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Macro Research – Itaú

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A new challenge for global growth

In a year that seemed to start with lower risks, the new coronavirus epidemic, centered in China, added a new source of uncertainty to global economic activity. The number of cases has accelerated significantly in recent weeks, and local authorities have taken drastic measures to try to contain the spread of the disease, such as restrictions on transportation to affected regions and extension of the Chinese New Year holiday. For the time being, most cases remain located in Hubei province, but there have been records of the virus in 23 other countries, from all regions.

In this context, we revised our China's GDP forecast to 5.8% (from 6.0%) in 2020 with downside risks if the contagion persists. Commodity prices, such as oil and copper, were also revised downwards, in line with the expected slowdown for the Asian country. In the U.S., assuming the contagion of the disease will be limited, we kept our 2020 GDP growth forecast unchanged at 2.0%. Over there, the main risk remains the presidential elections, amid increasingly polarized economic policy proposals. There are six possible names for the Democratic candidate, whose primaries started in the past few weeks, but remain undefined. In Europe, economic growth is expected to continue to be weak and, given that and the still low inflation outlook, monetary policy is set to remain stimulative.

In Latin America, the coronavirus impacts pose a downside risk for the region's already weak economic activity. Taking into account weaker data at the margin, we reduced our growth forecasts for Mexico and Peru this year, also considering, in the latter case, the likely impacts of the new virus on copper prices. In Chile, we expect an anemic growth, as the effects of the protests should continue impacting the local scene. In Argentina, we maintained our expectation of a significant decline in GDP this year. In this context, there is still room for additional monetary easing in the region. We expect further cuts in interest rates in Mexico, Chile and Peru.

In Brazil, the Monetary Policy Committee (COPOM) delivered the widely expected 25-bp rate cut, taking the Selic rate to 4.25% pa, and stated, clearly, that it sees as warranted the interruption of the easing cycle. We thus revised our expectations and now see the authorities leaving the base rate unchanged at 4.25% pa until year-end. Regarding economic activity, we continue to expect a gradual acceleration of the economy, with GDP growth of 2.2% in 2020 and 3.0% in 2021. We also made no changes to our inflation and exchange rate forecasts.

Hope you enjoy,

Mario Mesquita and Macro Team

Scenario Review

World

	2020		2021	
	Current	Last month	Current	Last month
GDP (%)	**3.1**	3.2	**3.3**	3.3

Latin America and Caribbean

	2020		2021	
	Current	Last month	Current	Last month
GDP (%)	**1.0**	1.1	**1.9**	1.9

Brazil

	2020		2021	
	Current	Last month	Current	Last month
GDP (%)	**2.2**	2.2	**3.0**	3.0
BRL / USD (eop)	**4.15**	4.15	**4.15**	4.15
Monetary Policy Rate (eop,%)	**4.25**	4.00	**4.50**	4.50
IPCA (%)	**3.3**	3.3	**3.5**	3.5

Mexico

	2020		2021	
	Current	Last month	Current	Last month
GDP (%)	**0.9**	1.1	**1.5**	1.5
MXN / USD (eop)	**19.60**	19.60	**19.80**	19.80
Monetary Policy Rate (eop,%)	**6.00**	6.00	**5.50**	5.50
CPI (%)	**3.2**	3.1	**3.3**	3.3

Argentina

	2020		2021	
	Current	Last month	Current	Last month
GDP (%)	**-2.0**	-2.0	**1.0**	1.0
ARS / USD (eop)	**80.0**	80.0	**112.0**	112.0
BADLAR - (eop, %)	**24.0**	24.0	**24.0**	24.0
Referece rate (eop,%)	**30.0**	30.0	**30.0**	30.0
CPI (%)	**43.0**	43.0	**43.0**	43.0

Chile

	2020		2021	
	Current	Last month	Current	Last month
GDP (%)	**1.2**	1.2	**1.9**	1.9
CLP / USD (eop)	**780**	780	**770**	770
Monetary Policy Rate (eop,%)	**1.25**	1.25	**1.25**	1.25
CPI (%)	**3.3**	3.3	**3.0**	3.0

Colombia

	2020		2021	
	Current	Last month	Current	Last month
GDP (%)	**3.1**	3.1	**3.0**	3.0
COP / USD (eop)	**3320**	3320	**3320**	3320
Monetary Policy Rate (eop,%)	**4.25**	4.25	**4.50**	4.50
CPI (%)	**3.3**	3.3	**3.0**	3.0

Peru

	2020		2021	
	Current	Last month	Current	Last month
GDP (%)	**3.3**	3.5	**3.5**	3.5
PEN / USD (eop)	**3.35**	3.35	**3.36**	3.36
Monetary Policy Rate (eop,%)	**2.00**	2.25	**2.00**	2.25
CPI (%)	**2.0**	2.0	**2.3**	2.3

Global Economy

Coronavirus and U.S. Election

- The outbreak of the coronavirus, and the measures taken to contain it, will likely limit China's growth to 5.8% (from 6.0%) in 2020, with risk of 5.0%-5.5% if the contagion persists.
- U.S. Election uncertainty to continue.
- ECB review: hawkish discussions unlikely to lead to hawkish decisions.
- Commodities: lower oil and copper prices due to China shock.
- Latin America: activity remains bumpy amid domestic and external uncertainties.

The outbreak of the coronavirus, and the measures taken to contain it, will likely limit China's growth to 5.8% (from 6.0%) in 2020, with risk of 5.0%-5.5% if the contagion persists.

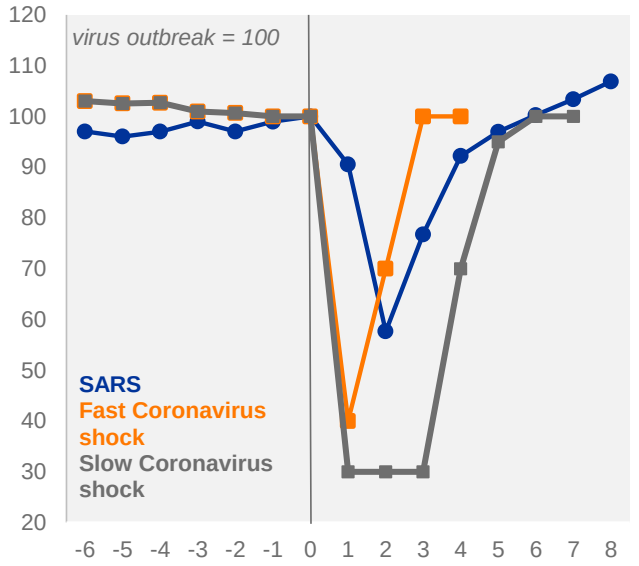
The coronavirus outbreak in Wuhan has accelerated significantly in recent weeks. The crisis has already exceeded the 2003 SARS outbreak. Most cases, and deaths, are in Hubei province, but the virus has spread to all regions in China and also to 23 other countries.

Policymakers have adopted forceful measures to reduce contagion/panic, which will impact activity significantly in 1Q20. Sixteen cities in the Hubei province are in lockdown, and there are also travel and transport restrictions across China. The government has extended the Chinese New Year holiday by two working days, but many locations request that people further delay their return to work.

Restrictions will only be relaxed if the virus outbreak subsides. Activity is likely to resume if contagion/low mortality outside Hubei continues. If not, restrictions will remain, and this will drag down activity even more.

For now, we revised our GDP forecast to 5.8% (from 6.0%). We use passenger traffic as proxy to monitor this impact (see chart). We expect a sharper but shorter hit to economic activity than occurred during the SARS outbreak (orange line in the chart). In this scenario, GDP growth will be at 5.5% in 1Q20, back to 6.0% in 2Q20 and ending 2H20 at 5.9%. For full-year 2020, GDP will be at 5.8%.

Passenger traffic as a proxy to monitor virus impact



Source: Haver, Itaú

However, there are still downside risks of 5.0%-5.5% if the contagion doesn't subside. Restrictions will remain in place, suppressing activity even further.

We expect policymakers to respond with stimulus just to mitigate the negative shock, but it will not be sufficient to offset the deceleration. China is under a structural slowdown, rebalancing from investment to consumption, so there is less room for stimulus.

U.S. Election uncertainty to continue.

U.S. growth remains robust, stabilizing at 2.0%. Consumption is likely to grow around 2.5%, supported by labor income growth and easy financial conditions. We expect Non-Residential investment and Export growth to resume, but at a slower pace than

consumption, supported by lower interest rates and fading trade uncertainties, with only a modest drag due to election uncertainty. We left our GDP forecast unchanged despite the Wuhan virus, as its impact is estimated to be less than -0.1 pp if the contagion is limited (see discussion in China).

The main risk to the U.S. outlook is a market unfriendly Democrat winning the presidency in 2021. Greater policy uncertainty could lower growth a bit in 2020 if a market unfriendly Democratic candidate is nominated in June (not our base case), given a possible platform of higher taxes and tighter regulation on banking, energy and tech industries. If such candidate is elected president, this could lead to a sharper equity price correction and much lower investment in 2021.

Next election focus is on Super Tuesday (Mar 3), when a third of the state delegates are set to be defined. The Democratic nominee remains uncertain, with six possible candidates. Trump is quite likely to be the Republican candidate. A moderate Democratic candidate seems more likely to win the nomination than an extreme one, given the party´s electoral profile, but we acknowledge that this is not a strong call, especially in an increasingly polarized country. Moderate Democrats may not have as clear a platform as the extreme ones.

Hence, we keep expecting 2% GDP growth for 2020, but we now see the 10-year U.S. Treasury at 1.9% (instead of 2.0%) for YE20 due to the effect of the Wuhan coronavirus on global growth.

ECB review: hawkish discussions unlikely to lead to hawkish decisions.

Policymakers cited possible hawkish changes to the inflation target, left open by the strategy review. Some ECB members recently commented on the possibility of, for example, implementing a band to the inflation target (example: from 1% to 3%) or changing the measure of housing prices on the CPI to better capture housing costs for home-owners, in a way that would add around 0.2-0.3 percentage points to inflation. These kinds of changes were left open to consideration by the strategy review started in the last ECB meeting, with a broad scope encompassing monetary policy tools, objectives, analysis and communication, expected to be concluded by end of 2020.

However, these changes are unlikely to be made, given weak growth, the low inflation outlook and no consensus among members. Growth decelerated to 1.0% yoy in 4Q19. PMIs indicate this pace to continue this year, coronavirus effects pose a downside risk and core CPI slowed down to 1.1% yoy in December. Thus, the introduction of hawkish changes like an inflation target band will likely face opposition by some ECB members, while changing the measure of housing prices could be done in a way that adds little to the Eurozone's CPI, as in other countries like the U.S.

We maintained our GDP forecast at 1.0% for 2020 and 2021, and also kept our year-end euro forecast at USD 1.12/EUR.

Commodities: lower oil and copper prices due to China shock.

We now forecast Brent and WTI prices at USD 60/bbl and at USD 55/bbl by 2020YE, respectively. China has a larger oil market share today than during the SARS outbreak (5.7 mb/d in 2003 vs. 13.9 mb/d today). Early estimates of the impact on Chinese oil demand are around 100 kb/d. OPEC has limited room to support prices with further supply cuts, as higher prices will lead to stronger U.S. shale production.

China's metal demand will also be hit, leading copper prices to USD 5,900/mt (prior: USD 6,200/mt). The Chinese economy is more service-driven than it was in 2003, but the virus shock is still going to hurt the construction sector.

LatAm: Activity remains bumpy amid domestic and external uncertainties.

