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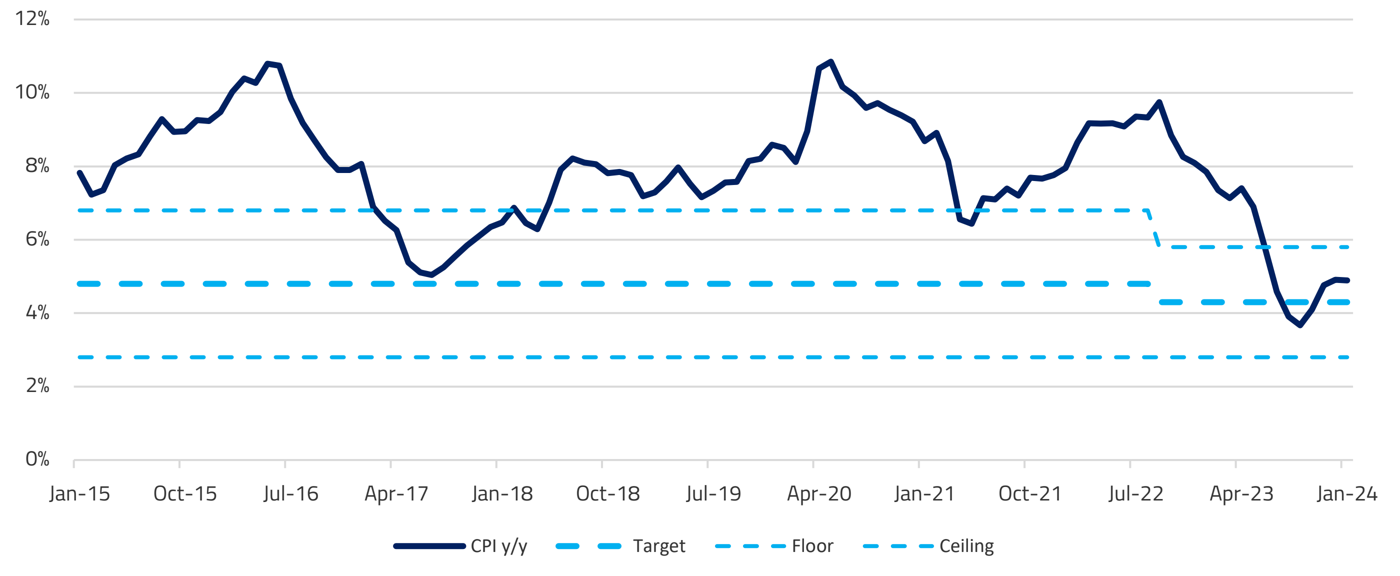
URUGUAY STRATEGY

In January, inflation exhibited stability, maintaining a consistent rate of 5.1% y/y, identical to its December figure. Additionally, core inflation saw a slight decline from 4.46% to 4.34% at the outset of the year, showing that inflationary pressures have not surged yet. Throughout 2023, the fiscal deficit, excluding social security transfers, remained steady at -3.2% of GDP, mirroring the previous year's result. However, following the consolidation of the non-monetary public sector and the Central Bank of Uruguay (CBU), the fiscal deficit expanded to 3.6% of GDP, representing a 0.2% deterioration compared to the previous year's close. In a positive economic development, goods exports rebounded in January, recording an 8% y/y growth after experiencing a 13% decline over the entirety of 2023. This upward trajectory is expected to persist at least through the first half of 2024, buoyed by the recovery of the agroexporter industry from the preceding drought, which should significantly contribute to a GDP growth anticipated to surpass 3.5%. As Uruguay gears up for internal elections in June, the political landscape is evolving, with prospective candidates beginning to transition from their current roles to focus entirely on their campaigns. Among the opposition candidates, who are currently favored to prevail in the general elections slated for October, diverse strategies are being pursued. Yamandú Orsi, the Mayor of Canelones and a leading contender, has announced his intention to step down from his position effective March 1st. Conversely, Carolina Cosse, the Mayor of Montevideo and Orsi's closest competitor, is likely to retain her mayoral post for as long as possible, given its significance as her primary platform since her victory in the 2020 elections, with her sights firmly set on the 2024 national elections.

