LatAm Macro, Fixed Income & FX Strategy

LatAm Local Markets Outlook

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LatAm Macro, Fixed Income & FX Strategy

Colombia

Colombia vs. Mexico in Local Rates Markets

Economic Data				
	Current Level		2016 Forecast	
	Mexico	Colombia	Mexico	Colombia
Policy Rate	3.75%	6.50%	4.25%	7.50%
Real Policy Rate	1.15%	-1.48%	1.45%	1.00%
Real GDP (% YoY)	2.50%	3.30%	2.30%	2.80%
Inflation (% YoY)	2.60%	7.98%	2.80%	6.50%
CA Deficit (% GDP)	-2.60%	-6.30%	2.70%	-5.90%
Fiscal Deficit (% GDP)	3.20%	-3.00%	3.20%	3.80%

- The real policy rate in Colombia is 250bps below the Mexican real policy rate in spite of the fact that Mexican inflation is expected to be below target in 2016 and Colombian inflation above target.
- The larger expected output gap in Colombia is not enough to explain this differential.

Market Data						
	Current Level		Change YTD		Expected Trend	
	Mexico	Colombia	Mexico	Colombia	Mexico	Colombia
Reference Rate	3.75%	6.50%	0.50%	0.75%	↗	↗
Fixing Rate	4.06%	6.21%	0.51%	0.66%	↗	↗
3m Fix	4.12%	6.67%	0.53%	0.82%	↗	↗
2y Swap	4.62%	6.50%	0.18%	0.23%	↗	↗
5y Swap	5.26%	6.66%	-0.28%	-0.05%	↗	↗
10y Swap	5.99%	7.07%	-0.40%	-0.37%	↗	↗
2s10s	138	57	-58	-60	↘	→
2s5s10s	-9	-24	-33	4	↗	→

Colombia vs. Mexico in Local Rates Markets

- The yield differential between TES and MBONO moved from 0bp to a high of 335bps in February 2016. This move was replicated in CDS in which 10y Colombia CDS went from trading below Mexico to trading 100bps over.
- Since February, these levels have compressed again to 215bps in local rates and 60bps in CDS.

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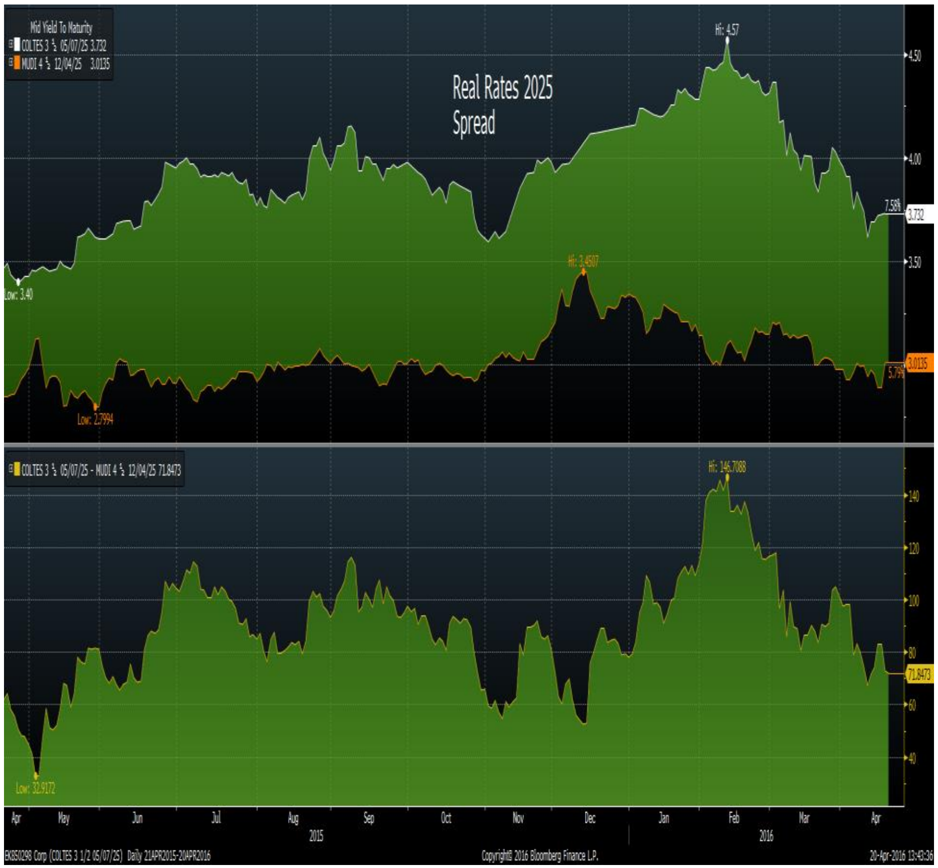
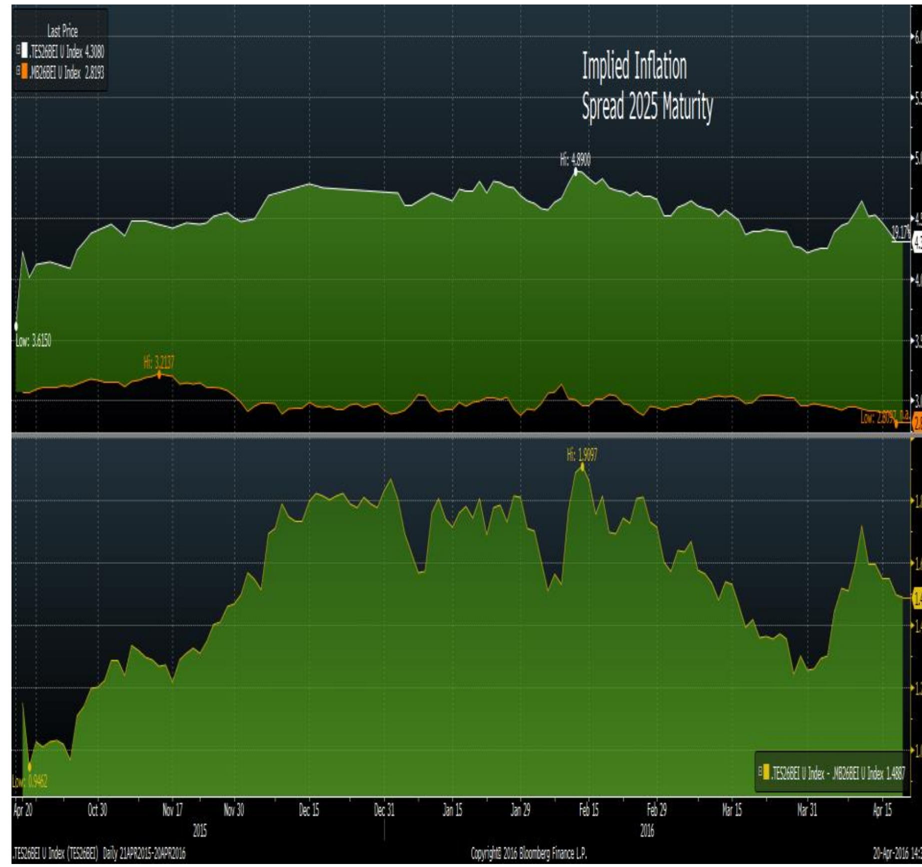
- The tightening in local rates of 120bps since February has come via 75bps of real rates compression and 45bps of narrowing in break even inflation differentials, in spite of continued negative news on the inflation front in Colombia.
- Real Rate Spread is now 70bps in 2026 maturities and 150 bps in Break-Even Inflation





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Colombia vs. Mexico in Local Rates Markets

- **At only 70bps above Mexico in Real Rates, Colombian TES look vulnerable to under-performance vs. Mexican MBONOs.**
  - Colombia more likely to get downgraded than Mexico.
  - Colombia's trend growth > Mexico's
  - Colombia's Financial Volatility > than Mexico's
  - Colombia's Economic Volatility > than Mexico's

Real Rate Spreads		
	Mexico	**Colombia**
Rating	BBB+	BBB
Outlook	Neg Moody's	Neg S&P
5y CDS	154bp	250bp
Avg 5y CDS Peers	130bp	156bp
Trend Growth	2.30%	3.40%
Rates Vol	3.8bp/day	7bp/day
FX Volatility	14.40%	16.80%
Inflation Volatility	.5pp	.8pp
Activity Volatility	.3pp	.6pp

- **Underweight nominal TES, overweight Inflation linked MBONO.**

Colombia vs. Mexico in Local Rates Markets

- Break even inflation in Mexico appear too low while in Colombia it appears fairly valued.
  - Favor linkers in Mexico. Remain neutral in Colombia.

