ECONOMICS **31 July 2020**

Brazil Macro Compass

Another Rate Cut, with impression of a “déjà-vu”

Ana Paula Vescovi* and
Brazil Macroeconomics Team
anavescovi@santander.com.br
+5511 3553 8567

- **In the wake of a constructive news flow for the BRL on both the domestic and international fronts, we expect the BRL to end this week at slightly stronger level against the USD than last Friday. Abroad, dreadful GDP data for advanced economies suggest that fiscal and monetary stimuli in these regions should remain high for more than a while. Onshore, promising data regarding Brazil’s balance of payments suggest an eventual return of foreign portfolio inflows after recent weakness.**

- **The nominal yield curve rallied around 20 bps for key maturities this week, likely on the heels of better global risk appetite, more signs of BCB willingness to cut rates, as well as technical factors (e.g., Treasury issuances). Local rates are pricing in a final “residual” rate cut of 25 bps and a small probability of even more stimulus.**

- **June’s fiscal performance was worse than expected, owing to rescheduled government payments, apparently with a limited impact on the yearly result. In any case, the numbers continue to show a substantial impact from the COVID-19 crisis on government finances. The figures reinforce our forecast that the 2020 public sector primary fiscal deficit will amount to ~12% of GDP, leading the gross general government debt to nearly 95% of GDP, on the heels of massive spending measures, deferrals of tax payments, as well as a cyclical revenue downturn. While we believe this fiscal expansion could lead to a certain outperformance of Brazil’s economy (vis-à-vis EM peers) for this year, the key question for the sustainability of the economic expansion after the pandemic is how to manage winding down this massive budgetary stimulus. Ending the fiscal stimulus (and implementation of economic reforms, in general) is expected to be a key market focus as we head closer to the end of this year.**

- **Regarding economic activity and following the batch of soft data releases for July that began to be released last week, the FGV's monthly industrial confidence rose 15.7% MoM (s.a.), to 89.8 points (90.1 points in the preview). In our view, this result suggests that the upward trend that began in May will continue. Nonetheless, industrial confidence stands 11.4% below February's level. All in all, the numbers suggest a gradual "normalization" of economic activity.**

- **According to the CAGED (establishment) survey, formal job creation continued to weaken in June. Net (unadjusted) job destruction stood at -10.9k, implying a considerably less pronounced payroll contraction than forecast (-195k). Yet the three-month average now points to a payroll contraction of -441k jobs. These numbers still signal a deterioration in labor market conditions.**

- **Although less than we calculated, the current account balance registered the fourth consecutive monthly surplus in June (USD2.2 billion), confirming that there is an adjustment on its way. Also important was the financial account outcome, which registered the first positive reading in foreign portfolio flows since February, thus suggesting a possible stop to the substantial capital outflows of domestic financial assets.**

- **We expect July trade balance (due on Monday) to register a USD8.1 billion surplus, which—if confirmed—would lead to a USD50.4 billion positive result in 12-month-to-date terms. Once again, we expect export growth rate to overcome the rate of imports, thus reinforcing our view that the pandemic has hit the latter harder than it has the former. We expect the trade balance to reach a USD60.5 billion surplus in 2020.**

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- **On Friday, IBGE releases IPCA inflation data for July. We expect a reading of +0.29% MoM (+2.24% YoY). We continue to see a muted pace for core prices, as economic slacks are expected to remain high for a considerable period: we forecast 2020 IPCA inflation at 1.5% (with the tracking hovering around 1.6%) and at 2.7% for 2021 (with downside risks).**

- **On Wednesday, the Brazilian Central Bank (BCB) announces its monetary policy decision. We now believe the Copom will trim the Selic policy rate, but this time in a "residual" move of 25 bps, in line with consensus (our previous call was for stability). This new level of the Selic rate (2.00%) will be a fresh new historical low, as improved financial conditions and muted core inflation encourages the authority to test a greater level of stimuli to (try to) bridge the gap between inflation expectations and next year´s mid-target. As per the forward guidance, we see Copom leaving the door ajar for additional stimulus, even as we see further rate cuts as even less likely, as we reach closer to what could materialize as an actual floor for Brazilian rate at the current juncture. However, we recognize that we have seen this movie before, and cannot fully rule out a few additional moves.**

