ECONOMICS

June 18, 2019

Brazil: Fiscal Policy

Climbing the Cliffs in Bad Weather

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- **We believe that deteriorating government revenues — mostly due to weakening economic activity — explains most of the recent downward revisions in fiscal projections for 2019. Nevertheless, it is important to reiterate that the structural imbalance of Brazilian fiscal policy largely reflects the unsustainable path of mandatory expenditures.**
- **While acknowledging that pension reform is not a silver bullet, its approval in Congress is certainly a prerequisite for fiscal consolidation, in our view. We expect the pension bill to result in BRL760 billion in savings over 10 years, which means keeping a little more than 60% of the original proposal.**
- **Despite the tight deadline, we believe that the possibility of the pension reform being approved in the Lower House before the parliamentary recess (i.e., by mid-July) has been growing. Final approval in the Senate is expected to take place in early September.**
- **We estimate that the social security spending-to-GDP ratio (considering the private sector regime) will peak in 2035 at around 9.5% and gradually decline thereafter.**
- **The reduction of payroll expenses, revision of tax exemptions, changes in the federative pact, and concessions/privatizations program are other examples of important proposals aimed at fostering fiscal and macroeconomic balance, including a more consistent resumption of economic activity.**
- **In our baseline scenario (assumptions are made explicit in this report), the primary result will return to positive territory in 2023, showing a gradual increase in the following years. With respect to the spending cap rule, we think the risks of non-compliance are low for the period from 2019 to 2021, non-negligible for 2022, and fairly high from 2023 onward.**
- **Lastly, we expect the gross public debt-to-GDP ratio to stabilize in 2025 at 82.7%. Under optimistic assumptions, this fiscal gauge would stabilize in 2024, while in a pessimistic scenario the stabilization would not happen before 2030.**

Figure 1: Our Forecast for Brazil (BRL billions)

Baseline Scenario	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
BRL billion - current values													
Total Revenues	**1,484**	**1,556**	**1,704**	**1,767**	**1,901**	**2,048**	**2,185**	**2,325**	**2,474**	**2,629**	**2,794**	**2,970**	**3,158**
Tax Revenues	905	953	1,013	1,080	1,153	1,236	1,320	1,409	1,504	1,604	1,712	1,827	1,952
Social Security Contributions	391	411	433	458	485	514	543	574	605	639	673	709	746
Non-Recurring Revenues	188	192	258	228	263	298	322	342	365	386	409	434	460
Transfers to States & Municipalities	**257**	**273**	**296**	**305**	**323**	**343**	**365**	**388**	**414**	**442**	**473**	**507**	**542**
Net Revenues	**1,228**	**1,283**	**1,408**	**1,462**	**1,579**	**1,705**	**1,820**	**1,937**	**2,060**	**2,187**	**2,321**	**2,464**	**2,616**
Total Expenditures	**1,352**	**1,401**	**1,458**	**1,524**	**1,599**	**1,681**	**1,765**	**1,853**	**1,945**	**2,041**	**2,141**	**2,246**	**2,355**
Social Security Expenditures	586	629	671	713	757	802	848	896	947	1,001	1,058	1,117	1,180
Payroll Expenditures	298	317	330	351	374	396	418	441	463	486	510	534	558
Other Mandatory Expenditures	201	205	208	212	216	220	225	231	238	244	251	258	265
Expenditures with Flow Control	137	140	144	148	152	158	165	171	178	185	192	200	208
Discretionary Expenditures	129	110	105	100	100	105	109	114	119	124	131	137	144
Primary Balance	**-124.2**	**-118.6**	**-49.5**	**-61.9**	**-20.2**	**24.3**	**55.2**	**83.9**	**115.3**	**145.6**	**179.3**	**217.6**	**261.7**
Primary Balance (% GDP)	**-1.8**	**-1.6**	**-0.6**	**-0.8**	**-0.2**	**0.3**	**0.6**	**0.8**	**1.0**	**1.2**	**1.4**	**1.6**	**1.8**
Nominal GDP	6,904	7,263	7,735	8,237	8,773	9,343	9,950	10,597	11,286	12,020	12,801	13,633	14,519

Source: National Treasury and Santander estimates

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.

