Macroeconomic Scenario Review: It's All About the Coronavirus; Updating Macro Forecasts

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

- **The coronavirus pandemic is quickly spreading in Brazil (as in many parts of the globe, of course), prompting massive deterioration in economic sentiment and market conditions. Importantly, the unprecedented economic consequences from this public health shock are making professional forecasting even more difficult, as scenarios become outdated by the day (if that long), much faster than economists' capacity to revise numbers and publish reports. In this piece, we summarize our latest set of scenario and forecast revisions, using (what now have become outdated) hypotheses from earlier this week.**
- **The direction of economic forecasts is clear: less GDP growth, worse budget results, a weaker FX rate, slower price gains and (maybe) even lower interest rate. We only hope that this year's fiscal expansion (already in the pipeline) will be discretionary and focused on the core of the problem, keeping the fiscal consolidation framework in place (and if possible, squeezing in the approval of any possible reform, such as the emergency fiscal amendment). The more intact the fiscal framework, the stronger the economy when a recovery (from the coronavirus outbreak) takes place.**
- **This week, we welcomed Brazil Central Bank's (BCB) moderate monetary policy reaction in the last Copom meeting, in the wake of the coronavirus shock. The authority cut the Selic rate by 50 bps (to a record low of 3.75%), in line with expectations but less than some market participants had been anticipating. On the one hand, the authority recognized the unquestionably deflationary nature of the coronavirus outbreak for Brazil's economy. On the other hand, the Copom correctly took into account the recent rise in budgetary risks, which could potentially make additional monetary stimulus counterproductive if the dose is exaggerated. The BCB will publish the Copom minutes (Tuesday) and the 1Q20 inflation report (Thursday): opportunities for the Copom to provide more information on their scenario assessment and policy guidance.**
- **Local rates had yet another bumpy week, following the continuing deterioration in global risk appetite and the relatively hawkish stance of the BCB (many local players were calling for a strong cut). We continue to like outright Jan'22 receivers, given our expected overnight rate path, but even that segment of the curve is now clearly contaminated by the prevalent negative mood with risky assets. The week was also far from calm for the local FX market, as the USD/BRL pair breached the unprecedented threshold of USD/BRL5.00 and set a new historical peak at USD/BRL5.25 (9.2% weaker than last Friday closing quote) in the most nerve-wracking moment. Although the recent measures reinforce our perception that authorities are likely to guarantee the normal functioning of the FX market, no one can ensure that the USD/BRL will recede to much stronger levels either quickly or at a steady pace. Uncertainties regarding the coronavirus fallout remain high and the impacts on Brazil's economy have yet to be seen. Consequently, let's all brace for a possibly, continuously bumpy ride ahead.**
- **Next week many January (pre-coronavirus crisis) activity indicators will hit the wires. On Thursday, we expect the IBC-Br (the BCB's activity index, a proxy for the official quarterly GDP on a monthly basis) to post a 0.5% MoM growth (1.3% YoY). On the inflation front, on Wednesday, the mid-month preview for the official CPI for March (IPCA-15) comes out: our calculations project a 0.06% MoM increase, which would imply a 3.72% YoY change if our estimate proves right. February's balance-of-payments data are due to be released (Wednesday), and we expect figures to underpin our assessment that the deterioration in the current account balance would soon cease to be a source of concern for market participants.**

Local market conditions - rates: Local rates had yet another bumpy week, following the continuing deterioration in global risk appetite and the BCB's relatively hawkish stance (many local players were calling for a strong cut). As of the closing of March 19, Jan'22s had widened ~70 bps in the week, with Jan'23s, Jan'25s, and Jan'27s surging about 100 bps in parallel. The National Treasury stepped up its market support through buyback auctions: volumes repurchased this week so far added up to BRL17.5 billion, bringing the total intervention this month close to BRL29 billion. Auctions volumes were concentrated (more than 90% of total) in linkers. The front end of the local curve (i.e., tenors shorter than six months) prices in a flat Selic rate for the next few months. In our view, this provides a good optionality, as we perceive the risk of imminent rate hikes as low. Beyond that, market activity in the near term should be more about risk premium (globally driven) than anything related to domestic gyrations -- although, in our view, it's fair to recognize that fiscal risk has increased significantly and should be translated into, everything else equal, a steeper curve. We continue to like outright Jan'22 receivers, given our expected overnight rate path, but even that segment of the curve is now clearly contaminated by the prevalent negative mood with risky assets. Zooming away from the short term, we notice that the long end of the local curve (i.e., five years and beyond) is back to levels seen before the rally that followed the pension reform approved last year (under a much higher Selic rate). Despite those seemingly attractive levels, we are not confident that the risk-reward of extended duration is any better than sticking to Jan'22s. Though the fiscal damage -- both in extent, reversibility, and in terms of impact to the reform agenda -- of the coronavirus outbreak; until that becomes clearer, we prefer to act conservatively.