Inflation Risk Premium		
	Mexico	**Colombia**
Inflation (% YoY)	2.60%	7.98%
1y Survey Inflation Expectations	**3.27%**	**4.54%**
Long Term Survey Inflation Expectations	3.36%	3.81%
Break Even Inflation 2019	**2.80%**	**4.61%**
Break Even Inflation 10y	**2.70%**	4.27%

- With only ~50bps of hikes priced into Mexico, and ~75bps priced into Colombia over the next year, the curve in Mexico looks very steep.

Curve Shape		
	Mexico	Colombia
Current Policy Rate	3.75%	7.98%
Implied Policy Rate in 1y	4.40%	6.43%
2s10s Curve	138	57
Rate Volatility	3.8bp/day	7bp/day

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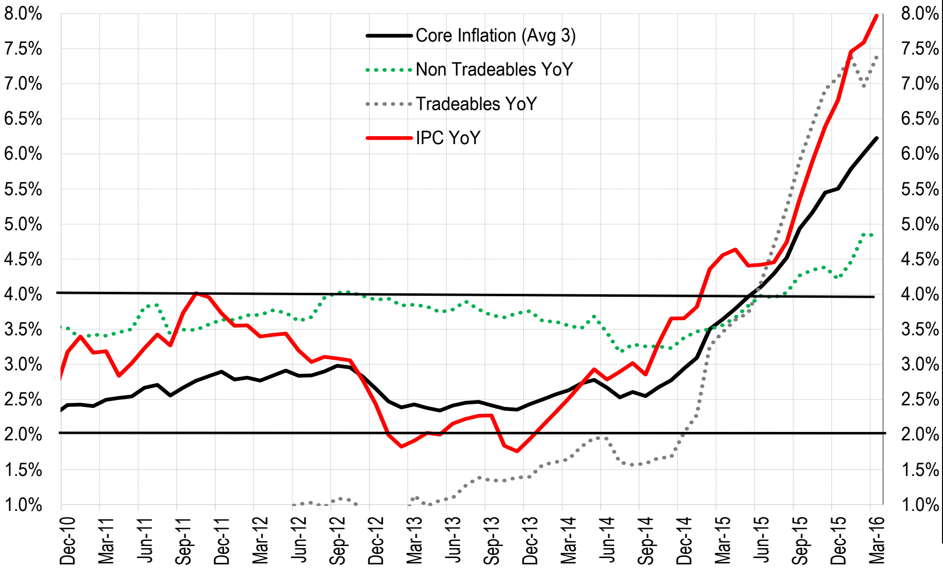
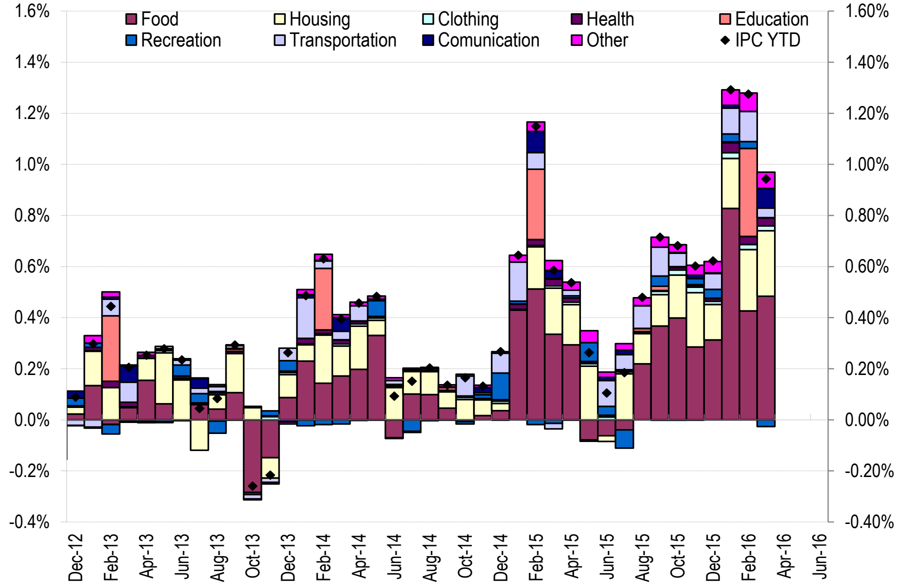
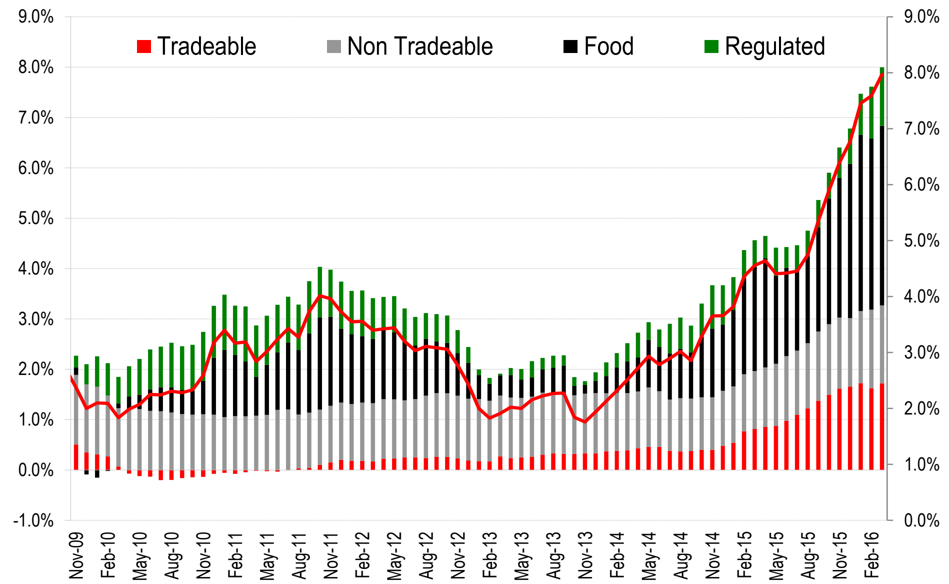
- Inflation has increased from below 3% to nearly 8% in a little over a year. The increase has been driven by food, tradables, and utilities, as well as core items.
- Core inflation has moved from 3.09% in February 2015 to 6.23% currently. Capacity utilization remains high and unemployment low. Inflation diffusion, indexation, and expectations remain high.
- **Outlook:**
  - Food and tradables should reverse course in 2H16, in our view, but likely at a slower pace than predicted by the Central Bank. Core inflation, in contrast, should continue to remain sticky, in our opinion, as the high previous inflation works its way through the economy, especially in the areas of rents and other indexed items.
  - We forecast inflation will end the year above 6% vs. the current level of 7.98%. More than 2 percentage points above the ceiling of the Central Bank’s 2-4% target. The path back below 4% in 2017 is uncertain and requires a pro-active monetary policy stance.



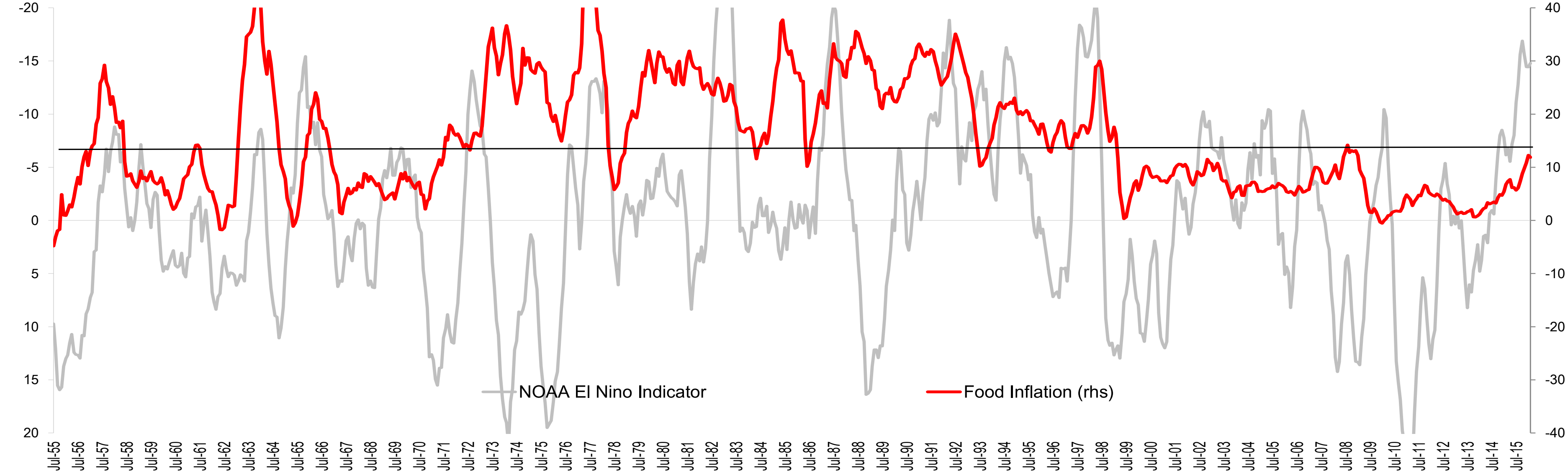
	Date	MoM		YoY	
		Last	Prior	Last	Prior
CPI	Mar-16	0.94%	1.28%	7.97%	7.59%
Average 3 Cores	Mar-16	0.61%	1.26%	6.23%	6.01%
Non Tradeable	Mar-16	0.25%	1.44%	4.83%	4.86%
Tradeable	Mar-16	1.00%	0.75%	7.38%	6.97%
Food	Mar-16	1.62%	1.44%	12.35%	11.86%
Regulated	Mar-16	0.96%	1.45%	7.24%	6.35%

