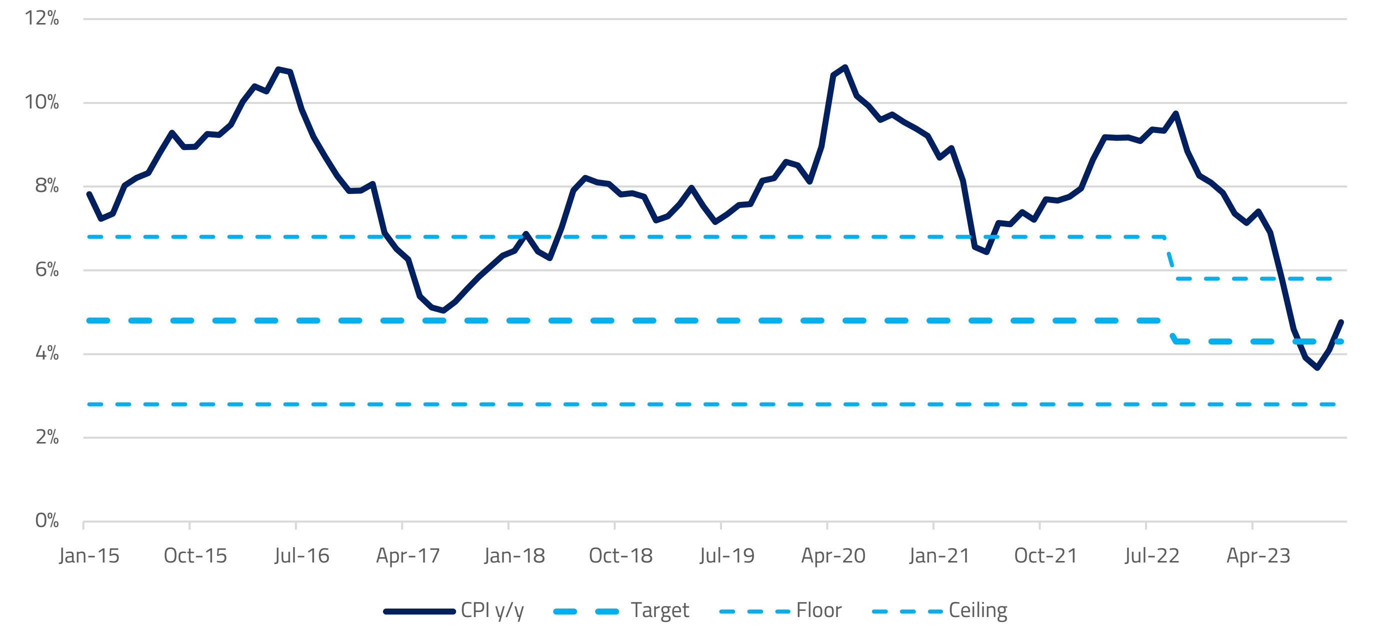
Franco Mercatini, CFA | fmercatini@latinsecurities.uy December, 2023

URUGUAY STRATEGY

As we bid farewell to 2023 and gear up for a brief summer break, it is an opportune moment to reflect and strategize for the coming year. 2024 beckons with the promise of being, in a word, entertaining. A series of significant events are set to punctuate the year, potentially setting new benchmarks. The anticipated paradigm shift under Argentina's new leadership, combined with national presidential elections in October and the U.S. in November, could potentially upend the current global equilibrium. Concurrently, the agro-export sector is striving to bounce back from drought impacts while pinning hopes on China's economic resurgence. Reflecting on the past year, it presented a mixed bag of achievements and challenges. Key indicators varied markedly between the first and second halves. The economy initially shrank but showed recovery signs in the third quarter. Inflation, which had been consistently decreasing, has recently shown signs of resurgence, presenting the central bank with new challenges. Fiscal result deteriorated in October, and fiscal management will continue to be a contentious issue, especially for a government championing fiscal prudence and public fund stewardship. Employment and wage growth in recent months have been surging, bolstering the government's reelection bid, even in the absence of a standout candidate. We recommend a shift in local currency debt preferences from nominal to inflation-linked securities, as inflation is expected to rise and fight to stay within target. The longer duration of linkers would favor of potential rate cuts and could provide a volatility cushion for unwanted electoral results.