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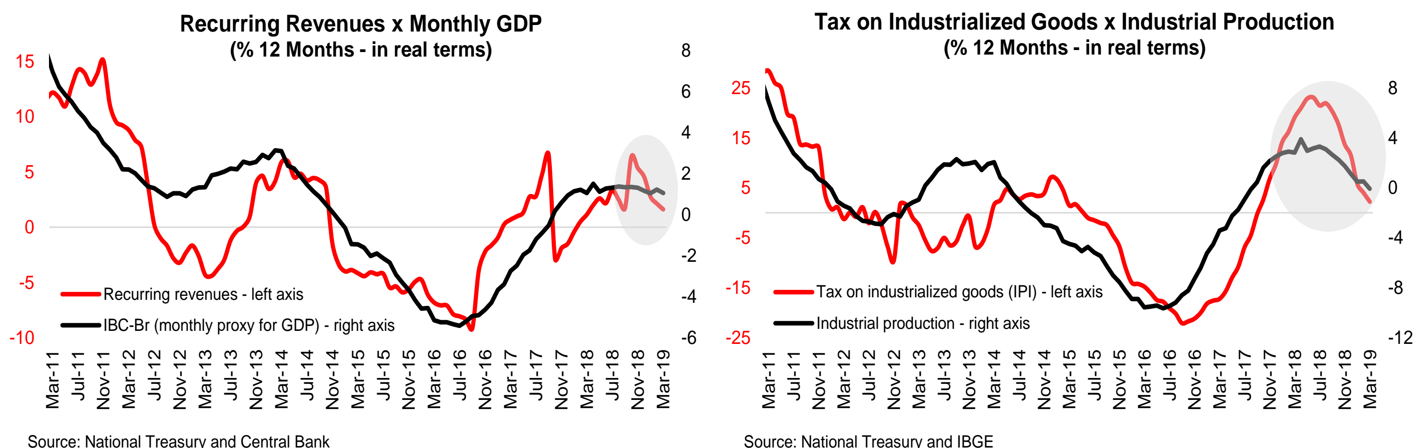
Losing Steam

Brazilian economic activity has been showing disappointing numbers recently. After the general election of 2018, confidence indexes and financial assets strengthened in Brazil, in line with signs from the incoming government of orthodox economic management and fiscal austerity. However, this improvement was not sustained (business and consumer confidence faltered and asset prices became much more volatile), and most of the activity indicators have lost momentum since the end of the year. Brazil's GDP contracted 0.2% q/q in 1Q19 (0.4% y/y), and the numbers for 2Q19 released so far have not been encouraging either. Looking at the GDP breakdown, it is worth noting the lethargic performance of domestic industry, stagnation of investment (investment rate is below 15% of GDP) and slowdown in household consumption. In our opinion, **the slow recovery of economic activity is explained by both conjunctural and structural factors**, such as a milder pace of global trade growth, the Argentine recession (which severely affects the Brazilian automotive industry), high unemployment, uncertainty related to the fiscal consolidation process, and loss of productivity due to misallocation of resources in previous years, among others. **This report does not seek to deeply investigate the causes of weakening domestic activity, but aims to evaluate how the main fiscal gauges should be affected in this scenario.**

As published by Brazil's National Treasury, central government revenues grew 1% y/y in the first four months of 2019 (in real terms), well below the increase of 7.4% y/y registered in the same period of 2018. Considering only the tax revenues (i.e., excluding non-recurring revenues such as concessions and royalties), there was a decline of 0.5% y/y from January to April 2019, a significant deceleration from the expansion of 9.6% y/y seen in early 2018. **Taxes levied on the stages of production processes were precisely those most affected by the fragility of Brazilian economic activity:** IPI – taxes on industrialized goods (-10.6% y/y from January to April 2019); PIS and COFINS – indirect taxes levied on gross revenues (-6.1% y/y and -8.5% y/y, respectively); CSLL – social contribution as a portion of net profit (2.3% y/y). **Although we foresee some improvement in economic activity during the second half of this year, in line with advances in the structural reform agenda** (this subject is best explored in the following sections**), tax revenue growth in 2019 should be rather modest** – we forecast 5.3% in nominal terms (equivalent to nearly 1.5% in real terms), below the 8.3% recorded in 2018.

In addition, so-called non-recurring or extraordinary events have boosted central government revenues in recent years, but their contribution to 2019 accounts is quite uncertain. A significant portion of the improvement in total government revenues between 2016 and 2018 can be explained by one-off factors, such as concessions (mainly in the oil and gas sector), refinancing programs for tax liabilities (e.g., REFIS and PRT/PERT, acronyms in Portuguese), and repatriation of undeclared assets held abroad. **According to our estimates, these extraordinary events added about BRL180 billion to government revenues in the last three years, corresponding to approximately 0.9% of GDP** (accumulated over the entire period).