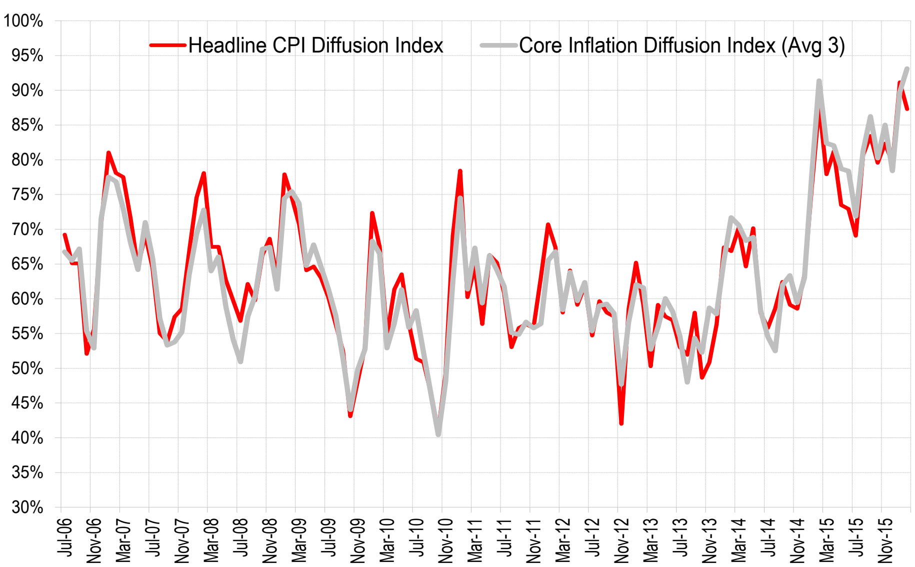


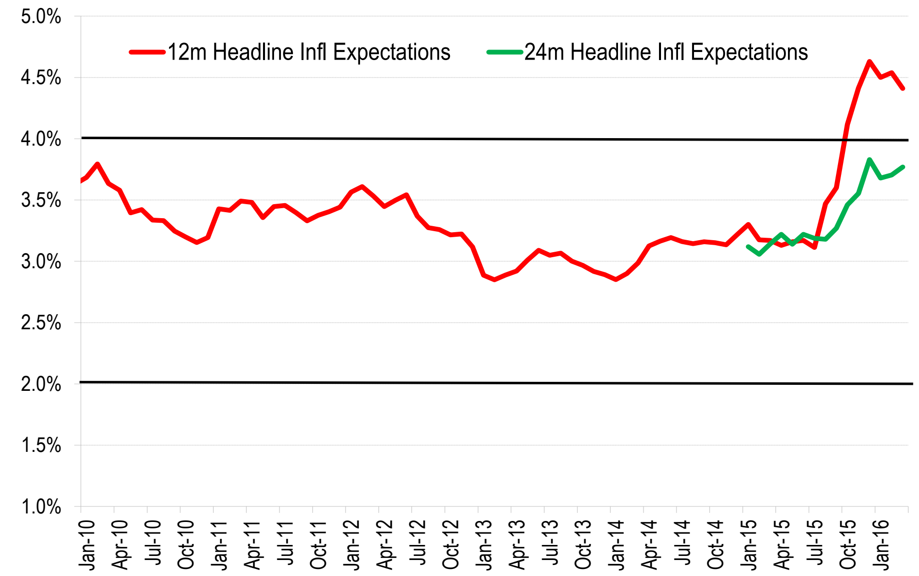


Sources: DANE, BanRep, Santander.