Local market conditions - FX: The week was also far from calm for the local FX market, as the USD/BRL pair breached the unprecedented threshold of USD/BRL5.00 and reached a new historical peak of USD/BRL5.25 (9.2% weaker than last Friday's closing quote) in the most nerve-wracking moment. Uncertainties stemming from the coronavirus pandemic, concern with (what looked like at a first glance) a lack of coordination amongst Brazilian authorities to deal with the public health crisis, and unease with the possibility of an aggressive interest rate cut by the BCB last Wednesday were possible causes for this staggering move, in our view. Interventions carried out by the BCB provided liquidity to the market and probably helped prevent an even stronger (and probably dysfunctional) weakening of the FX rate. The monetary authority sold USD1.1 billion to market participants in the spot market and provided another USD6.0 billion through repo spot operations. Additionally, confirming its declared intention to resort to all kind of alternatives to ensure the normal functioning of the FX market, the BCB also announced that it would start carrying out repo operations backed by USD-denominated sovereign bonds held by financial institutions based in Brazil. The Brazilian monetary authority stated that these operations may reach up to USD31 billion, providing even more liquidity to the local FX market. Given the moderate choice made by Copom members to cut the base interest rate by 50 bps last Wednesday—with a number of market participants expecting a 100-bp move then—and a more cautious tone regarding next steps, there was a reduction in the concern regarding an exaggerated reduction of the Selic rate, especially as structural fiscal issues are yet to be addressed (we do not refer to temporary increases in expenditures that will be necessary to deal with the coronavirus fallout). This fact, allied with a better coordination of public authorities regarding the conduct of measures to fight the public health crisis, the announcement of a swap line agreement between the U.S. Federal Reserve and the BCB (meaning an additional ammunition of USD60 billion for the BCB to provide liquidity to the local market, if needed), all helped the Brazilian FX rate to return to USD/BRL5.03 level at the time of this writing (4.2% higher than last Friday). Although the measures reinforce our perception that authorities are likely to guarantee the normal functioning of the FX market, no one can ensure that the USD/BRL will recede to much stronger levels — either quickly or at a steady pace. Uncertainties regarding the coronavirus fallout are still high and the impacts on Brazil's economy have yet to be seen. Consequently, let's all brace for a possibly, continuously bumpy ride ahead.

Activity outlook: Though the long-term effect on world economic growth due to drastic measures taken by many countries to combat the coronavirus outbreak remains uncertain, the early impact are clearly much greater than anticipated. In our view, external factors (e.g., reduced global trade, worsening financial conditions and risk aversion) will lower Brazilian GDP growth an additional 0.6 p.p. in 2020. Moreover, Brazil now face's local problems as the virus establishes itself in major cities. In addition to the worsening financial conditions at the local level, some local authorities are imposing lockdowns in order to limit the spread of the disease. Hence, we expect these cities' economies to be hard hit once most of their establishments are forced to close (either partially or fully). Our baseline scenario considers that the restrictive measures will be implemented only in those major cities, and only for about a month. We expect a local impact of 0.4 p.p. on 2020 GDP growth stemming from domestic factors. All in all we are revising our GDP growth forecast to 1.0% for 2020 and 2.0% for 2021, down from 2.0% and 2.5%, respectively. Our downward revision of next year´s estimate follows lingering effects of the crisis, particularly from a balance-sheet perspective. We acknowledge that risks are largely skewed to the downside, as the international experience so far shows that the coronavirus spreads easily, and it is likely that the restriction measures will be taken all over the country. Furthermore, , given that the magnitude and duration of the outbreak remains quite uncertain, the situation requires continued monitoring, and further revisions should consider the development of this crisis.