Local markets—FX: Although relatively in line with median market expectations, the strong contraction of German and U.S. GDP in 2Q20 (34.7% and 32.9%, respectively, in quarterly seasonally adjusted annualized terms) confirmed the general perception that advanced economies should continue to provide both fiscal and monetary incentives for more than a while, which means a high level of liquidity in the global financial market in the foreseeable future, in our view. Incidentally, that was the message that the Fed chairman, Jerome Powell, conveyed in his post FOMC-decision press conference, as he hinted that the Fed is in no rush to either move the fund target rate upward or even to provide a time frame for when that is going to be possible to materialize.

We think that is, supposedly, a good omen for emerging market currencies, as these resources may flood to riskier assets as opposed to less riskier ones. By the way, data on the Brazilian balance of payments for June unveiled a net purchase of domestic assets by foreigners in June—the first positive reading since February (more details in the section about external sector data), which somehow reinforces our perception of a possibly stronger currency at the end of this year. As a result, albeit still displaying a high volatility, we expect the BRL rate to strengthen against the USD for the second week in row, thus ending July among the top 10 performers among EM currencies.

Local markets—rates: Based on prices from Friday afternoon (at the time of this writing), the nominal yield curve observed a respectable rally this week. In the front end, the Jan-22 DI future was on the verge of closing the week at 2.64% (-18 bps from last Friday). In the back end, the Jan-27 DI future was trading at 6.08% (-25 bps from last Friday), keeping the steepness in that segment (i.e., 2027s vs. 2022s) around 340-350 bps, compared to ~150 bps early this year. The reasons behind this recent rally are not clear to us and could include a better global risk appetite, more signs of BCB willingness to cut rate, as well as technical factors (such as a more cautious issuance by the National Treasury, from the standpoint of bond supply).

Now the local rates market is fully pricing in a final, “residual” Selic rate cut of 25 bps, most likely at next week’s Copom policy meeting. To that end, DI futures seem to incorporate a small probability of even more stimulus afterward, possibly anticipating a statement from the BCB that keeps door ajar for further moves. We now join the (apparently broadening) consensus of analysts and look for a 25-bp cut next Wednesday. We project a terminal Selic rate of 2.00% in this cycle (i.e., no more cuts afterward), even as we do not see the BCB showing commitment to hold the rate steady afterward (see our Copom commentary below). Still, we recognize that the BCB seems inclined to test the effective lower bound of interest rates if there is room to do so, as the authority seeks to reduce as much as possible the uncomfortable gap of inflation expectations vis-à-vis next year’s target. Thus, the local curve should continue to price in a little likelihood for a sub-2% Selic rate, in our view.

Economic activity: This week, FGV continued to release the soft data of economic surveys for July. The results confirm last week's preview that already indicated positive figures.

For services, the confidence index rose 10.2 % MoM (s.a.), to 79.0 points, slightly better than the preview's 76.6 points and marking the third consecutive gain after April's sharp drop. The headline number has fallen 16.3% since February's pre-crisis level, meaning that 64.4% of the points lost between March and April have already been recovered. July's result follows an increase both in the current situation component (10.9%) and the expectations component (9.4%). In

terms of trends, the three-month average (of headline) posted a gain of 15.2%, the first positive result since February, after April's all-time low. In the details, the survey shows that expected demand and employment point to growth for a third month running (10% and 14.2%, respectively) and, for both components, the three-month average registered the first positive figure since February.

For retail and construction, the confidence index pointed to a growth of 2.0% and 8.6%, reaching 86.1 and 83.7, respectively. Both results were slightly better than in the preview (85.2 and 81.4), marking the third consecutive gain after April's sharp drop. The headline number has fallen 13.7% and 10% since February's pre-crisis level, meaning that 64.5% and 67.3% of the points lost between March and April have already been recovered, respectively.

