	37.4
Paris Club	0.0	3.4	3.4
IFI's	0.0	2.6	2.6
USD letes	0.0	15.4	15.0
Bonds	96.3	6.1	9.3
Repo	0.0	7.1	7.1
Total Uses	**861.8**	**48.1**	**75.6**
Repo	0.0	4.0	4.0
IFI's	0.0	31.0	31.1
IMF	0.0	25.0	25.1
Others	0.0	6.0	6.0
Deposits	0.0	3.3	3.3
Total Sources	**0.0**	**38.3**	**38.4**
Financing Gap	**-861.8**	**-9.8**	**-37.2**

Sources: Ministry of Economy and Santander.

ARGENTINA

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		2.4	-2.5	2.6	-1.8	2.9	1.0	2.0
Private Consumption (Δ% y/y)	74.1	3.6	-4.4	3.5	-1	3.6	0.0	1.5
Public Consumption (Δ% y/y)	12.6	5.3	2.9	6.8	0.3	1.9	-3.9	-4.0
Investment (Δ% y/y)	19.5	-3.5	-6.8	3.8	-4.9	11.3	4.3	7.0
Exports (Δ% y/y Local Currency)	18.8	2.3	-7	-0.6	5.3	0.4	5.3	9.0
Imports (Δ% y/y Local Currency)	26.5	3.9	-11.5	5.7	5.7	14.7	-0.4	9.0
GDP (US$ bn)		611	563	634	545	620	554	544
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)*		26.5	40.7	27.2	37.7	24.8	29.0	18.0
CPI core Inflation (Dec Cumulative)*		27.9	37.9	28.2	32.4	21.1	25.0	14.0
US$ Exchange Rate (Average)		5.5	8.1	9.2	14.7	16.56	25.1	33.7
Central Bank Reference Rate (eop)		15.4	26.9	33	24.8	28.75	36.00	23.45
Private sector credit (% of GDP)		14.5	12.7	13.7	12.9	15.3	15.7	16.1
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-3.6	-5	-6.1	-5.9	-6.12	-4.6	-3.9
Primary Balance, % of GDP		-2.3	-3.4	-4	-4.3	-3.9	-2.3	-1.6
Balance of Payments								
Trade Balance		0.3	0.4	-0.6	0.3	-1.4	-1.9	-1.3
Current Account, % of GDP		-0.7	-0.9	-1.5	-2.4	-4.8	-3.5	-3.0
Debt Profile								
Central Bank International Reserves (US$ bn)		30.5	31.4	25.5	38.7	55	62	66
Total Public Debt (net of public sector holdings, % of GDP)		19.9	18.4	22.8	26.7	26.6	32	34
Of which: Foreign-currency denominated (% of GDP)		12.3	11.9	15.3	18.2	18.1	22.4	23.8
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.4	6.9	5.8	7.6	7.2	7.1	6.8

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

BRAZIL

AN ECONOMY TAKING A BACKSEAT TO ELECTIONS

- **Anticipation and concern around the possible results of the October general elections are likely to be the main market drivers in 3Q18, in our view.**
- **Election results, in our opinion, will remain uncertain until close to the voting day, probably keeping risk premiums elevated across Brazilian assets and requiring Central Bank intervention in the FX market.**
- **Fundamentals have improved markedly over the past couple of years, and we believe the next president can benefit from a cyclical economic recovery provided she/he makes an effort toward fiscal consolidation.**

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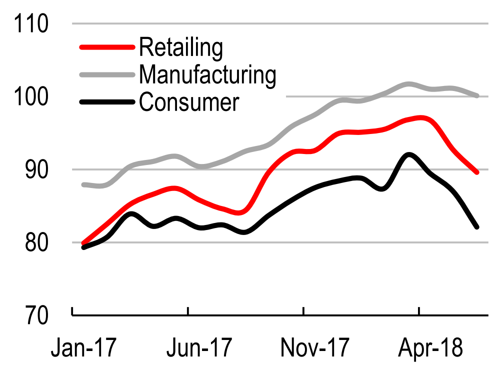
A quarter of waiting

The October 7 general election is the key event of this year (and probably also a key to many years ahead) in Brazil. A political system severely damaged by corruption scandals and poor economic performance is leaving space for outsiders and populist platforms to win electoral power, which could jeopardize Brazil's prolonged fiscal consolidation process (for the debt/GDP ratio to stabilize, it is still necessary to turn a primary deficit of 2% of GDP into a surplus of similar magnitude) and undermine the confidence required for the economic recovery to take off. Political and policy risks associated with the election are adding risk premium to asset prices, forcing the Central Bank and the Treasury to intervene in the exchange rate and local debt markets.

Such risks are not likely to vanish in the short term, as recent polls are pointing to a fragmented presidential race, currently led by candidates from tiny parties. Voter support for candidates from large parties may rise once money, regional alliances, and time on television start working to their benefit, but this will not happen before the official campaign starts (on August 16), and it may take even longer for polls to reflect that. Thus, in our view, it seems likely that the presidential election outcome will remain uncertain until the voting day, well into 4Q18. Consequently, market volatility should stay relatively high, in our view, and we believe the halt in the upward trend of confidence indicators that followed the May strikes should turn into a plateau for some months.

Confidence indices



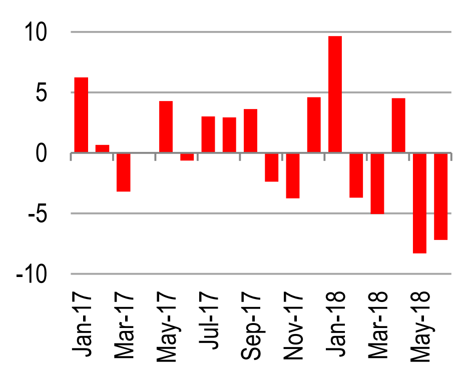
Seasonally adjusted data. Sources: FGV and Santander.

Brazil 2018 General Elections – Some Key Dates

Dates	Events
July 20 – August 5	Period for parties to promote conventions and define candidates/alliances (conventions are not mandatory).
August 15	Deadline for parties to register candidates.
August 16	Official beginning of electoral campaigns.
August 31 – October 4	Period of advertising broadcasts on radio and television.
September 17	Deadline for the Electoral Courts to rule on all candidacies. Deadline for parties to change candidates.
October 7	First round of voting.
October 28	Second round of voting.

Source: Superior Electoral Court.

Net portfolio flows – equity (USD bn)



Sources: B3 and Santander.

Monetary policy and the electoral calendar

The electoral calendar is also important for the next steps in the conduct of monetary policy, in our view. Recent Central Bank (BCB) communications have emphasized the importance of well-anchored inflation expectations, which have been helping the monetary authority to maintain a stimulative monetary policy despite a weakening currency and rising food and fuel prices. Polls ahead of the election, or the actual election result, may de-anchor inflation expectations for 2019 and beyond, by a combination of further currency depreciation and a perceived diminished credibility of the next Central Bank board. If that happens, we believe BCB may use its last two monetary policy meetings before the next government takes over (October 31 and December 12) to adjust monetary policy accordingly. Nevertheless, that is not our base case: we assume the election of a reformist president and inflation below the target midpoint in 2019, which would allow BCB to stay on hold until 2H19. We maintain our forecasts for the Selic rate at 6.5% and 7.5% at YE2018 and YE2019, respectively.

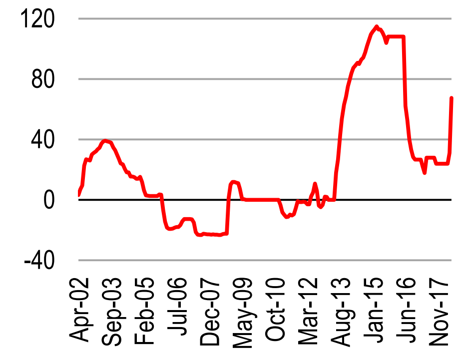
Exchange rate: BCB against the tide

The BRL continues to trade considerably weaker than our year-end forecast (3.50/USD), reflecting, in our view, a combination of a continued demand for hard currency for hedging (for more information, see our report *Falling Interest Rate Differentials Leading to BRL Weakness*, March 28, 2018), speculation, and foreign investment outflows. In our view, the drivers for that demand are likely to remain present in 3Q18: interest rate differentials are expected to remain at multi-year lows (as BCB remains on hold and the Fed and other central banks around the world continue to tighten), and the perception of political risk is likely to stay high, as we argued above.

Against that background, we expect BCB to continue intervening in the FX market, acting to smooth out volatility (but not targeting a specific level for the BRL), mostly by supplying USD in the form of FX swaps. BCB's current swap exposure is around USD 70 bn, and although in theory, there is no limit to this kind of intervention, which is settled in BRL and does not directly affect international reserves, we believe there should be a soft constraint at USD 242 billion in swaps' outstanding amount. At that level, Brazil's government ceases to have a long USD exposure; hence currency depreciation would no longer have a countercyclical fiscal effect. (For a further discussion, see *"Lethal Weapon": How Far Can the BCB Go with Swaps?* June 15, 2018.)

After the elections, assuming a reformist as president-elect, we believe diminishing political risk and rising confidence should lead to new portfolio inflows and to the unwinding of hedging and speculative USD long positions, bringing the BRL back to around 3.50/USD.

FX swaps outstanding notional (USD billion)

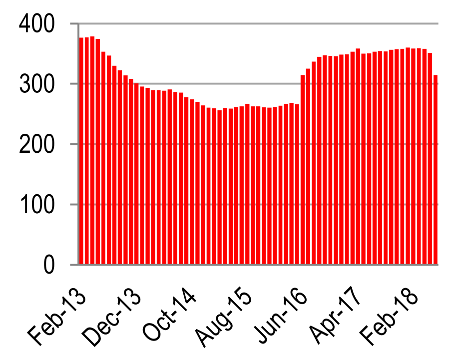


Sources: Brazil Central Bank and Santander.