Inflation outlook: Overall, we believe the consumer inflation outlook for the 2020-21 biennium remains quite favorable, given below-potential activity, a slow recovery process (possibly interrupted by the impact of the coronavirus outbreak), and well-anchored inflation expectations. That contrasts with the spike in the exchange rate, whose pass-through is limited not only by cyclical circumstances, but also overshadowed by declining commodity prices. For 2020, we project IPCA inflation at 3.0% (mid-target: 4.00%). For 2021, we expect it to climb to 3.5%, mainly due to larger adjustments of administered prices next year, with important ones being postponed from 2020. Though we are now observing an accommodation in meat prices after the upward impact of animal protein prices in late 2019 owing to the supply shock stemming from the African swine fever (ASAF) outbreak, a new shock, still with an uncertain impact, could add upward risk to the IPCA estimates for 2020 and 2021. Gasoline price are the first item that could potentially exert downward pressure on the IPCA this year and next. With the recent drop in international oil prices and our hypothesis that they are likely to hover around USD45/barrel this year and next year, we forecast an impact of -2% for both 2020 and 2021. Following lower commodity prices and the possible impact of coronavirus, "Food away from home" and "Service items" could also have a downward impact on inflation, using as parameter the trucker's strike that took place in Brazil in 2018. The headline inflation implies a milder deceleration in the IPCA-EX3 annual change to 2.9% (from 3.0% in 2019), underscoring an absence of demand-led inflation pressures.

Fiscal policy outlook: After weeks of tension between Congress and the executive branch, especially regarding the negotiations over the control of the narrow discretionary part of the budget, we expect both sides to cooperate on a common agenda in the near term. In fact, already rising concerns about the deteriorating public health caused by coronavirus (their "common enemy") could rise even more starkly, and the sense of urgency in the political environment is a substantial impetus for the executive and legislative branches to work together, in our opinion. We expect lawmakers and the government's economic team to spend more time and effort in the next few weeks discussing emergency measures to relieve the (potentially unprecedented) economic shock and mitigate systemic risks due to the rapidly spreading coronavirus. In the past few days, the Ministry of Economy has announced the first measures to help alleviate the economic hit from the global pandemic in Brazil; these aim to: (i) support employment by providing liquidity to businesses (e.g., deferral of the collection of payroll levies and taxes on small and medium-sized companies and expansion of credit lines to micro and small companies); (ii) expand the social safety net (e.g., adding about 1 million households to the *Bolsa Família* entitlement program, providing an allowance for individuals to withdraw more resources from FGTS (mandatory savings) accounts, early disbursement of year-end bonuses paid to retirees, early disbursement of year-end bonuses payments to formal workers; and (iii) raise expected spending on the public health system. More one-off relief measures were also announced, including a voucher to help informal workers and allowing companies to temporarily suspend job contracts (keeping part of their salaries, up to 50%). In order to gain more leeway to manage the public budget and fight against the coronavirus outbreak, the federal administration sked Congress to declare a state of emergency in Brazil (through December 31, 2020). Following the congressional approval, the measure will allow the government to suspend the 2020 primary fiscal target and the requirement of obligatory budget freezes for the compliance with this fiscal rule. We estimate a primary deficit of around BRL150 billion for central government this year, but we acknowledge that the risks are very tilted to negative side (i.e. higher primary deficit). Our previous expectation (-BRL105 billion) was revised due to three key factors: (i) lower GDP growth (from 2% to 1%, reducing tax revenue by BRL14.5 billion, according to our estimates); (ii) the significant fall in international oil prices (on annual average, from around USD60/barrel to around USD45/barrel, diminishing royalty payments by nearly BRL6.0 billion in spite of some partial offset from BRL depreciation); and (iii) economic relief measures already announced by the Ministry of Economy (increasing government's primary spending in approximately BRL25 billion). Since there are downside risks for Brazilian economic growth and global oil prices, combined with an expectation of strong expansion in primary spending to combat the coronavirus outbreak (especially after the approval of the state of emergency in the country), the government's primary deficit will possibly be much higher than our current estimate. On this matter, we note that the government has flexibility to request extraordinary outlays (subject to congressional approval) without breaching the constitutional spending cap rule in case of public emergency. In fact, the economic team has emphasized the need to preserve the constitutional expenditure ceiling, which is currently the most important anchor for fiscal policy and the Brazilian economy, in our view. That is the only way to credibly keep signaling a commitment to a fiscal consolidation path, avoiding an even sharper deterioration in market conditions and economic sentiment. Finally, we still expect the continuity of the reformist agenda this year, albeit more slowly - our baseline scenario considers the approval of an "emergency package bill" aimed at curbing mandatory expenditures, which would guarantee compliance with the spending cap rule until (at least) 2024, according to our calculations, as well as provide some room for higher public investment in coming years. Nonetheless, we recognize that the balance of risks for the execution of the government's reform agenda has worsened in the short term.