In manufacturing, FGV's industrial survey for July showed that headline business confidence rose 15.7% MoM (s.a.), to 89.8 points, slightly worse than the preview's 90.1 points. The headline index has shown its third gain in a row after April's sharp drop, meaning that 73% of the points lost between March and April have already been recovered. July's result follows an increase both in the current situation component (12.5%) and in the expectations component (18.8%). In terms of trends, the three-month average (of headline) registered a gain of ~16%, the first positive reading since February. In the details, the survey shows that current and expected demand gained 14.9% and 21.9 %, respectively, and, for the first time since January, the expected demand stands above the current demand, which is a better sign of industrial activity ahead. Expected production also showed a positive result (19.4%) for a third straight month, virtually recovering all the points lost between March and April. Despite the positive headline result, the industrial confidence index is still 11.4 % below the level seen before the COVID-19 crisis, which suggests a gradual "normalization" of economic activity. As an example of this "normalization", industrial capacity utilization rose to 72.3 % (76.2 in February), a much better result than the all-time low reached in April (57.3%), but still well below the historical average of 80%. The inventories surplus (i.e., percentage of respondents seeing inventories are excessive minus respondents seeing inventories as sufficient) points to a decline of -31.9 % and the three-month average posted the first decrease since March, though still high. Low capacity use and high inventory surplus are to remain a significant headwind for investment spending this year, in our view. All in all, the numbers suggest a gradual "normalization" of economic activity.

According to the Caged (establishment) survey, formal job creation continued to weaken in June. Net (unadjusted) job destruction stood at -10.9k, meaning a considerably less pronounced payroll contraction than forecast (-195k). This result follows job separations of 906k and hiring of 895k. After seasonal adjustments, net job destruction totaled -28.5k, much worse than the historical average for the month (net job creation of 64k). Year to date, net job destruction stands at -1.353 million, much worse than the 169k new jobs created in the same period of 2019 and the average of 353k new jobs created in the first six months since 2000. The three-month moving average now points to a payroll contraction of -441k jobs per month, a slightly better result than the previous month (an historical low of almost 500k). In sum, the Caged numbers still signal deteriorating labor market conditions.

Fiscal policy: According to data published this Friday by the BCB, the public sector posted a primary budget deficit of BRL188.7 billion in June. While slightly lower than the revised consensus (after Thursday's release of the central government's result), this headline is the worst monthly budget print on record (since its 1997 inception), and compares with an inflation-adjusted average of an ~BRL12 billion primary deficit for a June in 2014-19. The consolidated primary balance headline for June 2020 also compares with a full-2019 gap of BRL61.9 billion (0.9% of GDP). So far in 2020, the public sector's primary fiscal balance is negative in BRL 402.7 billion (11.6% of GDP), the worst mark in the entire historical series. The 12-month primary deficit also points in the same direction, standing at BRL458.8 billion (6.4% of GDP), the lowest balance ever recorded.

The BCB numbers show a relatively "better" performance from subnational entities (in comparison with the central government) year to date, which could partly reflect the emergency support measures implemented by the federal government to help states and municipalities in recent months. Altogether, regional governments post a primary fiscal surplus of BRL11.8 billion (0.3% of GDP) for 1H20 and BRL7.9 billion (0.1% of GDP) for the last 12 months. Government-owned firms post a primary fiscal surplus of BRL2.8 billion (0.1% of GDP) for 1H20 and BRL14.7 billion (0.2% of GDP) for the last 12 months. Given the considerable headwinds for the economy and tax collection, we expect a deterioration of the fiscal position of subnational entities—particularly states and municipalities—in coming months.

The bulk of the ongoing budgetary deterioration is seen in the federal government accounts, where the contributions (for the public sector) and the amount of information are usually larger than in subnational counterparties. According to data by the National Treasury Secretariat (with a slightly different approach compared to the central bank calculations), published on Thursday, the central government's primary deficit totaled BRL194.7 billion in June 2020, largely topping our expectation (-BRL 150 billion) and the consensus (-BRL 160 billion). Nearly all of the big difference between the actual result and our own projection is explained by higher than expected government expenses, on the heels of anticipated payments of yearend bonuses to retirees and the execution of a backlog of judicial payments (the so-called

precatórios). In historical terms, this is the worst-ever monthly budget result for the federal government. In fact, this bottom line is more than twice as large as the primary deficit seen for full-year 2019.

