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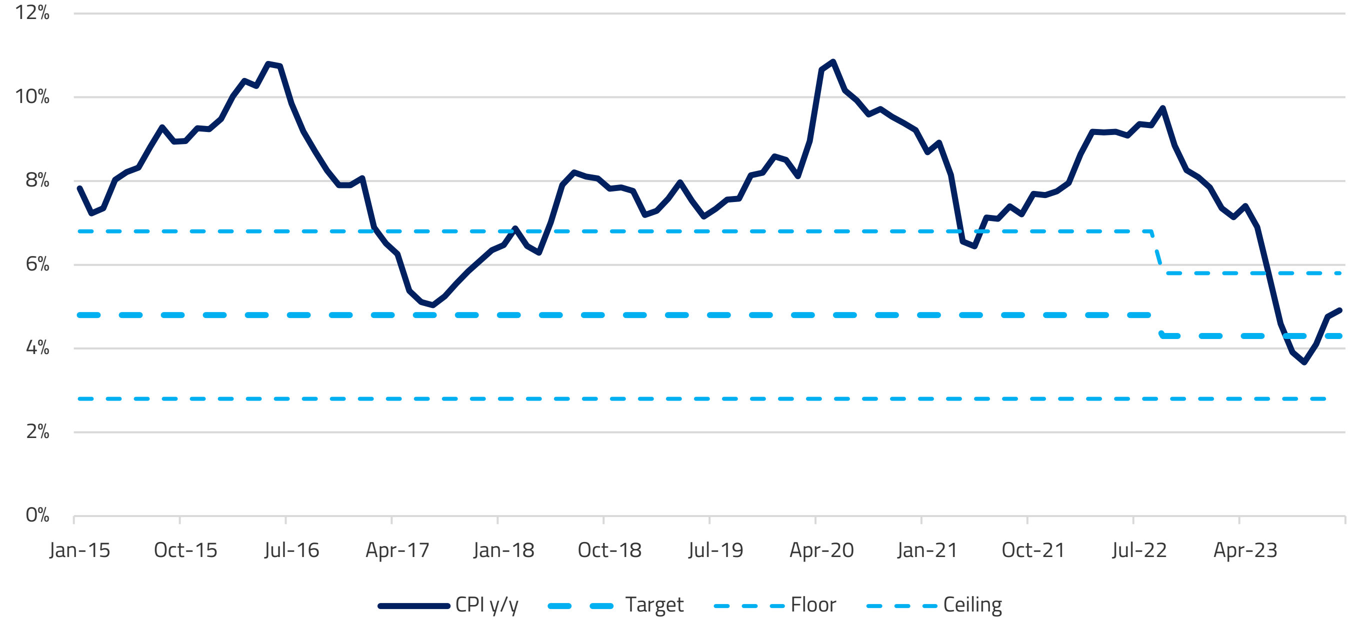
URUGUAY STRATEGY

Inflation concluded last year at 5.1%, marking its lowest point since 2005 and aligning with the targeted range for the first time in years. Despite a 13% year-on-year decrease, goods exports exhibited a robust performance, surpassing US$ 11.5 billion by the end of 2024, primarily attributable to a strong fourth quarter. The economy demonstrated growth at the onset of the fourth quarter, as indicated by October's Monthly Economic Activity Indicator (IMAE), and this positive trend is anticipated to persist, at least throughout the initial half of the current year. On the horizon, there loom several threats that could introduce uncertainty into financial markets. Firstly, the fiscal deficit remains elevated and significantly deviates from the government's targeted 2.6% for the conclusion of the ongoing year. The second threat is an archetype of low probability yet extremely high impact, represented by the potential plebiscite on the social security reform proposed by the central union of workers, the PIT-CNT. The Central Bank of Uruguay continued its monetary policy easing, reducing its reference rate by 25 basis points during the concluding meeting of the year.