Monetary policy outlook: The Copom (Monetary Policy Committee of the BCB) – has recently decided to lower the policy rate by 50 bps (vs. a 25-bp cut in the previous meeting), taking the Selic rate down to a new historic low of 3.75% p.a.. Even amid great market volatility and a high dispersion of projections in the street, this outcome was largely priced in by the yield curve and also at the median of analyst forecasts (we were not surprised, either). In the forward guidance, the Copom indicates that "the current environment recommends caution in the conduct of monetary policy and, at this moment, deems appropriate to keep the Selic rate at its new level." Amid such great uncertainty, however, the authority is not completely shutting doors on an eventual adjustment ahead, as "the Committee recognizes that the variance of its balance of risks has increased and that further economic data will be essential to determine its next steps." There is no doubt that the (highly unpredictable, ex-ante) coronavirus shock is behind the U-turn of a central bank that was pointing at the end of the easing cycle about 45 days before. In fact, the BCB recognizes that while data "on economic activity released since the previous meeting remains in line with the process of the gradual recovery", the latest activity numbers do not "yet reflect the impact from the coronavirus pandemic." In the wake of this brutal external shock, and its increasing spread domestically, global conditions are seeing in a clear reversal of an otherwise constructive picture for EMs. According to the authority, "the environment for emerging economies has become challenging, despite the additional provision of monetary stimulus in major economies", as the BCB cites the global growth slowdown, the decline in commodity prices, and the greater asset-price volatility. The balance of risks changed with the recent developments. On the deflationary side, the BCB refers to the possibility that "a worsening of the pandemic implies a larger-than-expected, both in magnitude and in length, increase in uncertainty and decline in demand." In the BCB view, the latter could enhance the deflationary pressures emerging from high economic slacks. In the inflationary side, the Copom claims that "the increase in monetary policy power, the deterioration of the external scenario, or the frustration with the continuation of reforms may increase the risk premium and generate a higher-than-expected path for inflation over the relevant horizon for the conduct of monetary policy." This last element (i.e., frustration with reforms, see the underlined phrase above) is just another evidence that the Copom is now seeing an increase in fiscal policy risks, which we believe was also a key factor behind such a moderate BCB step in the addition of stimulus. The central bank "stresses that questions about the continuation of the reform agenda and permanent changes to the fiscal consolidation process could result in a higher structural interest rate. Under such circumstances, additional monetary easing may be counterproductive and result in a tightening of financial conditions." In our view, that this "yellow light" signal might follow recent Congress decisions to elevate mandatory expenses, under an apparently more tensioned backdrop for the execution of further reforms, strictly necessary to complete the fiscal consolidation process (and take Brazilian economy out of the woods). Of secondary relevance, but always worth mentioning: BCB simulations point to IPCA inflation at 3.0% for 2020 (mid-target: 4.0%) and at 3.6% for 2021 (mid-target: 3.75%), for a scenario assuming "a path for the Selic rate that ends 2020 at 3.75% p.a. and rises to 5.25% p.a. in 2021", as well as exchange rate (USD/BRL) stable all the way at 4.75. The fluidity of economic and financial conditions make assumptions and estimates (not only of the BCB's, of course, but ours and the markets') outdated by the minute, so that at this juncture the most important message by the BCB is the mention to "a higher-than-usual variance in the balance of risks." The BCB also left a promise that will continue to act (within its mandate) to help ease the impact of the shock in the Brazilian economy, pledging to use "its arsenal of monetary, exchange rate and financial stability policies to fight the current crisis." All in all, we welcome the BCB's moderate monetary policy reaction in the wake of the coronavirus shock, confirming our expectations days before the meeting. On one hand, the authority recognized the unquestionably deflationary nature of the coronavirus outbreak in the Brazilian economy (as worse activity and lower commodities offset the weaker BRL). On other hand, the Copom correctly took into account the recent rise in budgetary risks, which could potentially make additional monetary stimulus counterproductive if implemented in an exaggerated dose. While the Copom's flight plan is to be on hold, that could change amid a rapid deterioration of economic conditions (e.g., news flows of spreading lockdowns in Brazil's largest cities) and the possibility of some sort of agreement between executive and legislative branches to keep the fiscal consolidation framework for the medium term in place (to be seen). We maintain our expectation of a 25-bp rate cut in the next meeting, with our YE2020 Selic rate call kept at 3.50%. For the end of next year, we project 4.00%. Assuming that the current fiscal policy framework remains in place (in particular, the constitutional spending cap), we believe that an interest-rate scenario of "even lower for even longer" is quite feasible.