On the revenue side, the central government's primary revenue tumbled 30.1% YoY in June (adjusted for inflation), following both a cyclical economic deterioration as well as the effects of temporary tax reliefs. Based on official estimates pointing to deferrals of BRL20.4 billion last month, we can deduce that the postponement of tax collections accounted for nearly 60% of the YoY tumble in total revenue in June. Year to date, total revenue is down 16.5% in real terms, with Cofins federal sales tax (-32.4% YTD) and social security contributions (-19.0% YTD) as key dragging forces. The government estimates tax deferrals adding to BRL81.3 billion for the period, suggesting that the "purely cyclical" change in real federal year-to-date revenue could be around -6%.

On the federal spending front, June saw an expansion of 144% in real terms from the year-ago level, on the heels of government support programs in the wake of the pandemic (totaling a full BRL 97 billion for the month). Those include the emergency aid to households (adding BRL45 billion in June) and the emergency aid to regional governments (adding BRL20 billion in June). There were also BRL20 billion in payments of backlogged judicial decisions (*precatórios*), as the calendar of execution of these payments was displaced from March and April to June. There were also pressures from the anticipation of payments of yearend bonuses to retirees (versus an original schedule of payments in the latter half of the year), so that pension costs (INSS) rose 58% YoY in real terms. So far in 2020, real federal outlays are jumping by 40% from the year-ago level, boosted by the various government initiatives to fight the effects of the pandemic, both from a health and an economic standpoint. Official numbers indicate that the expenses related to fighting the effects of COVID-19 totaled nearly BRL211 billion year to date, which is less than half of the total announcement of spending measures so far (estimated by official sources in nearly BRL505 billion). This means that the next few months should continue to see a significant widening on the federal (and consolidated) fiscal deficit.

Year to date, BCB calculations indicate that the central government's primary fiscal deficit stands at BRL417.2 billion (12.1% of GDP), by far the worst-ever first half of the year for the fiscal accounts since the series 1997 inception. Before 2020, the worst primary balance for first half of the year had been in 2017 (-1.7% of GDP). In 12 months, the central government's fiscal gap (from the standpoint of the BCB estimates) is now BRL481.5 billion or 6.7% of GDP, also the worst number on record.

In spite of a much lower interest bill (5.0% of GDP, reflecting Selic policy rate at historical lows) the massive addition of fiscal stimulus (resulting in a tumbling primary balance) continue to produce a widening in the public sector's 12-month nominal budget deficit. The latter reached an all-time high (since 1997) of BRL818.6 billion, or 11.4% of GDP in June, as compared to 8.8% in May and 5.9% at year-end 2019.

As one can imagine, the debt figures do not show any relief at all, owing to the (necessary) efforts to fight the pandemic: the general government's gross debt rose by a full 3.6 p.p. of GDP in June to reach an all-time high of 85.5% of GDP. The public sector's net debt to GDP ratio rose by 3.0 p.p. to 58.1%, the highest level since 1Q03. Our preferred indicator of government debt— the gross debt deducted of FX reserves-rose by a similar amount (3 p.p.), to 59.0% of GDP, the highest level since 2Q06.

In our baseline scenario, the impact of this year's GDP contraction (our forecast is -6.4%) on tax federal collection, combined with deferral of tax payments could imply primary revenue losses of approximately BRL245 billion for 2020, as compared to the pre-pandemic outlook. On the expenditure side, we expect the wide set of primary fiscal spending measures to fight COVID-19 impact will add up to nearly BRL500 billion (~7% of GDP) in the current year. In the add-up for full-year 2020, we see the public sector primary deficit totaling BRL 845 billion (12.2% of GDP), whereas the 2020 public sector nominal deficit (including nominal interest payments) is expected to reach BRL1.13 trillion (16.4% of GDP). We forecast an expansion of the gross debt by 19 p.p. this year (to 94.8%) and further increases until 2027, when the indicator should peak at levels slightly above 100%, and follow a (gradual) convergence path afterward. The net debt gauge will likely follow the similar dynamic, in our view: we estimate an increase from 55.7% in 2019 to 67.5% in 2020 and a peak at 77.2% in 2027.