Figure 2. Economic Activity vs. Tax Revenues

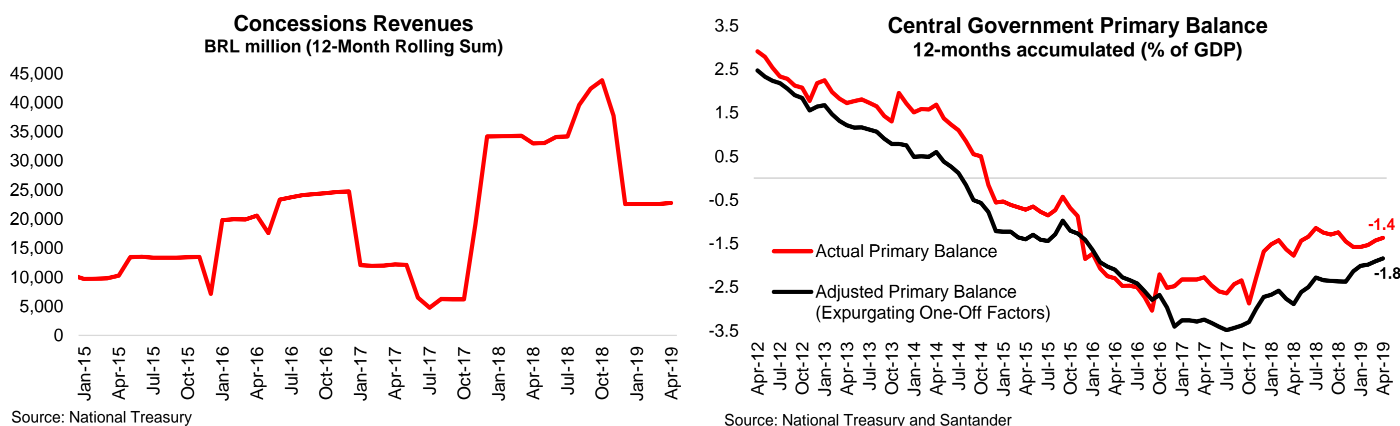


For 2019, the Brazilian government expects to raise a large amount of money from auctioning off the excess oil in the transfer-of-rights area[1], a giant pre-salt oil reserve located in Rio de Janeiro. The transfer-of-rights oil contract dates back to a 2010 agreement between the Brazilian government and its giant state-owned oil company. The auction is scheduled for November 6, while the payment to the state-controlled oil company (USD9.06 billion due to oil contract revisions) is

[1] The government sold the rights to over 5 billion barrels of oil in a new exploration area, but the contract foresaw a revision of the agreement's value, taking into account changes in the exchange rate and international oil prices. The Brazilian oil regulator (ANP, acronym in Portuguese) estimates there are approximately 17 billion barrels of recoverable oil in the area, which motivated the government to auction off rights for the exploration of the excess oil.

expected to take place on December 13. **According to market and government estimates, the blockbuster auction of excess oil could provide revenues of around BRL105 billion (USD27 billion).** Thus, after the payment to the state-owned company, the Brazilian government would collect some BRL70 billion as extraordinary revenues. **However, obtaining this vast amount of cash in 2019 depends on political and legal factors**, such as whether or not Congress must approve the auction. **Thus, our baseline scenario assumes that transfer-of-rights oil revenues will be accounted for in 2020,** substantially helping the primary balance next year. Moreover, **we believe that the federal government will share a large amount of these resources with states and municipalities (about BRL20 billion)**, aimed at relieving their fragile fiscal situation – **our scenario incorporates net revenues totaling BRL50 billion for the federal government next year.**

Figure 3. Extraordinary Revenues and Adjusted Primary Balance



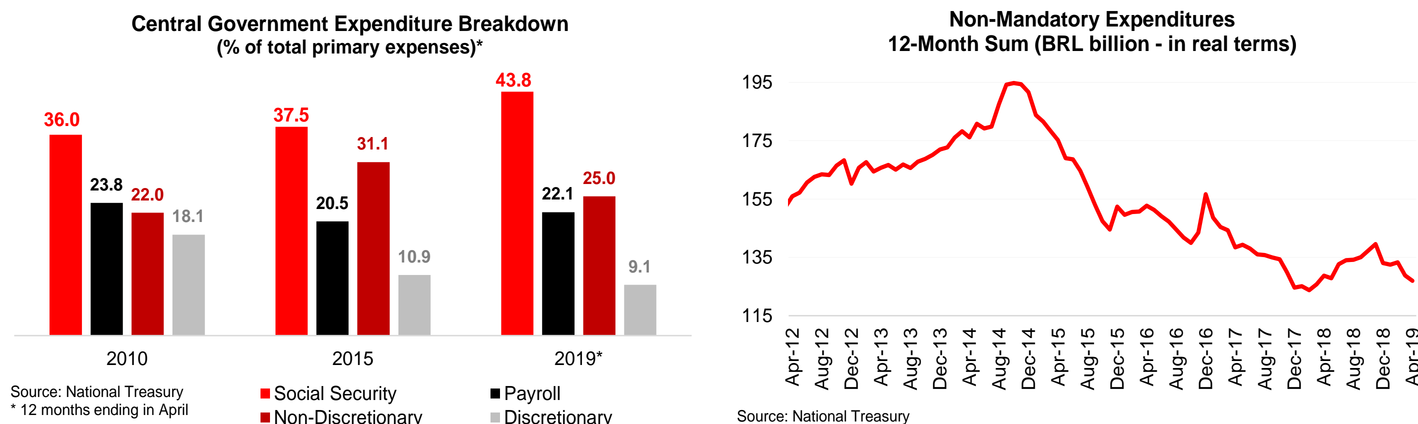
Hence, disappointing economic activity and a lower contribution from extraordinary revenues should result in total central government revenues expanding 4.8% in 2019 (in nominal terms), down from 7.3% in 2018. We project the following nominal growth rates for the main revenue groups: tax revenues (5.3%); social security revenues (5.1%); and non-recurring revenues (2.4%).