Inflation rose by 1.53% m/m in January after the adjustment of administered prices. Despite the notable uptick in monthly inflation figures, the annualized inflation rate remained stable compared to December. Additionally, the m/m increase in January closely paralleled that of the previous year, standing at 1.55%. As customary for January,

Exhibit 1. Inflation showed stability to start the year.
y/y Inflation and CBU's target range

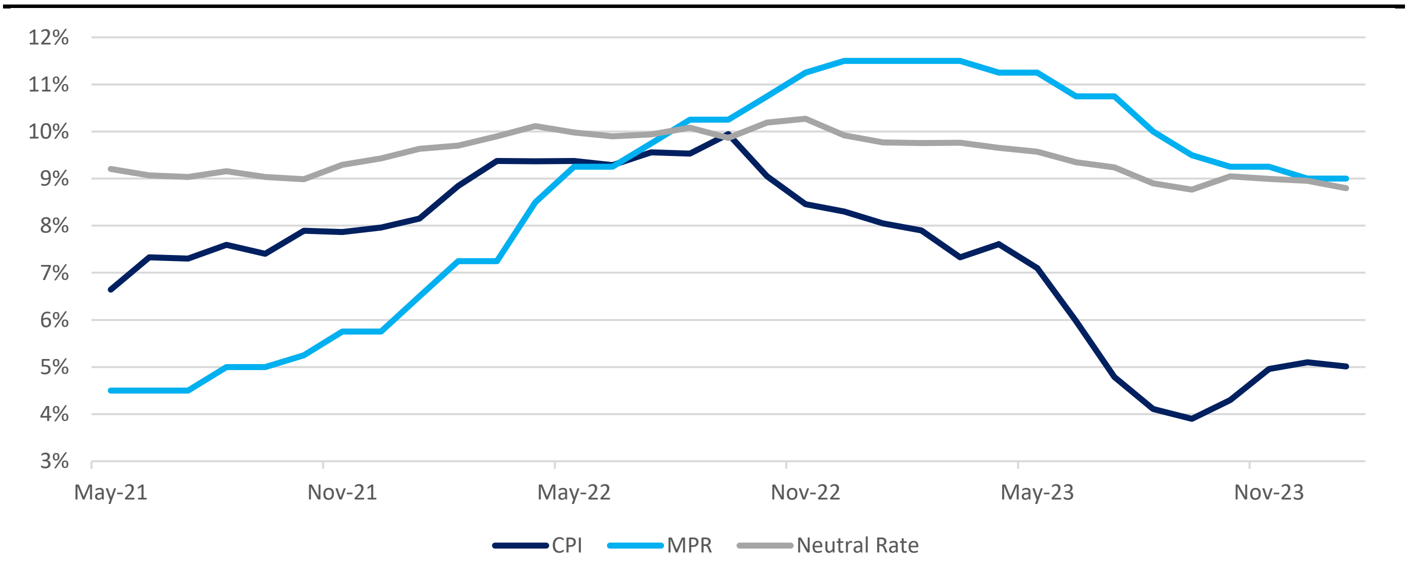


Source: INE

administered goods and services, which undergo price adjustments, were the primary contributors to the monthly inflation figure. Specifically, divisions such as housing, water, gas, electricity, and others surged by almost 5%, contributing 64 basis points to the overall increase. The food and non-alcoholic beverages division followed as the second-highest contributor, with a 1.75% rise, adding 46 basis points to the total. Meanwhile, core inflation, excluding volatile elements, dipped to 4.34% from 4.46% in December, signaling a stabilization of price increases nearer to the midpoint of the target range, set between 3% and 6%. Despite the absence of significant inflationary pressures thus far, we anticipate a potential acceleration in price increases in the latter part of the year, as key threats persist. The appreciation of the Uruguayan Peso (UYU) by over 2% from mid-December to the end of January has been driven by heightened demand for local currency from tourism and companies facing one-time expenses, thereby mitigating some price pressures. Moreover, both internal and external factors are poised to contribute to higher inflation levels. With monetary policy currently at or very close to the neutral level, the announced future rate cuts are expected to lead to an expansionary monetary policy, contributing for an economic growth which is expected to exceed its long-term potential. Furthermore, employment and salaries are projected to continue their upward trajectory, with previously established agreements driving salary growth ahead of inflation. Globally, countries have struggled to reach a more accommodative monetary policy stance given the persistent levels of inflation, suggesting that monetary conditions may remain tighter than initially expected. In such circumstances, the independence of a central bank becomes crucial, especially as forthcoming rate cuts may not align with the current economic scenario. In an electoral year, governments vying for reelection often endeavor to enhance the standard of living through heightened consumption. Consequently, short-term measures such as cheaper credit and increased public spending serve as rapid methods to achieve this goal.

The Central Bank of Uruguay (CBU) left its Monetary Policy Rate (MPR) unchanged. During its January meeting, the Central Bank of Uruguay (CBU) opted to maintain its reference rate at 9%, indicating alignment with current outcomes and trajectory. According to the CBU, expectations have continued to decline and have now reached historic lows at 6.4%, nearing the upper limit of the target range. In its Monetary Policy Report for the fourth quarter of 2023, the central bank foresees approximately 100 basis points of rate cuts over the course of the year.