Colombia Economics: Inflation

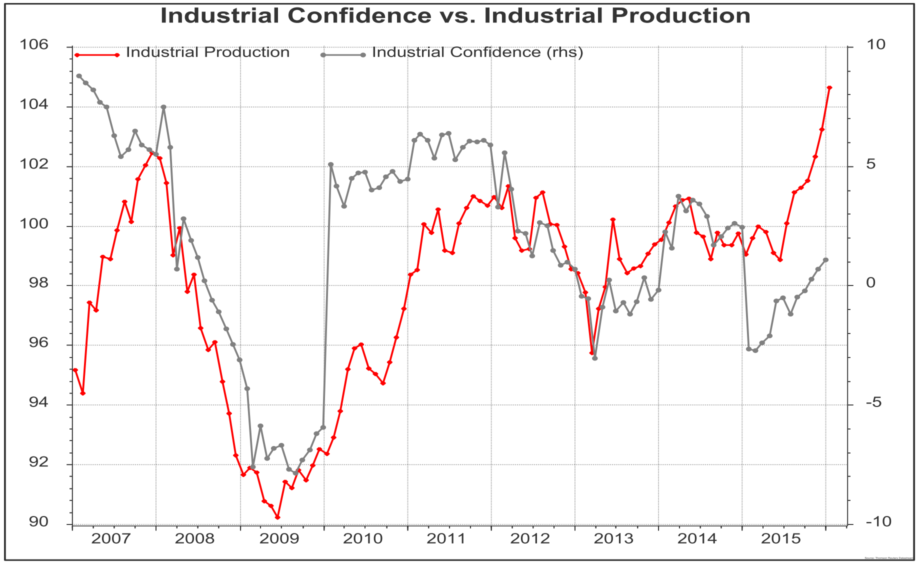


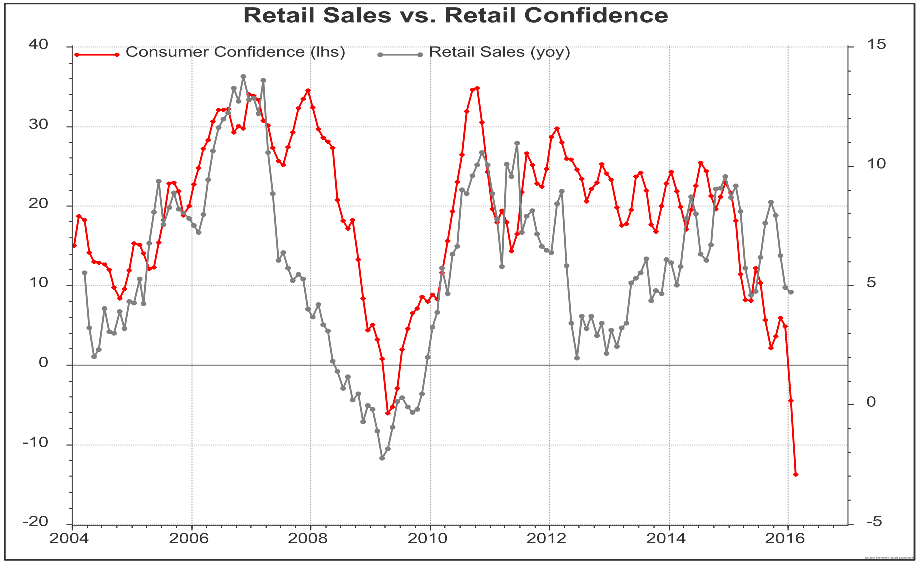


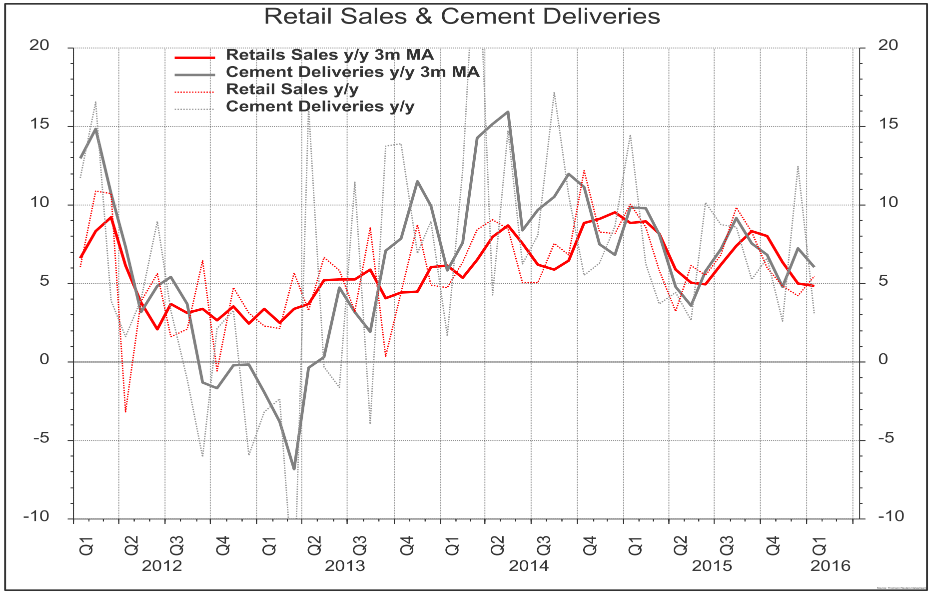


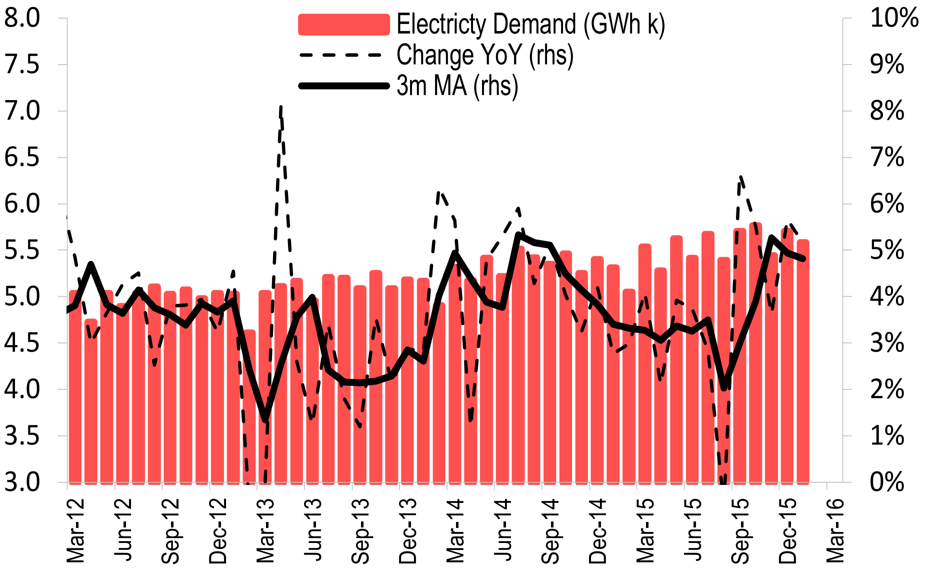
Sources: Bloomberg, DANE, BanRep, Santander.

- Despite the drop in confidence, as yet, neither high-frequency activity nor labor force data confirm a large drop in household spending (65% of GDP).
- Government consumption and investment will likely be the focal points of economic weakness in 2016, in our view, followed by private investment.
- **Downside risks**, in our opinion, stem from setbacks in infrastructure projects and further declines in oil production, funding pressures, as well as a potential sentiment-driven consumer retrenchment and weather-related disruptions.
- We see the following as **upside risks:** (1) further gains in confidence based on higher oil prices; (2) the potential success of a peace deal; and (3) higher growth among trading partners.
- We forecast GDP growth of 2.8% this year, below the recent average but quite solid vs. regional peers.

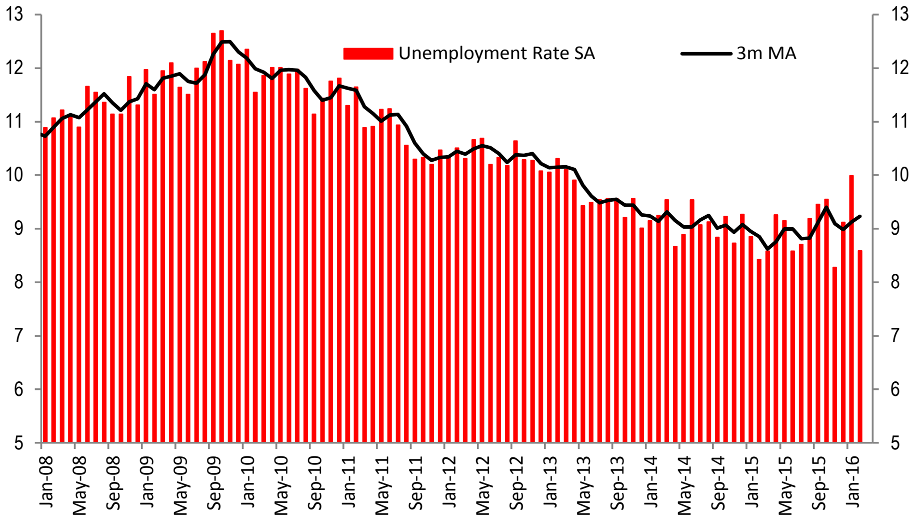


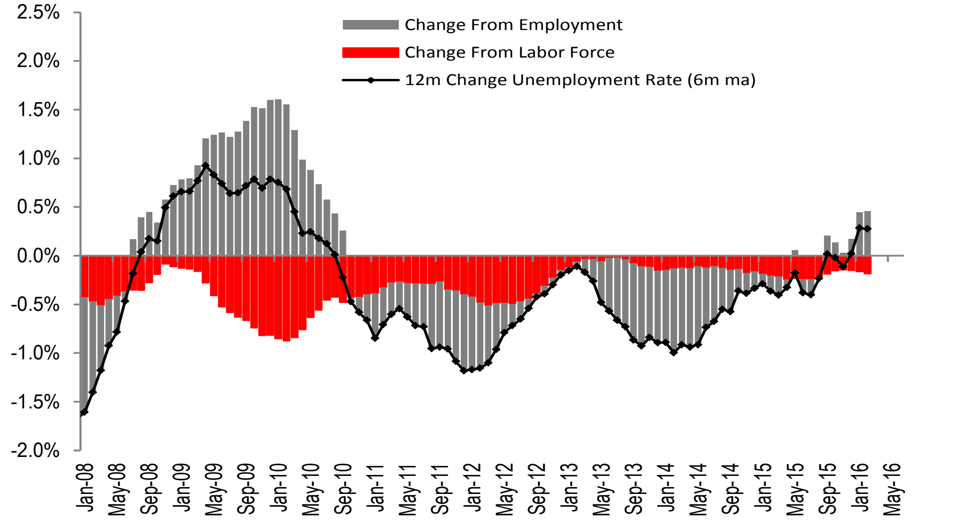


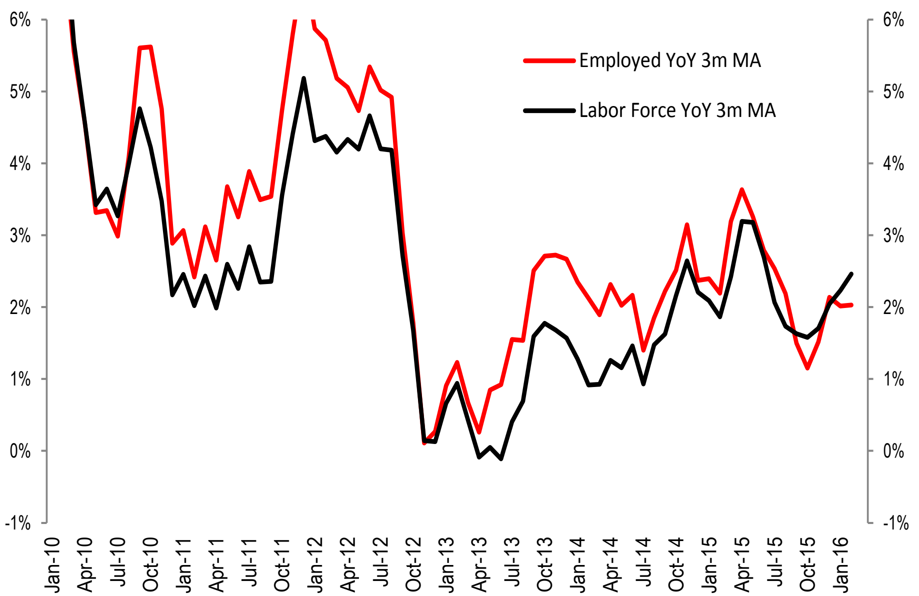




Sources: Bloomberg, DANE, BanRep, Santander.