2019 and beyond

Although we do not work with alternative scenarios, we believe it is worth pondering Brazil's strengths and weaknesses and what kinds of constraints and opportunities they present to the economic management of the next president. In our view, whoever is elected will probably take office in a country with a high level of international reserves, a combination of a low current account deficit and strong FDI inflows, controlled inflation, relatively low interest rates, reduced corporate and consumer leverage, no major contingent liabilities in the banking sector or state-owned firms, and an economic recovery under way. The fiscal position remains challenging – as we mentioned above, a fiscal adjustment of around 4% of GDP in a recurrent fashion still needs to be achieved – but one of the main problems (social security) has been extensively discussed, and most of the candidates agree it needs to be tackled immediately. Assuming that whoever is elected president would like to win reelection in 2022 (which includes, of course, holding on to power until the end of the first term), it will be in her/his best interests not to spoil a relatively strong cyclical recovery that now mostly depends, in our view, on building a sustainable path for the public debt and not provoking turmoil in the markets.

International reserves (net of FX swaps, USD billion)



Sources: Brazil Central Bank and Santander.

That is not to say that the scenario is bullish regardless of who is elected, but perhaps the likely market reaction to the result of the presidential election will not be as binary as some market players are expecting. Despite the current perceived polarization, the rewards of leaning toward the center remain quite attractive, in our view – as the president-elect of Mexico seems to have recently noticed.

BRAZIL

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		3.0	0.5	-3.8	-3.6	1.0	2.0	3.2
Private Consumption (Δ% y/y)	62.8	3.5	2.3	-3.2	-4.2	1.0	3.0	2.9
Public Consumption (Δ% y/y)	20.8	1.5	0.8	-1.4	-0.6	-0.6	0.1	1.0
Investment (Δ% y/y)	16.5	5.8	-4.2	-14.0	-10.2	-1.8	4.5	9.5
Exports (Δ% y/y Local Currency)	11.3	2.4	-1.1	6.9	1.9	5.2	3.3	3.2
Imports (Δ% y/y Local Currency)	-11.4	7.2	-1.9	-14.0	-10.3	5.0	8.7	3.5
GDP (US$ bn)		2,471	2,455	1,801	1,796	2,055	1,953	2,106
Monetary and Exchange Rate Indicators								
IPCA-IBGE Inflation (Dec Cumulative) (%)		5.91	6.41	10.67	6.29	2.90	3.50	4.00
IGP-M Inflation (Dec Cumulative) (%)		5.53	3.67	10.54	7.18	-0.50	7.60	4.50
US$ Exchange Rate (Average)		2.16	2.35	3.33	3.49	3.19	3.56	3.53
Central Bank Reference Rate (eop)		10.00	11.75	14.25	13.75	7.00	6.50	7.50
Stock of Credit To Nonfinancial Private Sector (% of GDP)		50.85	52.21	53.65	49.55	47.13	45.8	45.6
Fiscal Policy Indicators								
Public Sector Fiscal Balance (harmonized) (% of GDP)		-3.0	-6.0	-10.2	-8.9	-7.8	-5.6	-5.6
Primary Balance (% of GDP)		1.71	-0.56	-1.85	-2.47	-1.7	-2.3	-1.8
Balance of Payments								
Trade Balance, % of GDP		0.02	-0.27	0.98	2.66	3.30	2.70	2.60
Current Account, % of GDP		-3.03	-4.24	-3.27	-1.30	-0.50	-0.80	-1.00
Debt Profile								
International Reserves (US$ bn)		358.8	363.6	356.5	365.0	381.1	380.0	380.6
Total Public Debt (net of public sector holdings, % of GDP)		30.5	32.6	35.6	45.9	51.6	57.9	62.8
Of which: Foreign-currency denominated (% of GDP)		-10.2	-10.3	-10.5	-10.5	-10	-9.8	-9.8
Labor Markets								
Unemployment Rate (% eop)		6.2	6.5	9.0	12.0	11.8	11.2	10.6

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

CHILE

The Recovery Faces Increasing Challenges

- **Growth surprised on the upside in 1H18, but the recovery remains relatively fragile: poor in quality jobs and led by mining. We expect a slowdown in 2H18, for statistical and fundamental reasons.**
- **We expect inflation to rise to 3% or so, mainly on external factors, but the low starting point gives BCCh time to adjust monetary policy. Global USD and oil trends will be key factors for inflation, in our view.**
- **The new government promised fiscal prudence, ruling out a stimulus in the near term; we see lower copper prices as a growing threat.**

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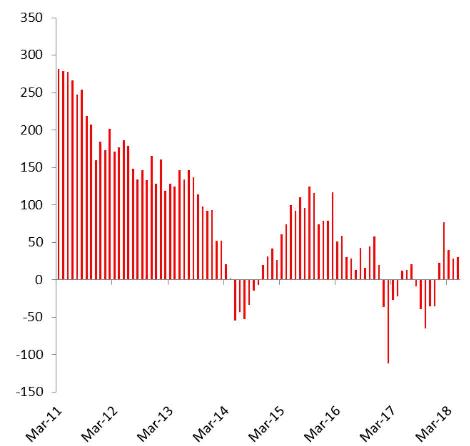
The recent release of May's IMACEC (the monthly GDP proxy) reaffirmed perceptions of a steady recovery in the real economy. Growth averages 4.7% y/y year-to-date, and although a year-ago strike in the mining sector is inflating y/y readings, the non-mining sector is also showing encouraging results: +5.5% y/y in the April-May period, with the 2Q18 print likely coming out near 5% y/y, as per our figures. The BCCh expects 2018 GDP growth to be at 3.25%-4.00% (as per June's IPoM), but we believe this range will likely be adjusted upward in future revisions (3.75%-4.25% could be a reasonable new range). Santander's official GDP estimates are now 4.0% for 2018 and 3.3% for 2019.

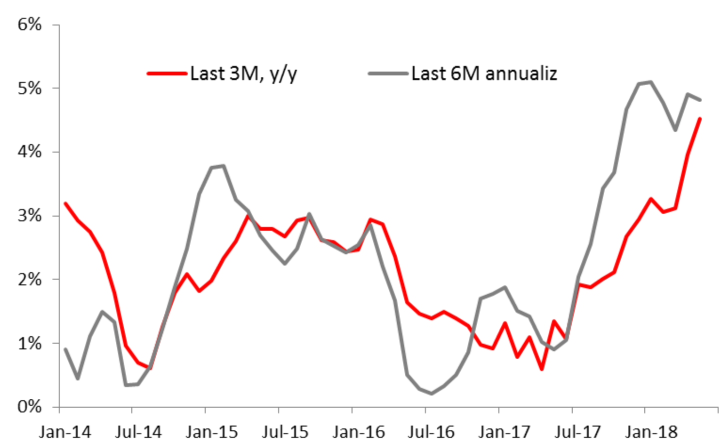
The recovery is being typically cyclical, as outperforming sectors are the ones that suffered the most during the previous slowdown: construction in particular (projected at +5% y/y in 2Q18, after a 7% plunge a year ago), and investment in general terms (+6% estimated in 2Q18), with non-mining exports also gaining momentum. Private consumption is also performing well, especially durable goods sales, such as new cars, which soared 22% y/y year-to-date. Non-durable sales are growing by a more moderate 2.4% y/y year-to-date, which is reasonable considering that consumer spending did not suffer in the previous slowdown, thanks to abundant consumer financing and a resilient labor market.

Job creation in the formal private sector



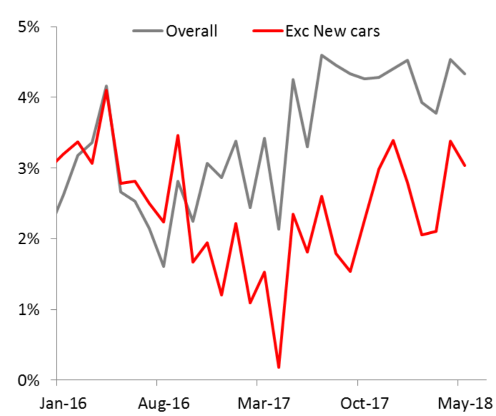
Thousands of new jobs in the last 12 months. Source: INE Santander.

Non-mining IMACEC: Growth reaches 5-year highs



Sources: BCCH and Santander.

Retail sales (y/y chg, last 3M)



Sources: INE and Santander.

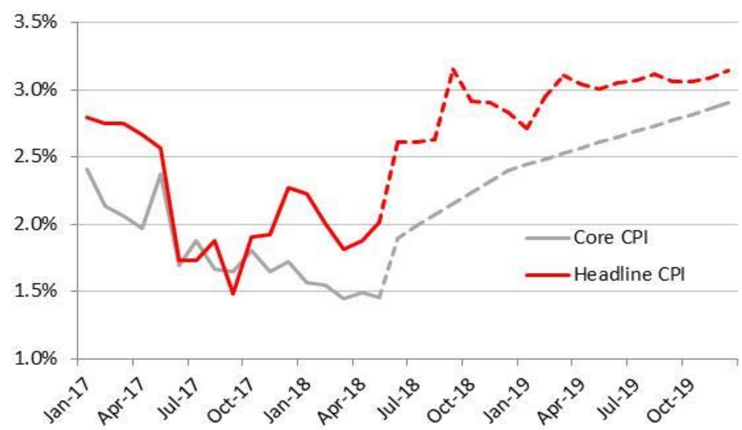
On the domestic front, the key component to sustaining growth in the near future is investment: business confidence continues to hover around 55, well above the low 40s of the previous years, suggesting to us that there is room for some acceleration (the "boom" conditions of 2011-12 are still distant, though).

