Fixed Income & Economics Daily

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FX & RATES STRATEGY RESEARCH

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

- **COLOMBIA: Minutes of the August MPC Meeting**

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- The Central Bank of Colombia (BanRep) will publish today the Minutes of the August 31 MPC Meeting. In the August meeting the Central Bank cut the reference rate by 25bps, in line with consensus, reducing it to 5.25%.
- The decision was a three-way split, with four members voting for a 25-bps cut, two members voting for a deeper cut of 50bps and one member voting to keep rates on hold. The minutes should provide a better understanding of the three different postures.
- The highlight of the statement was that BanRep suggested that the interest rate was close to neutral, and no longer described it as contractionary. The discussion regarding the neutral rate could provide important guidance regarding which risk factors the MPC could focus on in the next meeting and the probability of more cuts this year.

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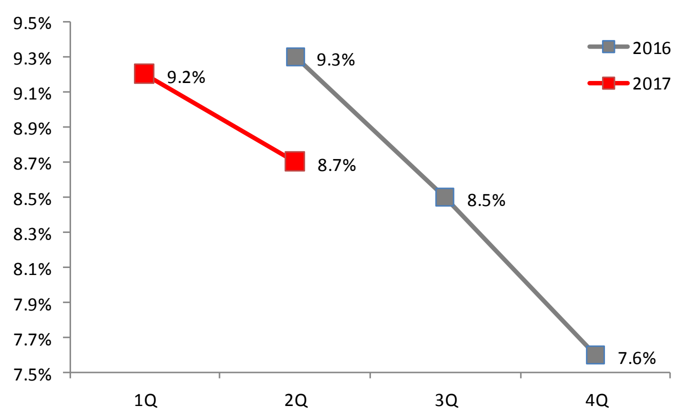
The Unemployment Rate Reached 8.7% in 2Q17

Sergio Galvan*, Rodrigo Park*, Martin Mansur*, Cristian Cancela*
+5411-4341-1728
sgalvan@santanderrio.com.ar

The unemployment rate declined to 8.7% in the second quarter of 2017 according to Indec figures, down from the 9.3% observed in the same quarter of last year. Most of the unemployment decline in the last year was explained by a lower activity rate (to 45.4% from 46%), where employment rate reached 41.5% in the last quarter, 0.2 p.p lower compared to 2Q16.

We expect that the unemployment rate will continue declining in the following months due to seasonal factors and in a context of GDP growth accelerating on the margin (+4% y/y in June from +0.3% in 1Q17). Also, the recent acceleration of total registered employment growth (which we estimate will increase to +2.5% y/y in 3Q17 from +1.5% annually in 2Q17), will play in favor of the unemployment rate decline.

Declining unemployment rate



Unemployment rate. Sources: INDEC and Santander.

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CPI Trend Suggests Easing Unlikely Until August 2018

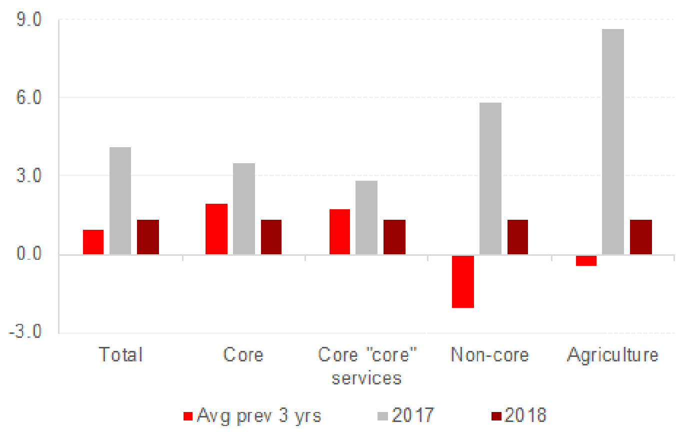
David Franco*
+5255-5257-8170
dfranco@santander.com.mx