Exhibit 2. MPR is close to its neutral level.
Inflation, expectations and MPR



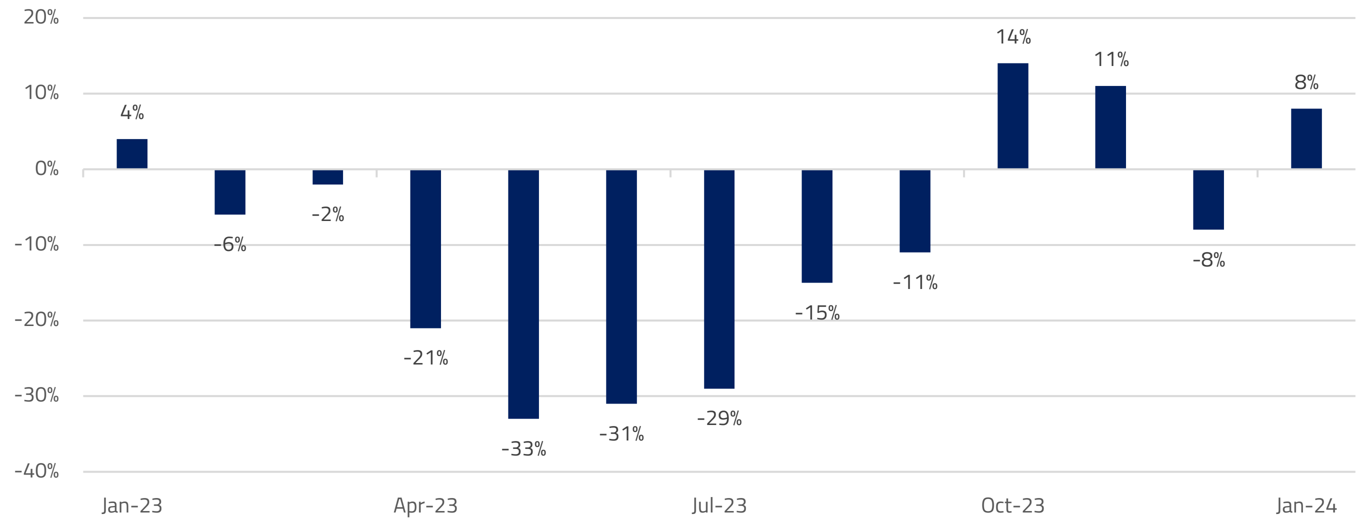
Source: INE; CBU

However, recent shifts in expectations from other central banks, notably the Federal Reserve (FED), which is now anticipated to maintain higher rates in response to unexpected inflation upticks and robust economic indicators, may prompt the CBU to reassess its projections. As previously mentioned, we anticipate inflation to begin accelerating towards the end of the second quarter or early third quarter. The committee's report highlights that external inflationary pressures have proven more resilient than anticipated, posing a greater challenge in achieving a low and stable inflation level without compromising economic activity. Given these factors, we currently anticipate inflation to end the year within the target range but anticipate significant challenges in doing so. Nonetheless, the Ministry of Economic and Finance's recent forecast of 4.9% inflation by December appears overly optimistic and is likely to require revision in the near term.

Goods exports started the year on a positive note. After experiencing a 13% decline over the course of 2023, exports rebounded in January, posting an impressive 8% year-on-year growth and reaching a total of US$917 million. In nominal terms, January's figures stand out, surpassing the previous record for that month. Meat reclaimed its position as the primary exported product, generating US$176 million and exhibiting a notable 34% year-on-year growth, followed closely by cellulose at US$174 million, with a more modest growth of 3%. The most significant surge was observed in wheat exports, which skyrocketed by 308% attributed to improved harvest conditions and higher market prices. Brazil retained its status as the largest importer of Uruguayan products, accounting for 22% of total demand and expanding by 26% compared to the previous January. Meanwhile, China, although still a significant market, received 13% of total exports but experienced a 6% decline. Since October, year-on-year exports have been on an upward trajectory, growing by 14% in October, 11% in November, albeit experiencing an 8% decline in December. This recovery aligns with our thesis from last year, indicating that economic revitalization commenced in the fourth quarter and is likely to continue throughout the first semester.

Exhibit 3. Goods exports grew 8% y/y in January.