The CPI fell in December thanks to the yearly discount in the electricity bill. In the past month, the inflation reading exhibited a decline of 0.11% m/m, ultimately settling the year at 5.1% y/y—a figure in accordance with analysts' predictions and well within the targeted range of 3% to 6%. The overall performance of monetary policy in 2023 achieved its objective, successfully reducing year-end inflation from 8.3% to 5.1% y/y. The efficacy of monetary policy, which concluded the year in proximity to its anticipated neutral level, was complemented by external factors. Notably, oil prices remained relatively stable, showing minimal changes compared to their December 2022 levels. This stability in oil prices played a pivotal role, contributing to a near 2% year-on-year growth

Exhibit 1. Inflation finished the year inside the target range.
y/y Inflation and CBU's target range

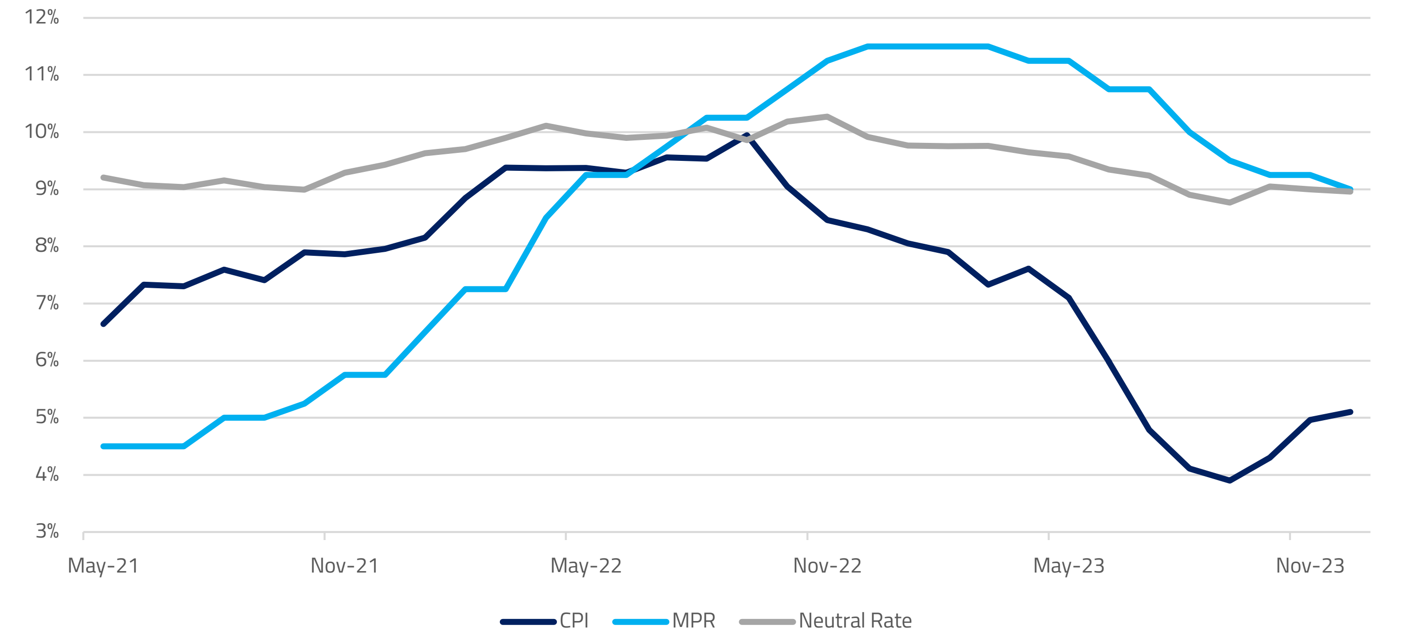


Source: INE

in the transport division of the index. Furthermore, for the second consecutive year, the local currency experienced appreciation, resulting in reduced prices for imported goods, which witnessed substantial growth over the past 12 months. Conversely, the division most impactful for those particularly vulnerable to the effects of inflation—namely, food and non-alcoholic beverages—registered a higher-than-average increase, surging by 6.15%. Consequently, core inflation, which excludes volatile elements, exhibited a more restrained uptick, standing at 4.5% year-on-year compared to the overall index. As emphasized previously, we anticipate a gradual uptick in inflation in the coming months. A neutral monetary policy, coupled with a devalued currency and elevated relative prices in neighboring countries, is poised to contribute to this inflationary trend. However, reassured by the core data, we maintain the expectation that inflation will not escalate uncontrollably, remaining well-contained within the desired levels.

The Central Bank of Uruguay (CBU) continues to have an optimistic view on inflation. In its December meeting, the CBU made the decision to decrease its reference rate by 25 basis points, bringing it to 9%. This action signifies a shift from a restrictive stance to a level considered neutral based on the metrics provided by the central bank. The most recent Monetary Policy Report outlines an expected inflation trajectory ranging from 5% to approximately 5.3% over the next 24 months. Notably, all indicators relevant to the central bank indicate inflation expectations persisting above the 6% ceiling of the target range. Contrary to the central bank's outlook, business owners anticipate inflation to reach 7%, while analysts project a slightly lower figure of 6.1% within the next 24 months. Additionally, the implicit inflation derived from interest rate curves suggests a value close to 6.5% over the same period. The decision to transition from a restrictive monetary policy stance, coupled with the current inflation trajectory that has risen from its September low of 3.9% to 5.1%, reflects a more optimistic perspective from monetary authorities compared to the prevailing sentiment in the broader market. Given the persistence of expectations at their current levels, it is our contention that the latest estimates provided by the central bank may be overly optimistic.