Looking ahead, however, the outlook seems to be getting a bit cloudy, considering lower copper prices, faltering demand from LatAm countries, and mounting global trade disputes involving China, Chile's main trading partner. For the BCCh, another fragile aspect of the ongoing recovery has been private sector employment: job creation here was negative until December, and from then on, only 40k jobs per month have been created in y/y terms (vs. 140k in the 2012-13 expansion). Our sense here is that job creation will improve, but modestly, as labor productivity has ample room to grow).

On the inflation front, the ongoing global USD rally and rising international oil prices have changed the outlook in Chile. Recent history indicates that 40% of overall inflation and 50% of core inflation present a high degree of correlation with the FX cycle, and local fuel prices follow global trends with a lag, so the global picture will be highly relevant for Chile's inflation in upcoming quarters.

So far inflation has remained in check (headline at 2.5% y/y in June, core IPSAE at 1.9% y/y), due to the stronger currency (until April), and the lack of domestic cost pressures (inertia from past CPI evolution diminished, and nominal salaries decelerated to 3% y/y in April, in part due to large immigration flows). Finally, the traditionally erratic fresh foodstuffs also behaved well in recent months, with y/y inflation falling to 3.6% in June from 4.9% in January.

Inflation: Headline as well as core CPI should increase in upcoming quarters



Headline CPI projection based on market inflation forwards. Core CPI projection based on own estimates, Source: INE, Santander.

That said, the outlook for upcoming months is more inflationary. First, the 9-10% CLP slide since February will likely add pressures to tradable goods, in our view. Our working assumption for the short term pass-through (six months) is 11%. In this context, if the FX rate stays around 650, overall inflation may easily jump 100 bps from May's 2%. Second, local gasoline prices are increasing due to rising WTI prices, and given the workings of the MEPCO system, further 4-5% rises (from June) are virtually guaranteed, in our view, which implies 25 bps added to the overall CPI (of which 15 bps would be already included in the FX pass-through calculation.) Third, as the economy recovers, the output gap will tend to narrow, although we believe these effects should appear more in 2019.

Against this backdrop, the BCCh has recently raised its 2018 CPI estimate to 2.8% (+50 bps) and 2019's to 3.0% (+20 bps). Likewise, core inflation projections now stand at 2.3% and 3.0%, suggesting a gradual contamination from non-core to core CPI components. Santander's official estimates stand at 2.9% (headline, both 2018 and 2019), and 2.3% and 2.8% (core).

In this context, we believe the BCCh's next policy move should be a hike, but its timing is still controversial. Purely based on current GDP/CPI data, rates should have been hiked already, but in our view, the board will likely wait until core inflation and formal job creation reach more normal levels, which we expect to occur entering 4Q18. As a result, we expect the first 25 bps hike in December and at least +75 bps during 2019.

Regarding fiscal policy, the new Piñera administration announced that prudence will be the driving element of the next few years, given the need to curb the gross public debt uptrend observed since 2013 (from 13% to 24% of GDP). In this context, Finance Minister Larraín practically ruled out a cut in the corporate income tax rate, now at 27%, adding that this would only be feasible once the fiscal situation starts to improve significantly.

So far this year, the actual fiscal deficit has barely changed despite the increase in copper-related revenue: in the last 12 months to May, it reached 2.6% of GDP, vs. 2.7% in December, with the mining sector providing extra revenue for 0.3%/GDP. This reaffirms the high spending inertia created by the social reforms of the previous administration, to which we should add the cost of new government programs, estimated at 1% of GDP per year when fully implemented.

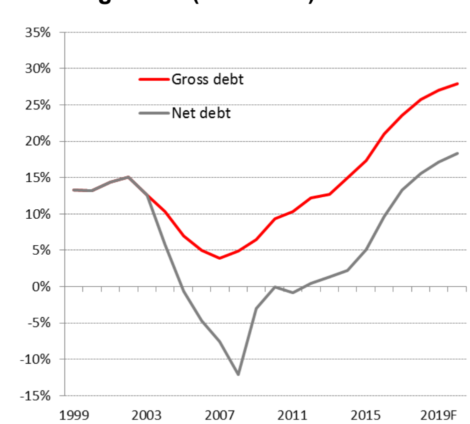
FX rate vs. inflation (y/y chg)

Core tradables exclude fresh foodstuffs and energy items. Sources: INE and Santander.

BCCh policy rate (%)

As per our growth-inflation balance model. Sources: BCCh and Santander.

Sovereign debt (% of GDP)



Net debt defined as gross Treasury debt minus financial assets in hands of the Treasury (including sovereign wealth funds). Sources: Treasury and Santander.

CHILE

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		4.0	1.8	2.3	1.3	1.5	4.0	3.3
Private Consumption (Δ% y/y)	12	4.6	2.7	2.1	2.2	2.4	3.8	3.6
Public Consumption (Δ% y/y)	65	2.8	3.8	4.8	6.3	4.0	3.3	3.6
Investment (Δ% y/y)	28.4	3.3	-4.8	-0.3	-0.7	-1.1	5.7	4.9
Exports (Δ% y/y Local Currency)	39	3.3	0.3	-1.7	-0.1	-0.9	6.8	2.7
Imports (Δ% y/y Local Currency)	39	2.0	-6.5	-1.1	0.2	4.7	7.5	4.9
GDP (US$ bn)		279	261	244	250	277	310	322
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		3.0	4.6	4.4	2.7	2.3	2.9	2.9
CPI core Inflation IPCX1 (Dec Cumulative)		2.4	5.1	4.7	2.9	1.9	2.3	2.8
US$ Exchange Rate (Average)		495	570	654	677	649	630	640
Central Bank Reference Rate (eop)		4.50	3.00	3.50	3.50	2.50	2.75	3.50
Private sector credit (% of GDP)		83.2	85.0	88.0	88.2	90.0	91.0	92.0
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-0.6	-1.6	-2.1	-2.7	-2.8	-2.2	-1.9
**Primary Balance, % of GDP		-0.1	-1.0	-1.4	-2.0	-2	-1.4	-1.1
Balance of Payments								
Trade Balance, % of GDP		0.7	2.5	1.4	2.2	2.8	2.9	3.0
Current Account, % of GDP		-4.1	-1.7	-2.3	-1.4	-1.5	-1.4	-1.8
Debt Profile								
Central Bank International Reserves (US$ bn)		41.1	40.5	38.6	40	40	40	40
Total Public Debt (gross, % of GDP)		12.1	14.1	16.2	21.5	25.5	25.6	26.2
Of which: Foreign-currency denominated (% of GDP)		1.9	2.5	3.2	3.5	4.0	4.5	5.0
Labor Markets								
Unemployment Rate (% eop)		5.9	6.4	6.2	6.5	6.7	6.6	6.5

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

COLOMBIA

NEW GOVERNMENT, SAME CHALLENGES

- **In the second round of voting, in June, Ivan Duque was elected as the new president for the 2018-2022 term. He will take office on August 7 and will have the support of a center-right/right majority in Congress.**
- **Fiscal consolidation is one of the main challenges that the new government will face, in our view.**
- **Leading indicators continue to point to ongoing recovery. We expect the economy to continue to pick up and forecast growth of 2.5% y/y in 2018.**
- **Inflation is under control, and we expect BanRep to maintain the interest rate on hold for the rest of the year.**

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Ivan Duque, the newly elected president

As expected, Ivan Duque, center-right candidate, was elected as the new president in the second round of voting held on June 17, with 54% of the votes and with a 10 ppt lead over Gustavo Petro, leftist candidate. However, Petro did better than the polls suggested and made history by capturing the highest support ever recorded for a leftist candidate. As per Colombian laws, Gustavo Petro will have a seat in the Senate, giving him a political platform for the next presidential elections, in our view.

Duque will take office on August 7 and will have the support of a center-right and right majority in the Congress, thus placing him in a position to potentially pass important legislation and reforms. Among the key policy areas that he plans to address during his administration are the Peace Agreement and fiscal policy. Duque has stated that he will seek to amend parts of the Peace Agreement, including the section on the special tribunal "Justicia Especial de la Paz." In terms of fiscal policy, Duque campaigned under the promise of lowering corporate taxes, which currently stand at 33%, above the 27.3% average in the region (as reported by Deloitte in February). Moreover, Duque stated that he is in favor of reforms that would decrease current expenditures and reduce tax evasion. Markets will be paying close attention to Duque's fiscal policy in the years ahead, as his administration has the important task of continuing with fiscal consolidation. Alberto Carrasquilla, former minister of finance under Alvaro Uribe's government in 2003-2007, was picked by Mr. Duque to lead fiscal policy as the new Minister of Finance.

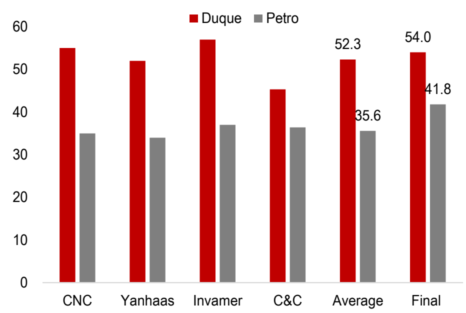
Fiscal consolidation continues to be an important task, in our view

In May, the Fiscal Rule Committee revised the fiscal target path, lowering its targets for 2019-2026 and reflecting a gradual convergence to a 1.0% structural fiscal balance. The revision mainly reflects a wider output gap than previously estimated (4.0% in 2019 vs. 2.7%) as well as lower oil prices (long term at $66/bbl vs. $75/bbl). For 2019, the fiscal target was revised down to 2.4% from 2.2%, which still implies a notable adjustment of 0.7 ppts of GDP. Following the announcement, Fitch confirmed Colombia's BBB rating with stable outlook, highlighting the better macroeconomic outlook. However, Fitch noted that the fiscal adjustment for 2019 remains challenging in the absence of additional reforms. The rating agencies have named low growth and rigid expenditures as some of the most important obstacles that Colombia faces in achieving fiscal consolidation. Among some of the pending recommendations from the Special Commission, we believe pension reform would be key in providing some relief on the expenditure side, giving space for a sustainable fiscal consolidation as pensions are estimated to account for 28% of total expenditures. The 2018 fiscal adjustment target of 0.5 ppts of GDP, on the other hand, seems achievable, in our view, in particular due to the 0.3% of GDP extra income from higher than expected dividends from Ecopetrol in the 2017 fiscal year.