There is some relief in the respective domestic political environments, but challenges remain. While in Chile the big wave of protests seems to be behind us (at least for now), the consequences of the demonstrations are ongoing. Reforms (specifically pertaining to taxes and pensions) advanced in Congress, with meaningful concessions to demands from the opposition. In Colombia, protests were lighter relative to Chile, and so were the consequences for the fiscal accounts and activity. Still, the social mood and the low popularity of the government mean that measures to reduce the fiscal deficit (such as privatizations and tax increases) will be difficult to implement. Legislative elections in January took place in Peru, after the country's top court ruled against the

dissolved Congress. The result is a Congress less hostile to the president but more fragmented, making any significant reform unlikely. Meanwhile, in Mexico the sharp increase in minimum wages is another domestic policy risk. In Brazil, the legislative agenda resumed, and markets will focus on new reforms to reduce the country's fiscal imbalances. Finally, in Argentina the process of debt restructuring began, but without any clarity so far on what the government proposal will be. In any case, we believe it will be difficult for the government to reach a quick deal with creditors.

Meanwhile, activity in the region remains weak, and the outbreak of coronavirus is a downside risk, especially to the open economies of the West Coast. We reduced our 2020 growth forecast for Peru (to 3.3% from 3.5%) and for Mexico (to 0.9% from 1.1%). In Chile, we left our forecast unchanged (at a weak 1.2%) despite a stronger rebound of activity at the end of 2019. In Argentina we continue to expect another sharp GDP contraction this year (-2.0%), while in Brazil the recent weak activity readings are consistent with a gradual recovery, supported by monetary policy but curbed by fiscal and quasi-fiscal tightening.

Space for some further monetary policy easing remains. In Chile, the peso has stabilized despite the pause in the central bank's intervention program. If activity weakness persists (which is likely, given the degree of uncertainty) and the currency remains well-behaved without the need of the central bank's support, then the central bank will likely resume the easing cycle. In Peru, we now expect another 25-bp cut during the first half of 2020. In Mexico, the central bank is adopting a cautious approach amid all the uncertainties facing the inflation outlook, but the widening output gap and stronger Mexican peso will likely keep inflation under control, allowing for additional interest rate cuts (we see the policy rate at 6.0% by the end of this year, down from 7.25% currently). In Colombia, where the policy rate sits close to neutral levels and growth is around potential, the central bank is expected to remain on hold for this year. Finally, in Brazil, the monetary authority cut the Selic rate by 25 bps in February, to 4.25%. We expect the Selic rate to remain stable at this level until year-end.

Forecasts: World Economy:

	2014	2015	2016	2017	2018	2019	2020F	2021F
GDP Growth								
World GDP growth - %	3.6	3.5	3.3	3.7	3.7	3.0	**3.1**	**3.3**
USA - %	2.5	2.9	1.6	2.4	2.9	2.3	**2.0**	**1.8**
Euro Area - %	1.4	2.0	1.9	2.7	1.9	1.6	**1.0**	**1.0**
Japan - %	0.0	1.3	0.6	1.9	0.8	0.8	**0.4**	**0.7**
China - %	7.4	7.0	6.8	6.9	6.7	6.1	**5.8**	**5.8**
Interest rates and currencies								
Fed Funds - %	0.1	0.3	0.7	1.4	2.4	1.6	**1.6**	**1.6**
USD/EUR - eop	1.21	1.09	1.05	1.20	1.15	1.12	**1.12**	**1.12**
YEN/USD - eop	119.8	120.4	117.0	112.7	109.7	108.6	**107.5**	**107.5**
DXY Index* - eop	90.3	98.7	102.2	92.1	96.2	96.4	**96.6**	**96.6**

Source: IMF, Bloomberg and Itaú

* The DXY is a leading benchmark for the international value of the U.S. dollar, measuring its performance against a basket of currencies that includes the euro, yen, pound, Canadian dollar, Swiss franc and Swedish krona.

Brazil

Copom signals interruption of the easing cycle

- We maintained our GDP growth forecasts at 1.2% in 2019, 2.2% in 2020, and 3.0% in 2021. Economic activity is on a moderate upward trend despite weak data in November and December 2019.
- Our primary deficit estimates stand at 1.0% of GDP for 2020 and 0.5% of GDP for 2021. If government spending remains under control, public debt is likely to decline in the coming years.
- We maintained our exchange rate forecasts at BRL 4.15 per USD in 2020 and 2021.
- Our inflation estimates remain at 3.3% this year and 3.5% next year.
- The central bank's Monetary Policy Committee (Copom) cut the benchmark Selic rate to 4.25% p.a in February, and signaled the interruption of the easing cycle. Hence, we expect the Selic rate to remain stable throughout the year, at 4.25% p.a.

Activity loses momentum at the margin, but recovery is the trend

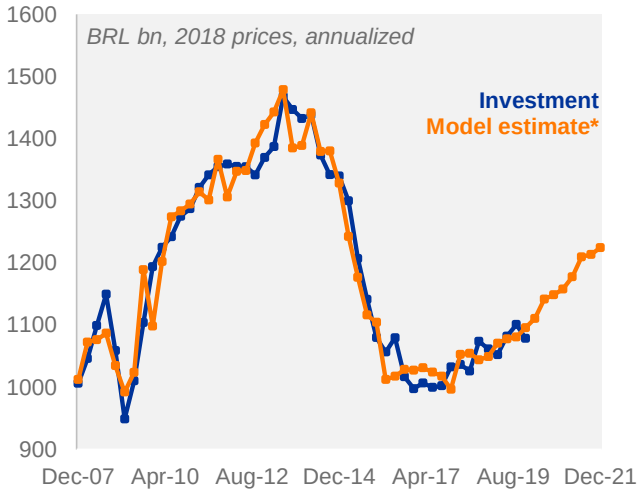
The most significant economic activity figures (industrial sector, services, retail) receded in November and probably declined again in December 2019, leading to negative statistical carryover into 1Q20 and reinforcing our view that GDP growth will lose momentum in the beginning of this year. Our forecasts for GDP growth are + 0.6% qoq/sa in 4Q19 and +0.3% qoq/sa in 1Q20.

Investment probably retreated in 4Q19 after advancing in the previous two quarters. Notwithstanding such volatility, investment is likely to continue increasing moderately going forward, as suggested by the next chart, driven by expanding private credit. The model considered in the chart is composed by variables such as credit, public investment, commodity prices and global GDP. Private credit has been growing strongly, while the other variables are stagnant or experiencing low growth. Therefore, the recovery is gradual.

Our underlying growth indicator reached 2.0% in annualized terms in December. This indicator was running at about 1.0% until mid-2019. Its improvement is a sign that the economy is in a moderate acceleration process, notwithstanding weaker data at the margin in November and December.

We recognize, however, that the prospect of a marginally less expansionary monetary policy than we expected and, in particular, the potential impact of a more pronounced slowdown in the Chinese economy, as a reaction to the Coronavirus outbreak, **add downside risk to our growth projections.**

Investment in a moderate recovery trend



** Model: Investment determined by private credit, public credit, public investment, commodity prices and global GDP*

Source: IBGE, BCB, BBG, Itaú

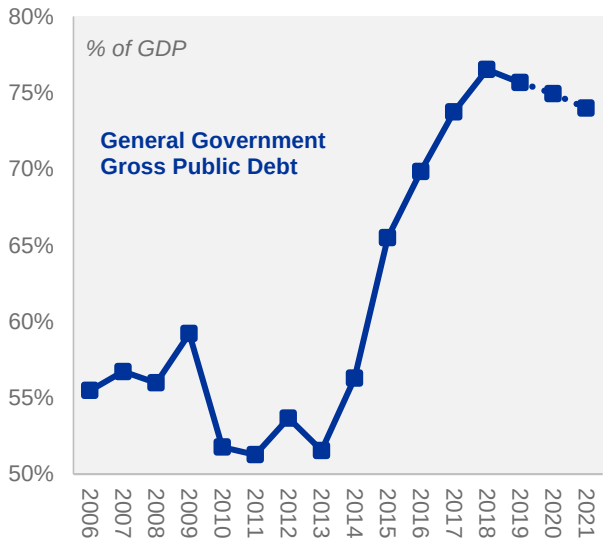
Public debt is set to decline in the coming years

Continuing reforms will allow the consolidation of a new fiscal regime of slower growth in public expenses, introduced by the spending cap constitutional amendment (EC 95/16). The approval of the pension reform and anti-fraud measures cover about half of the fiscal challenge and the other half depends on continuing adjustments in mandatory expenses.

Fiscal policy should focus on curbing growth in personnel expenses and adjustments in benefits tied to the monthly minimum wage, which will be discussed in the so-called Emergency and Federative Pact proposed constitutional amendments (or PECs) being processed in the Senate, and in the administrative reform that must yet be submitted by the government.

Mandatory expense control, the continuation of quasi-fiscal tightening, government asset sales, low interest rates and faster economic growth create conditions for a reduction in gross debt in the next years (see chart).

Better debt dynamics in the next years



Source: Central Bank, Itaú

This does not mean that the ongoing fiscal adjustment can be interrupted. Asset sales, below-equilibrium interest rates and above-potential growth are temporary factors. Structural stabilization of gross debt requires a better primary budget balance. We expect this move to materialize gradually, with the primary surplus reaching 1.0% of GDP by 2023.

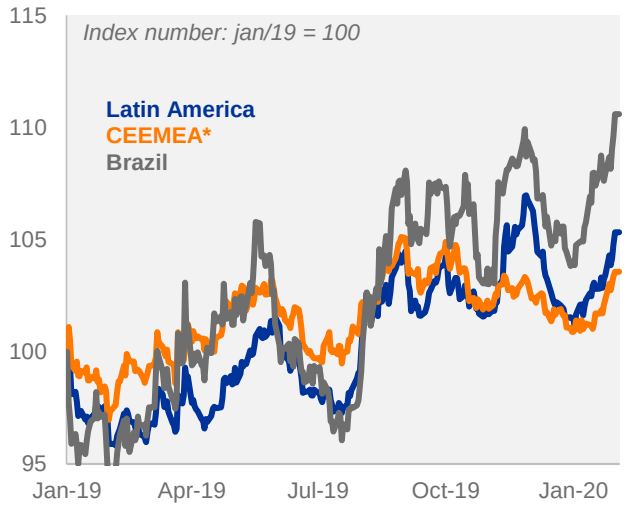
Our estimates for the primary deficit are 1.0% of GDP in 2020 (BRL 80 billion) and 0.5% in 2021 (BRL 40 billion). The 2020 result would be worse than in 2019 (BRL 62 billion or 0.9% of GDP) due to the expectation of lower extraordinary revenues: we anticipate BRL 40 billion (0.5% of GDP) from non-recurring events this year vs. BRL 63 billion (0.9% of GDP) last year.

Our exchange rate forecast remains at BRL 4.15 per USD

The Brazilian real reached new all-time lows in the past month. Risk aversion triggered by concerns about the impact of the new coronavirus on global economic activity pressured emerging market assets in recent weeks. The Brazilian real reached a new all-time low against the U.S. dollar and other local assets also depreciated. The exchange rate is now hovering around BRL 4.25 per USD, up from 4.10 at the beginning of the year.

There is room for a slight BRL appreciation, driven by stronger capital inflows in the face of expectations of stronger economic growth in Brazil, offsetting at least, to some extent, the impact of a slimmer interest rate differential. For now, the absence of clear signs confirming a pickup in economic activity and lower appetite for risk globally should restrain capital flows.

Emerging market currencies under pressure



**Includes countries in Central and Eastern europe, Middle east and Africa*

Source: Bloomberg, Itaú

The current account deficit has been widening gradually due to the deteriorating trade balance. The trade surplus receded to USD 47 billion in 2019 from USD 58 billion in 2018. Exports declined due to the slowdown in global trade and with major trading partners, such as Argentina. Imports receded as well. For the next years, we expect the trade surplus to fall further, to USD 40 billion in 2020 and 2021, in line with the economic rebound and consequent advance in imports.