Exhibit 2. The MPR reached its neutral level.
y/y Inflation, MPR and neutral rate

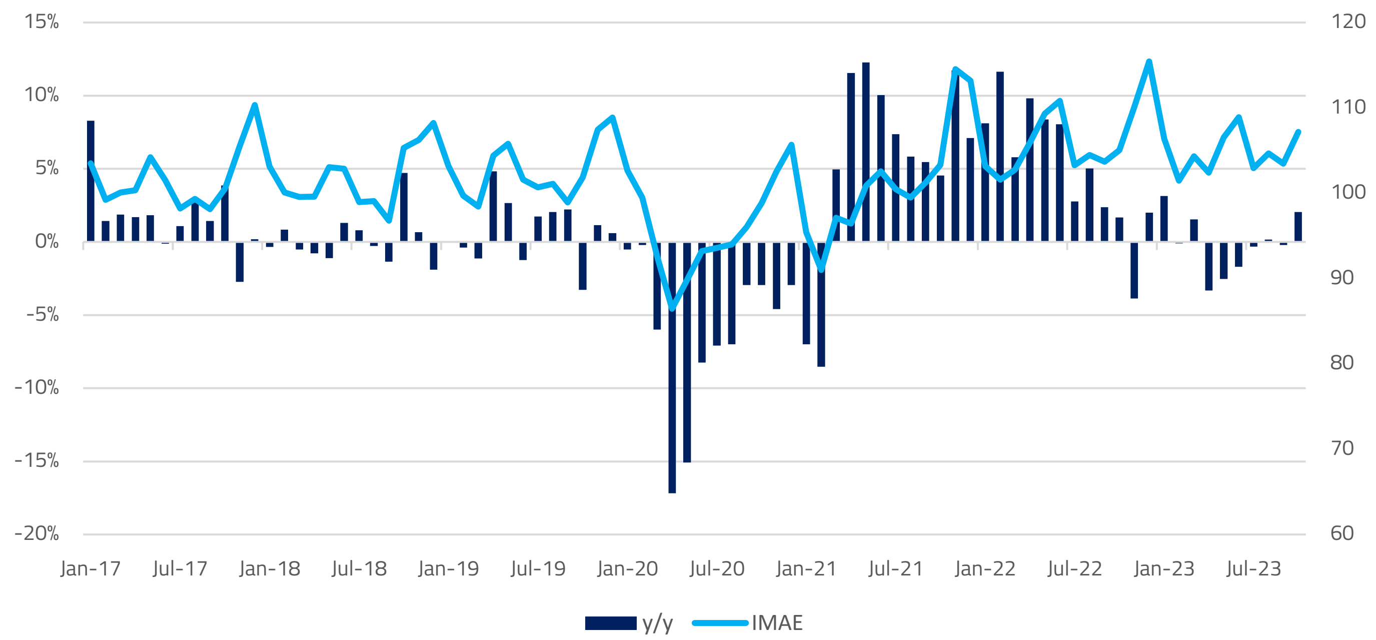


Source: INE; BEVSA

Politics could interfere with the monetary policy in 2024. As we embark on an electoral year, with national elections scheduled for October, there is a growing concern about the possibility of monetary policy decisions being influenced by political considerations. Over the past four years, the central bank has maintained an unprecedented level of independence, acting in accordance with its objectives rather than being swayed by political motivations. However, recent actions and the recently released report raise some red flags in our assessment. Despite the current inflation levels and the performance over the last 12 months, there is a likelihood that the government may capitalize on the situation to showcase its success during the electoral campaign, regardless of the anticipated mild shift in the trajectory. The interest rate policy trajectory outlined in the monetary policy report indicates an additional 100 basis points of rate cuts during 2024, followed by hikes in 2025. This projection seems to present a contradiction between current inflation expectations and the forecasted interest rate adjustments. Since reaching the minimums in September, when inflation dropped to 3.9%, we have held the hypothesis that inflation would rise, potentially testing the 6% ceiling of the target range. The recent updates on interest rates seem to align with our viewpoint. Despite the central bank's forecasts suggesting relative stability in inflation over the next 24 months, it appears that the real objective is closer to 6% than to the center of the range at 4.5%. These developments raise concerns about the potential politicization of monetary policy decisions in the lead-up to the elections.