In our view, the deterioration in government revenues explains most of the recent downward revisions in fiscal projections for 2019. Nevertheless, it is important to keep in mind that the structural imbalance of Brazilian fiscal policy largely reflects the unsustainable path of non-discretionary expenditures, which we explore in the next section.

Facing the Root Causes of the Problem

We (and most analysts) have emphasized that public-account balancing is not feasible without the reduction of so-called non-discretionary expenditures, which represent almost 91% of total government primary spending (Figure 4). Moreover, since social security currently accounts for approximately 45% of total outlays and we have seen a rapid demographic transition in Brazil, the approval of the pension reform is crucial to the balancing of government finances. For instance, we estimate that social security spending as a percentage of GDP would jump from 8.7% in 2019 to 14% in 2040, considering a scenario in which there is no pension reform. This dynamic is clearly an impediment for bringing fiscal accounts back to a sustainable path.

Figure 4. Central Government Expenditures

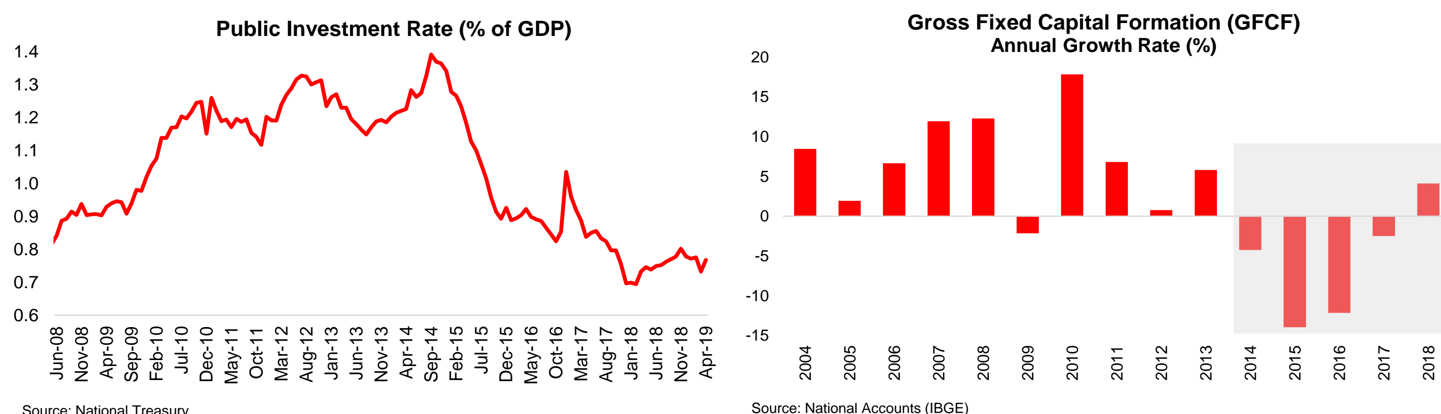


Thus, while acknowledging that pension reform is not a silver bullet (other fiscal measures must be implemented), its approval in Congress is certainly a necessary condition for fiscal consolidation. (For more information, please see *The Moment of Truth: From Intentions to Bargaining*, March 28, 2019; *It's Show Time: The Battle for Social Security Reform*, February 20, 2019; and *10 Macro Propositions for 2019*, January 7, 2019).