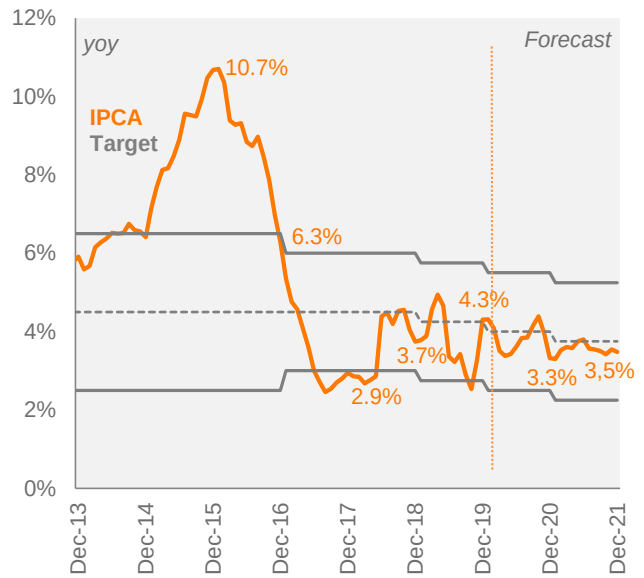
The current account deficit should hover at 2.5%-3.0% of GDP in the next years, causing no concern. In particular, the way to finance this deficit (mostly direct investment in the country) is healthy because this flow is not very volatile and is related to structural fundamentals. For the current account, we anticipate deficits of USD 51 billion in 2020 and USD 52 billion in 2021.

Our 2020 inflation forecast stands at 3.3%, for now

Our inflation forecast for 2020 remains at 3.3%. We anticipate a 3.4% hike in regulated prices. As for market-set prices, we expect advances of 4.5% for food consumed at home, 3.8% for services and 1.8% for industrial items. In our view, the shock in beef prices carries potential deflationary bias going forward, as some of the cost increase for the product observed in the last two months of 2019 may be reversed during this year and the next.

In addition to beef, other items also indicate potential downward bias for inflation in 2020, notably electricity tariffs and gasoline. **Therefore we see some room for a downward revision in our forecast of 3.3% in 2020.** Importantly, the first IPCA report for January 2020 features the new weighting structure of the index, based on the 2017-2018 Household Budget Survey (POF).

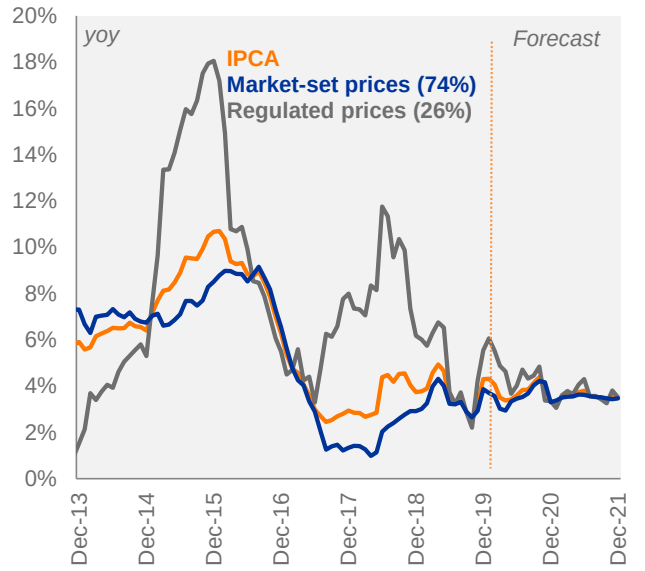
Below-target inflation in 2020 and 2021



Source: BCB, IBGE, Itaú

We forecast 3.5% inflation in 2021, slightly below the 3.75% target. **There is no sign of significant inflationary pressures over the relevant monetary policy horizon.** Several factors contribute to extending the benign inflation dynamics. Favorable inertia, anchored expectations, and the economy's substantial spare capacity continue to exert downward pressure, especially on core measures. Given the magnitude of the output gap and the time it takes for it to close, we do not see at this moment significant risks of demand-led inflation over the relevant monetary policy horizon (which includes 2020 and, with increasing weight, 2021). The exchange rate is still the main upside potential to our scenario.

We foresee the IPCA at 3.3% in 2020 and 3.5% in 2021



Source: IBGE, Itaú

Monetary policy: interrupting the easing cycle

In its first meeting in 2020, the Monetary Policy Committee (Copom) delivered the widely expected 25-bp rate cut, taking the benchmark Selic rate to 4.25% pa, and stated, clearly, that it will interrupt the monetary easing cycle. In the post-meeting statement, authorities continued to highlight that, in their basic scenario, risk factors in both directions remain. On the one hand, the high level of economic slack may continue to produce an inflation path below expectations. On the other hand, the current degree of monetary stimulus, which, according to the committee, acts with lags on the economy, may increase the trajectory of inflation in the relevant horizon to monetary policy. Such risk gets more intense in the event of an increase in the power of monetary policy resulting from changes in financial

intermediation and in the credit and capital markets – a factor that had already been discussed in previous communications, but received greater prominence in this statement.

Considering that the current stage of the economic cycle recommends caution and taking into account the lagged effects of monetary policy, authorities deemed it appropriate to interrupt the easing process. It should be noted that, in their wording, committee members opted for "interrupt" rather than "end", which signals they may eventually, under appropriate circumstances, revisit the issue (the text suggests that easing might only resume if inflation forecasts for 2021 begin to deviate from the 3.75% target). Even so, the committee maintained the message that its next decisions will continue to depend on the evolution of economic activity, the balance of risks and on inflation forecasts and expectations. In our view, this should place special importance on inflation forecasts for 2021, which were described in the text as having an increasing weight for monetary policy.

Hence, considering the communication and inflation forecasts presented in the Copom statement, we expect the base rate to remain unchanged at 4.25% pa until year-end (vs. 4.0% in our previous scenario, which assumed another 25bp-cut).

Forecast: Brazil

	2014	2015	2016	2017	2018	2019F	2020F	2021F
Economic Activity								
Real GDP growth - %	0.5	-3.5	-3.3	1.3	1.3	**1.2**	**2.2**	**3.0**
Nominal GDP - BRL bn	5,779	5,996	6,269	6583.3	6,889	**7,267**	**7,742**	**8,301**
Nominal GDP - USD bn	2,455	1,800	1,798	2062.6	1,884	**1,842**	**1,865**	**2,000**
Population (millions)	201.7	203.5	205.2	206.8	208.5	**210.1**	**211.8**	**213.3**
Per Capita GDP - USD	12,169	8,847	8,764	9974	9,038	**8,763**	**8,807**	**9,377**
Nation-wide Unemployment Rate - year avg (*)	6.8	8.5	11.5	12.7	12.3	11.9	**11.6**	**11.2**
Nation-wide Unemployment Rate - year end (*)	7.1	9.6	12.7	12.4	12.2	11.6	**11.4**	**11.0**
Inflation								
IPCA - %	6.4	10.7	6.3	2.9	3.7	4.3	**3.3**	**3.5**
IGP–M - %	3.7	10.5	7.2	-0.5	7.5	7.3	**4.0**	**4.0**
Interest Rate								
Selic - eop - %	11.75	14.25	13.75	7.00	6.50	4.50	**4.25**	**4.50**
Balance of Payments								
BRL / USD - eop	2.66	3.96	3.26	3.31	3.88	4.03	**4.15**	**4.15**
Trade Balance - USD bn	-4	20	48	67	58	47	**40**	**40**
Current Account - % GDP	-4.1	-3.0	-1.3	-0.7	-2.2	-2.8	**-2.7**	**-2.6**
Direct Investment (liabilities) - % GDP	3.6	3.6	4.1	3.3	4.1	4.5	**4.6**	**4.3**
International Reserves - USD bn	374	369	372	382	387	367	**347**	**347**
Public Finances								
Primary Balance - % GDP	-0.6	-1.9	-2.5	-1.7	-1.6	-0.9	**-1.0**	**-0.5**
Nominal Balance - % GDP	-6.0	-10.2	-9.0	-7.8	-7.1	-5.9	**-5.1**	**-4.2**
Gross Public Debt - % GDP	56.3	65.5	69.9	73.7	76.5	75.7	**75.0**	**74.1**
Net Public Debt - % GDP	33.1	36.0	46.2	51.4	53.6	55.6	**56.9**	**57.4**

Source: IBGE, FGV, BCB and Itaú

(*) Nation-wide Unemployment Rate measured by PNADC

Argentina

Race against the clock

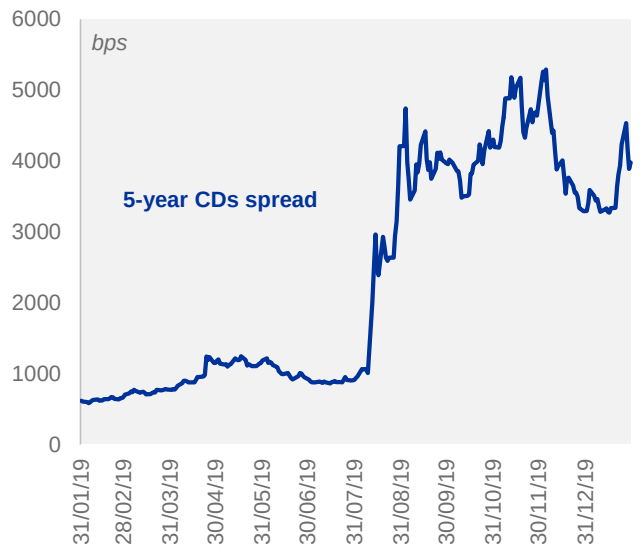
- The government expects to conclude the debt restructuring process by the end of March. The schedule is tight, in our view, and the risk of protracted negotiations is high, as a sizable haircut is needed. In this context, and also considering the low level of international reserves, the odds of missing a payment before a deal with creditors is reached remain high.
- With harsh exchange-rate controls, interest rates continued to decline and the official exchange rate stabilized, at the cost of real (official) exchange-rate appreciation and widening spreads in the parallel markets for dollars.
- We maintained our forecast of 2% GDP contraction this year, as lack of external financing, uncertainty and controls will likely affect investment and offset some modest expected increase in consumption. Our inflation forecast stands at 43% (thanks partly to price controls).

Seeking debt relief

The government said it would present a debt-restructuring offer by mid-March. The announcement came in response to the recent CDS widening. Following the positive market response to the fiscal package passed by Congress in December last year (mostly tax hikes), the government has fallen short in providing further details on planned fiscal consolidation, growth path and future payments to the IMF. President Fernández reiterated that Argentina needs an opportunity to grow, to be in condition to pay its debt.

The amount at stake. Argentina owes USD 65.9 billion in foreign-currency-denominated bonds under foreign law, of which around USD 40.2 billion are in the hands of the private sector, with payments totaling USD 6.9 billion in 2020 (mostly interest payments). The stock of foreign-currency sovereign bonds under Argentine law totals USD 38.9 billion, with debt service of USD 5.7 billion to the private sector this year. A restructuring of USD 9.0 billion in Letes (short-term bills maturing in August, after compulsory payment postponements) is likely. So far, the treasury has continued to service dollar-denominated debt other than Letes making use of international reserves, but President Fernandez warned that Argentina needs a "fairly fast resolution" of the debt problem. The treasury will pursue a quick restructuring using the collective action clauses (CACs) embedded in foreign-law bonds. CACs allow the bond issuer to change bond financial conditions with the consent of certain majorities of bondholders. If debt restructuring concludes successfully, we expect the government to unilaterally change the domestic-law foreign-currency bonds in line with the new financial terms of the foreign-law bonds.