FX, balance of payments outlook: About a month ago, when we published our last review on the macroeconomic scenario (see our February 14 report, *Macroeconomic Scenario: Still on Track, but More Gradually*), the Brazilian currency was hovering around USD/BRL4.35, a level significantly higher than the USD/BRL4.00 at YE2019. In our opinion, part of the weakening could be attributed to two items: (i) delays in the progress of the reform agenda in Congress; and (ii) uncertainties stemming from the coronavirus outbreak, whose impacts had initially seemed to be more limited to China. Given that we had expected both to be reversed in the coming quarter, we had believed that the FX rate would show some strengthening ahead, ending this year around USD/BRL4.10, higher than the USD/BRL4.00 previously projected owing to worse terms of trade. One month later and with the outbreak turning into a pandemic that has ravaged economies all over the planet and hit financial markets mercilessly, commodity and equity prices have collapsed, market participants' risk aversion has skyrocketed and fears of a global recession have become widespread. On top of that, signs of higher fiscal risks have emerged, both on the possibility of delays in reforms and also with discussions that could have led to some back-tracking on the fiscal consolidation process. As a result, Brazil's FX rate has breached the unprecedented USD/BRL5.00 threshold recently. Hence, we come to the key question for the coming months: Do we believe these misfortunes can be reversed in a timely manner? Our answer is, "yes'. Governments have launched a set of fiscal and monetary measures to counterbalance the pandemic's hit, which could feed through economies more intensely in 2H20, when we expect lockdowns to be gradually reversed. Therefore, we believe commodity and equity prices should get out of the doldrums, as risk aversion subsides. On the domestic front, the necessity to approve emergency measures to address the Covid-19 fallout seemed to lead to some improvement in the relations between the Executive and the Legislative branches, which should pave the way for the approval of parts of the reformist agenda down the road, in our view. However, we believe the damages and uncertainties of 1H20 should not be reversed in an equivalent period of time, which means 'financial conditions' are not going to be the same in the end of 2020 as those seen before the crisis began. Hence, although better than the fire-sale levels we are still likely to see in 1H20, prices are not going to fully recover from their recent bottom in 2020, but rather in 2021. As a result, we have revised once again our end-of-period forecast for the FX rate to USD/BRL4.30 from USD/4.10 for 2020, while keeping the projection at USD/BRL4.00 for YE2021. Despite the substantial appreciation as compared with the current levels, we expect the FX rate to average USD/BRL4.60 in 2020 and USD/BRL4.15 in 2021. That is, we expect the bulk of the BRL strengthening to materialize from the last quarter of 2020 onwards. Owing to the strong slowdown we believe the world economy is likely to face in 1H20 and the gradual healing process in 2H20, we think is reasonable to count on some significant deceleration in international trade flows as well. Likewise, as the world economy gets out of the doldrums, foreign commerce should also improve. Once international trade goes down, commodity prices goes down and the other way round. Thus, Brazil's terms-of-trade—which hinge chiefly on commodity prices—are also likely to get worse ahead of us before they start improving from the 2H20 onward, in our view. Therefore, we expect Brazilian export proceeds to present a V-shaped curve in the period, which should grant to the trade balance a similar silhouette. However, we call our readers' attention to our belief that Brazil's economy could register a slower economic pace than previously anticipated (please refer to the Economic Activity section), which means import outlays should also be smaller than formerly calculated. Additionally, we think the weaker FX rate average level should help both attenuating the drop in export proceeds and curbing the increase in import outlays, a combination that should turn trade balance into a less steep V-shaped curve. All in all, whereas we were forecasting trade surpluses of USD38.3 billion and USD29.6 billion for 2020 and 2021, respectively; we now anticipate USD29.8 billion and USD33.6 billion in the same comparison. Last but not least, the weaker-than-anticipated growth and weaker-than-projected FX rate level could also have a significant impact on the remittances of profits and dividends from companies based in Brazil to foreign partners as well as on Brazilian citizens' international travel expenditures–which surpass by far the foreign travelers' revenue obtained by the country. As a result, we expect current account deficit to shrink to USD36.0 billion in 2020 (2.2% of GDP) and then to expand to USD45.0 billion (2.3% of GDP) in 2021. Previously, our calculations indicated an expansion in the current account deficit on both this year and the next one (USD56.7 billion and USD66.4 billion, respectively).