Given the continuous expansion in social security spending, the **Brazilian government has been containing expenditures mainly through cuts in discretionary lines**, which plunged to BRL127 billion in April 2019 from BRL176.1 billion in April 2014 (12-month sum). This reduction in non-mandatory expenses has been helping the government to meet the fiscal spending cap rule[2]. However, **the ability to reduce these expenses is limited, since it imposes risks of government shutdown.**

In addition, the federal government's investment rate almost halved from late 2014 to early 2019 (from 1.39% of GDP in September 2014 to 0.77% of GDP in April 2019). **The sharp decline in public investment over the past five years partially explains the dismal performance of gross fixed capital formation in the period (accumulated contraction of 26%), which shaved nearly 5pp from Brazil's GDP, according to our calculations.**

Figure 5. Public and Overall Investment



Combining the (i) significant reduction in discretionary expenses, (ii) restrictions imposed by the spending cap rule, and (iii) accelerated growth of the social security deficit, the **government's pension reform proposal sent to Congress undoubtedly plays a major role in the 2019 Brazilian macroeconomic outlook.** Although there are still uncertainties surrounding the potential fiscal savings and timeline for approval, the most recent developments have been favorable for pension reform, in our view. We note that most political parties seem increasingly aware of the need for this measure to improve the economic environment.

Hence, we present below (Figure 6) our updated estimates for the watered-down version of pension reform (i.e., fiscal savings after negotiations in Congress). We expect the bill to result in around BRL760 billion in savings over 10 years, which means keeping 60% of the amount originally proposed. Therefore, despite our baseline scenario pointing to a fiscal impact below the desired savings of (at least) BRL1 trillion in 10 years, as reiterated by the government's economic team, our estimates seem to be somewhat better than the median market expectations. Furthermore, it is worth noting that our previous forecast – released in late March – was about BRL100 billion lower.

Looking at the balance of risks, we highlight as the main downside a potential failure to approve changes to the rules for granting wage benefits, already taking into account that some changes were made in the original proposal sent by the government (it would represent a reduction of around BRL80 billion of projected fiscal savings over ten years). In contrast, **we think the main upside risk is the potential reinclusion of state and municipal servants in the final agreement for pension reform.** Last week, the rapporteur in the Lower House's Special Committee withdrew states and municipalities from his revised draft. Despite fiscal gains arising from changes to the rules for states and municipalities, which are not included in the BRL1.2 trillion initially estimated by the government, we evaluated the reinsertion of this item in the proposed constitutional amendment as fundamental, since public finances in most regional governments are in dire straits. We calculate that if the new rules for federal servants also apply to states and municipalities, there would be a reduction of nearly BRL350 billion and BRL175 billion of projected social security expenditures over ten years, respectively. **Another upside risk is the potential tightening of the transition rule for civil public servants in relation to what was presented by the pension reform's rapporteur in the Lower House.**

[2] Constitutional amendment (95/2016) approved in late 2016 mandating that the federal government's total primary expenditures cannot increase more than cumulative inflation in the 12 months from June of the preceding year.

Despite the tight deadline, we believe that the possibility of the pension reform being approved in the Lower House before the parliamentary recess (i.e., by mid-July) has been growing. The final approval in the Senate is expected to take place in early September.

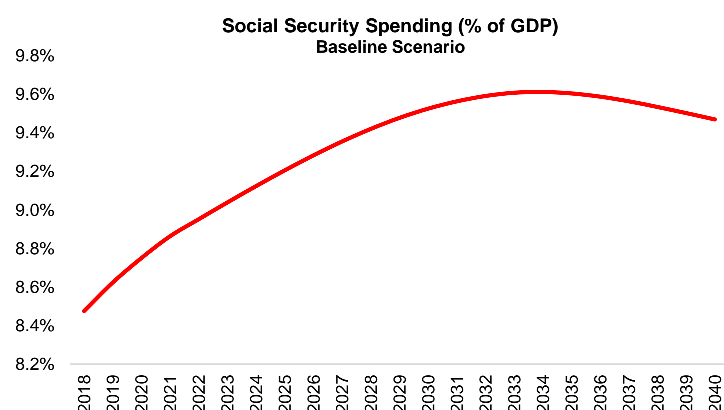
According to our baseline scenario, the social security spending-to-GDP ratio (considering the private sector regime – RGPS) would peak in 2035 at around 9.5% and gradually decline thereafter. On the other hand, considering a scenario without pension reform, we calculate this ratio would increase continuously, reaching very worrying levels of 11.2% in 2030, 13.7% in 2040 and 16.4% in 2050.