Risks do not recede



Source: Bloomberg

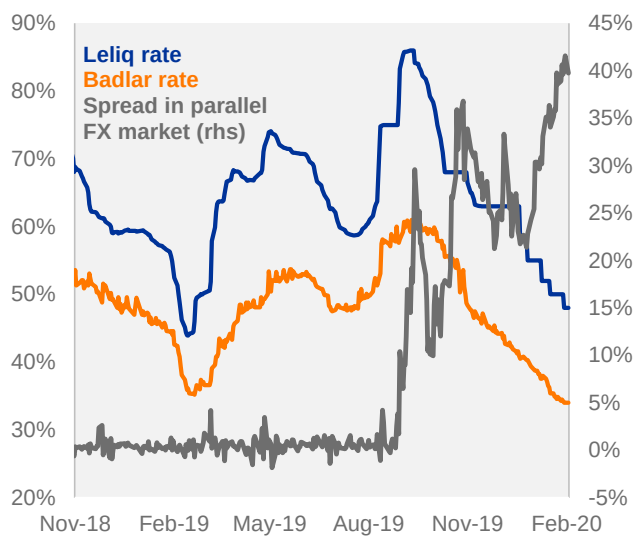
A protracted negotiation is a risk. In fact, calling investor meetings and getting majorities to change financial conditions is a complex process. On top of that, the need for a large haircut is high in our view, given our scenario of low growth and unwillingness to deliver a sharp fiscal adjustment. We think a credible offer will likely need a smoother schedule of payments to the IMF than the current one. However, a renegotiation with the IMF (stand-by or extended fund facility) will likely include

conditions that the Argentine government will find hard to accept. In this complex scenario, the risk of missing debt payments before a deal is reached is high, also considering the low level of international reserves. Alternatively, an "attractive" proposal to bondholders for the sake of speed will risk being unsustainable, potentially leading to the need for a new debt restructuring a few years from now.

Capital controls made it

Interest rate paid on time deposits continued to slide down. The Leliq rate (now a 14-day bill instead of 7-day) was cut to 48% (a drop of 1500 bps since mid-December 2019) and the monetary authority slashed the rate paid on one-day repo with banks to 24%. The Badlar rate (the rate paid on time deposits) fell below 35% by the end of January. Capital controls and weak imports has allowed the central bank to purchase USD 4.2 billon since late October (when restrictions on exchange-rate purchases started) and stabilized the exchange rate at 60 pesos to the dollar. The spread in the parallel markets for dollars currently stands at 40%.

Lowering rates



Source: BCRA

But there was only a modest reduction in inflation, despite real (official) exchange-rate appreciation. Elypsis consulting estimates a 3.2% mom CPI increase in January and 2.8% in February (down slightly, from 3.7% in December) despite the public-services price freeze and a stable foreign exchange. We left our inflation forecast for this year unchanged at 43%, down from 53.8% in 2019. We continue to see the exchange rate at 80 pesos to the dollar and the Leliq and Badlar rates at 30% and 24%, respectively, by year-end.

GDP growth will likely post a third consecutive contraction in 2020. We forecast GDP to drop 2% this year due to controls and uncertainty, in spite of some consumption rebound supported by an improvement in real wages and high dollarization of savings.

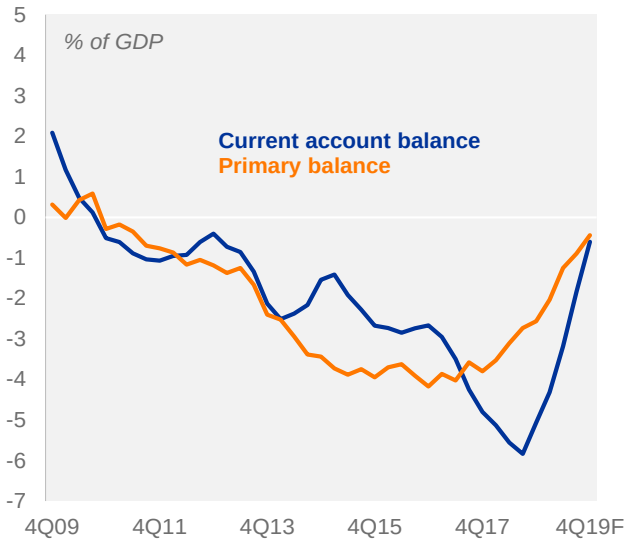
Sharp adjustment of twin deficits in 2019

Tighter fiscal policy and weaker peso led to a significant reduction of the twin deficits. The treasury ran an estimated primary deficit of 0.4% of GDP in 2019, down from 2.6% in 2018. The nominal deficit for 2019 came in at 3.8% of GDP. Strict expenditure control, in a context of high inflation, drove a 10.7% yoy reduction of primary expenditures in real terms. Lower fiscal expenditures more than offset a 1.4% loss in tax collection due to recession. Meanwhile, the trade surplus marked the highest reading since 2009. The trade balance posted a surplus of USD 16.0 billion, above a deficit of USD 3.7 billion in 2018. At the margin, the annualized surplus adjusted for seasonality reached USD 26.2 billion in 4Q19, as total exports increased by 29.3% qoq/saar and imports plummeted by 35.8% qoq/saar.

Tax hikes will likely prevent the federal primary balance from worsening this year. Higher export taxes, suspension of the scheduled tax-rate cuts on corporate income and payroll, and new taxes on dollar purchases (savings, credit cards, travel, etc.) will likely provide additional revenues of at least 1% of GDP. We have revised our fiscal deficit forecast for this year upward to 0.4% of GDP from 1%. We note that risk is tilted to a higher deficit, because the new formulas for the adjustment of tariffs and pensions have yet to be announced, and the impact of energy subsidies could be significant after their temporary freeze. Furthermore, these levels of primary deficit are still far from being enough to put the current debt-to-GDP ratio at sustainable levels.

Meanwhile, controls and a weak economy will likely lead to a further improvement of the current-account balance. We expect the trade surplus to remain wide this year (USD 14.5 billion), with a current-account surplus of 0.4% of GDP, from an estimated deficit of 0.6% of GDP for 2019.

Spending less



Source: INDEC, Ministry of Finance and Itaú

Forecast: Argentina

	2014	2015	2016	2017	2018	2019F	2020F	2021F
Economic Activity								
Real GDP growth - %	-2.5	2.7	-2.1	2.7	-2.5	**-2.9**	**-2.0**	**1.0**
Nominal GDP - USD bn	563.9	642.4	556.8	642.0	520.0	**442.3**	**449.2**	**470.2**
Population (millions)	42.7	43.1	43.6	44.0	44.5	**44.9**	**45.4**	**45.4**
Per Capita GDP - USD	13,215	14,894	12,506	14,458	11,665	**9,843**	**9,899**	**10,363**
Unemployment Rate - year avg	7.3	6.5	8.5	8.3	9.2	**11.0**	**11.0**	**11.0**
Inflation								
CPI - % (*)	38.0	26.9	41.0	24.8	47.6	53.8	**43.0**	**43.0**
Interest Rate								
BADLAR - eop - %	20.38	27.25	19.88	23.25	49.50	39.40	**24.00**	**24.00**
Reference rate - eop - % (****)	-	-	24.75	28.75	59.25	55.00	**30.00**	**30.00**
Balance of Payments								
ARS / USD - eop	8.55	13.01	15.85	18.77	37.81	59.90	**80.00**	**112.00**
Trade Balance - USD bn	3.1	-3.0	2.0	-8.5	-3.7	16.0	**14.5**	**12.0**
Current Account - % GDP	-1.5	-2.7	-2.7	-4.8	-5.3	**-0.6**	**0.4**	**0.0**
Foreign Direct Investment - % GDP	0.9	1.8	0.6	1.9	2.0	**1.0**	**0.5**	**0.8**
International Reserves - USD bn	31.4	25.6	38.8	55.1	65.8	44.8	**40.0**	**40.0**
Public Finances								
Primary Balance - % GDP (**)	-3.4	-4.0	-4.2	-3.8	-2.6	-0.4	**-0.4**	**-0.4**
Nominal Balance - % GDP (**)	-2.4	-3.9	-5.8	-5.9	-5.2	-3.8	**-3.8**	**-3.8**
Gross Public Debt - % GDP	47.4	55.5	55.6	59.0	89.4	**98.8**	**94.1**	**95.0**
Net Public Debt - % GDP (***)	22.0	25.4	27.6	31.5	56.7	**63.8**	**69.2**	**70.2**

(*) National CPI for 2017 and 2018.
(**) Excludes central bank transfer of profits from 2016.
(***) Excludes central bank and social security holding.
(****) Lebac 35-day for 2016, 7-day Repo rate for 2017 and 7-day Leliq rate for 2018 and 2019.
Sources: Central Bank, INDEC and Itaú

Mexico

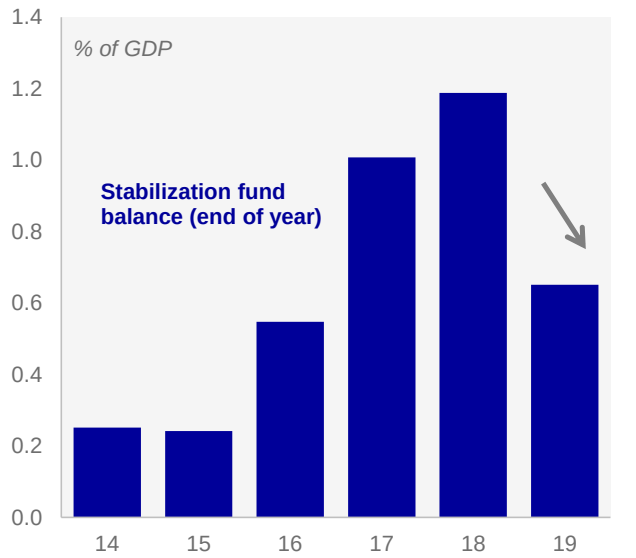
Stagnant economy means easing cycle will continue

- AMLO's administration met fiscal targets by using resources from the rainy-day fund, aided by a slow implementation of expenditures. Looking ahead, we believe that managing the fiscal accounts will be complicated by weak economic activity, the challenge of increasing oil production and diminished fiscal buffers.
- The flash GDP estimate for 4Q19 suggests that the economy was stagnant in 2019 overall, contracting by 0.1%. We now expect economic activity to recover more gradually in 2020, growing by 0.9% (we previously estimated 1.1%). An improvement from last year is still expected due to the fading effect of the government transition on fiscal spending and the approval of the USMCA in the U.S. Congress, which reduces uncertainty.
- We expect Banxico's monetary policy rate to reach 6.00% by the end of 2020, with the first 25-bp rate cut of the year coming at the February meeting. Low headline inflation, a widening output gap and a stronger Mexican peso support gradual rate reductions. However, persistent core inflation and latent inflationary risks (such as the minimum wage hike) may prompt the bank to ease in a gradual, stop-and-go approaches.

Responsible fiscal results so far

AMLO's administration met fiscal targets by using resources from the rainy-day fund, aided by a slow implementation of expenditures. The 2019 nominal fiscal deficit stood at 1.6% of GDP (compared with a deficit of 2.1% of GDP in 2018), below the 2019 MoF target of 1.9% of GDP. In turn, the 2019 primary surplus stood at 1.1% of GDP (down from 0.6% in 2018), also slightly better than the MoF target of 1.0% of GDP. The fiscal targets were met despite lower revenues (associated with weak economic activity and low oil production) through the use of resources from the stabilization fund ("rainy-day fund") amounting to 0.5% of GDP (by the end of 2019 the fund's balance was at 0.7% of GDP) and a slow implementation of expenditures (there is often a period of underspending at the beginning of a new administration). However, managing the fiscal accounts is likely to be a more complicated task in the coming years, as boosting (or even stabilizing) oil production will be challenging to achieve amid weak economic activity (MoF has an optimistic assumption for 2020 GDP growth: 2.0%, vs. a market consensus forecast of 1.0%), spending promises and less fiscal savings to draw upon.