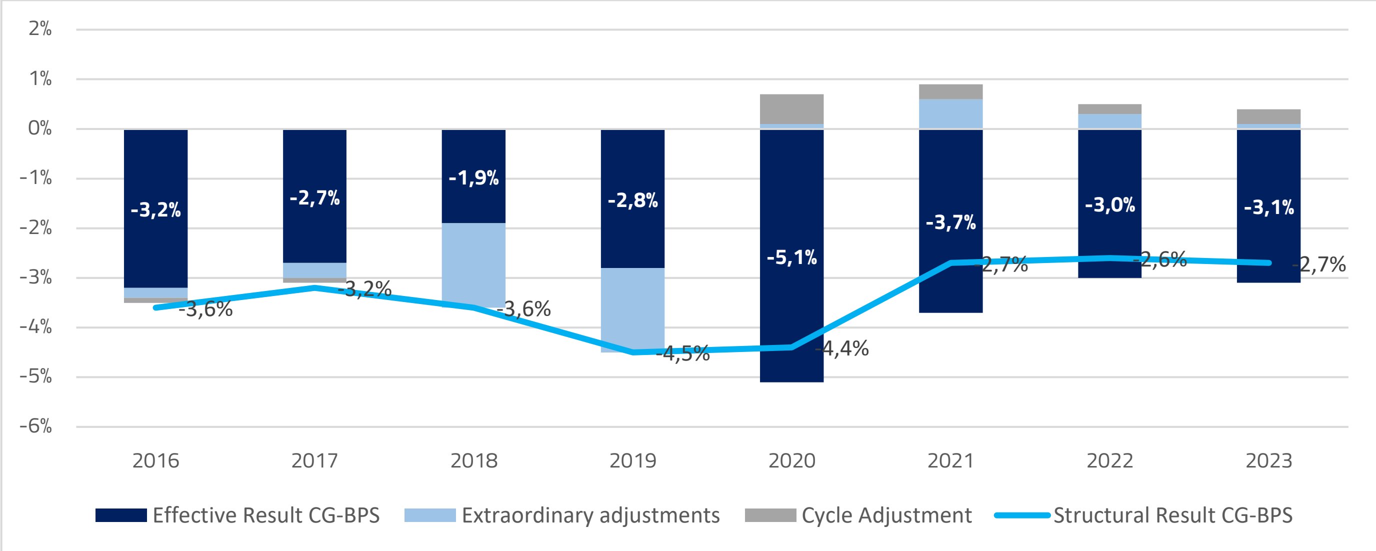
y/y goods exports growth



Source: Uruguay XXI

The government complied with the fiscal rule in 2023. In 2023, the government successfully adhered to the fiscal rule, as confirmed during a press conference led by Minister Azucena Arbeleche, where the Ministry of Economic and Finance (MEF) unveiled the previous year's outcomes and updated projections for the current year. The existing fiscal rule encompasses three key pillars: the structural fiscal outcome of the central government-social security (CG-BPS), constraints on the growth of primary expenses, and the debt ceiling. The first pillar, concerning the structural fiscal outcome (factoring in potential rather than observed GDP) for 2022, was met with a projection of -2.7%. Similarly, the second pillar, allowing for a maximum real increase of 2.1% in primary expenses, was also fulfilled, with expenses declining by 0.4% of GDP. However, the increase in debt of US$2.42 billion exceeded the originally permitted US$2.2 billion. Nonetheless, Parliament invoked the exception clause, raising the debt ceiling by 30% to US$2.86 billion, citing extraordinary circumstances such as the drought. The observed fiscal outcome, prior to adjustments for extraordinary events and considering anticipated GDP growth, stood at -3% of GDP (-3.2% if we exclude social security transfers), mirroring the figure from the end of 2022, an improvement from the -3.9% recorded in October. Looking ahead to the current year, the structural fiscal outcome is projected to decline to -2.9% of GDP, with the observed outcome at -3%. This entails an increase in the fiscal deficit projection of 0.7% from the accountability law ratified in June 2022. If this target is met, it