Figure 6. Potential Gains from Pension Reform – Government Proposal and Estimates for the Modified Version

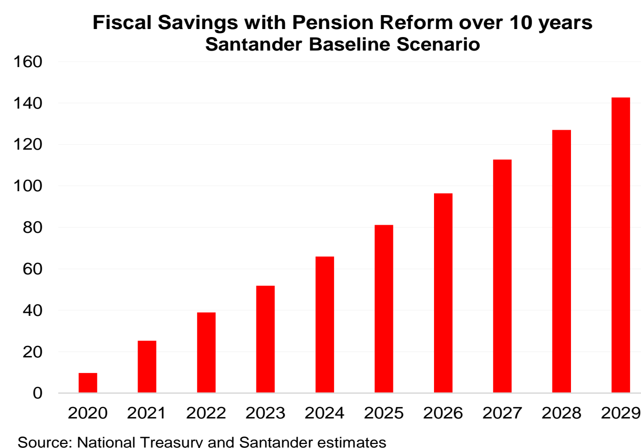
Social Security Reform - Main Measures	Savings in 10 years (BRL billion) *Government estimates*	%	Savings in 10 years (BRL billion) *Watered-down version - Santander estimates*	%	*% of watering down*
Private Sector (RGPS)	**807.9**	**65.3**	**571.0**	**75.3**	**29.3**
Urban Workers	**743.9**	**60.2**	**571.0**	**75.3**	**23.2**
Retirement by Period of Contribution	432.9	35.0	333.2	43.9	23.0
Period of Contribution	363.4	29.4	293.0	38.6	19.4
Professor	12.0	1.0	4.2	0.6	65.0
Special	57.6	4.7	36.0	4.7	37.5
Retirement by Age	128.0	10.4	87.0	11.5	32.0
Disability Retirement	79.4	6.4	63.5	8.4	20.0
Survivor Benefit	111.7	9.0	95.5	12.6	14.5
Others	-8.2	-0.7	-8.2	-1.1	0.0
Rural Workers	**92.4**	**7.5**	**0.0**	**0.0**	**100.0**
Retirement by Age	66.4	5.4	0.0	0.0	100.0
Survivor Benefit	26.1	2.1	0.0	0.0	100.0
Public Sector (RPPS)	**224.5**	**18.2**	**142.5**	**18.8**	**36.5**
Change in the Social Security Contribution Rates (RGPS)	-28.4	-2.3	-28.4	-3.7	0.0
Change in the Social Security Contribution Rates (RPPS)	27.7	2.2	23.7	3.1	14.4
Wage Benefit	**169.4**	**13.7**	**45.0**	**5.9**	**73.4**
Continuous Cash Benefit Program (BPC)	**34.8**	**2.8**	**0.0**	**0.0**	**100.0**
TOTAL IMPACT	**1,236.5**	**100.0**	**758.5**	**100.0**	**38.7**

Source: Ministry of Economy and Santander estimates

Figure 7. Fiscal Savings and Private Sector Social Security Spending with Pension Reform



Source: National Treasury and Santander estimates



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What Else Needs to Be Done?

As mentioned above, **we have consistently advocated that, in addition to pension reform approval, other expenditure cut measures should be carried out** this year and in the coming years to: **(i)** respect the spending cap rule without significant risks of government shutdown; **(ii)** improve the dynamics of the structural primary balance; and **(iii)** stabilize the public debt-to-GDP ratio. Among these measures, we note the creation of a new rule for automatic minimum wage adjustments, small changes in civil servant wages (even in nominal terms in the next few years), and reversal of tax breaks.

We present below the assumptions of our baseline scenario for the federal government and evaluate their implications for key fiscal gauges, including forecasts for the government's main revenues and expenditures. Furthermore, we also provide a few examples of calculations for alternative scenarios that adopt more optimistic or pessimistic hypothesis.

Baseline Scenario – Main Assumptions:

1) Pension reform approved in 2H19 (BRL760 billion in savings over 10 years);
2) BRL110 billion in revenues from state asset sales between 2019 and 2022 (we highlight BRL50 billion in 2020 from transfer-of-rights oil revenues);
3) Minimum wage adjusted only by inflation in 2020 and by inflation plus 50% of real GDP growth onward;
4) No (nominal) changes in civil servant wages in 2020, adjustment by inflation onward;
5) Reduction of BRL70 billion in tax breaks until 2022;
6) Real GDP growth averaging 2% between 2019 and 2022; real interest rates averaging 3% in the same period. Thereafter, we assume real GDP growth at 2.5% and real interest rates at 3.5%.

As presented below (Figure 8), **we forecast a primary deficit of BRL118.6 billion (-1.6% of GDP) for the central government in 2019**, **achieving its fiscal target of BRL139 billion. In our baseline scenario, the primary result will return to positive territory in 2023 and see a gradual increase in the following years.**

For 2020, the relatively strong improvement in the primary result (-BRL49.5 billion or -0.6% of GDP) is mainly associated with the transfer-of-rights oil resources, as discussed earlier. Looking further ahead, we call attention to the more contained performance (lower growth rates) of payroll and other mandatory expenditures, owing to the changes in the minimum wage adjustment rule and tougher restrictions on civil servant salary increases.