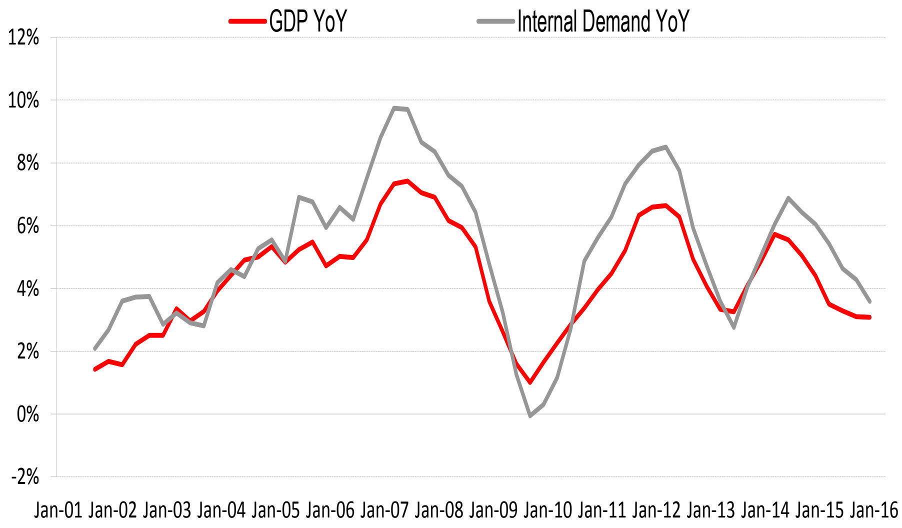
Sources: Bloomberg, DANE, BanRep, Santander.

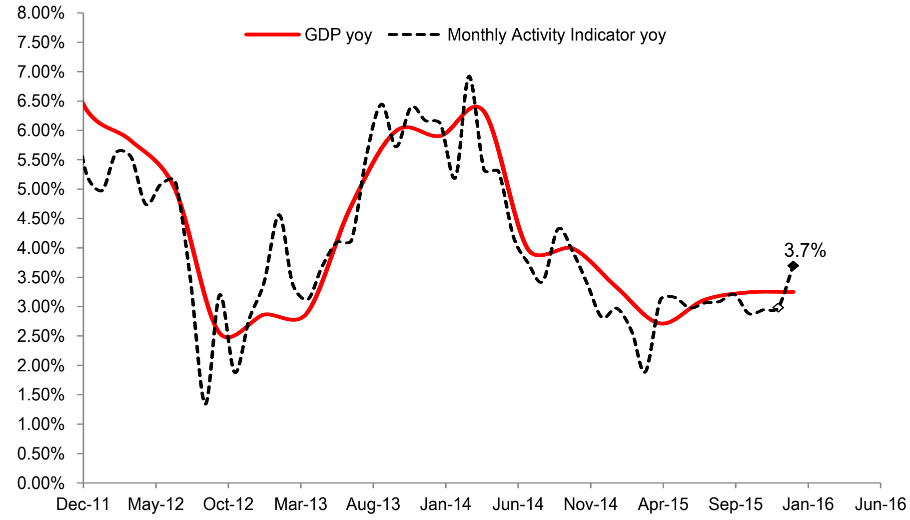
Colombia Economics: GDP

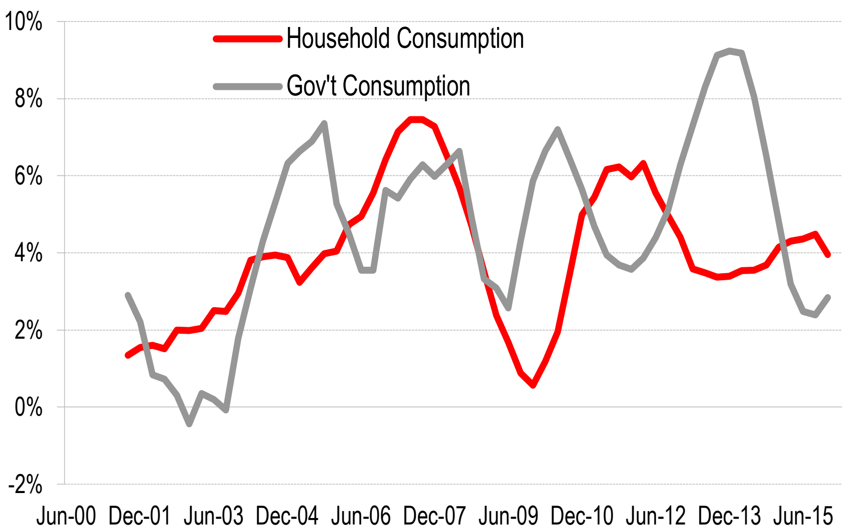
	2014					2015				
	1	2	3	4	Year	1	2	3	4	Year
GDP	**6.3%**	**4.0%**	**4.0%**	**3.3%**	**4.4%**	**2.7%**	**3.1%**	**3.2%**	**3.3%**	**3.1%**
Internal Demand	**6.9%**	**6.3%**	**5.6%**	**5.4%**	**6.0%**	**4.4%**	**3.1%**	**4.2%**	**2.6%**	**3.6%**
Final Consumption	**4.7%**	**3.9%**	**3.9%**	**4.7%**	**4.3%**	**4.1%**	**3.7%**	**4.4%**	**3.6%**	**3.9%**
Households	3.7%	3.6%	3.9%	5.4%	**4.1%**	4.3%	3.8%	4.4%	3.3%	**4.0%**
Government	8.3%	5.1%	3.6%	2.2%	**4.8%**	1.9%	2.2%	3.3%	4.0%	**2.8%**
Non Durables	2.9%	2.4%	3.0%	4.4%	**3.2%**	4.4%	4.1%	4.6%	3.4%	**4.1%**
Semi Durables	1.8%	2.6%	1.6%	6.5%	**3.1%**	5.7%	2.8%	5.6%	4.5%	**4.7%**
Durables	5.2%	11.0%	16.3%	21.0%	**13.4%**	5.1%	1.4%	-4.8%	-8.4%	**-1.7%**
Services	5.1%	4.5%	4.4%	4.6%	**4.7%**	4.4%	4.2%	4.5%	3.7%	**4.2%**
Capital Formation	**12.8%**	**16.2%**	**10.2%**	**7.7%**	**11.7%**	**6.5%**	**0.8%**	**3.4%**	**0.2%**	**2.7%**
Fixed Capital Formation	10.4%	8.4%	11.4%	8.8%	**9.8%**	7.3%	3.6%	0.5%	0.0%	**2.8%**
Agropecuario	2.3%	0.2%	1.4%	2.0%	**1.5%**	-5.4%	-3.0%	0.2%	2.7%	**-1.4%**
Machines and Equipment	8.4%	2.7%	8.7%	8.8%	**7.1%**	0.6%	-2.0%	-0.3%	-5.3%	**-1.7%**
Transportation Equipment	-1.5%	5.5%	13.2%	20.7%	**9.5%**	41.3%	6.0%	3.1%	-5.1%	**11.3%**
Construction and Buildings	7.0%	1.0%	15.2%	7.5%	**7.7%**	2.3%	10.1%	-8.2%	8.0%	**3.0%**
Civil Works	27.6%	16.0%	8.8%	5.3%	**14.4%**	3.7%	7.2%	7.6%	2.5%	**5.2%**
Services	12.3%	9.6%	13.7%	8.6%	**11.1%**	1.9%	4.6%	-3.3%	0.7%	**1.0%**
Exports	**2.6%**	**-11.3%**	**4.9%**	**-0.1%**	**-1.0%**	**4.1%**	**-0.2%**	**-5.2%**	**-1.0%**	**-0.6%**
Imports	**7.9%**	**3.7%**	**6.7%**	**12.8%**	**7.8%**	**12.3%**	**-0.7%**	**7.4%**	**-2.9%**	**4.0%**
GDP	**6.3%**	**4.0%**	**4.0%**	**3.3%**	**4.4%**	**2.7%**	**3.1%**	**3.2%**	**3.3%**	**3.1%**