would signify a shortfall compared to the estimated sustainable long-term deficit of -2.5%. Nonetheless, avoiding a deterioration in public accounts during an electoral year would mark an exception to historical patterns, albeit not representing significant progress.

Exhibit 3. The structural fiscal deficit closed at 2.7% of GDP.
Structured and observed fiscal results and adjustments as % of GDP



Source: MEF

In conclusion, our outlook on local currency debt remains optimistic, with a particular preference for inflation-indexed bonds. Presently, the opposition holds an advantage in the upcoming elections, a scenario that historically has been associated with heightened inflation expectations. Furthermore, as previously mentioned, we anticipate inflation to rise throughout the year, potentially testing the upper boundary of the target range. While we don't foresee an inflationary spiral, we believe it prudent to exercise caution and transition from nominal bonds to inflation-indexed securities. This strategic shift would serve as a hedge against any escalation in inflation expectations, safeguarding our portfolio against potential risks.

Exhibit 4. Projections

Inflation	2022	2023	2024	2025
MEF	8.1%	5.1%	4.9%	n/a
BCU	8.1%	5.1%	5.0%	5.3%
Mkt Consensus	8.1%	5.1%	6.3%	6.0%
Latin Securities	**8.1%**	**5.1%**	**5.7%**	**5.4%**

GDP growth	2022	2023	2024	2025
MEF	4.9%	0.5%	3.5%	3.1%
BCU	4.9%	1.0%	4.0%	4.0%
Mkt Consensus	4.9%	0.5%	3.3%	2.5%
Latin Securities	**4.9%**	**0.5%**	**3.5%**	**3.0%**

Exchange Rate	2022	2023	2024	2025
MEF	40.1	39.0	44.5	n/a
Mkt Consensus	40.1	39.0	41.4	43.3
Latin Securities	**40.1**	**39.0**	**41.5**	**44.0**

Source: CBU, Latin Securities, MEF

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