The week ahead: Next week many January (pre-coronavirus crisis) activity indicators will hit the wires. First the Monthly Retail Survey will be released on Tuesday, and we expect retail sales will continue their downward trajectory. We estimate a 1.0% MoM fall for the core retail sales (1.4% YoY) and 1.8% drop in the broad approach (0.1% YoY). Second, on Wednesday, we expect the Monthly Services Survey to present better figures with a 0.6% MoM growth (2.0% YoY). Finally, on Thursday, we expect the IBC-Br (the BCB's activity index, a proxy for the official quarterly GDP on a monthly basis) to post a 0.5% MoM growth (1.3% YoY). On the inflation front, on Wednesday, the IBGE (Brazil's statistics bureau) is scheduled to release its mid-month preview for the official CPI for March (IPCA-15): our calculations indicate a 0.06% MoM increase, which would imply a 3.72% YoY change if our estimate proves right. We estimate lower administered prices (e.g., for gasoline, due to downward adjustments in January and February, and for electricity, due to the lack of additional fee usually charged in dry periods—the so-called "green flag"). February's balance-of-payments data are due to be released (Wednesday), and we expect figures to underpin our assessment that the deterioration in the current account balance would soon cease to be a source of concern for market participants. According to our calculations, the current account balance should have registered a USD3.5 billion deficit last month, meaning that—if our estimate proves right—a USD52.5 billion imbalance in 12M-to-date terms (2.9% of GDP); roughly the same level observed in January 2020 (a USD52.3 billion deficit). That is, after the double-digit monthly imbalance observed in January 2020, which was highly affected by the seasonal influence of debt service payments and the remittance of profit and dividends, in addition to "virtual" import of oil platforms due to accounting adjustments—the current account deficit should have returned to a level compatible with our previous forecast for this year as a whole (-USD56.7 billion or 3.2% of GDP). We believed that a small increase compared with 2019's figure (USD49.5 billion, or 2.7% of GDP) would be enough to dim fears about the sustainability of the Brazilian balance of payments. Last but not least, the BCB will also publish the Copom minutes on Tuesday and the 1Q20 inflation report on Thursday: naturally, those are opportunities for the Copom to provide more information on their scenario assessment and policy guidance.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: They Have Not Got It (Yet)* (February 20, 2020)
- *Macroeconomic Scenario: Still on Track, but More Gradually* (February 14, 2020)
- *FX Compass – BRL: We Hope They'd Got It* (January 23, 2020)
- *Brazil Macro Propositions for 2020* (January 13, 2020)
- *Macroeconomic Scenario: A Better Outlook* (December 13, 2019)

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
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	598-1747-6805
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Luciano Sobral*	Senior Economist/Strategist – Brazil	lusobral@santander.com.br	5511-3012-6209
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
Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
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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