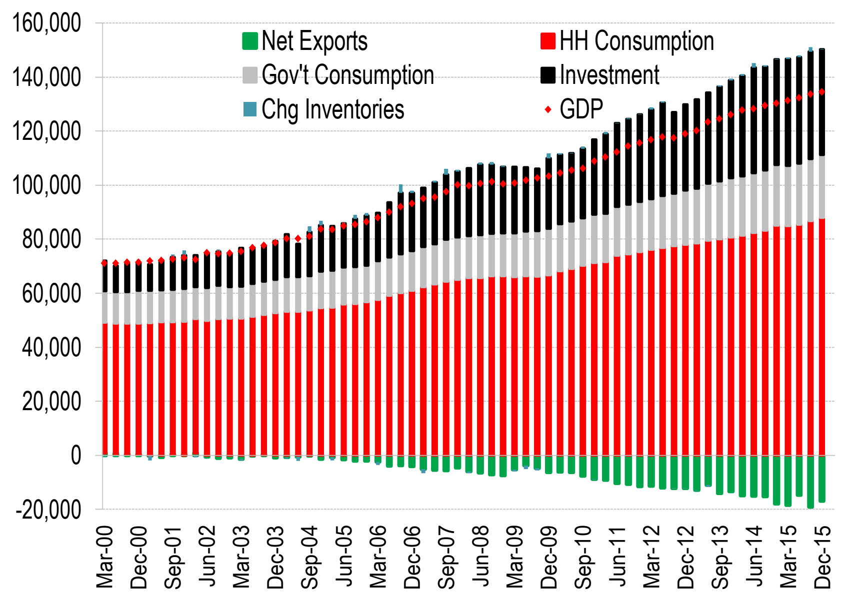
Sources: Bloomberg, DANE, BanRep, Santander

Colombia Economics: GDP









Sources: Bloomberg, DANE, BanRep, Santander

- The current account deficit of US$18.9 billion, or 6.5% of GDP, is driven by a US$18 billion trade deficit.
- The basic balance deteriorated in 2015 from a surplus of US$4.5 billion to a deficit of US$1.4 billion.
- For 2016, we forecast a relatively unchanged CA deficit of US$18 billion. However, we see it as well covered by capital inflows based on the sale of state-owned ISAGEN.
- This is a one-off sale, however, and thus we think the market will be looking for signs that the CA deficit can stabilize and improve 2016. In this respect, the passage of a comprehensive tax reform in 2H16 will be key, in our view. We believe any delay or watering down of said reform could lead to the entrenchment of external and fiscal vulnerabilities and the deteriorating ratios that they engender, potentially leading to sovereign ratings downgrades.

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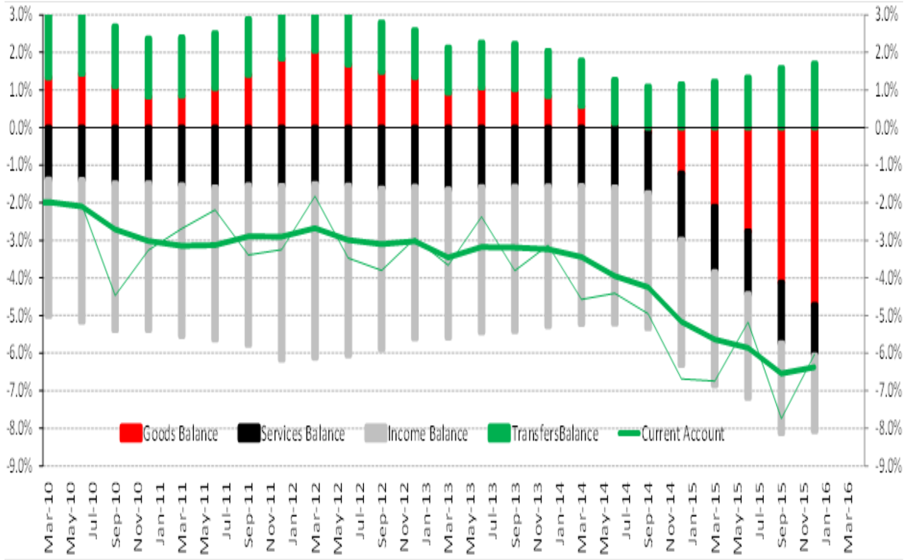
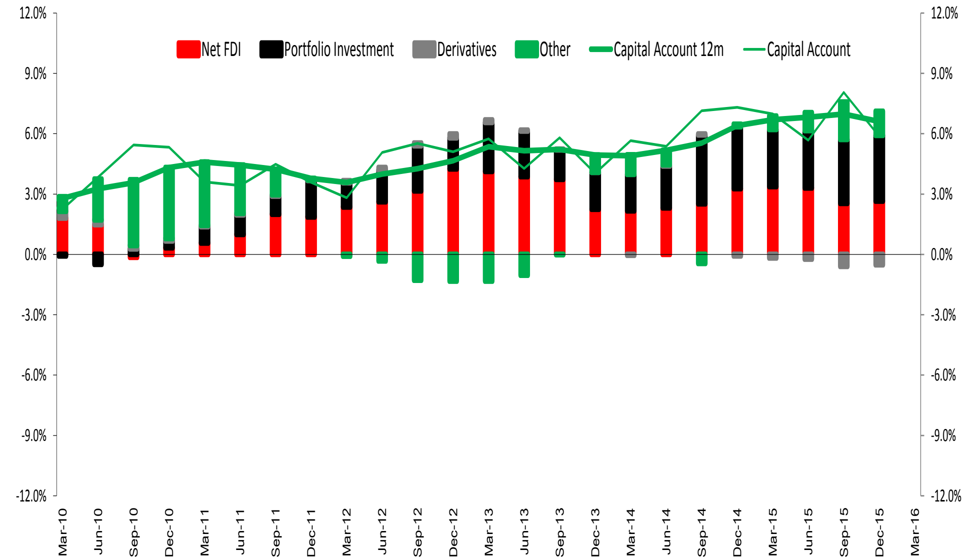
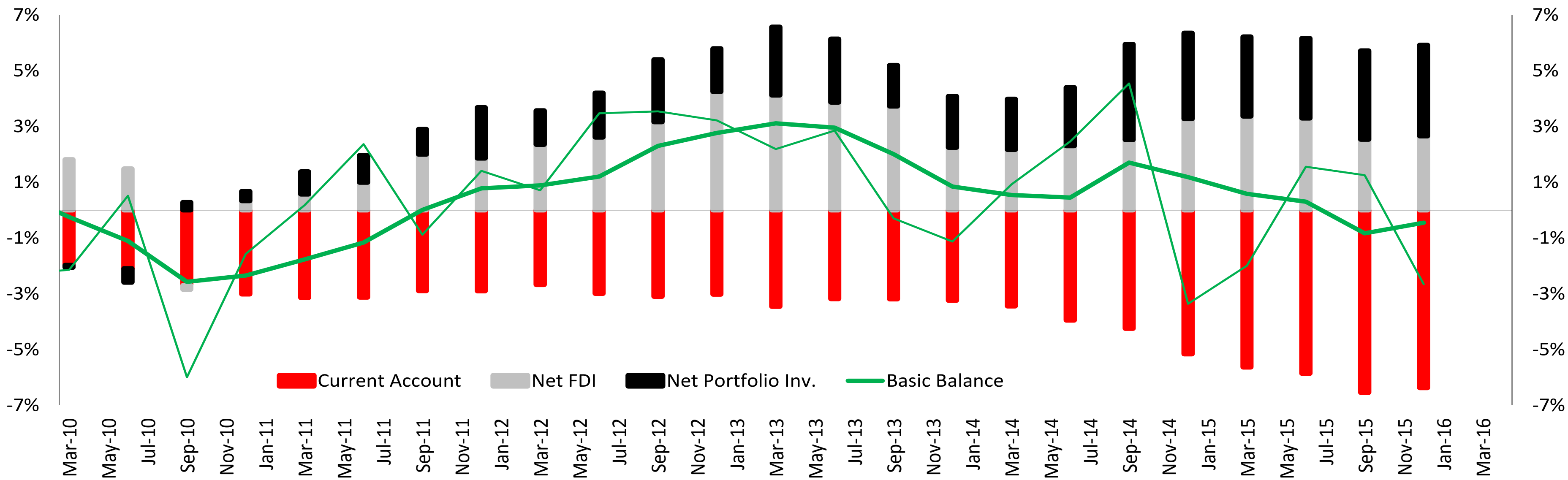