Another important issue refers to the risks of non-compliance with the spending cap rule. In our view, the risks are low for the period from 2019 to 2021 – for 2019, for example, we estimate a fiscal slack of around BRL30 billion. **However, we foresee non-negligible risks for 2022 and fairly high risks from 2023 onward (Figure 9).**

The so-called "fiscal margin" (difference between the spending ceiling and sum of mandatory expenses) would substantially improve with the approval of the pension reform, as seen in Figure 9. Nevertheless, because there is a minimum level of discretionary spending to prevent public shutdown (we currently estimate it at BRL85 billion), the scenario would remain challenging.

Although the expenditure ceiling rule has constitutional triggers to be pulled in case of non-compliance (e.g., no hiring of employees and freezing of public servants' wages), this scenario should be avoided as much as possible, in our opinion, since it could cause problems regarding the implementation of public policies and provision of services to society. This is not to say that the rule should not be applied if the negative scenario materializes; after all, in our view, law enforcement is crucial for restoring credibility among market participants of the balance of Brazilian public finances.

Figure 8. Baseline Fiscal Scenario – Main Revenues and Expenditures

Baseline Scenario	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
BRL billion - current values													
Total Revenues	**1,484**	**1,556**	**1,704**	**1,767**	**1,901**	**2,048**	**2,185**	**2,325**	**2,474**	**2,629**	**2,794**	**2,970**	**3,158**
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Net Revenues	**1,228**	**1,283**	**1,408**	**1,462**	**1,579**	**1,705**	**1,820**	**1,937**	**2,060**	**2,187**	**2,321**	**2,464**	**2,616**
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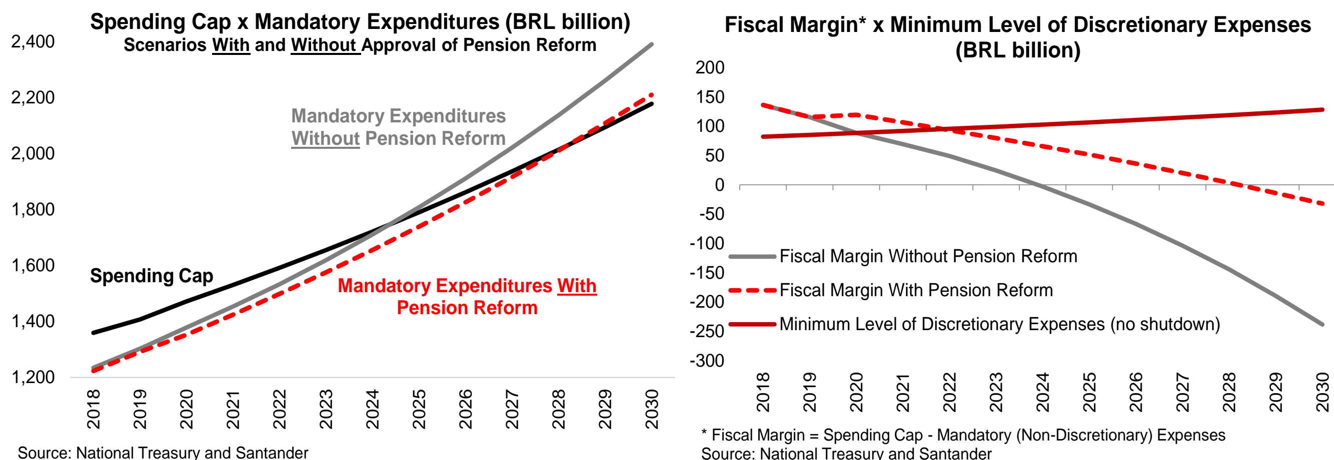
Primary Balance	**-124.2**	**-118.6**	**-49.5**	**-61.9**	**-20.2**	**24.3**	**55.2**	**83.9**	**115.3**	**145.6**	**179.3**	**217.6**	**261.7**
Primary Balance (% GDP)	**-1.8**	**-1.6**	**-0.6**	**-0.8**	**-0.2**	**0.3**	**0.6**	**0.8**	**1.0**	**1.2**	**1.4**	**1.6**	**1.8**
Nominal GDP	6,904	7,263	7,735	8,237	8,773	9,343	9,950	10,597	11,286	12,020	12,801	13,633	14,519

Source: National Treasury and Santander estimates

Figure 9. Risks of Non-Compliance with the Spending Cap Rule



In order to analyze the sensitivity of the main fiscal metrics, we also ran simulations loosening and tightening some of our basic assumptions. The following are two examples of alternative scenarios that bring different hypotheses for the major expenditure groups.