Activity continued its improvement during October. Following a slight dip in September, economic activity rebounded by 1.3% m/m and 2% y/y in October, as reported by the IMAE. This resurgence aligns with expectations, indicating a continued recovery in economic activity from the third quarter of 2023 onwards. Exhibit 3 illustrates the economic challenges stemming from last year, primarily attributed to a regional drought negatively impacting the supply of key export products and the global slowdown that resulted in lower commodity prices. As production normalized, activity has progressively improved since then. On average, the CBU anticipates a 4% annual growth in GDP over the next 24 months, with substantial support expected from the exporting industry and private consumption. However, this positive outlook introduces a paradox between the stability of low inflation and the

Exhibit 3. Activity rose in October.
IMAE & y/y change



Source: CBU

robust growth in activity, particularly in the context of an expansionary monetary policy. The coexistence of these factors prompts a closer examination of the potential implications and challenges within the economic landscape.

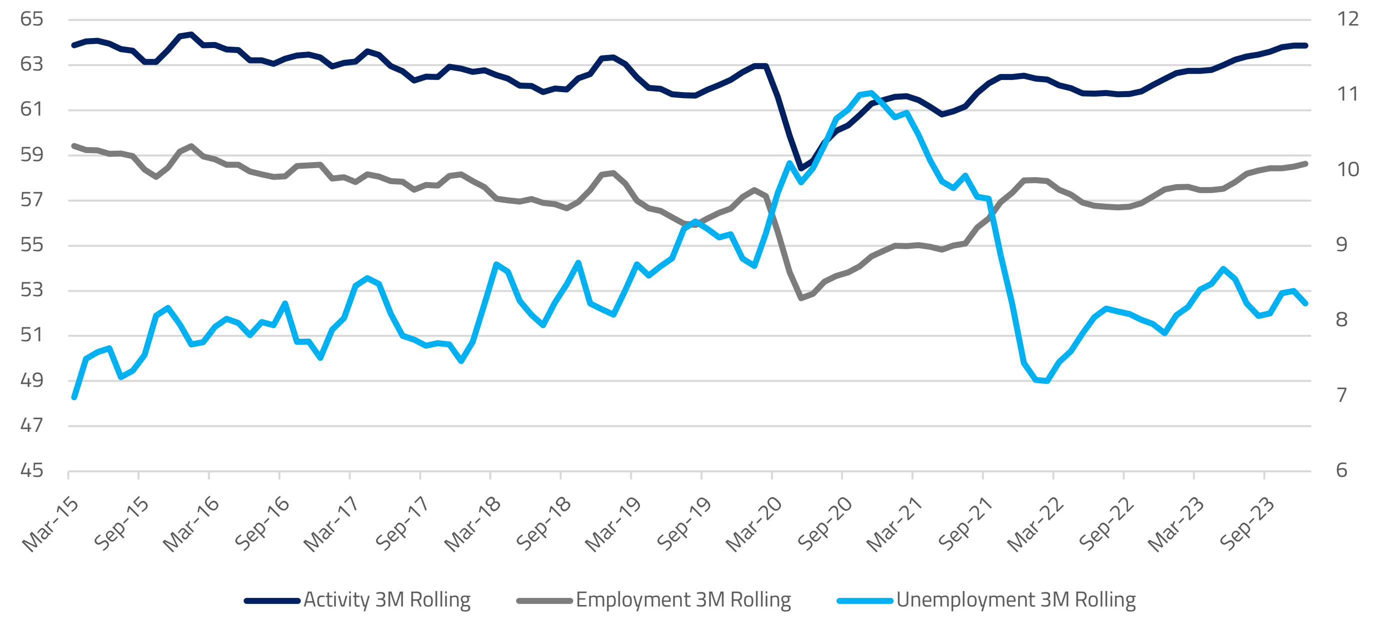
The job market closed the year strongly. In 2023, the creation of 39,000 new jobs contributed to closing the year with an unemployment rate of 7.8%, marking a 10bp improvement compared to the previous year. Both the activity rate and employment figures demonstrated positive growth, reaching 63.8% and 58.9%, respectively. This signifies a notable 1.1% and 1.2% improvement in each of these variables compared to figures from December. Upon closer examination, out of the 39,000 newly employed individuals, 53,000 joined the formal sector, while the number of unregistered workers decreased by 14,000. However, it's worth noting that a considerable portion of the strides made in formalizing the job market during the pandemic has been eroded. The percentage of unregistered workers, which had dropped below 20% in 2021, has now risen to nearly 22.5%. Although the improvement remains noteworthy, especially considering the pre-pandemic average of around 25%, the trend is leaning towards the negative side. Employment and activity levels indicate that the labor market is currently at historical highs, further supported by an enhancement in real salaries, culminating in the highest recorded workforce payroll levels to date.