The year-end inflation figures are set to be the lowest since 2005. After dropping to 3.9% y/y in September, inflation edged closer to 5% in November. Last month's price increase of 0.34% m/m aligned with analysts' predictions. Similarly, core inflation climbed by 0.31% m/m, culminating in a 4.26% rise over the past year. This trend suggests that managing inflation has been a significant triumph for the current government. Several factors have

Exhibit 1. Inflation rose in November.
y/y Inflation and CBU's target range

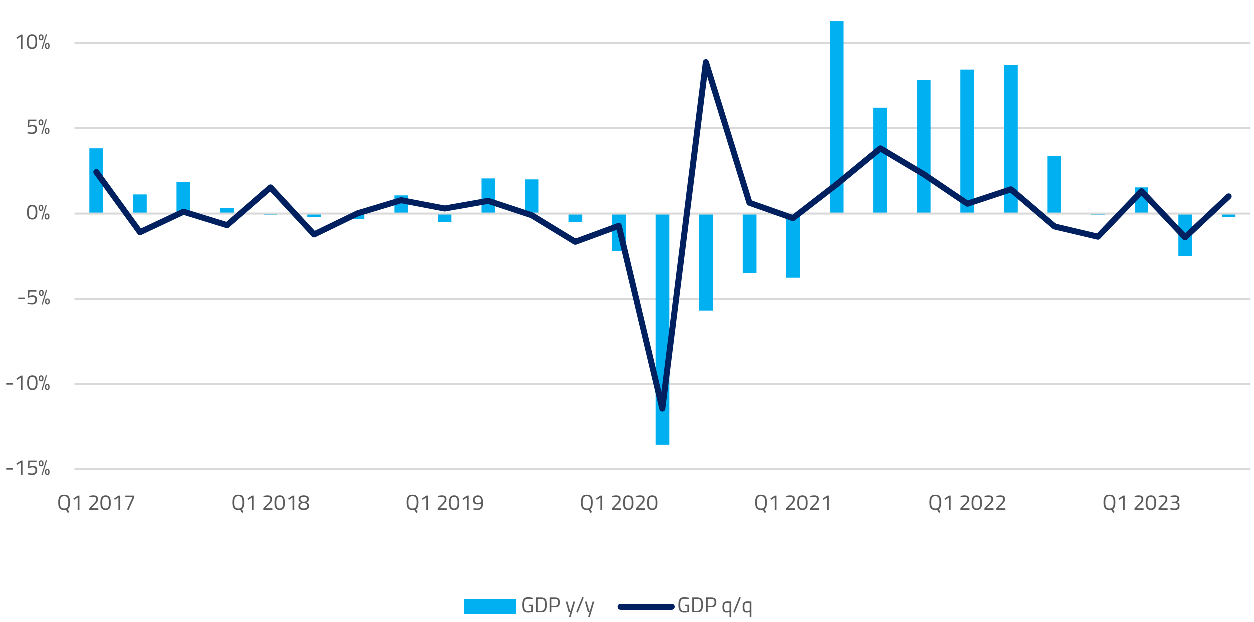


Source: INE

driven inflation towards this year-end figure of around 5%. The Central Bank of Uruguay's (CBU) monetary policy over the past 18 months has been a critical factor, despite facing criticism from the opposition and export sectors. The CBU maintained its course, witnessing quicker results than anticipated. The monetary policy rate escalated from 4.5% in August 2021 to 11.5% by December 2022, effectively reducing inflation from 10% to 3.9%. Since April, the CBU has been gradually lowering the interest rate, ending the year at 9.25%. The monetary policy report's dot plot anticipates approximately 100 basis points in rate cuts next year. However, with inflation expectations remaining above the target range's upper limit, a shift from contractionary to expansionary monetary policy could lead to higher inflation rates. The CBU plans to continue its easing policy, a trend expected to be mirrored globally, essentially reversing previous economic tailwinds. Additionally, the disinflationary trends observed globally in 2023 are likely to recede as the supply shock that initially drove inflation has subsided, and its counteracting effects are diminishing. While significant progress has been made, particularly in transitioning from monetary aggregate to interest rate management, structural changes are still partially implemented, as indicated by analysts' and business leaders' expectations. Facing a shift from tailwinds to headwinds next year, the CBU will likely find it challenging to keep inflation within desired limits, especially considering the electoral year's typical constraints against measures needed to lower inflation.