Rainy-day fund helped the government meeting fiscal target



Source: SHCP, INEGI, Itaú

Solid external accounts in 2019

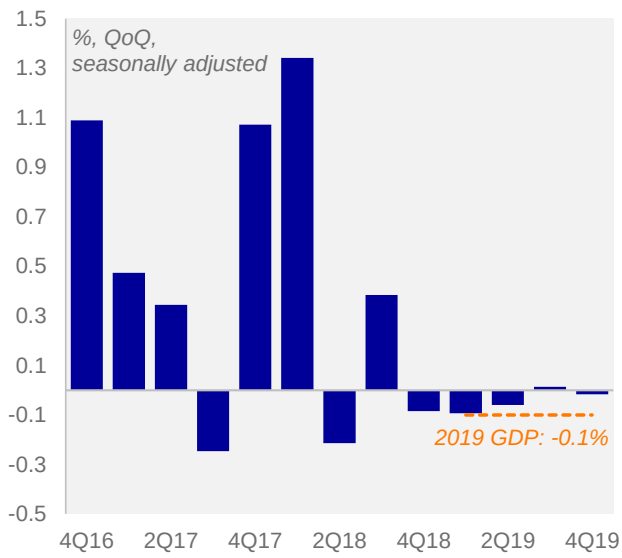
The trade balance improvement in 2019 reflected weak internal demand. The 2019 trade balance stood at a USD 5.8 billion surplus, an improvement from the USD 13.6 billion deficit recorded in 2018. This improvement was supported mainly by the non-energy balance, as the energy balance remained broadly stable. The non-energy balance improved mainly as a result of weak non-oil imports (-0.6% in 2019, from 8.5% in 2018) that were dragged down by lower

capital imports (-8.9%, from 11.9%), reflecting weak gross fixed investment. Meanwhile, manufacturing exports also decelerated in 2019 (to 3.4%, from 9.1% in 2018), but at a slower pace than non-oil imports did. Looking ahead, we now expect the trade balance to deteriorate in 2020 (relative to 2019) to a deficit of USD 5.0 billion (we previously expected a wider deficit of USD 7.0 billion). A soft recovery in internal demand will likely support an acceleration in non-oil imports.

Stagnant GDP

Mexico's GDP remained stagnant in 4Q19. The flash estimate of 4Q19 GDP growth published by Mexico's statistics institute, INEGI, came in at 0.0% quarter over quarter (practically unchanged from 3Q19) using seasonally adjusted figures. The 4Q19 flash estimate implies that GDP contracted by 0.1% in 2019, which would be Mexico's first GDP contraction since 2009. Looking at the breakdown (also using seasonally adjusted figures), we see that industrial production deteriorated further (to -1.0% in 4Q19 from -0.1% in 3Q19), while service-sector growth recovered to 0.3% (from 0.1%). In turn, primary-sector growth fell to 0.9% (from 3.3%).

Stagnant GDP



Source: INEGI, Itaú

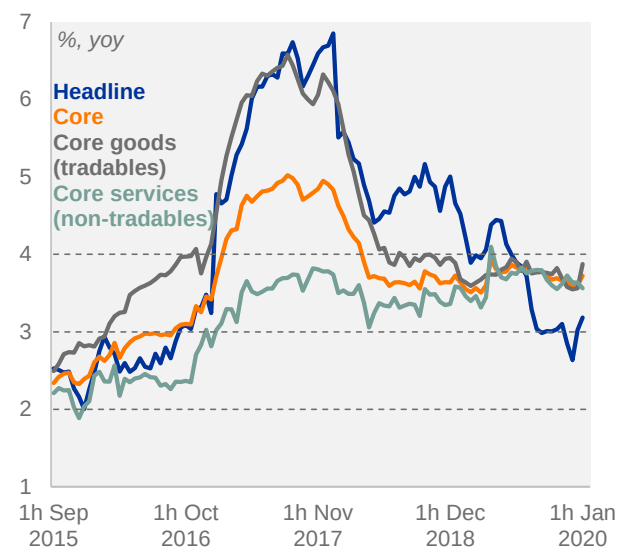
We now expect economic activity to recover more gradually in 2020, growing by 0.9% (we previously estimated 1.1%). The fading effect of the government transition on fiscal spending and the approval of the USMCA in the U.S. Congress (which has reduced uncertainty) should support some recovery this year.

Moreover, if the recent stabilization of oil output lasts, the mining sector could also contribute to a GDP growth improvement in 2020. However, recent activity indicators have made us even more cautious on the pace of recovery.

Temporary inflation rebound

Annual inflation in the first half of January was pushed up by adjustments in the excise taxes on tobacco and sugary drinks (mainly reflected in cigarette prices) and an unfavorable base effect. Headline CPI stood at 3.18% year over year in the first half of January (up from 3.02% in the second half of December). In turn, core inflation accelerated to 3.73% (from 3.60%), with core goods inflation accelerating while core services inflation slowed down. Within core goods, we note that cigarette prices increased sharply (by 15.4% year over year in the first half of January, after an 8.3% increase in the second half of December). Moreover, the headline and core inflation figures also reflect a transitory rebound due to an unfavorable base effect, as a lower VAT in the northern frontier regions in January 2019 pulled down monthly inflation rates during the first two months of 2019.

Transitory inflation rebound



Source: INEGI, Itaú

We have revised our inflation forecast for 2020 to 3.2% from 3.1%. A transitory rebound in annual inflation is likely to occur in the first two months of the year. Looking ahead, we expect increasingly slack conditions and a stable exchange rate to exert downward pressure on inflation.

Gradual easing ahead

In its last monetary policy decision of 2019, Banco de Mexico (Banxico) cut its policy rate by 25 bps (to 7.25%), with the corresponding minutes reflecting a cautious tone. The statement maintained that the balance of risks for growth were tilted to the downside, while noting that inflation could hover "moderately" above the path forecasted in the latest inflation report if the increase in the minimum wage translates into cost-push inflationary pressures. The corresponding minutes suggested that most of the committee members are concerned about the effect of the minimum wage on inflation. Some members noted that the recently announced revised minimum wage for 2020 will make it more challenging to hit the 3% inflation target in 2020 (as foreseen in the latest quarterly inflation report). Moreover, a majority of the committee members is advocating for gradual rate moves, arguing that monetary policy must respond to the evolution of inflation relative to its projected path, adding that both external and internal risks prevail and expressing concern about medium- and long-term inflation expectations remaining above the 3% target.

Comments from most Banxico committee members since the latest policy decision reaffirm the likelihood of a gradual monetary policy easing in 2020. Deputy Governor Javier Guzman mentioned that Banxico risks losing credibility (by not meeting inflation targets) if it is not cautious with monetary policy. Echoing language in the last monetary policy statement, Governor Alejandro Díaz de Leon noted that both headline and core inflation trends in 2020 could reflect cost-related pressures resulting from the recent minimum wage revisions, potentially pushing them modestly above the levels anticipated in the last Quarterly Inflation Report. In turn, Deputy Governor Jonathan Heath commented that monetary policy should be less restrictive but that the easing must be gradual given the persistent upside risks to inflation.

We expect Banxico's monetary policy rate to reach 6.00% by the end of 2020 (down from its current level of 7.25%), with the first 25-bp rate cut of the year coming at the February meeting. Low headline inflation, a widening output gap and stable exchange rates will likely support lower rates. However, persistent core inflation and latent inflationary risks (such as the minimum wage hike) may prompt the central bank to space out the cycle with pauses at certain points this year.

Forecast: Mexico

	2014	2015	2016	2017	2018	2019F	2020F	2021F
Economic Activity								
Real GDP growth - %	2.8	3.3	2.9	2.1	2.1	**-0.1**	**0.9**	**1.5**
Nominal GDP - USD bn	1,312	1,170	1,076	1,165	1,221	**1,251**	**1,311**	**1,348**
Population (millions)	119.7	121.0	122.3	123.5	124.7	**125.9**	**127.1**	**128.2**
Per Capita GDP - USD	10,958	9,673	8,800	9,429	9,790	**9,934**	**10,315**	**10,512**
Unemployment Rate - year avg	4.8	4.4	3.9	3.4	3.3	3.5	**3.6**	**3.6**
Inflation								
CPI - %	4.1	2.1	3.4	6.8	4.8	2.8	**3.2**	**3.3**
Interest Rate								
Monetary Policy Rate - eop - %	3.00	3.25	5.75	7.25	8.25	7.25	**6.00**	**5.50**
Balance of Payments								
MXN / USD - eop	14.8	17.2	20.7	19.7	19.7	18.9	**19.6**	**19.8**
Trade Balance - USD bn	-3.1	-14.7	-13.1	-11.0	-13.6	5.8	**-5.0**	**-12.0**
Current Account - % GDP	-1.9	-2.6	-2.3	-1.7	-1.8	**-0.1**	**-1.2**	**-1.4**
Foreign Direct Investment - % GDP	2.3	3.1	3.5	2.8	3.1	**2.3**	**2.0**	**1.9**
International Reserves - USD bn	193.0	176.4	176.5	172.8	175.0	180.8	**184.0**	**186.0**
Public Finances								
Nominal Balance - % GDP	-3.1	-3.4	-2.5	-1.1	-2.1	**-1.6**	**-2.1**	**-2.2**
Net Public Debt - % GDP	39.8	44.0	48.2	46.1	46.1	**45.3**	**46.3**	**46.6**

Source: IMF, Bloomberg, INEGI, Banxico, Haver and Itaú

Chile

Still too many unknowns

- Chile's congress unanimously passed a tax modernization bill that will help finance the recently announced social agenda, while the government reached a deal with part of the opposition to advance a pension reform bill. Both pieces of legislation include meaningful concessions to opposition demands relative to the government proposals that were submitted before the recent protests started.
- Activity ended 2019 with a better-than-expected acceleration, yet with abundant domestic uncertainty and global growth concerns, we are maintaining an unfavorable forecast of 1.2% growth for this year (similar to 2019).
- The central bank paused its FX intervention program. Still, the peso has not overshot, even with the risk-off market mode in global markets. We continue to expect the exchange rate to end this year at 780 CLP/USD (from 753 CLP/USD at the close of 2019). Besides external factors, the domestic political scenario (including the process of writing a new constitution) will dictate Chilean asset prices throughout the year.
- We expect the central bank to remain cautious regarding future rate moves in the short term. We still expect more easing later in the year (to 1.25% by year-end), but we note that the risks tilt toward stable rates given the domestic uncertainties.