Sources: Bloomberg, DANE, BanRep, Santander

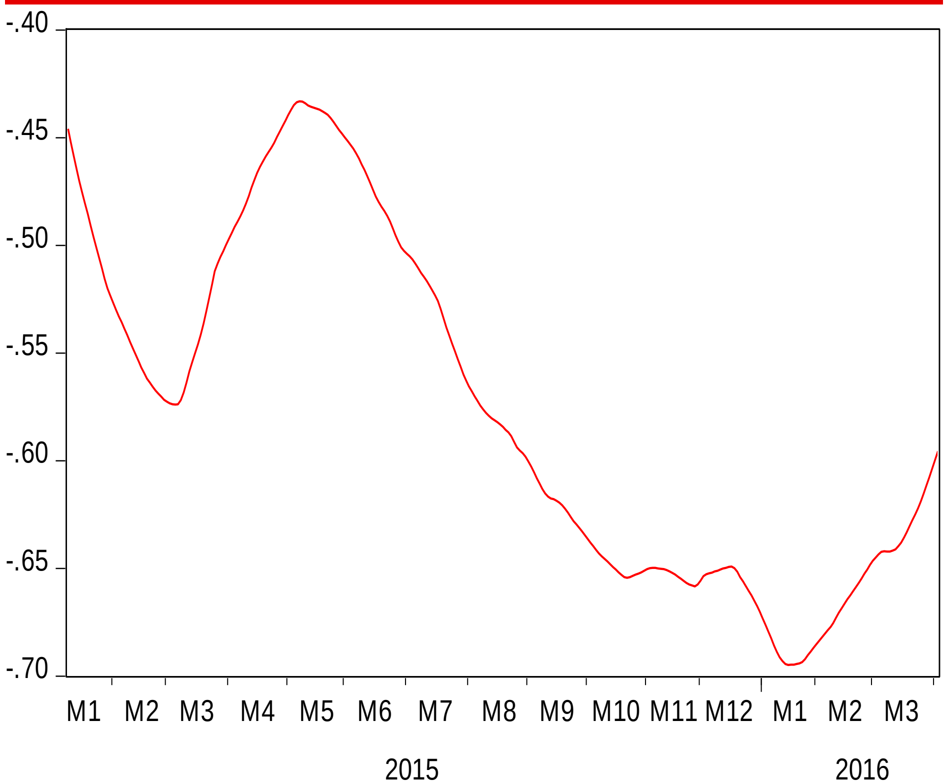
	Current Level	Change (%)		Expected Trend	
	5-Apr-16	Last 1m	Last 3m	1m	3m
USD/COP	3066	-2.9%	-2.9%	↗	↗
CLP/COP	4.54	-3.2%	0.9%	→	↗
MXN/COP	174	-2.5%	-5.9%	→	↗
BRL/COP	846	-0.8%	5.6%	→	↗

- The rally in oil has made the COP the second best performer in LatAm FX in 2016, after the BRL. Barring additional oil upside, we expect the COP's outperformance to fade going forward and look for underperformance starting in June, after ISAGEN-related inflows have abated.
- From a valuation standpoint, the COP looks fair, in our view, but we think higher inflation, twin deficits, and liquidity injections suggest the likelihood of further devaluation in 2H16. A weaker COP remains the only adjustment mechanism for the economy, given that, in our view, neither monetary nor fiscal policy can adopt anti-cyclical stances in the face of a slowing economy.
- Upside risks include a continued rally in oil markets, or an improvement in sentiment on the back of the passage of a peace deal. In contrast, further ratings actions arising from a delay of tax reforms represent downside risks.

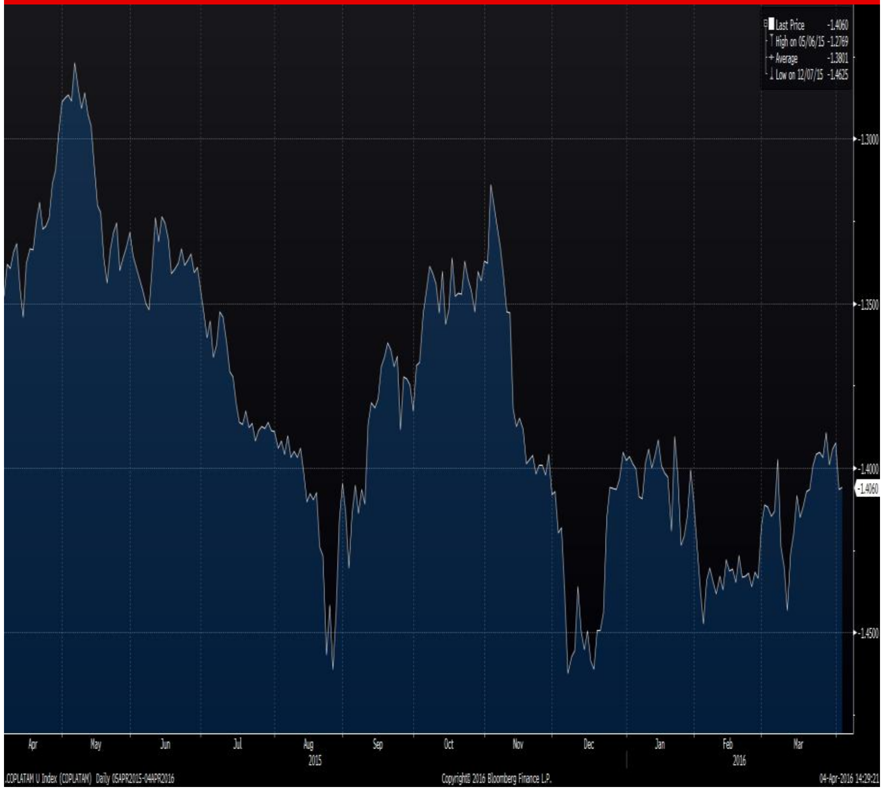
Colombia Markets: FX Near-Term Drivers

- Correlation with oil is still strong, though off the most extreme level levels seen in January.
- Relative performance vs. peers has been range bound, despite the outperformance of COP rates markets.

USD/COP Correlation with Oil



COP performance vs. LatAm FX

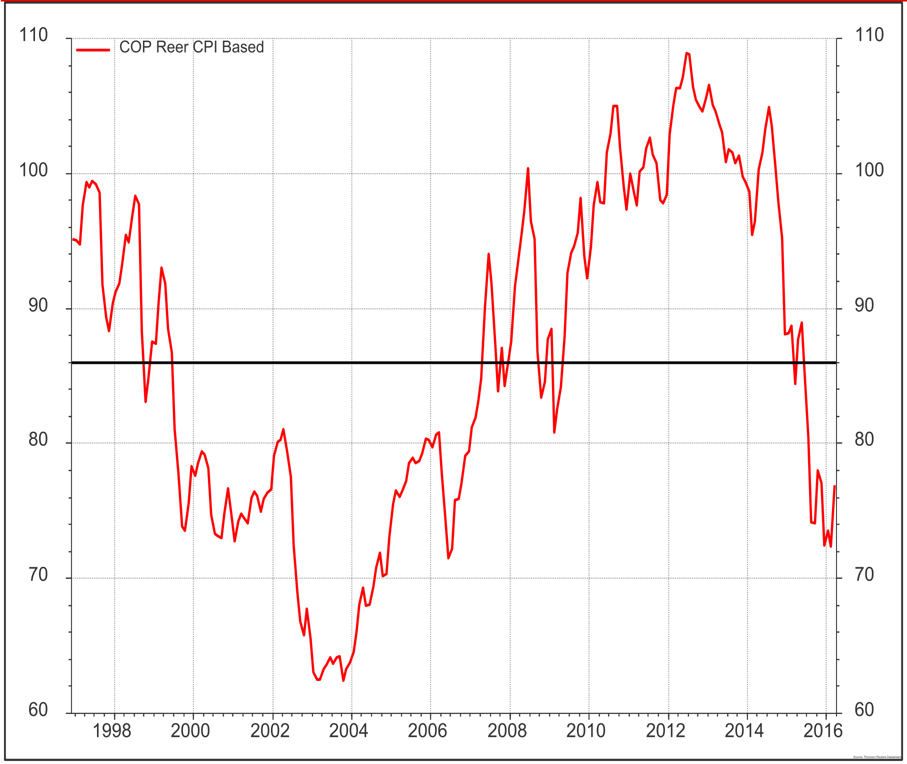


Sources: Bloomberg, DANE, BanRep, Santander.

- The COP's real exchange rate is 18% below its 10y average, the biggest discount in LatAm after Brazil; however, at 10% below its 20y average, the REER is at less of a discount than Brazil and Mexico and is tied with Chile.

Deviation from 10y Average REER

REER vs. 20y Average Level



Sources: Bloomberg, DANE, BanRep, Santander.