Activity will continue its recovery at least through the first half of the year. The economic activity bounced back growing by 1% q/q in Q3, after falling in Q2. Even though there was an improvement in the last quarter, GDP levels remain 0.2% below Q3 2022 and average growth throughout the year is expected to be below 1%. Exports grew for the second consecutive time compared to the same month from the previous year, showing that the sector is moving forward after the drought that took place between Q3 2022 and Q1 2023. Moreover, advanced December data point to a double-digit growth during the month. During Q3, exports of goods and services fell by 9.2% y/y, with imports growing by 5%, contributing to a -4.3% GDP growth during that period. On the positive side, consumption continued its solid trajectory, despite the exchange rate differential with neighboring countries.

Exhibit 2. GDP grew on a q/q basis but remains below last year's level.
GDP growth q/q and y/y



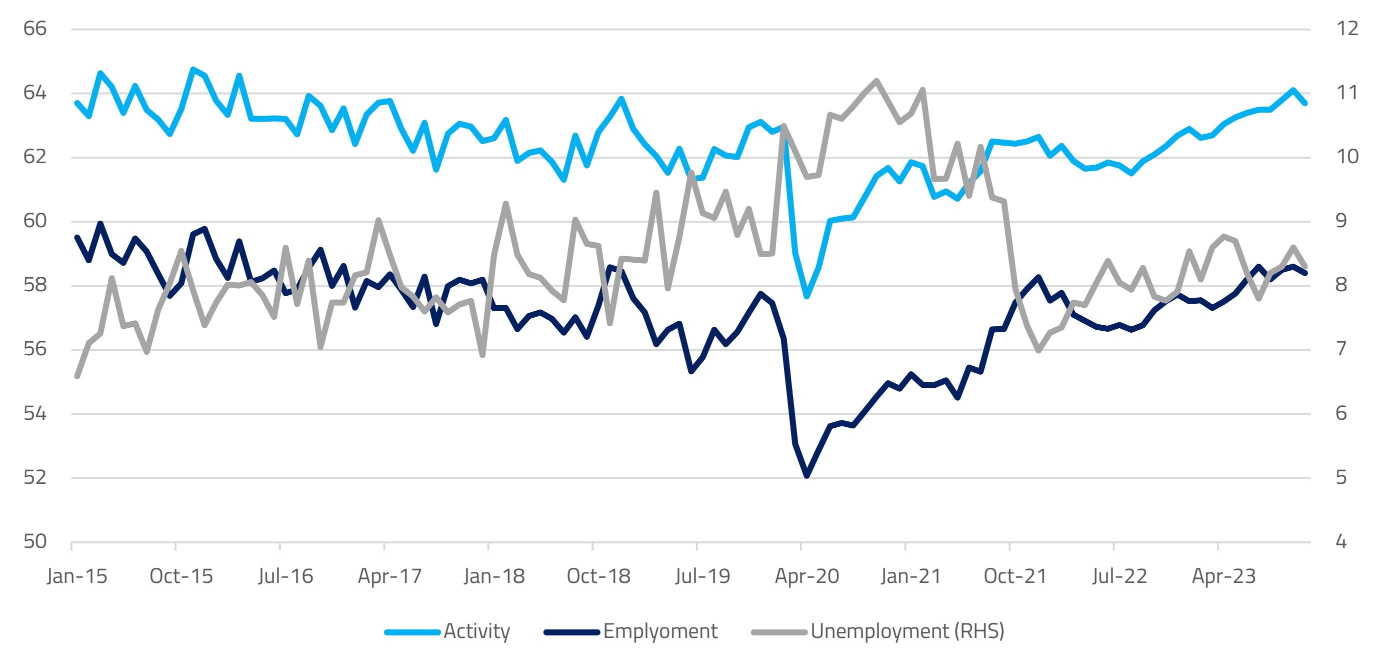
Fuente: BCU

Household consumption grew by 3.4%, whilst the government's increased by 2.7%. We expect this tendency to continue throughout the year, employment remains in a solid trajectory, with salaries increasing above inflation. Moreover, the cross-border consumption with Argentina will favor from the newly elected government in the neighbor country. The official FX has depreciated by 55% the week after the election, and prices of goods services that were fixed have been released, driving inflation to 1% daily during the first two weeks of December. This should help correct the price imbalance in border cities which was heavily affecting retailers in the area. Investment bounced back as gross capital formation increased by 9.1% y/y after falling by 7.1% last quarter.