Leading indicators continue to point to ongoing recovery

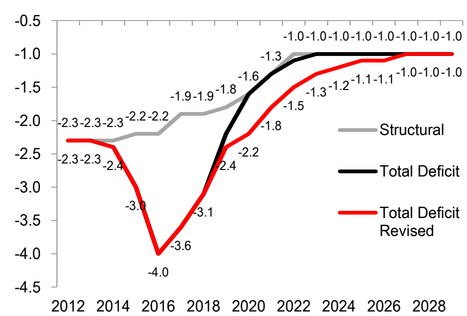
In 1Q18, GDP expanded 2.2% y/y, improving from 1.8% y/y growth in 1Q18. In

Duque wins over Petro in the run-off



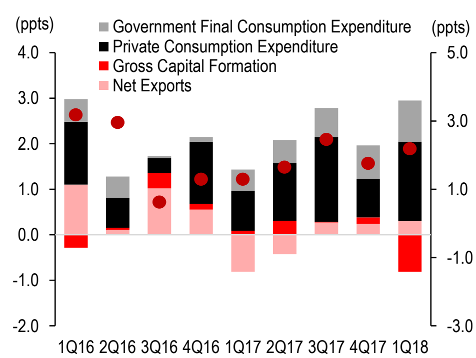
Sources: CNC, YanHass, Invamer, Cifras & Conceptos, Registraduria, and Santander.

New fiscal targets



Source: Ministry of Finance.

GDP contribution by component*



*Note: Non-seasonally adjusted. Sources: DANE, Santander seasonally adjusted terms the economy grew 0.7% q/q, accelerating slightly from the average of 0.5% q/q in 2H17. In general, the economy continues to be supported by consumption, with private consumption being the main driver. In contrast, fixed investment continues to be a drag on the economy, contracting 3.9% y/y in 1Q18 after expanding a mild 0.6% y/y in 2017. On the supply side, the economy continues to be supported by the tertiary sector, which expanded 5.0% y/y in 1Q18, while the secondary sector declined 2.3% y/y. Construction activity in particular continues to lag the economic recovery, as it contracted 8.6% y/y in 1Q18, its sixth consecutive contraction.

Leading indicators suggest that the economy continued to recover in 2Q18. Among these, both retail and industrial production indicators posted solid results in April: industrial production was up 10.5% y/y, the highest expansion since March 2014**,** while retail sales expanded 6.3% y/y, exceeding the 5.3% y/y average expansion in 1Q18. While these figures were boosted by the seasonal factor of Holy Week (in March this year vs. April in the previous year), seasonally adjusted series also posted positive numbers, with industrial production expanding 6.5% y/y and core retail sales up a solid 4.9% y/y.

In the secondary sector, recent readings from the PMI and exports point to an improvement for the rest of 2Q18. In May, exports continued to expand at a double-digit 14.2% on a 12-month accumulated basis, suggesting a continued recovery in the manufacturing sector. Moreover, June PMI increased to 53 pts, the highest level since January 2016, also suggesting an ongoing recovery in the manufacturing sector. On the service side, consumer confidence continues to improve, turning positive in April for the first time since February 2015, indicating some support for consumption in the months ahead.

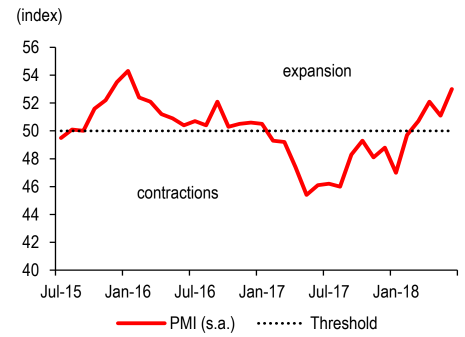
Finally, business confidence continued to improve in 1H18, and as political uncertainty fades, we believe confidence could improve further in the months to come, which could potentially translate into an important boost to investment, as could Colombia's new membership in the OECD. In all, we consider that the recent economic readings are consistent with our 2.5% GDP growth forecast in 2018, but we acknowledge that there are risks to the upside if there is a quick rebound in investment.

Inflation under control; BanRep on hold

Headline inflation bottomed out in April at 3.13% y/y, and since then, it has increased consistently at a moderate pace, reaching 3.19% in June. One of the key drivers that is slowly pushing inflation up is higher food prices. Food inflation remains subdued in annual terms (1.74% y/y in June), but its contribution to the headline has been increasing slowly but consistently since March. Tradable inflation has been the other source of pressure, as it reflects the recent depreciation of the COP (6% since mid-April) and high gasoline prices (+8.9% y/y in June) on the back of high oil prices. In contrast, non-tradable inflation has somewhat offset these pressures, as it has maintained a downward trend since January 2018, although it remains above the 4% upper band. In 2H18, we forecast that inflation will continue to increase moderately, ending 2018 at 3.3%, as we expect food inflation to continue to normalize and expect further pressures from gasoline prices and related services.

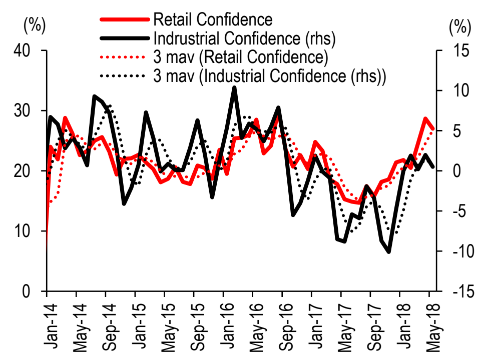
In terms of monetary policy, at the last meeting (June 26) the board continued to express concern about the strength of the economic recovery, noting that the factor supporting the 2.2% y/y growth in 1Q18, namely government expenditure, is not sustainable, although the board also acknowledged that leading indicators point to a more dynamic 2Q18. However, at the same time, the MPC considers that inflationary risks remain to the upside and expects inflation to end 2018 at 3.3%. As of this writing, the IBR curve is assigning a 30% probability of an interest rate hike in October. However, under this scenario of still early stages of recovery and moderately increasing inflation, our baseline scenario is that BanRep will remain on hold for the rest of the year. It is important to note that the composition of the board will change, as the new deputy director, Carolina Soto, will replace Adolfo Meisel in July, and in August, the new minister of finance, Alberto Carrasquilla will also join the board, replacing the current minister Mauricio Cardenas. Despite this, we do not expect a significant change in BanRep's stance in the coming months.

PMI pointing to more dynamic activity in industrial sector



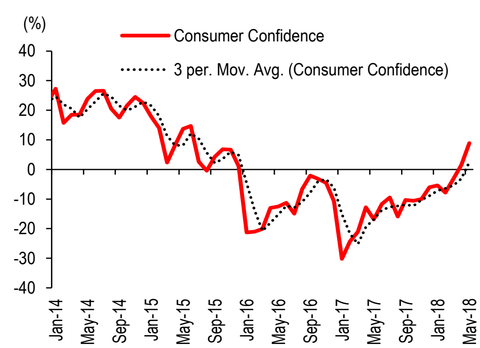
Sources: Davivienda, Markit, and Santander.

Improving business confidence



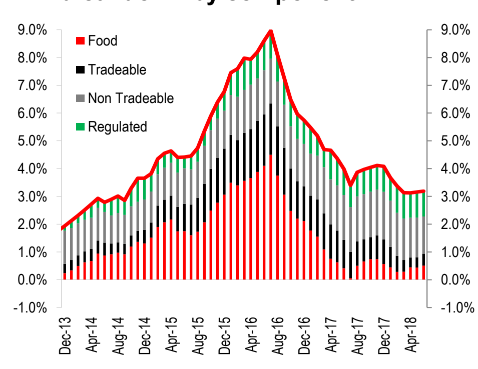
Sources: Fedesarrollo and Santander.

Positive consumer confidence



Sources: Fedesarrollo and Santander.

CPI breakdown by component



Sources: DANE and Santander.