Reforms advance

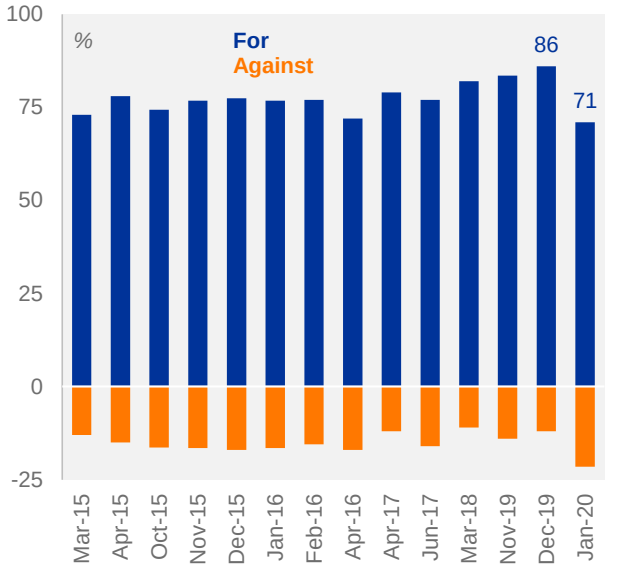
Chile's congress unanimously passed a tax modernization bill that will help finance the recently announced social agenda. The final version of the bill is in sharp contrast to the original plan submitted around 17 months ago. Before the social unrest flared up, former finance minister Felipe Larraín was pursuing a reform program headlined by the reintegration of the tax system. This would have permitted the full use of corporate taxes as a credit by shareholders (against income tax on dividends). Currently, only partial credit is available, hence the bill would have reduced the tax burden. That proposal was abandoned at the close of last year and adjusted to include measures that would boost tax revenue, including a wealth tax on properties exceeding USD 0.5 million and a new top income tax bracket. The bill is expected to raise close to 0.8% of GDP per year, compared with the more revenue-neutral initial proposal. The reform, along with a portion of Chile's sovereign wealth funds and new debt issuance, will help finance a near 2.0%-of-GDP stimulus package that has been announced. The updated fiscal plan points to real expenditure growth of close to 10% in 2020, the highest spending increase since the 16.5% hike seen during the global financial crisis in 2009. In this context, we estimate that the nominal fiscal deficit will rise to 4.4% of GDP from 2.8% of GDP.

The government reached a deal with part of the opposition to advance a pension reform bill. As in the case of the tax reform, the latest pension reform bill includes significant concessions to opposition demands (relative to the government's proposal from before the protests started). The centrist Christian Democrat (DC) party came on board with the government's bill after agreeing to strengthen the state entity envisioned to manage additional pension contributions. The government's bill seeks a 6-pp increase in pension contributions per worker (from the current 10%). Under the proposal, half of the additional contribution (3 pp) would go to individual capitalization accounts, while the other half (3 pp) would be paid into a public fund to shore up current and future pensions. An independent public institution would administer the extra 6%. The increase, to be paid by employers, would be gradual over several years. Other opposition parties proposed having the full 6% increase go to the state fund. Meanwhile, an opposition-led labor reform proposal is advancing. The senate's labor commission has approved the proposal in its general form (reducing the working week from 45 to 40 hours). The government has criticized the initiative, however, and has been canvassing in favor of more labor flexibility.

As the April referendum vote nears, support for the creation of a new constitution has weakened, amid uncertainty over what body should be in control of a possible redrafting. By January, according to the Cadem survey, support for drafting a

new constitution had dropped by more than 10 pp, to a still-high 70%. Meanwhile, the preferred body that would be mandated to draft the new constitution – fully elected representatives or a mix of elected officials and current legislators – is now unclear; previously, the former option had clear popular backing. If the creation of a new constitution is approved in the April referendum, elections for the members of the constituent body would be held in October. They would have up to a year to draft the new constitution, which would then be submitted for ratification in a second referendum. Hence, the uncertainty and risks to the macro business environment will remain high and persistent.

Still high support for Constitution reform



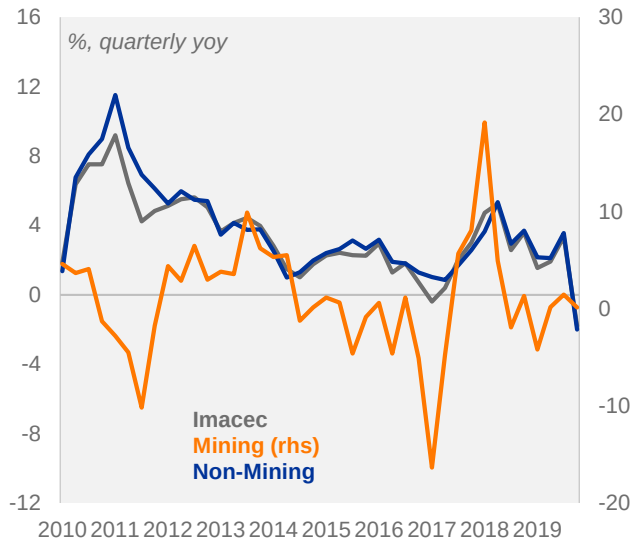
Source: Cadem

Improved carryover for 1Q20

Activity at the close of 2019 reflected a faster-than-expected normalization following the protest-affected months of October and November. The monthly GDP proxy (Imacec) grew by 3.5% from November to December, building on a 1.0% gain in November (-5.3% in October). Activity in the month was led by non-mining sectors (construction and manufacturing), which was a positive development for the domestic demand recovery. As a result, Imacec grew by 1.1% yoy in December (3.3% drop in the prior two months), exceeding the market consensus forecast of a modest decline.

During 2019, mining was the key activity drag, while the disruptions of 4Q19 meant that non-mining activity had weakened notably by year-end. In the final quarter of 2019, activity dropped by 1.8% yoy, the worst result since the global financial crisis. Non-mining activity fell by 2.0% yoy (+3.6% in 3Q19), while mining slowed to 0.1% (from 1.4% in 3Q19). For the full year of 2019, activity increased by 1.2% (+4.0% in 2018), with mining production shrinking by 0.6% (+5.2% in 2018), hampered by weather conditions in 1H19. Meanwhile, non-mining growth was 1.4% in 2019, down from 3.9% in 2018. At the margin, activity fell by 13.2% qoq/saar (+2.7% qoq/saar in 3Q19). Because the bulk of the shock to non-mining activity occurred at the start of the quarter, with some recovery toward the back end, there is likely to be a favorable carryover effect for 1Q20.

Final quarter drag



Source: BCCH, Itaú

Nevertheless, a number of headwinds are likely to constrain the recovery this year. High inventory levels, subdued sentiment, signs of labor market loosening and a deceleration of consumer credit growth all point to restrained consumption dynamism. As for investment, falling capital goods imports, historically low confidence and downward revisions to global growth expectations will likely limit the room for new projects beyond reconstruction efforts.

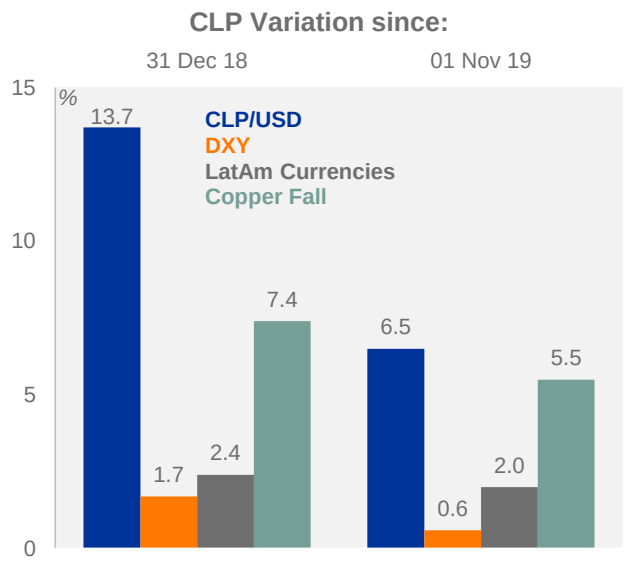
We maintain our forecast of weak 1.2% growth for this year (in line with last year) with some recovery in 2021 (to 1.9%). Lower growth expectations for China, amid the coronavirus pandemic, offset the stronger-than-expected activity seen at the end of

2019. Nevertheless, the risks to our scenario tilt upward, and additional growth potential could materialize if swift solutions to global challenges reactivate risk-seeking sentiment and widespread domestic protests do not resume.

A pause in the FX intervention program

Developments on the international front have dominated the CLP's recent movements, reducing the likelihood of a FX intervention response. In early January the board deemed no new intervention necessary, committing to renewing only the outstanding stock of NDFs (USD 4.5 billion). While global risks diminished following the phase-one trade pact between the world's two largest economies (supporting the CLP), the rapid spread of the coronavirus raised global growth concerns. As a result, the risk-off market mode led to a strengthening of the U.S. dollar, declining stock values and lower commodity prices (with copper particularly affected). Still, the resultant CLP volatility is unlikely to reactivate the FX intervention program given the non-idiosyncratic nature of the depreciation. We continue to expect the exchange rate to end this year at 780 CLP/USD (from 753 CLP/USD at the close of 2019). Besides external factors, the domestic political scenario (including the envisioned process of writing a new constitution) will dictate Chilean asset prices throughout the year and may lead the central bank to resume dollar sales.

Recent movement is not idiosyncratic



Source: Bloomberg

A large trade surplus is expected this year, in line with expectations of a sharp external deficit correction. With internal demand constrained and export growth normalizing, we expect the current account deficit to narrow to 0.4% of GDP this year (from the nearly 3% we estimate for last year). The swift external deficit adjustment will likely alleviate some pressure on the CLP.

Fluid scenario leads to central bank caution

The board of the central bank unanimously voted to hold the policy rate at 1.75% in January. The communiqué signaled that a neutral stance would continue, pointing to stable rates for at least this quarter as policymakers accumulate additional information about how the economy is responding to the recent disruptions. An update to the baseline scenario will take place in the March Inflation Report (IPoM).

While the activity weakness was broadly in line with the central bank's expectations, inflation has behaved better than anticipated. A sharp activity decline in October and November, the peak protest period, was followed by some normalization at year-end. Meanwhile, although last year's inflation rate was 0.4 pp below the central bank's forecast, the board again highlighted that there are two opposing forces currently in play: one inflationary (the accumulated CLP depreciation), the other disinflationary (weakening internal demand).

We expect inflation to rise in coming months before ending the year at a near-target level of 3.3%, below the central bank's current 3.5% forecast. We expect the 1Q20 IPoM update to reflect the diminished inflationary pressure, along with a potential upside revision to its growth forecast range for 2020 (currently at 0.5%-1.5%). Overall, caution regarding future rate moves will still likely prevail in the short term as the board opts to accumulate and digest additional information. Although we still expect more easing later in the year (to 1.25% by year-end), we note that the risks tilt toward stable rates given the domestic uncertainties and the central bank's already-expansionary monetary policy stance.

Forecast: Chile

	2014	2015	2016	2017	2018	2019F	2020F	2021F
Economic Activity								
Real GDP growth - %	1.8	2.3	1.7	1.3	4.0	**1.2**	**1.2**	**1.9**
Nominal GDP - USD bn	257	239	255	280	298	**277**	**271**	**281**
Population (millions)	17.8	18.0	18.2	18.4	18.8	**19.1**	**19.5**	**19.7**
Per Capita GDP - USD	14,465	13,283	14,012	15,181	15,887	**14,521**	**13,915**	**14,300**
Unemployment Rate - year avg	6.4	6.2	6.5	6.7	7.0	7.0	**8.5**	**8.0**
Inflation								
CPI - %	4.6	4.4	2.7	2.3	2.6	3.0	**3.3**	**3.0**
Interest Rate								
Monetary Policy Rate - eop - %	3.00	3.50	3.50	2.50	2.75	1.75	**1.25**	**1.25**
Balance of Payments								
CLP / USD - eop	606	709	670	615	694	753	**780**	**770**
Trade Balance - USD bn	6.5	3.4	4.9	7.4	4.7	4.2	**11.6**	**11.8**
Current Account - % GDP	-1.7	-2.4	-1.6	-2.1	-3.1	**-2.9**	**-0.4**	**-0.6**
Foreign Direct Investment - % GDP	9.2	8.8	4.8	2.1	2.0	**3.0**	**2.1**	**2.2**
International Reserves - USD bn	40.4	38.6	40.5	39.0	39.9	40.6	**30.0**	**30.0**
Public Finances								
Nominal Balance - % GDP	-1.6	-2.1	-2.7	-2.7	-1.6	-2.8	**-4.4**	**-3.9**
Net Public Debt - % GDP	-4.3	-3.4	0.9	4.4	5.7	**8.2**	**13.9**	**16.7**