Employment figures retraced in November but will close the year on a high note. In the past month, the activity rate declined from 64.1% to 63.7%, marking its lowest point since August. Simultaneously, the employment rate saw a slight decrease from 58.6% to 58.4%, although the unemployment rate also dipped from 8.6% to 8.3%. Despite these setbacks in November, the job market has generally maintained robust performance throughout the year, even as economic growth has been sluggish. On average, the year is expected to yield around 40,000 new jobs, a figure consistent with that of 2022. Post-pandemic, activity rates have rebounded, reaching their highest levels since 2016. The next goal should be to reduce the unemployment rate to around 7%, echoing the lowest rates of the previous electoral cycle. Additionally, the wage bill is currently at an all-time high, evidenced by the highest ever number of employed individuals and a 4.6% real wage increase over the past year. Looking ahead to 2024, we anticipate a continued recovery in employment levels, albeit at a slower rate, coupled with ongoing real wage growth, which may contribute to heightened inflationary pressures.

The fiscal deficit rose to 4.4% in October. Even though we expect the fiscal deficit to inertially improve due to higher inflation and a higher tax revenue during the year, the current level matches December's 2019 and could be used as a silver bullet for the opposition during the electoral campaign. One of the current government's strongest focuses in the 2019 electoral campaign was the mismanagement and excessive spending from previous

Exhibit 3. Employment debilitated during November.
Activity, Employment and unemployment (RHS) rates



Fuente: INE

administrations. Not only internal audits have not found anything illegal on how public funds were used, but the fiscal deficit is on its way to show little to no improvement in the entire cycle. Even though extraordinary events such as the pandemic first and the drought later made the government incur in temporary expenses and led to lower tax collections, it will be very hard to convince the electorate that the GDP is running below its potential level and the structural fiscal result is running at a much lower level.

In conclusion, the upcoming electoral year presents a critical test of the government's dedication to the country's long-term prosperity. Given that current surveys overwhelmingly favor the opposition in the October elections, the temptation to adopt populist measures will be strong. Historically, electoral years tend to see fiscal performance decline by more than 1% of GDP on average. The CBU forecasts rate cuts of 100 basis points, with expectations remaining above the upper limit of the target range and the present monetary policy rate hovering near its neutral estimated level. In light of these factors, we advise giving preference to inflation-linked securities over nominal local currency bonds. The longer average maturity of these inflation linkers positions them well to benefit from potential rate cuts and offers a safeguard against the possibility of elevated inflation levels next year. Ultimately, we anticipate that the local currency will align with the general trend of price increases in the economy, depreciating at a rate comparable to inflation. Following a robust performance in 2022 and a stable 2023, foreign exchange trends are likely to shift as the appeal of local currency instruments diminishes compared to their attractiveness 12 months ago, reducing their demand in the domestic market.

Exhibit 4. Projections

Inflation	2022	2023	2024	2025
MEF	8.1%	6.7%	5.8%	n/a
BCU	8.1%	5.7%	5.0%	n/a
Mkt Consensus	8.1%	5.2%	6.5%	6.1%
Latin Securities	**8.1%**	**5.1%**	**5.5%**	**5.4%**

GDP growth	2022	2023	2024	2025
MEF	4.9%	1.3%	3.7%	3.1%
BCU	4.9%	1.0%	4.0%	4.0%
Mkt Consensus	4.9%	0.8%	3.1%	2.5%
Latin Securities	**4.9%**	**1.0%**	**3.5%**	**3.0%**

Exchange Rate	2022	2023	2024	2025
MEF	40.1	41.9	44.5	n/a
Mkt Consensus	40.1	39.8	42.0	44.8
Latin Securities	**40.1**	**40.0**	**42.5**	**45.0**

Source: CBU, Latin Securities, MEF

Important Information

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