COLOMBIA

	% GDP	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		4.6	4.7	3.0	2.0	1.8	2.5	3.0
Private Consumption (Δ% y/y)	61.1	4.0	4.6	3.1	1.4	1.8	2.7	3.6
Public Consumption (Δ% y/y)	16.1	8.9	4.7	4.9	1.8	4.0	4.6	3.5
Investment (Δ% y/y)	23.7	6.1	11.8	-1.2	0.3	0.6	-0.9	1.5
Exports (Δ% y/y)	18.9	4.7	-0.3	1.7	-1.4	-0.7	1.8	2.9
Imports (Δ% y/y)	19.8	7.4	7.8	-1.1	-4.0	0.3	1.6	2.6
GDP (US$ bn)		382	381	293	283	314	346	380
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		1.9	3.7	6.8	5.75	4.09	3.26	3.19
Core inflation (Dec Cumulative)		2.8	3.3	5.2	5.14	5	3.7	3.5
US$ Exchange Rate (Average)		1869	2400	2740	3050	2952	2850	2750
Central bank reference Rate (eop)		3.25	4.50	5.75	7.50	4.75	4.25	5.25
Bank lending to the private sector (% chg YoY, Dec)		14	14	12	9	10	12	12
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-2.4	-2.4	-3.0	-4.0	-3.6	-3.1	-2.4
Primary Balance, % of GDP		0.0	-0.2	-0.5	-1.1	-0.8	-0.2	0.5
Balance of Payments								
Trade Balance (% of GDP)		-0.7	-3.0	-4.7	-3.3	-1.5	-1.0	-1.0
Current Account (% of GDP)		-3.3	-6.6	-6.4	-4.3	-3.3	-3.0	-3.0
Debt Profile								
Central Bank International Reserves (US$ bn)		43.6	47.3	46.7	46.7	47.3	47.6	48.0
Total Public Debt (gross, % of GDP)		31.6	38.3	37	44	45	45	44
Of which: Foreign-currency denominated (% of GDP)		8.5	11	14	16	16	15	15
Labor Markets								
Unemployment Rate Avg. (year-end % of EAP)		8.4	8.7	8.6	8.7	8.6	8.0	7.5

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

MEXICO

MEXICAN ELECTIONS AND PUBLIC FINANCES

- **Andrés Manuel López Obrador won the presidential election overwhelmingly, with the largest victory margin registered since 1994.**
- **AMLO has advocated a smooth political transition and preserving macroeconomic stability.**
- **The main challenge for public finances is low government revenue, in our view.**
- **Fiscal consolidation: fundamental issue for macroeconomic stability.**

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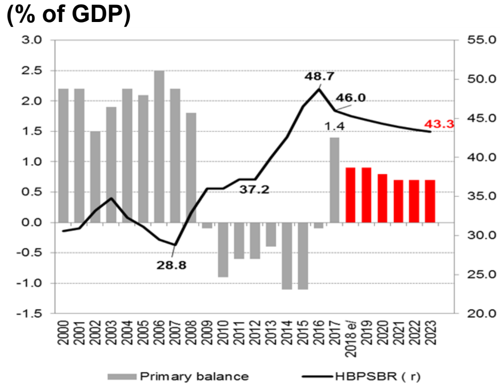
Mexican elections' results

On July 1, the National Electoral Institute (INE) announced that the leftist candidate Andrés Manuel López Obrador (AMLO) had won the presidential election with 53.0-53.8% of votes. Ricardo Anaya, his nearest challenger and candidate of the National Action Party (PAN), received 22.1-22.8% of votes, and José Antonio Meade, the candidate of the ruling Institutional Revolution Party (PRI), came in third, with 15.7-16.3% of votes. No presidential candidate since 1994 has had such an overwhelming victory. AMLO, in his victory speech, reiterated his campaign promise to respect Central Bank independence and maintain fiscal discipline, which was well received by the market.

In the Lower House, AMLO's coalition (Morena+PT+PES) should have 312 of 500 seats – meaning it would hold a simple majority (above 50%) but not a qualified majority (two thirds of the seats). In the Senate, AMLO's coalition should end up with 70 of 128 senators – again, over 50% but under two thirds. We highlight that in order to change the Constitution, a qualified majority is needed. AMLO will be the first president with a majority in the Lower House and the Senate and control of Mexico City, together with another four state governorships.

Budget Primary Balance and HBPSBR*/ (% of GDP)



*/Historical Balance of the Public Sector Borrowing Requirements; Ministry of Finance forecasts

The broadest measure of public sector debt.

Sources: Ministry of Finance and Santander.

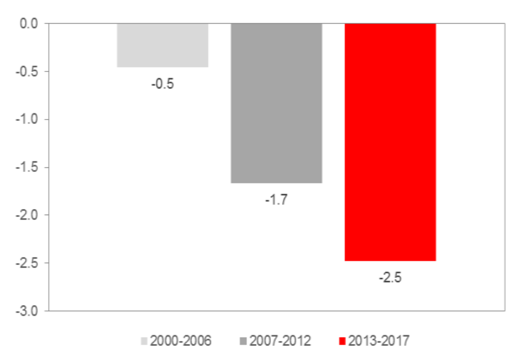
Public finances: low tax revenue is the main challenge

Recently there has been some improvement in the fiscal accounts. The Ministry of Finance (SHCP) reported that the fiscal deficit, including Banco de Mexico's Operating Surplus (BMOS), was 1.1% of GDP in 2017 below the deficit approved by the Congress of 2.4% of GDP and below 2016's deficit of 2.6%. For 2018 we expect a deficit of 2.0%, yet the data for January-May suggest that the final figure may be better than expected, possibly around 1.5% of GDP.

During 2017 the primary balance registered a surplus of 1.4% of GDP, registering the first primary surplus since 2008, when it was 1.8% of GDP.

We note that 70% of the resources from BMOS were used to reduce the federal government's indebtedness (MXN225.2bn). The remaining 30% (MXN96.5bn) was used as follows: contribution of MXN80.3bn to the Budgetary Revenues Stabilization Fund (FEIP); contribution of MXN13.6bn to the Social Security Protection System Fund; and MXN2.8bn to international organizations.

Public sector budget balance (annual average % of GDP)



Sources: Ministry of Finance and Santander.

As a result of BMOS, the total public debt balance measured by the Historical Balance of the Public Sector Borrowing Requirements (HBPSBR) fell to 46% of GDP in 2017 from 48.7% in 2016.

Indeed, 2017 results were the best since 2008, when the registered deficit was 0.1% of GDP and the primary surplus was 1.8% of GDP. In that year the HBPSBR represented 32.9% of GDP. In 2007, that percentage was at its minimum level of 28.8% of GDP.

However, the recent improvement comes after some years of a looser fiscal stance. The rapid growth of public debt between 2009 and 2016 was the result of higher fiscal deficits and particularly a consequence of primary surplus "converted" into deficits. During 2013-17, the budget deficit averaged 2.5% of GDP each year, while during the two previous presidential periods, 2000-2006 and 2007-2012, the average deficit was 0.5% and 1.7% of GDP, respectively. This shows that running a continual primary deficit implies greater demand for additional resources that translate into increases in the public debt.

We believe that the central issue of public finances is that revenue continues to limit greater levels of expenditure. Public revenue was at 19.5% of GDP on average during Fox's presidency (2000-2006), increased to 22.24% during Calderon's administration (2007-2012) and to 23.3% during Peña Nieto's presidency (2013-2017). In other words, as a percentage of GDP, it showed a 3.7 ppt improvement in 17 years. However, at the same time, budgetary expenditure increased on average by 5.8 ppt of GDP during the same period.

According to OECD, Mexico is the member country with the lowest governmental revenue as a percentage of GDP (17% vs. an average of 34% for OECD members as a group). Indeed, revenue from taxes as a percentage of GDP remains low, despite a recent improvement from 9.0% (2000-2006) to 11.8% (2013-2017). This improvement was due to higher income tax collected, rising from 4.1% of GDP in 2000-2006 to 6.4% in 2013-17.

At the same time, collection of value-added tax rose from 3.1% of GDP during Fox's administration to 3.7% during Calderon's mandate, remaining at 3.7% during Peña Nieto's presidency. In Mexico VAT is not a generalized tax – for example, less than half of goods included in the CPI are excluded.

On the other hand, the special taxes on production and services of gasoline and diesel (IEPS) show poor performance. During 2000-2006, the collection of IEPS represented 0.7% of GDP, but during 2007-2012 it was -0.8% of GDP (subsidy to final prices of gasoline). In 2013-17, collection was positive but only accounted for 0.6% of GDP. Special taxes on production and services for other goods and services represented only 0.7% of GDP in 2013-17.

With the decline in oil prices and production, petroleum revenue from the public sector fell to 5.5% in 2013-17 from an average of 8.4% between 2007 and 2012, adding pressures to the budget.

Summing up, the improvement in tax revenue has come fundamentally from the collection of income tax (ISR); in contrast, government revenue continues to be limited by VAT revenue and by special taxes.

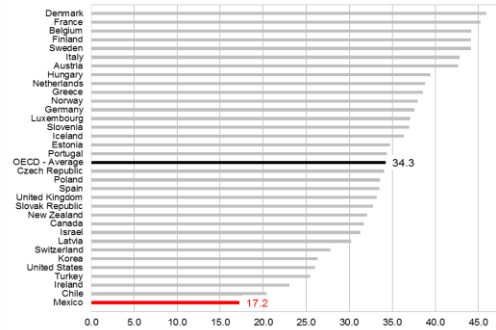
Regarding expenses, current expenditures grew to 15% of GDP in 2013-17, vs. 11.9% and 14.3% registered in the two previous administrations, while transfers and subsidies (fundamentally social expenditures) increased from 1.9% of GDP between 2000 and 2006 to 3.4% between 2013 and 2017. Personal services expenditures, on the other hand, declined moderately, falling from 6.0% of GDP during the Fox administration to 5.7% during the current Peña mandate.

The General Economic Policy Preliminary Guidelines 2018 show that the Ministry of Finance projects that the 2019-2023 period could sustain a fiscal deficit of 2.0%, which would essentially represent the expenditure investment of Pemex and the Electric Federal Commission, while during this entire period there would be a primary surplus each year (0.8% annual average), which would allow the SHRFSP to follow a downward trend. Thus, fiscal consolidation implies achieving continued primary surpluses in the coming years.

This scenario does not imply new taxes, but it has several fundamental premises: (i) sustained growth in the US economy (2.0% annually) that would boost Mexican exports; (ii) gradual recovery of oil production due to the energy reform; and (iii) a strengthening of the internal market. The Ministry of Finance also notes some risks to fiscal consolidation. These are: (i) unfavorable outcome of NAFTA renegotiations; (ii) lower US growth; (iii) restrictive international financial conditions; (iv) low oil prices and production; and (v) a demographic transition in which the retired population is growing faster than the rest of the population.