Source: IMF, Bloomberg, BCCh, INE, Haver and Itaú

Peru

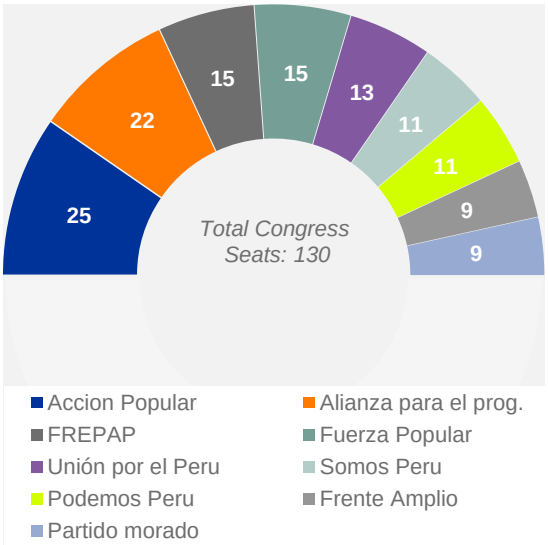
Lower political risk, for now

- Recent legislative elections have produced a fragmented Congress. While the new Congress should have more friendly relations with President Vizcarra, passing meaningful reforms will be difficult. Moreover, the electorate's discontent with the political class increases the odds of a competitive antiestablishment presidential candidate emerging in the 2021 election, along with the concomitant risk of shifting economic policies.
- We have lowered our 2020 GDP growth forecast for Peru to 3.3% (from 3.5%) to reflect the likely impact of the coronavirus outbreak on China's economy. We expect economic activity in 2020 to be supported by stronger local spending, an expansionary monetary policy and reduced conflict between political forces.
- We now expect the BCRP to cut the policy rate by 25 bps, to 2.00%, during 1H20 and to keep rates at that level throughout 2020. Below-potential growth and tame inflation support the likelihood of the central bank further easing its monetary policy.

A fragmented Congress

Recent legislative elections have produced a fragmented Congress, but this will likely help to ease political uncertainty. Congressional elections were held in January, after the Constitutional Court ruled that the executive's decision to dissolve Congress was legal. The results show that the political parties Acción Popular and Alianza para el Progreso led in voter preference but failed to win either an absolute majority (66 out of 130 seats) or a qualified majority (87 out of 130 seats). We also note that the party Fuerza Popular (Fujimorismo) – which has often confronted the executive branch since President Vizcarra took office – lost ground, dropping from 73 seats after the 2016 congressional elections to 15 seats now, also reflecting the electorate's distrust and discontent regarding the traditional political class. The newly elected Congress will serve until the end of the current administration's term in July 2021. The fragmentation of the Congress will likely result in less confrontation between the legislative and executive branches, reducing political uncertainty. However, passing meaningful reforms will be difficult. Moreover, the electorate's discontent with the political class increases the odds of a competitive antiestablishment presidential candidate emerging in the 2021 election, along with the concomitant risk of shifting economic policies.

A fragmented Congress



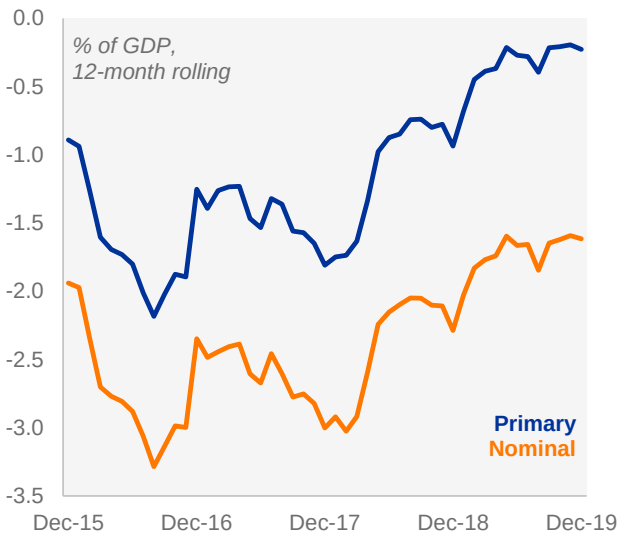
Source: ONPE, Itaú

2019 fiscal balance complied with the fiscal rule

Peru's fiscal balance improved in 2019, supported by an expansion in fiscal revenues and weak public capital spending. The non-financial public sector nominal fiscal deficit stood at 1.6% of GDP for 2019 (down from 2.3% of GDP in 2018), below the MoF's fiscal cap of 2.9% of GDP and the government's estimate of 2.2% of GDP, while the primary deficit improved to 0.2% of GDP in 2019 from 0.9% of GDP in 2018. Looking at the breakdown, we see that total revenues increased by 4.2% year over

year in real terms in 2019, with tax revenues growing by 3.7% year over year in real terms. Meanwhile, total primary expenditure grew by 1.0% year over year in real terms in 2019, supported by non-financial expenditure growth (3.1%), but with fixed capital expenditure declining by 6.3% (associated with weak spending by regional and local governments).

Fiscal balances improved

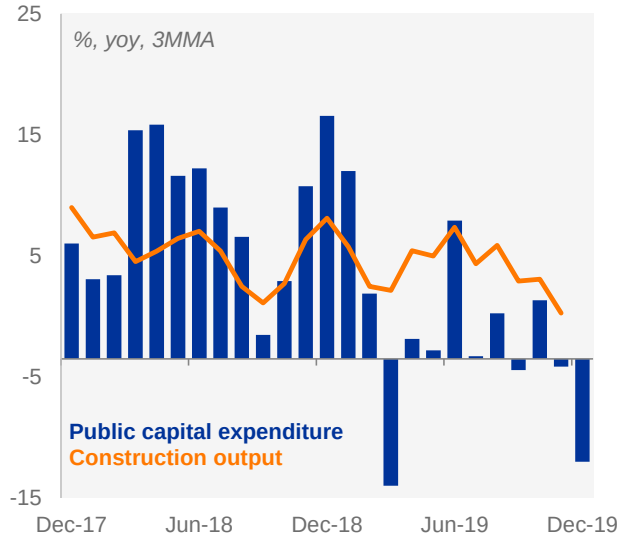


Source: BCRP, Itaú

GDP growth pace likely moderated in 4Q19

We estimate that the pace of economic activity growth moderated in 4Q19, bringing 2019 GDP growth to 2.2%. Leading indicators suggest that economic activity continued to decelerate in December, after growing by a weak 1.9% year over year in November. Fishing output contracted by 48.5% in annual terms in the last month of the year, while mining production decelerated to 1.6% from 4.1% in November. Likewise, in December, cement consumption and public capital expenditure – indicators associated with construction output – fell by 0.9% year over year and 16.1% year over year, respectively, in real terms.

Weak public capital expenditure execution drags construction output



Source: BCRP, Itaú

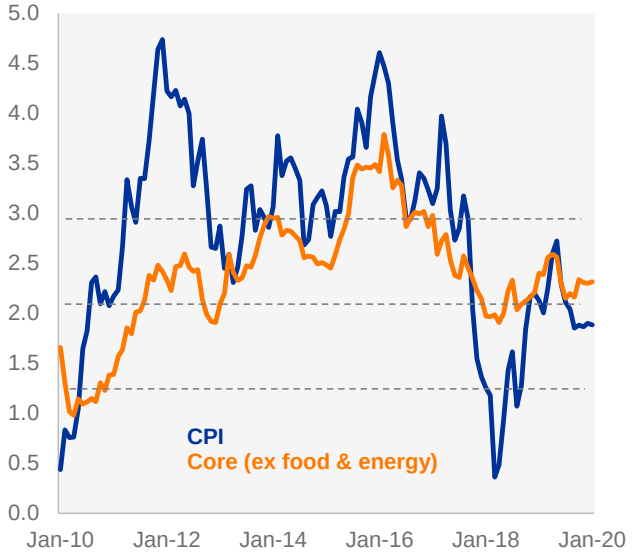
For 2020, we now expect GDP to recover at a slower pace (of 3.3%, down from our previous forecast of 3.5%), given the likely impact of the coronavirus outbreak on China's economy and the disappointing economic data that came in at the end of 2019. Nevertheless, we expect an economic recovery to be supported by stronger local spending, an expansionary monetary policy and a less uncertain political environment.

Low inflation

Annual headline and core inflation remained practically unchanged in January. Annual headline inflation stood at 1.89% (compared with 1.90% in December), making January the fifth consecutive month with an inflation rate below the central bank's target. In turn, core CPI stood at 2.31% (2.30% in December). The indicator that tracks the percentage of items with annual inflation rates above the 2% target remains low, standing at 24.5% in January, practically unchanged from December.

We expect the annual inflation rate to be 2.0% by the end of 2020. A gradual closing of the output gap will likely keep inflation on target this year.

Below-target headline inflation



Source: BCRP, INEI, Itaú

An additional rate cut

In its first policy decision of the year, the Central Bank of Peru (BCRP) kept its policy rate unchanged at 2.25%, while noting that any additional rate cuts will depend on future data. The BCRP noted that economic activity figures point to a gradual closing of the output gap while the balance of risks for inflation is moderately tilted to the downside. The committee will monitor inflation and its components to evaluate potential future adjustments to its monetary policy stance.

In a recent interview, BCRP President Julio Velarde reaffirmed his assessment of a dovish inflation and economic activity outlook. While Velarde sees some recovery in economic activity, he is still not observing inflationary pressures and still sees some risk of domestic demand being weaker than expected. He reiterated that the policy rate is already very expansionary but did not rule out additional rate cuts.

We now expect the BCRP to cut the policy rate by 25 bps, to 2.00%, during 1H20 and to keep rates at that level throughout 2020. Weak economic activity and low inflation support the likelihood of the central bank further easing its monetary policy.

Forecast: Peru

	2014	2015	2016	2017	2018	2019F	2020F	2021F
Economic Activity								
Real GDP growth - %	2.4	3.3	4.1	2.5	4.0	**2.2**	**3.3**	**3.5**
Nominal GDP - USD bn	202	191	195	214	225	**230**	**241**	**255**
Population (millions)	30.8	31.1	31.5	31.8	32.0	**32.5**	**32.9**	**33.1**
Per Capita GDP - USD	6,568	6,142	6,184	6,736	7,042	**7,077**	**7,325**	**7,704**
Unemployment Rate - year avg	5.9	6.5	6.7	6.9	6.6	**6.7**	**6.6**	**6.5**
Inflation								
CPI - %	3.2	4.4	3.2	1.4	2.2	1.9	**2.0**	**2.3**
Interest Rate								
Monetary Policy Rate - eop - %	3.50	3.75	4.25	3.25	2.75	2.25	**2.00**	**2.00**
Balance of Payments								
PEN / USD - eop	2.98	3.41	3.36	3.24	3.37	3.32	**3.35**	**3.36**
Trade Balance - USD bn	-1.5	-2.9	2.0	6.7	7.2	**5.5**	**6.5**	**6.8**
Current Account - % GDP	-4.5	-5.0	-2.6	-1.2	-1.6	**-1.6**	**-1.7**	**-1.8**
Foreign Direct Investment - % GDP	1.9	4.3	3.5	3.2	2.9	**2.7**	**2.2**	**2.1**
International Reserves - USD bn	62.3	61.5	61.7	63.6	60.1	68.3	**70.0**	**71.0**
Public Finances								
NFPS Nominal Balance - % GDP	-0.2	-1.9	-2.3	-3.0	-2.3	-1.6	**-2.0**	**-1.8**
NFPS Debt - % GDP	19.9	23.3	23.9	24.9	25.8	**26.5**	**27.4**	**27.6**

Source: IMF, INEI, BCRP, Itaú

Colombia

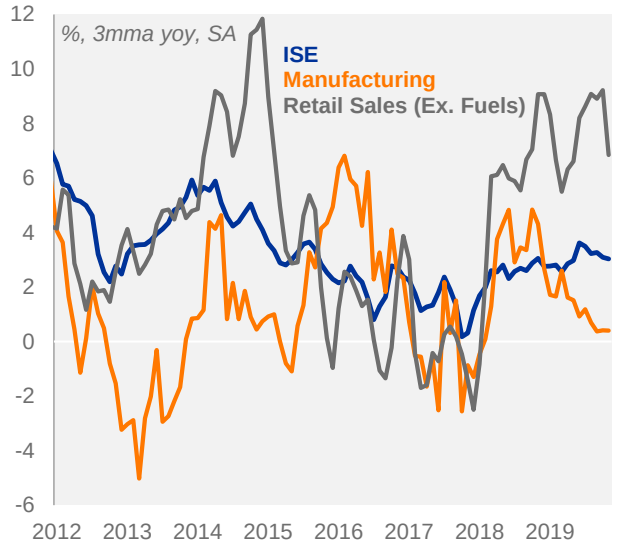
Stable rates persist

- Activity was weaker in November, as expected, partly affected by disruptions caused by recent protests, but the impact is likely to be short-lived. We expect rebounding business confidence and an improving labor market to offset global growth risks and lead to near-potential growth of 3.1% for this year (compared with the 3.3% expected for 2019).
- The central bank extended the period of stable rates to 21 months, while the staff of the bank acknowledged that a rate hike is the likely next move later this year. Nevertheless, with the output gap still negative and a plethora of global and domestic risks, we expect the board to keep the policy rate stable at the mildly expansionary rate of 4.25% over most of our forecast horizon.