A) Optimistic Scenario

Pension reform approved in 2H19 (**BRL900 billion** in savings over 10 years);
Minimum wage adjusted only **by inflation until 2022** and by inflation plus 50% of real GDP growth onward;
No (nominal) changes in civil servant wages **until 2022** and adjustment by inflation onwards.

In the optimistic scenario, the **central government's primary result becomes a surplus in 2022. Moreover, the risks of non-compliance with the spending cap rule remain very low until 2024, becoming non-negligible in 2025 and high from 2026 onwards.**

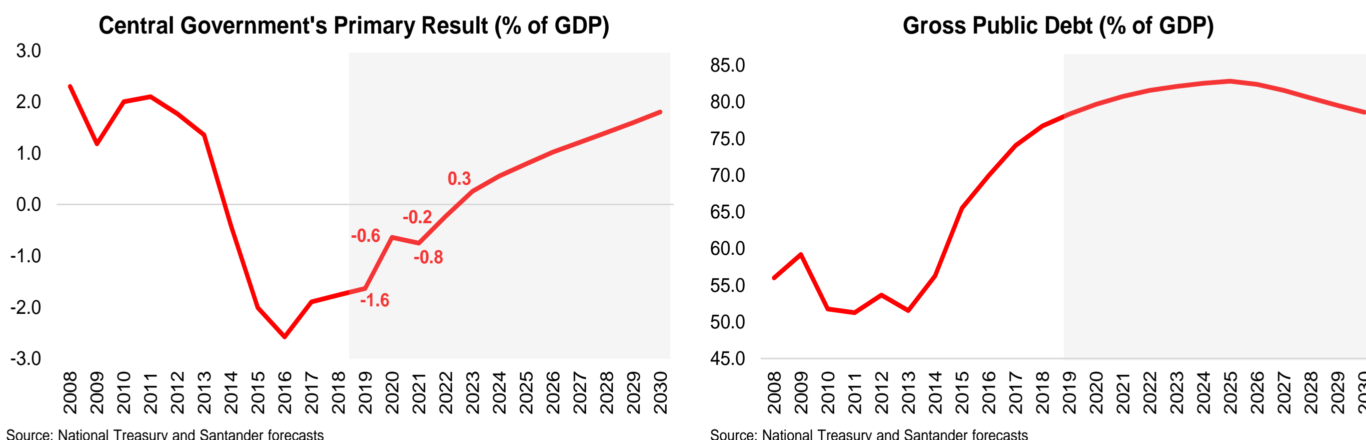
B) Pessimistic Scenario

Pension reform approved in 2H19 (**BRL600 billion** in savings over 10 years);
Minimum wage adjusted under the **former rule**: inflation (t-1) + real GDP growth (t-2);
Nominal changes in civil servant wages **until 2022 and annual real gains of 1% onward**.

In the pessimistic scenario, the **central government's primary result returns to positive territory only in 2027. With regard to the fulfillment of the expenditure ceiling rule, there would be non-negligible risks already in 2021 and very high risks from 2022.**

Concerning the potential impact of pension reform and other measures on the public debt trajectory, more detailed analyses will be presented in a forthcoming report, with particular attention to non-recurring resources that would help to reduce government indebtedness (e.g., advanced payments from BNDES to the National Treasury). **Nonetheless, as a preview, we highlight that in our baseline scenario, gross public debt-to-GDP would stabilize in 2025 at 82.7% (Figure 10). Under the assumptions of the optimistic scenario, this fiscal gauge would stabilize in 2024, while in the pessimistic scenario the stabilization would not happen before 2030.**

Figure 10. Baseline Fiscal Scenario – Primary Result and Gross Public Debt



Final Considerations

The precarious nature of Brazilian fiscal accounts seems consensual among market participants. In fact, significant structural problems in the government's finances have culminated in an unsustainable trajectory for public debt, threatening the resumption of economic growth and (current) low levels of inflation and interest rates. The rebalancing of the fiscal framework depends on the containment of mandatory expenses, especially social security. Moreover, conjunctural factors have also been hindering an improvement in public accounts, especially the weakening economic activity.

We reiterate our view that the approval of pension reform will be only the first (important) step of a broad agenda of measures to adjust Brazilian fiscal policy. The reduction of payroll expenses, revision of tax exemptions, changes in the federative pact, and the concession/privatization program are other examples of relevant measures to foster fiscal and macroeconomic balance, including a more consistent resumption of economic activity.

In spite of the most auspicious signs for the progress of structural reforms, **the completion of fiscal adjustment** (e.g., return of primary surpluses and stabilization of public debt) **should take several years, requiring continued government commitment to these issues. In addition to more in-depth coverage of Brazilian public debt scenarios in forthcoming reports, as already indicated, we will also study in greater detail the outlook for regional public finances (states and municipalities), since many of them are in an even more serious situation than the federal government.**

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