Low levels of public revenue still reflect limited tax collection, despite some recent improvement. This, in turn, has put significant restrictions on increasing public expenditures, above all pensions and social expenditure. Moving forward, besides the continued effort to improve expenditure efficiency and the "inertial" earnings created from sustained growth, we believe sustainable growth in expenditures will require fiscal reform that leads to greater tax collection in order to continue the fiscal consolidation process, preserving economic stability.

OECD: Government revenue 2016 (% of GDP)



Sources: OECD and Santander.

Sovereign ratings and public debt

	Moody's	S&P	Fitch	Gross debt (% of GDP)*/
Mexico	**A3**	**BBB+**	**BBB+**	**54**
Latvia	A3	A-	A-	35
Lithuania	A3	A	A-	37
Malaysia	A3	A-	A-	54
Peru	A3	BBB+	BBB+	26
Poland	A2	BBB+	A-	51
Thailand	Baa1	BBB+	BBB+	42

*/ IMF data for 2017

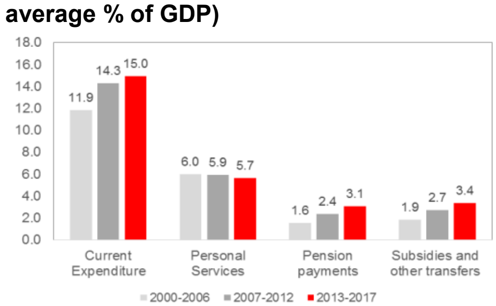
Sources: Source: Sovereign Debt Ratings, IMF, and Santander.

Government tax revenue (annual average % GDP)

	Tax Revenues	Income Tax	Value Added Tax	Fuels excise tax IEPS	Others IEPS
2000-2006	9.0	4.1	3.1	0.7	0.3
2007-2012	8.8	5.0	3.7	-0.8	0.5
2013-2017	11.9	6.4	3.7	0.6	0.7

Sources: Ministry of Finance and Santander.

Public sector current expenditure (annual average % of GDP)



Sources: Ministry of Finance and Santander.

MEXICO

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		1.4	2.8	3.3	2.9	2.0	2.4	2.5
Private Consumption (Δ% y/y)	73.9	1.8	2.1	3.4	3.7	3.0	2.8	3.0
Public Consumption (Δ% y/y)	10.9	0.5	2.9	1.9	2.4	0.1	2.0	1.0
Investment (Δ% y/y)	20.9	-3.4	3.1	5.0	1.1	-1.5	0.2	1.6
Exports (Δ% y/y Local Currency)	17	1.4	7.0	8.4	3.5	3.8	6.8	6.0
Imports (Δ% y/y Local Currency)	21.5	2.1	5.9	5.9	2.9	6.4	6.5	6.5
GDP (US$ bn)		1,275	1,313	1,170	1,077	1,154	1,200	1,244
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		4.0	4.1	2.1	3.3	6.8	4.0	3.6
CPI core Inflation (Dec Cumulative)		2.8	3.2	2.4	3.4	4.9	3.8	3.5
US$ Exchange Rate (Average)		12.8	13.3	15.9	18.7	18.7	19.1	17.7
Central Bank Reference Rate (eop)		3.50	3.00	3.25	5.75	7.25	7.50	6.75
Bank Lending to Private Sector (% of GDP)		14.7	14.8	16	16.9	17.5	18.5	19.0
Fiscal Policy Indicators								
Fiscal Balance, % of GDP		-2.3	-3.2	-3.5	-2.6	-1.1	-2.0	-2.0
Primary Balance, % of GDP		-0.4	-1.1	-1.1	-0.1	1.4	0.9	0.9
Balance of Payments								
Trade Balance		-0.1	-0.2	-1.3	-1.2	-1.0	-1.0	-1.0
Current Account, % of GDP		-2.4	-1.8	-2.5	-2.2	-1.7	-1.6	-1.6
Debt Profile								
Central Bank International Reserves (US$ bn)		176.5	193.2	176.7	176.5	172.8	175.0	178.0
Total Public Debt (gross, % of GDP)		40.4	43.2	47.3	48.7	46.0	45.3	44.8
Of which: Foreign-currency denominated (% of GDP)		10.2	11.9	14.6	18.3	15.7	15.1	14.7
Labor Markets								
Unemployment Rate (year-end, % of EAP)		4.9	4.8	4.3	3.9	3.4	3.4	3.3

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

PERU

CONSISTENT GROWTH EXPECTED

- **We maintain our call that 2018 should be a year of consistent economic growth, supported by private consumption from a looser monetary policy and by public investments from the reconstruction program, and with a background of inflation fluctuating within the target range of 1-3%.**
- **Real GDP growth in 1Q18 was 3.2% q/q, based on accelerated investments and on private consumption. Moreover, the economic activity index calculated by INEI shows that economic dynamism continued in the beginning of 2Q18 (national production growth of 3.3% in 12 months accumulated through April).**
- **Although the economy heated up in 1Q18, we maintain our forecast for GDP growth in 2018 at 3.5%, as we believe the decline in the government's popularity should weigh on confidence (business and consumer) in the coming quarters, and commodity prices should lose steam with the potential intensification of the US-China trade war.**
- **We maintain our forecast of 2018 inflation at 2.5%, even after the hike in the ISC rate, which is an additional source of inflationary pressure. We expect the BCRP to hike the reference rate in 4Q18, raising it to 3.0%.**

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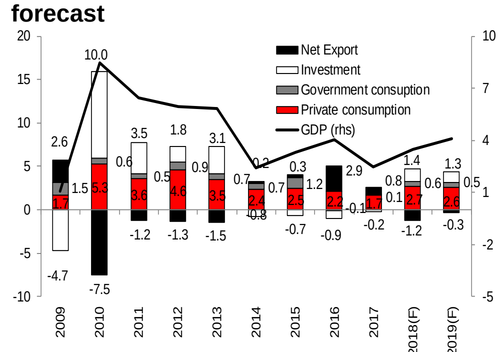
As we highlighted in the last *Strictly Macro* (March 28, 2018), the strengthening of macro fundamentals – low public debt ratio to GDP, low current account deficit, low external financing needs, inflation expectations well anchored to the inflation target, and favorable global growth conditions ahead – should be sufficient to allow the Peruvian economy to weather the domestic political crisis that resulted in the resignation of President Kuczynski and Martin Vizcarra's assumption of the office of president. Thus, we see 2018 as a year likely without either a notable economic transformation or a sovereign downgrade. In our view, in 2018 Peru should experience consistent economic growth, supported by private consumption stemming from the loosened monetary policy and by public investments from the reconstruction program, and with a background of inflation fluctuating within the target range of 1-3%.

Economic recovery under way

Economic data for 1Q18 has confirmed our expectations for 2018. Real GDP growth was 3.2% y/y, accelerating from 2.2% y/y registered in 4Q17. The economy's comeback was driven by consumption (private and government) and public investments in the reconstruction program, the mining sector, and infrastructure plans. Real GDP growth in 12 months accumulated increased to 2.7% in 1Q18 from 2.5% in 4Q17, based on investment growth of 1.7%, vs. a 0.7% contraction at the end of 2017. Both public and private investments registered improvements; public investment climbed to a 1.3% growth rate in 12 months from -2.3% posted in 2017, and private investments accelerated to 2.8% from 0.3%, despite the political crisis that has weighed on both since 4Q17. The breakdown of our real GDP growth forecast sees domestic demand (consumption + investments) increasing by 3.7% and net exports falling by 1.2% by YE2018 (i.e., domestic demand accelerating and net exports contracting).

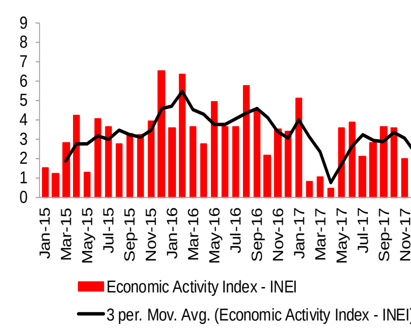
Moreover, the economic activity index calculated by INEI posted an increase of 7.8% y/y in April, showing that economic dynamism continued at the beginning of 2Q18. The economic activity index registered growth of 4.4% in the period January-April and growth of 3.3% in the 12 months accumulated through April. According to the INEI, April's results showed that the economic recovery is widespread, with manufacturing, agriculture, other services, trade, construction, transport, and fishing being the highlights. INEI believes that economic growth in 2Q18 (based on preliminary data) could be explained by the improvement in

GDP breakdown – (contributions) & forecast



Sources: Instituto Nacional de Estadística e Informática and BCRP.

Economic Activity Index (y/y)

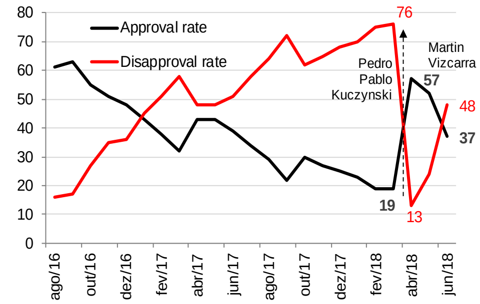


Sources: INEI and Santander.

household consumption reflected in retail sales increasing by 3.2% y/y, consumer loans up 7.5% y/y, and non-durable goods imports up 14.0%. Likewise, total exports increased by 17.4% y/y, with traditional goods up 14.0% y/y, mainly mining such as copper, silver, and zinc, while non-traditional exports jumped by 27.5% y/y; these include agriculture, textiles, fishing, and chemicals, among others.