- **Higher agriculture prices and a new indirect toll from the gasoline shock warrant another upward revision to our end-2017 CPI forecast to 6.3% (previously 6%).**
- **While we maintain our end-2018 CPI call at 3.8%, we now foresee a more gradual disinflation process.**
- **This necessitates keeping the policy rate unchanged at the current 7% until at least the July 1 presidential election.**
- **We expect the MXN to remain a key input in Banxico's reaction function as the Board changes leadership on December 1.**
- **A constructive development for the inflation outlook is that longer-term inflation expectations remain anchored.**

Higher inflation credited to volatile categories

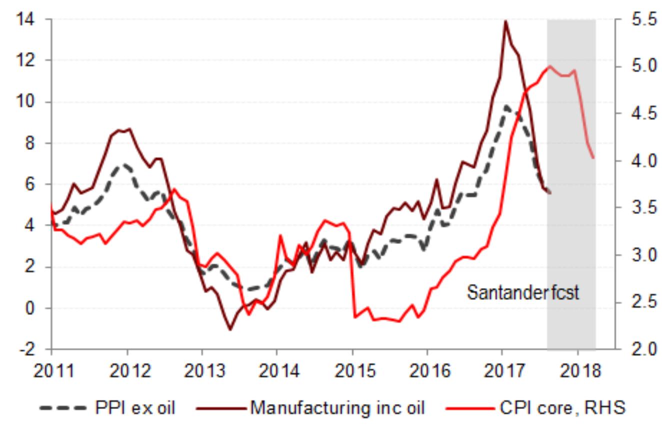
Inflation indicators remain consistent with a transitory shock; however, further acceleration in the volatile categories also remains problematic from a short-term perspective. Indeed, cumulative inflation through August accelerated to 4.1% compared to only 1% (average) over the previous three years and topping the 3.2% pace in 2008, the last time inflation was abnormally high (6.5% at year-end). The recent acceleration in non-core prices can be attributed to unusually high agriculture prices stemming from a supply-side shock due to bad weather and a new indirect impact from the gasoline price shock that hit in January (a 25% increase in public transportation prices in the State of Mexico). This warrants yet another upward revision to our CPI forecast for end-2017 to 6.3% (previously 6%); however, our forecast for the policy-sensitive core measure remains unchanged at 5%.

1. Cumulative inflation through August



Note: 2018 is Santander forecast. Source: Inegi, and Santander.

2. PPI disinflation is gaining traction



Source: Inegi, Bloomberg and Santander.

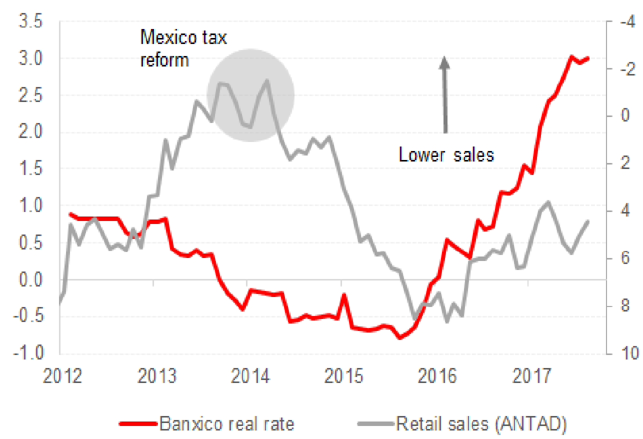
What goes up must come down

Core inflation has remained high but stable, and we remain confident in our view that the worst of the inflation shock is already behind. We expect the core gauge to fall below the 4% top of Banxico's 3% +/-1pp target range in 2Q18 and continue its disinflation process, though more gradually. The impact of bad weather on both agriculture and gasoline understandably raises concerns for the short-term outlook, but the structural return of core inflation remains our central scenario. Indeed, Mexico's unusually high inflation is at odds with very low inflation across core economies and surprisingly fast disinflation in most EM countries. In fact, the spread of core CPI between Mexico and its top trading partners is at its widest level in 15 years.