Clearly, among EM, the Brazilian economy is seeing one of the largest fiscal impulses to fight the economic (and health) consequences of the pandemic. While we believe that this fiscal expansion could lead to a certain outperformance of the Brazilian economy (vis-à-vis EM peers) for this year, the key question market for the sustainability of the economic expansion after the pandemic is how to manage the winding down of this massive budgetary stimulus. The winding down of fiscal stimulus (and implementation of economic reforms, in general) is expected to be a key market focus as we head closer to the end of this year.

Balance of payments: Due to much larger remittances of profit and dividends than preliminary figures provided by the BCB had indicated (until June 19, there was a net inflow of USD1.0 billion, but the final reading was remittance of USD1.8 billion), the current account surplus in June fell short of our estimate (USD2.2 billion vs USD3.7 billion, respectively). Nonetheless, the outcome has not changed our view that there is an adjustment on its way, as the trade balance continued to point toward a stronger contraction on imports than on exports and services account remained muted—chiefly due to a collapse of tourism outlays. Consequently, we continue to expect the current account balance register a USD1.4 billion annual surplus in 2020 as compared with the USD49.5 billion deficit registered in 2019.

Despite the negative surprise with the current account balance in June, the release of the balance of payments brought a promising update related to the financial account. For the first time since February, there was a net purchase of Brazilian domestic financial assets by foreigners (USD2.4 billion), with positive readings in all categories (equities, funds and fixed-income bonds). Although small (and for now inconclusive), the outcome may mark the end of massive sales of these assets (there was a USD33.6 billion outflow between January and May) and lower the pressure over the currency, which reinforces our perception the BRL may appreciate further down the road.

Inflation: On Friday, IBGE releases the IPCA inflation for July. We expect a reading of +0.29% MoM (+2.24% YoY).

This reading will be pressured by administered prices that should go up 1.29% MoM, driven by the recovery of gasoline and the concentration of electrical energy tariff adjustments that had been postponed since the beginning of COVID-19 crisis. However, free prices will remain close to zero. Industrial goods will have a slightly rise of 0.09% MoM—some tradable items will continue on the positive side, although they will decelerate if compared to last readings. We expect services to post a slightly negative MoM change of 0.06%, as the sector continues to face headwinds from partial shutdowns. Finally, we expect food-at-home number to continue their usual seasonal cooling down at mid-year (which started in July’s IPCA-15), reaching -0.24% MoM.

We continue to see a muted pace for core prices, as we expect economic slacks to remain high for a considerable period, despite the cushioning of demand generated by government stimulus and the reopening of a number of regional economies. Well-anchored inflation expectations also to play a big role: we forecast 2020 IPCA inflation at 1.5% (with the tracking hovering around 1.6%) and at 2.7% for 2021 (with downside risks).

Monetary policy: On Wednesday, the BCB is scheduled to announce its monetary policy decision. We believe the Copom (monetary policy committee) will once again trim the policy rate, but this time in 25 bps. The new level of the Selic rate (2.00%) will be a fresh new historical low, once again. This projection is in agreement with most analysts and the pricing of the yield curve.

In the last Copom, the BCB stated that the Committee foresaw that “any possible adjustment to the current monetary stimulus would be residual.” The Copom also recognized that “the remaining space for monetary policy stimulus is uncertain and should be small.”

On one hand, the pandemic’s clearly disinflationary effects continue to support the notion that additional stimuli remains necessary to bridge the gap between expected inflation (3.00%) and the center target (3.75%) for 2021, the main policy horizon as of now. Our own Taylor rules would point to interest rate below 1% in times of fiscal normality, judging from a purely cyclical (supply-demand) standpoint. On other hand, the deterioration of the fiscal outlook—especially with respect to an emerging economy—indicates the need for greater caution in the monetary policy steps, as the BCB navigates unchartered waters. As already signaled by the committee at its last meeting, reducing interest beyond an “effective minimum” level can potentially prove counterproductive, given a possible deterioration in financial conditions and hypothetical elevation of risks from a prudential standpoint.