Exports fell 13% during 2023, reaching US$11.5bn. Despite the unfavorable comparison with the previous year, the overall performance of total goods exports exhibited robustness, surpassing 2021 levels by 5.5% and significantly outperforming the pre-pandemic years. When scrutinizing individual products, the primary export, meat, experienced a 4% decline in volume and a 15% reduction in average price. In contrast, cellulose exports, the second-highest selling product, witnessed a 7% increase attributed to a 20% price reduction but a notable 33% surge in volume, facilitated by the inauguration of the third pulp mill plant. China emerged as the primary destination for local products, accounting for 22% of the total demand, followed closely by Brazil with 19% and the European Union with 16%.

The recent pension system reform is at danger and so is the system's long-term sustainability. For years, the need for a comprehensive reform of the pension system has been a consensus across the entire political spectrum,

Exhibit 3. Employment reached its highest levels since 2016.

3-month rolling employment and activity rate



Source: CBU

irrespective of orientation. However, due to the unpopular nature of the required measures for long-term sustainability, previous administrations procrastinated addressing the issue until the current government took office. In April, the Parliament finally sanctioned a reform aimed at theoretically ensuring the pension system's viability and stabilizing its long-term deficit. The approved reform included unpopular measures such as raising the retirement age from 60 to 65 and eliminating certain privileges for specific groups of workers. Seizing this opportunity, the PIT-CNT is now mobilizing support for a plebiscite to overturn the recent reform. Their proposed changes, if enacted, could jeopardize the entire system, notably by eliminating pension funds and shifting to a collective system with no individual savings, lowering the retirement age back to 60, and mandating the minimum pension to align with the national minimum salary through constitutional means. Despite the central union's advocacy, no concrete projections have been presented, and the potential impact on public finances remains uncertain. Some analysts speculate that the new pension system could immediately widen its deficit to 10% of GDP. However, the path to approval is challenging, given the lack of strong support from any political party, despite over 60% of the population expressing a willingness to vote in favor of the plebiscite. The likelihood of the reform passing through a plebiscite is slim, as it faces criticism from almost every independent and political technical expert. The project's best chance lies in securing the support of Carolina Cosse, who, being second in the polls of the internal elections garnering the union’s backing could mean a significant advantage. While Cosse has not definitively stated her stance on the reform, aligning with the PIT-CNT's structure could enhance her position. Contrary to the scenario when the reform was approved, its rejection through a plebiscite could lead to a credit downgrade for the country and a notable increase in the Sovereign spread.

In conclusion, we anticipate the economic recovery to persist at least through the first half of the year, accompanied by improvements in the job market. The substantial enhancement in activity is expected to drive a significant increase in private consumption. Additionally, the relative price differential with Argentina has markedly decreased since the inception of Milei's government, owing to its current foreign exchange devaluation and the 25% month-on-month inflation in December, favoring neighboring cities and reducing the attractiveness of outbound tourism. As of now, local currency instruments have demonstrated positive performance in the initial weeks of the year, yielding returns ranging from 0.6% to 1.5%. The implicit inflation, as reflected in the interest rate curves, hovers around 6%, aligning with expectations. Despite our anticipation of inflation concluding the year within the target range, we recognize several inflationary threats that could materialize throughout the year. Consequently, we maintain a preference for exposure to linkers over nominals as we consider they should overperform throughout the year, and should see an increase on its demand on a potential government change.

Exhibit 4. Projections

Inflation	2022	2023	2024	2025
MEF	8.1%	6.7%	5.8%	n/a
BCU	8.1%	5.7%	5.0%	5.3%
Mkt Consensus	8.1%	5.2%	6.1%	6.0%
Latin Securities	**8.1%**	**5.1%**	**5.7%**	**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**	**39.0**	**42.5**	**45.0**

Source: CBU, Latin Securities, MEF

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