The following factors are consistent with this outcome:

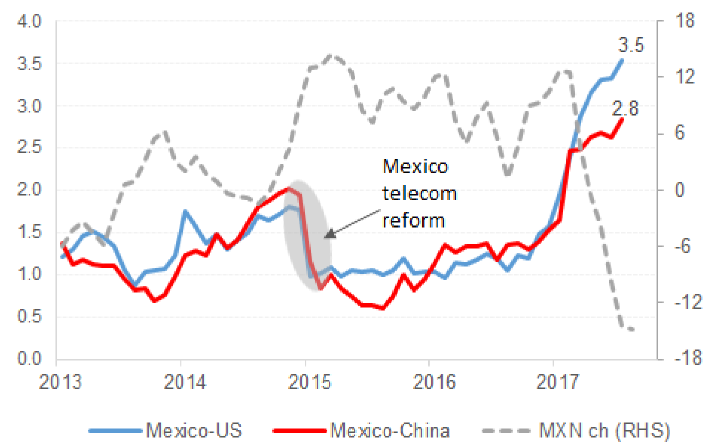
- Core prices, mainly for goods where the FX pass-through effect are concentrated, have already converged to their average pace of the previous two years. Core goods-food items are a point-in-case, given the potential contamination from agriculture prices (for this subindex, the inflation divergence between this year and the 2015-16 average slowed from 0.4% in first three months of this year to 0.1% in the quarter ending in August).
- Wholesale price inflation, a reliable barometer of future core CPI trends, marked its seventh consecutive decline (using core annual rates) in August, led by a sharp decline in manufacturing goods. Indeed the PPI-CPI core spread has narrowed to 115 bps from 540 bps back in February.
- Wages are not tracking inflation higher despite Banxico's warning that labor market slack has faded. (Private workers have settled for one-year ahead nominal wage increase of 5% so far this year, equivalent to -1.5% real wage, compared to a +1.7% real wage gain in the same period of last year).
- Banxico's credibility remains firm judging by the relatively well-anchored inflation expectations over longer terms from analysts and those derived from markets (Analysts still expect headline inflation to mean revert to its 3.5% norm, which is where the 10-20yr breakeven rates are trading).

3. Mind the loss of momentum in spending



Note: 1yr fwd real rate discounted using 12-m fwd CPI forecast
Antad retail sales is %y/y, 3mma
Source: Banxico, Bloomberg, ANTAD and Santander.

4. Core CPI spread: Mexico vs top trading partners



Note: Core CPI spread on annual rates. MXN spot change over 6 months.
Source: Inegi, Bloomberg and Santander.

MXN turning tides will be critical for Banxico

Banxico's preemptive hiking that pushed the ex-ante real rate to 3% in combination with the progress on Mexico's fundamentals (growth, fiscal consolidation, CA deficit, successful oil rounds) have provided support to the MXN, which has stabilized around 17.70. Additionally, Mexico and most EM peers have continued to benefit from global inflows consistent with investors' yield appetite amid relatively contained Fed uncertainty. Notwithstanding our constructive view on MXN (which also explains our below-consensus CPI call), market uncertainty around the July 1 presidential election and NAFTA remake (in order of relevance) is likely to emerge going into 2018. This means MXN will remain even more important for inflation dynamics during 1H18 and the Board will likely err on the cautious side even if the Fed announces plans to normalize more gradually. So we believe Banxico will keep its policy rate unchanged at 7% and only consider rate cuts at its August meeting (the 2018 monetary policy calendar will be announced by year-end but Fed-convergence means meeting dates will be similar to those scheduled this year). The new governor will make its debut at Banxico's Board on December 1, and we expect the policy strategy to remain consistent with cementing inflation expectations. Also, note a potential correction in the FX is likely to be met by FX interventions (Banxico's ammo on its FX swaps is worth US$18 billion).

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Diana Ayala	Economist - Colombia	diana.ayala@santander.us	212-350-0979
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537
Fixed Income Research			
Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Equity Research			
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

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