Despite the political crisis that resulted in the resignation of President Kuczynski, we believe the smooth assumption of office by Martin Vizcarra, and Vizcarra's maintaining Kuczynski's economic policy, could lead to a lower than expected reduction in GDP growth. It is worth noting that according to Ipsos polls, Martin Vizcarra began his administration with a 57% approval rating, and although his popular approval had declined to 37% in the poll released on June 11, it remains higher than that of former President Kuczynski (19%), which we believe has a positive impact on the economy in terms of confidence and expectations.

Presidential approval vs. disapproval rate



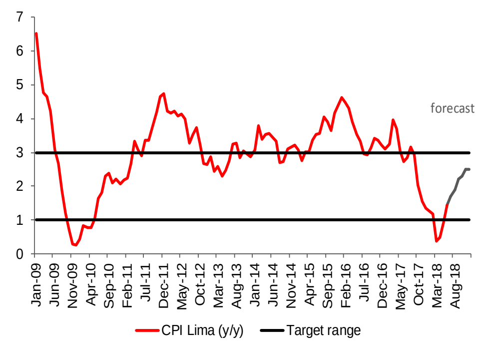
Source: Ipsos (June).

Outlook for economic activity

We are maintaining our forecast for 2018 GDP growth at 3.5%. The ongoing increase in fiscal revenue, lifted by a hike in the ISC tax rate (Impuesto Selectivo al Consumo) and by the improvement of commodities prices in 1Q18, creates room to maintain a lax fiscal policy, which we see as positive for growth in the short term. In addition, the recent easing monetary cycle should continue benefiting private consumption, in our view.

Since last year, we have highlighted the importance of investments in the mining sector, which is less susceptible to the political cycle, to the economic recovery expected for this year. Besides this, we also have highlighted all infrastructure plans linked to the Pan American Games (planned at being 1.3% of GDP) as well as the reconstruction program.

CPI Lima (y/y)



Source: BCRP.

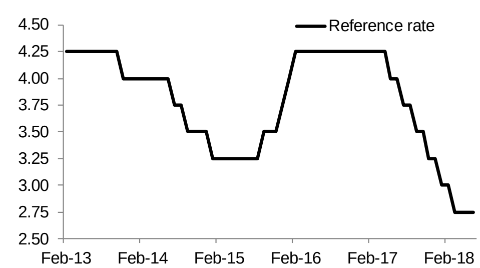
As a cautionary note, although President Vizcarra is more popular than Kuczynski (as noted above), his popular approval is eroding rapidly. In June, his disapproval rating exceeded his approval, at 48% vs. 37%, according to the latest Ipsos poll (cited above and in top chart at right); this reduction in popularity is likely to weigh on confidence (business and consumer) in the coming quarters. Furthermore, we see commodities prices losing steam with the potential intensification of the US-China trade war.

It will be important to monitor the plans of the newly appointed Minister of Finance, Carlos Oliva, and also to monitor how supportive Congress and the government will be of his proposals. The former MinFin was in office for only two months, and he was ousted due to his proposals for increasing taxes and for fiscal consolidation.

Inflation and monetary policy

We are maintaining our forecast for 2018 inflation at 2.5%. As we expected, inflation gained traction throughout 2Q18 as a result of the end of the statistical effect and also as domestic demand heated up. In addition, the government raised the ISC tax rate last May, pressuring mainly non-durable goods prices. Lima CPI in June registered an increase of 1.4% y/y in prices, which is within the target range of 1-3%. May National CPI registered 0.9% y/y, in an upward trend. CPI excluding food and energy is signaling inflation at 2%. We are maintaining our baseline scenario that the easing cycle has ended. We also maintain our call that the BCRP will have to hike the reference rate in 4Q18, raising it to 3.0%. According to the BCRP, it is appropriate to maintain an expansionary policy stance until it is certain that the inflation convergence towards its target will take place when inflation expectations are anchored in a context in which the level of economic activity is close to its potential level of growth. We believe that in 4Q18, the BCRP will begin targeting 2019 inflation, and therefore, economic activity should be close to its potential and inflation should be between the center and ceiling of the target.

Reference rate (% p.a.)



Source: BCRP.

PERU

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		5.8	2.4	3.3	4.0	2.5	3.5	4.1
Private Consumption (Δ% y/y)	61.4	5.7	3.9	4.0	3.3	2.5	3.0	2.6
Public Consumption (Δ% y/y)	11.2	6.7	6.0	9.8	-0.5	1.6	1.0	0.0
Investment (Δ% y/y)	28.2	11.5	-3.1	-2.8	-3.9	-2.3	4.5	0.0
Exports (Δ% y/y Local Currency)	23.9	-1.3	-0.9	4.0	9.5	8.5	6.0	-2.3
Imports (Δ% y/y Local Currency)	24.6	4.2	-1.4	2.4	-2.2	4.0	3.0	0.0
GDP (US$ bn)		198	203	192	197	217	219	222
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		2.9	3.2	4.4	3.2	1.4	2.5	2.5
WPI Inflation (Dec Cumulative)		1.6	1.5	2.6	1.9	-0.6	2.0	2.0
US$ Exchange Rate (Average)		2.7	2.8	3.2	3.4	3.24	3.40	3.57
Central Bank Reference Rate (eop)		4.00	3.50	3.75	4.25	3.25	3.00	3.75
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		0.9	-0.3	-2.1	-2.3	-3.0	-3.6	-3.0
**Primary Balance, % of GDP		2.0	0.8	-1.1	-1.3	-1.9	-2.5	-1.9
Balance of Payments								
Trade Balance, % of GDP		0.3	-0.7	-1.5	1.0	2.9	1.5	0.9
Current Account, % of GDP		-4.7	-4.4	-4.8	-2.7	-1.3	-2.0	-2.5
Debt Profile								
Central Bank International Reserves (US$ bn)		65.7	62.3	61.5	61.7	63.6	64.6	65.1
Total Public Debt (gross, % of GDP)		20.0	20.1	23.3	23.8	24.8	27.0	28.0
Of which: Foreign-currency denominated (% of GDP)		9.0	8.7	11.1	10.3	8.7	8.7	8.7
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.5	5.2	6.2	6.7	6.9	6.0	6.0

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

URUGUAY

GDP SLOWDOWN AND HIGHER INFLATION EXPECTATIONS

- **We now estimate GDP growth of 1.3-2.3% y/y vs. our prior 2.3-3.0%, due to a weaker peso, softer household consumption, and a significant decline in soybean exports.**
- **The peso weakened 9.9% y/y as of July 9 but remains strong from a RER perspective, implying downward risks for the UYU. We revised our year-end forecast to UYU/USD 32.0 from the previous UYU/USD 30.5.**
- **We estimate year-end inflation could escalate to 8.4% y/y, while the fiscal deficit, at 4% of GDP, is likely to breach the new official target.**

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Lower GDP growth and higher inflation based on a weaker peso

Tighter global financial conditions and regional turmoil have worsened economic prospects for 2018 and 2019. GDP growth in 2017 strongly relied on household consumption, as peso strength lowered prices for imported durable goods and tourism services measured in local currency. However, in May, the UYU weakened 8% m/m – the sharpest monthly slide of the currency since October 2008 in the aftermath of the global financial crisis – cumulating 9.2% ytd and 9.9% y/y.

Prior to the peso weakening, household consumption had already decelerated due to declining employment since end-2014. Household consumption grew 2.8% y/y in real terms as of 1Q18, down from the 4.4% y/y average in 2017. Unemployment edged up to 8.3% YTD as of May, stagnant vs. 2017 exclusively because of a sharp decline in the participation rate. In fact, employment reached its lowest level since October 2007, when the labor market was still feeling the effects of the 2002 financial crisis. Low employment is consistent with a persistent decline in fixed investment (-2.3% y/y in 1Q18) and negative business confidence sentiment as profitability falls against a background of rising tax and labor costs. As per the March industrial survey, only 8% of total firms had constructive views on the economy, vs. 22% with negative sentiment, resulting in a negative 14% balance.

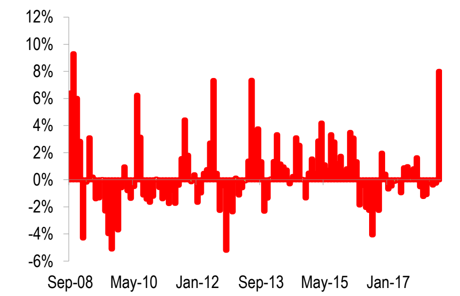
We expect 2018 GDP to grow 2.3% y/y on average, based on a 2.6% y/y increase in household consumption. However, we keep a downward bias on both consumption and activity levels, considering a significant 8% y/y decline in consumer confidence during April-May 2018, which we think is related to declining employment and a weaker peso. In addition, climatic conditions during the southern summer and autumn season strongly affected the production of soybeans – a key export sector with nearly 20% of total goods sales, which we expect to collapse by 60-70% y/y, weighing on GDP figures.

Net/net, 2.3% y/y growth in overall GDP would imply a slack 1.3% y/y excluding the oil refinery effect, implying a substantial deceleration from 2017 readings (3.7% y/y without the ANCAP effect). State-owned refinery ANCAP was closed for almost eight months during 2017 due to maintenance work and a strike by the workers' union, negatively affecting activity levels by 1.0-1.5 ppts, according to our estimates. Excluding that impact, activity grew by 3.7% y/y in 2017. We expect the opposite to occur in 2018, when GDP readings released by the Central Bank (estimated at 2.3% y/y) should be "inflated" by the reopening of the refinery.