Activity disruption looks short-lived

Activity was weak in November, as expected, partly due to a higher comparison base and disruptions caused by recent protests. Shrinking car and motor sales (-16.0% year over year) led a moderation in retail sales to 4.4% in November (from 7.4% in October), but core retail activity also moderated. In the quarter ending in November, retail sales grew by 6.1% (8.3% in 3Q19), while core sales growth edged down to 8.9% (from 9.4% in 3Q19). At the margin, retail sales excluding vehicle and fuel sales slowed to 6.5% qoq/saar from 11.3% qoq/saar in 3Q19. Manufacturing production in the quarter ending in November grew by a milder 0.4% yoy (1.5% in 3Q19), while at the margin activity declined by 0.3% qoq/saar (+1.2% in 3Q19). Despite the robust domestic demand and weakening of the Colombian peso, manufacturing activity has continued to disappoint. Overall, the growth rate of the coincident activity index (ISE) slowed to 2.9% yoy in November (from 3.3% in October) and to 3.0% in the quarter ended in November (from 3.3% in 3Q19). On a seasonally- and calendar-adjusted basis, activity momentum moderated to 0.6% qoq/saar (from 2.3% in 3Q19).

Mild activity slowdown



Source: DANE

Looking ahead, a pick-up of business confidence in December bodes well for activity growth. Confidence was boosted mainly by recovering expectations at the margin, likely linked to protest actions losing momentum. The industrial confidence index maintained by the think-tank Fedesarrollo came in at 8.5% (0 = neutral) in December, up from -1.1% at the close of 2018 and the 2019 low of +1.3% in November. The improvement from last year was due to better expectations for production in the upcoming quarter, a less disappointing evaluation of current order volumes and lower inventory levels. Meanwhile, there are better signs coming from the labor market. Employment was broadly flat relative to 4Q18, compared with the 1.8% fall seen in 3Q19, with private salaried posts driving job creation.

We expect robust investment and consumption to drive a GDP growth rate of 3.1% this year (compared with the 3.3% estimated for 2019 and 2.6% in 2018). The main risks are associated with the global outlook (as it affects external demand and oil prices) and domestic social unrest. To date, the protests have been mostly peaceful and not as disruptive or persistent as in other countries in the region.

External accounts remain at uncomfortable levels

The trade deficit widened further in November. The USD 1.7 billion deficit (up from a USD 0.9 billion deficit one year earlier) lifted the rolling 12-month trade deficit to USD 10.9 billion (up from USD 10.6 billion as of September and USD 7.0 billion in 2018). At the margin, the trade deficit is even wider, at USD 12.4 billion (annualized) in the quarter ending in November, similar to the level registered in 3Q19.

Exports remained weak, still held back by commodities. In the quarter ending in November, exports fell by 12.6% (-11.5% in 3Q19), with oil sales falling by 3.1% (-18.9% in 3Q19) and coal exports down 29.8% (similar to 3Q19). At the margin, exports declined by 13.5% qoq/saar (-29.1% in 3Q19). Imports in the quarter declined by 3.1% yoy, deteriorating from the 5.1% growth posted in 3Q19, as capital goods imports dropped by 6.3% (+6.5% in 3Q19), intermediate goods imports fell by 2.2% (+4.3% in 3Q19) and consumer goods imports slowed to 0.1% (from 6.2% in 3Q19). At the margin, imports growth moderated to 0.1% qoq/saar in the quarter ended in November from 1.5% in 3Q19.

We expect the current account deficit to remain wide this year, at nearly 4.5% (similar to last year's level). Still-weak global trade growth amid robust domestic demand are likely to keep the external deficit elevated. FDI inflows to Colombia have generally covered the entire CAD in recent years, but the last-four-quarter net direct investment coverage ratio is sitting at two-thirds as of 3Q19. We expect the Colombian peso to end the year at 3320 COP/USD (up from 3287 COP/USD in 2019), but the risks are tilted toward a weaker currency, given balance-of-payment weakness amid domestic political issues (demonstrations, concern about the fate of structural reforms) and the international risks related to the coronavirus.

Disinflation continues

At the start of 2019, annual inflation edged down 18-bps at the start of the year to 3.62%, favored by moderating food and energy prices, while, core inflation was steady near the 3% target. A key inflation drag continued to come from durable goods (1.87% yoy vs. 1.48% last month), hinting that the pass-through from the accumulated COP depreciation remains low. Additionally, energy prices moderated to the slowest pace since December 2015 by reaching 3.10% (4.0% in December). The pull from food and non-alcoholic prices moderated to 5.13%, from 5.80% at the close of 2019, amid the normalization process (from earlier supply shocks). Inflation excluding food and energy prices remained broadly stable at 3.37% (3.40% previously), while service inflation ticking down 14-bps to 3.61% point to well-behaved core price dynamics. At the margin, inflation over the last three months (SA, annualized) dropped to 1.9%, from 3.3% in 4Q19 (5.1% in 3Q19), amid moderating energy and service inflation.

We expect inflation to end the year close to the target at 3.3%. Food price normalization, after last year's supply shock, along with broadly anchored inflation expectations, would limit inflationary pressures ahead.

No rate moves on the horizon

In its first monetary policy meeting of the year, the central bank policy committee unanimously decided to keep the reference rate at 4.25%. The decision extended the period of stable rates to 21 months. The tone of the press conference and the minutes was again neutral, pointing to stable rates for the time being. In fact, in its quarterly monetary policy report, the technical staff's baseline scenario for reference rate was deemed in line with analyst expectations of stable rates until the final quarter of this year before a 25-bp hike (to 4.5%) by year-end, consistent with a narrowing of the negative output gap within the next two years and inflation converging to the 3% target.

The central bank foresees 3.3% activity growth in 2020, up from an estimated 3.2% for last year, while the negative output gap is estimated to be narrower than one quarter ago amid more dynamic domestic demand. Robust private consumption and investment are expected to drive this growth, along with some recovery of demand from trading partners. Meanwhile, public consumption is expected to slow

amid the fiscal consolidation process. General Manager Echavarria commented that the mismatch between robust consumption and stubbornly high unemployment could point to a higher structural unemployment rate (in line with the staff's estimation of a narrower output gap). Meanwhile, inflation is reckoned to be under control as the supply shock caused by high food prices continues to fade and inflation expectations remain near the target. The limited pass-through to date, as well as expectations for a broadly stable Colombia peso in the short term and a modest appreciation in the medium term, could also help contain price pressure. Nevertheless, the committee will monitor how the evolution of the coronavirus pandemic affects domestic activity and price dynamics.

We believe that the central bank will remain on hold for most of our forecast horizon (through 2021). Broadly anchored inflation expectations would limit the need for higher rates amid domestic and external risks to activity.

Privatization effort to meet fiscal goals as growth disappoints

A nominal fiscal deficit of 2.5% of GDP was recorded last year, within the fiscal rule's guidelines (deficit ceiling of 2.7%) but a tick above the government's target of 2.4%. Finance Minister Alberto Carrasquilla said that costs related to Venezuelan immigration and additional health expenditures were behind the higher deficit. Meanwhile, the fiscal deficit target of 2.2% was retained for this year (fiscal rule: 2.3%). On the activity front, the authorities are less upbeat than before, even if some forecasts remain optimistic. Last year the economy is estimated to have grown by 3.3% (in line with our call), a projection that was revised downward from 3.6%. For this year, a more modest acceleration to 3.7% is expected (Itaú: 3.1%), compared with the previously projected 4.0%.

Privatizations remain in the pipeline, with the administration considering sales that could amount to 0.6% of GDP. Recently, the government has been able to broadly meet its short-term targets because Colombia's public finances have benefited from higher-than-expected central bank dividends and elevated revenues from state-owned Ecopetrol (which are not sustainable going forward). Overall, a still-fragile structural revenue stream points to a likely need for additional tax reforms and additional privatization – both of which will be difficult to execute in the current domestic social environment – in order to keep the rating agencies at bay. Moody's long-term foreign debt rating on Colombia is Baa2 with a stable outlook, while S&P's rating is one notch below that, at BBB- with a stable outlook. Fitch recently reaffirmed its rating on Colombia at BBB- with a negative outlook.

Forecast: Colombia

	2014	2015	2016	2017	2018	2019F	2020F	2021F
Economic Activity								
Real GDP growth - %	4.7	3.0	2.1	1.4	2.6	**3.3**	**3.1**	**3.0**
Nominal GDP - USD bn	381	294	282	311	331	**319**	**323**	**336**
Population (millions)	47.7	48.2	48.7	49.3	49.8	**50.4**	**50.9**	**51.4**
Per Capita GDP - USD	7,997	6,098	5,791	6,307	6,641	**6,323**	**6,350**	**6,536**
Unemployment Rate - year avg	9.1	8.9	9.2	9.4	9.7	10.5	**10.0**	**9.6**
Inflation								
CPI - %	3.7	6.8	5.8	4.1	3.2	3.8	**3.3**	**3.0**
Interest Rate								
Monetary Policy Rate - eop - %	4.50	5.75	7.50	4.75	4.25	4.25	**4.25**	**4.50**
Balance of Payments								
COP / USD - eop	2,377	3,175	3002	2,932	3,254	3,287	**3,320**	**3,320**
Trade Balance - USD bn	-6.2	-15.6	-11.1	-6.1	-7.1	**-10.0**	**-9.2**	**-7.0**
Current Account - % GDP	-5.2	-6.3	-4.3	-3.3	-3.9	**-4.5**	**-4.4**	**-4.0**
Foreign Direct Investment - % GDP	4.2	4.0	4.9	4.5	3.3	**4.4**	**4.2**	**4.0**
International Reserves - USD bn	47.3	46.7	46.7	47.6	48.4	53.2	**54.2**	**55.1**
Public Finances								
Nominal Central Govt Balance - % GDP	-2.4	-3.0	-4.0	-3.6	-3.1	-2.5	**-2.2**	**-2.0**
Central Govt Gross Public Debt - % GDP	40.2	45.0	46.0	47.0	50.6	**51.6**	**52.2**	**53.3**

Source: IMF, Bloomberg, Dane, Banrep, Haver and Itaú

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