No one really knows for sure where exactly this effective lower bound stands and how this changes overtime. In any case, given the downside risks for the economy (including an unescapable overreliance in an unsustainable level of government stimulus, from a medium to long-term perspective), the muted readings in core inflation of late, an apparent distension of (global and local) financial conditions, the Copom now seems willing to test a higher level of stimuli. That is the reason why we recently (and once again) are now changing our call for the terminal Selic rate level for this cycle. For now, we project that level at 2.00%, but with a somewhat less conviction than (we erroneously had) in previous occasions when we expected the BCB to end the cycle.

In this sense, we believe the Copom statement will seek to buy the BCB some degrees of freedom, in an environment of still high uncertainty. Thus, we see the Copom leaving door ajar for additional stimulus, even as we see further rate

cuts less likely than before, as we reach closer to what could turn up to be an actual floor for Brazilian interest rate at the current juncture.

Next week: On economic activity, the week's highlight is the release of industrial production next Tuesday (August 2), the first hard data for June. We expect a gain of 6.4% MoM (s.a.) and a decline of -11.4% YoY, meaning that almost 40% of the level of output lost between March and April will be recovered. Despite the positive result, our projection implies that industrial production is still 16% below the reading observed in February, before the crisis. Our expectation is of a gradual recovering of economic activity, following the preliminary soft data released that pointed to continued improvement. The IBGE's National Household Survey (PNAD) publication for June, scheduled to be released last Wednesday, was transferred to next Thursday (August 6). The justification for the postponement was the difficulty in contacting the selected households due to the restrictions of social isolation in combating the pandemic. These figures are essential for tracking the deterioration in the labor market conditions on the sequence of the COVID-19 crisis and therefore gauging the downside risks ahead.

Next Monday we will learn July trade balance for which we expect a USD8.1 billion surplus on the heels of USD19.5 billion exports revenue and USD11.4 billion import outlays. Adjusting these readings for the number of business days, seasonal influences and factoring out deals related to oil-platforms (which are mere accounting adjustments rather than real purchase/sales), we calculate that exports will have expanded 5.2% as compared with the previous month, while imports will have contracted 1.9% in the same comparison. In year-to-date terms, it becomes easier to note that the pandemic has hit imports in a stronger way than it has done on exports, as we calculate the former to have declined 13.4%, while the latter should have decreased 6.5%. As we believe the Brazilian economy should recover in a more gradual fashion than the global economy, this pattern is likely to persist for a while, in our opinion, which means the trade balance should continue to increase in year-to-date terms. We expect trade balance to reach a USD60.5 billion surplus in 2020.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Trade Balance Jul/20 (USD billion)	Mon, 03-Aug	8.1	7.5
- Exports (USD billion)	Mon, 03-Aug	19.5	17.9
- Imports (USD billion)	Mon, 03-Aug	11.4	10.4
Vehicle Sales Fenabrave Jul/20 (units)	Tue, 04-Aug	- -	132,833
Industrial Production Jun/20 (% MoM sa)	Tue, 04-Aug	6.4	7.0
Industrial Production Jun/20 (% YoY)	Tue, 04-Aug	-11.4	-21.9
Selic Rate (% pa)	Wed, 05-Aug	2.00	2.25
National Unemployment Rate Jun/20 (% nsa)	Thu, 06-Aug	- -	12.9
Vehicle Production Anfavea Jul/20 (units)	Thu, 06-Aug	- -	98,708
Vehicle Sales Anfavea Jul/20 (units)	Thu, 06-Aug	- -	132,818
IPCA inflation (% MoM)	Thu, 07-Aug	0.29	0.26
IPCA inflation (% YoY)	Thu, 07-Aug	2.24	2.13

Sources: The National Treasury Secretariat, Brazilian Central Bank, IBGE and Santander.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: Turning point?* (July 30, 2020)
- *Updating our Inflation, FX and Interest Rate Forecasts* (June 25, 2020)
- *FX Compass – BRL: A roller-coaster ride* (June 25, 2020)
- *Inflation: How Low and How Long?* (June 17, 2020)
- *FX Compass – BRL: Despite a little help from our friends* (May 21, 2020)

CONTACTS / IMPORTANT DISCLOSURES

Macro Research

Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888

Fixed Income Research

Juan Arranz*	Chief Rates & FX Strategist – Argentina& FX	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778

Equity Research

Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Daniel Gewehr*	Head, Brazil	dhgewehr@santander.com.br	5511-3012-5787

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