UYU remains strong from a RER perspective, skewing FX risks on the upside, particularly in light of a major adjustment in neighbor Argentina

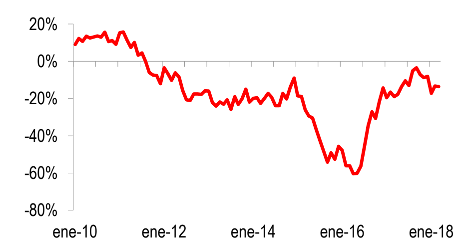
Despite substantial UYU weakening in recent months, the peso remains strong from a real exchange rate (RER) perspective and also compared with Uruguay's main regional partners. Our estimates as of June point to a 16% overvaluation against the US dollar. While this represents a slight improvement compared to December 2017 (21% overvaluation), the UYU likely remains the

In May, the peso weakened the most since 2008



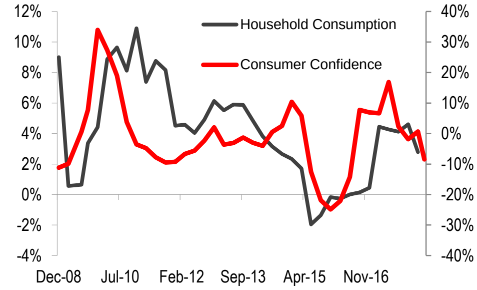
UYU/USD. % average monthly change. Source: BCU.

Business sentiment remains subdued



Net balance between positive and negative responses regarding economic perspectives. Source: CIU.

Household consumption decelerates on the back of UYU weakening



Consumer Confidence and Household Consumption. % y/y change. Sources: BCU and UCUDAL/SURA.

strongest currency in the region. According to our estimates, at ARS/USD 28.7, the ARS remains nearly 10% undervalued against the USD compared to average RER between Argentina and the US since 1994. Similarly, the BRL appears to be 10-15% undervalued, while the Chilean peso appears to be closer to neutral levels. Recent weakening of the ARS remains critical to the UYU, considering that more than 60% of total inflows come from neighbor Argentina. Following robust +28% y/y tourism inflows in 2017 – as both the UYU and ARS remained similarly 20% overvalued – the prospects for the 2018-19 summer season are less appealing considering the new valuation gap between both currencies. In this changing context, we have revised our year-end FX forecast to UYU/USD 32.0, up from the previous UYU/USD 30.5 and current quotes near UYU/USD 31.5. However, we keep a strong downward bias on the UYU under the material likelihood that (i) downside risks for activity could materialize, (ii) the BRL could close above the expected BRL/USD 3.5-3.6, and (iii) the US 10-year yield could end above 3.2%.

In this regard, we have raised our inflation forecast to 8.4% y/y vs. the prior 7% y/y, above consensus levels as per the June Central Bank Survey (7.5% y/y). Inflation closed June at 8.1% y/y, up from a range of 6.5-7.0% y/y in previous months, driven by rising FX quotes and higher food and vegetable prices. This poses increasing political challenges in a year of ongoing negotiations for wages that will stay in force for the next one to two years. In March, authorities kicked off negotiations suggesting nominal wage increases between 6.5% and 11.0%, subject to specific wage levels and expected performance of the different activity sectors. At the time, inflation expectations were slightly above 7.0%, creating pressure for additional wage increases.

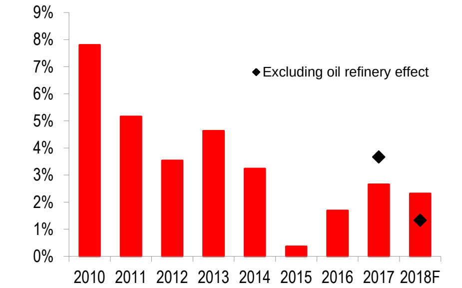
New fiscal targets likely to be breached

The fiscal deficit worsened to 4% of GDP as of May vs. 3.5% of GDP in 2017, as rising expenses – particularly pensions, social, and health services – outpaced revenues. The primary deficit stood at 0.8% of GDP in May, forcing authorities to reduce the primary target from the previous 0.5% of GDP surplus to the current 0% of GDP as per the fiscal budget bill recently sent by the Ministry of Finance to Congress. As a result, the nominal target is now 3.3% of GDP vs. the prior 2.9%, still challenging in our view. For 2019, the new nominal target is 2.8% of GDP (prior 2.5%) with a primary target of 0.6% of GDP (prior 0.8%), also likely to be breached, in our view, considering (i) additional 0.2% of GDP spending planned for the coming year, (ii) relatively optimistic 3.3% y/y GDP growth projections amid stronger headwinds, (iii) rising expenses from pensions and health programs that are not being tackled as long-awaited reforms continue to be delayed, and (iv) historical evidence showing that public spending rises during presidential election years (such as 2019).

In this context, it is hard to anticipate how the main rating agencies will react. For now, they have maintained investment-grade status (BBB/BBB-), which we believe is in response to fiscal tightening measures implemented during 2016-17, mainly through higher personal income tax and administered prices. However, a worse fiscal picture increases downgrade risks, as occurred in 2016, when both S&P and Moody's downgraded their rating outlooks.

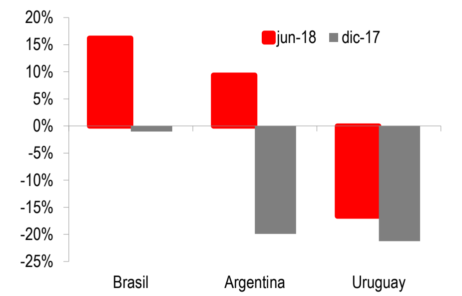
In sum, the constructive macroeconomic picture we envisaged at the start of the year changed for the worse amid rising global risk aversion, FX weakness in the region, and a persistently strong RER that continues to exert downward risks on the UYU. That said, Uruguay's strengths – its political stability, current account surplus, strong reserves/liquidity ratios, ample financing sources, and strong likelihood that FDI levels will recover as Finnish firm UPM constructs a second pulp mill in 2020 – partially protect the country from negative external shocks. In our view, this gives authorities a reasonable time frame to implement delayed structural reforms – pensions, labor market, public sector, and trade agreements – that we view as the measures needed to shield Uruguay from the risks of a mutating global environment.

We lowered 2018E GDP growth to 1.3-2.3%



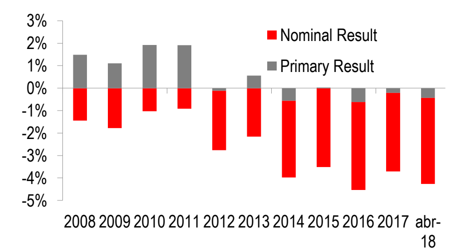
GDP growth, % y/y average change. Sources: BCU and Santander.

UYU remains strong from a RER perspective



Overvaluation (-) or undervaluation (+) against the USD. Current bilateral real exchange rate (RER) of each country against its long-term average since 1994. Monthly quotes. Source: Santander estimates.

Fiscal situation worsens, increasing likelihood of missing official targets



Uruguay public sector result as % of GDP. Source: Ministry of Finance.

New fiscal targets vs. those set in 2017

	Nominal		Primary	
2018	-3.3%	~~-2.9%~~	0%	~~-0.5%~~
2019	-2.8%	~~-2.5%~~	0.6%	~~-0.8%~~

In terms of GDP. New targets set in the Fiscal Budget Bill sent to Congress on June 30, 2018 against those set a year ago. Source: Ministry of Finance.

URUGUAY

	GDP %	2013	2014	2015	2016	2017	2018F	2019F
National Accounts & Activity Indicators								
Real GDP (Δ% y/y)		4.6	3.2	0.4	1.7	2.7	2.3	2.5
Private Consumption (Δ% y/y)	66.0	5.5	3.0	-0.5	0.1	4.4	2.6	2.7
Public Consumption (Δ% y/y)	13.8	4.9	2.5	2.2	2.9	-1.3	-0.6	2.5
Investment (Δ% y/y)	22.9	4.8	0.0	-9.0	-3.9	-13.8	3.3	9.1
Exports (Δ% y/y Local Currency)	24.0	-0.1	3.5	-0.6	-0.2	7.6	2.2	4.0
Imports (Δ% y/y Local Currency)	27.3	2.8	0.8	-7.3	-6.2	-0.4	2.4	8.0
GDP (US$ bn)		57.6	57.3	53.4	52.8	59.2	61.7	63.1
Monetary and Exchange Rate Indicators								
CPI Inflation (Dec Cumulative)		8.5	8.3	9.4	8.1	6.6	8.4	7.5
WPI Inflation (Dec Cumulative)		9.2	10.3	10.0	7.7	6.6	8.0	7.5
US$ Exchange Rate (Average)		20.5	23.2	27.3	30.1	28.7	30.6	33.2
Central Bank Reference Rate (eop)		n/a	n/a	n/a	n/a	n/a	n/a	n/a
Monetary Base (Δ% y/y)		16.1	10.7	9.5	6.1	12.9	11.2	10.0
Fiscal Policy Indicators								
**Fiscal Balance, % of GDP		-2.3	-3.4	-3.4	-3.9	-3.5	-3.8	-3.6
**Primary Balance, % of GDP		0.4	-0.6	0.0	-0.6	-0.2	-0.3	-0.1
Balance of Payments								
Trade Balance, % of GDP		1.4	2.8	3.2	5.4	6.8	5.2	4.1
Current Account, % of GDP		-3.4	-3.1	-0.8	0.8	1.6	0.0	-1.1
Debt Profile								
Central Bank International Reserves (US$ bn)		16.3	17.6	16.0	13.8	16.2	17.2	17.8
Total Public Debt (gross, % of GDP)		57.5	58.5	58.8	63.2	65.4	69.1	71.8
Of which: Foreign-currency denominated (% of GDP)		40.1	44.0	54.0	53.1	41.8	45.3	45.6
Labor Markets								
Unemployment Rate (year-end, % of EAP)		6.5	6.6	7.5	7.8	8.8	8.5	8.2

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

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