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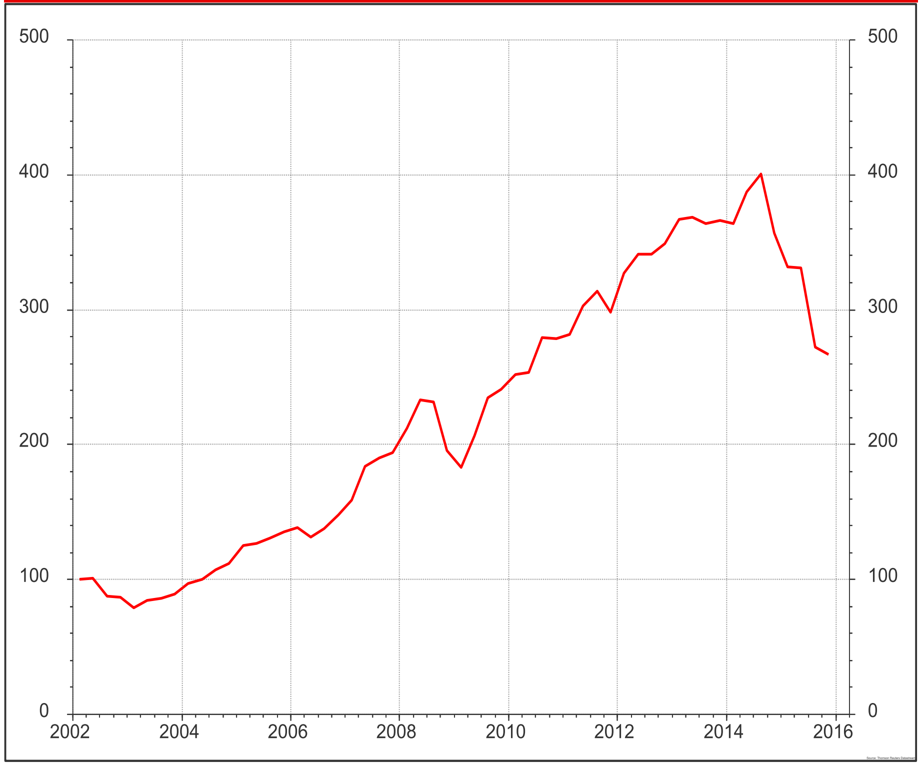
Colombia Markets: FX Valuation II

- Local asset prices such as real estate are not particularly cheap by historical standards, according to our calculations.
- External debt as a percentage of GDP is growing quickly, creating more demand for U.S. dollars going forward and higher vulnerability to a funding squeeze, in our view.

Local Real Estate in USD Terms (2002=100)



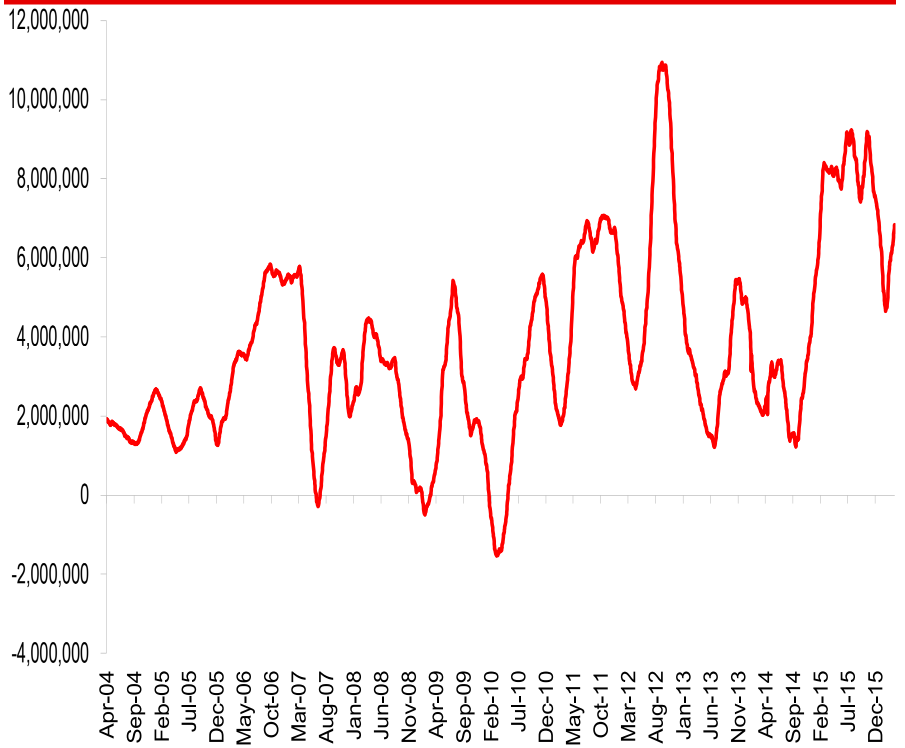
External Debt as % of GDP

Sources: DANE, BanRep, Santander.

- M0 and the monetary base are growing at around 20% and BanRep continues to inject liquidity into the system via open-market operations and outright purchases of TES bonds.
- While this strategy may help to avoid a large contraction in credit, we believe it will be to the detriment of inflation and the currency. We expect a weaker COP in 2H.

Monetary Base Growth (y/y %)

Open-Market Operations



Sources: DANE, BanRep, Santander.

Colombia Markets: Rates—Summary of Views

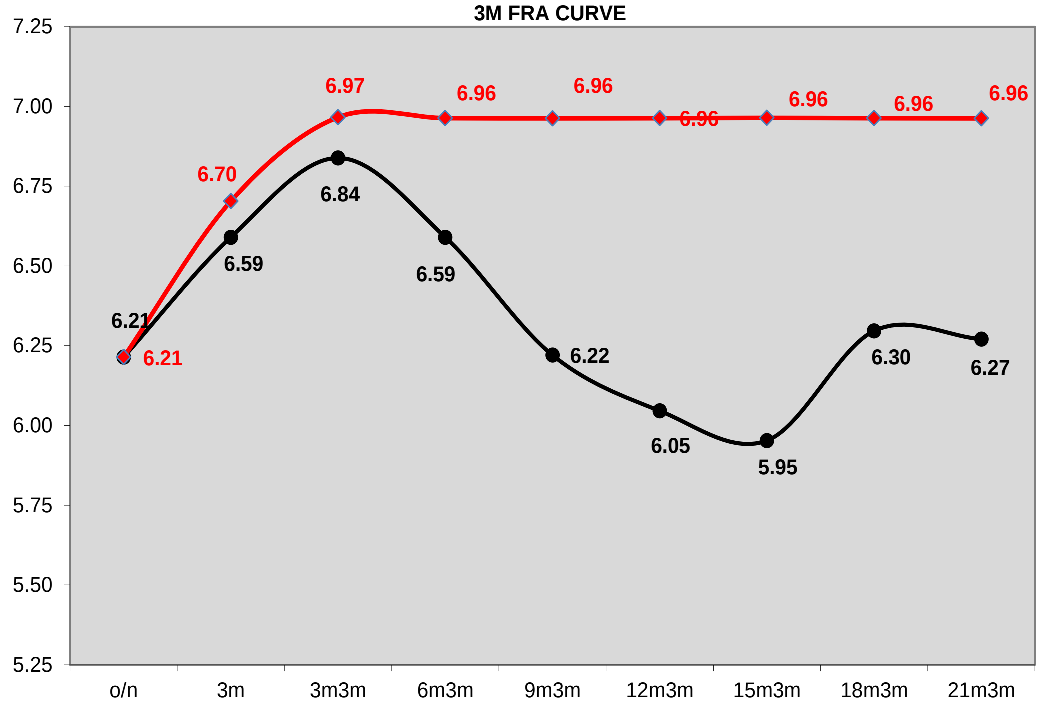
	Current Level	Change (bp)		Expected Trend	
	5-Apr-16	Last 1m	Last 3m	1m	3m
Reference Rate	6.50	25	75	↗	↗
Overnight IBR	6.21	23	66	↗	↗
3m IBR Fix	6.50	17	61	↗	↗
2y IBR	6.25	-9	-16	↗	↗
5y IBR	6.47	-35	-42	↗	↗
10y IBR	7.02	-57	-59	↗	↗
TES 18	7.11	-39	-32	↗	↗
TES 24	7.90	-68	-52	↗	↗
TES 30	8.37	-76	-84	↗	↗
2s10s slope	0.77	-49	-43	→	→

- The rally in COP rates in 2016 has been the most pronounced among major LatAm peers (ex Brazil). A large flattening has ensued in the face of consistent hikes by BanRep.
- **Money markets and front end:** Pay 1y IBR. BanRep may hike more than the 50 bps priced, and once done with its cycle we believe it will not be able to provide the cuts that are currently priced into the 6m6m IBR swap curve.
- **Long end:** The long end has outperformed due to its "high beta" status and a supportive technical position. Going forward, the scope for outperformance vs. LatAm will be more based on carry than further valuations, in our view.
- **Curve:** The curve should flatten further on the back of a more aggressive BanRep. However, after the more than 50 bps of flattening year to date, the curve is vulnerable to steepening in the near term due to an increased risk perception.

Colombia Markets: Rates—Front-End Pricing Cuts Too Early

- Near-term hiking risks remain to the upside, in our view, with BanRep potentially having to hike beyond 7.25%; however, the market is starting to price cuts as early as late summer. Our recommendation: Pay 1y or 9m IBR.
- Sticky core inflation will not allow BanRep to cut rates until 1Q17 at the earliest, in our view.

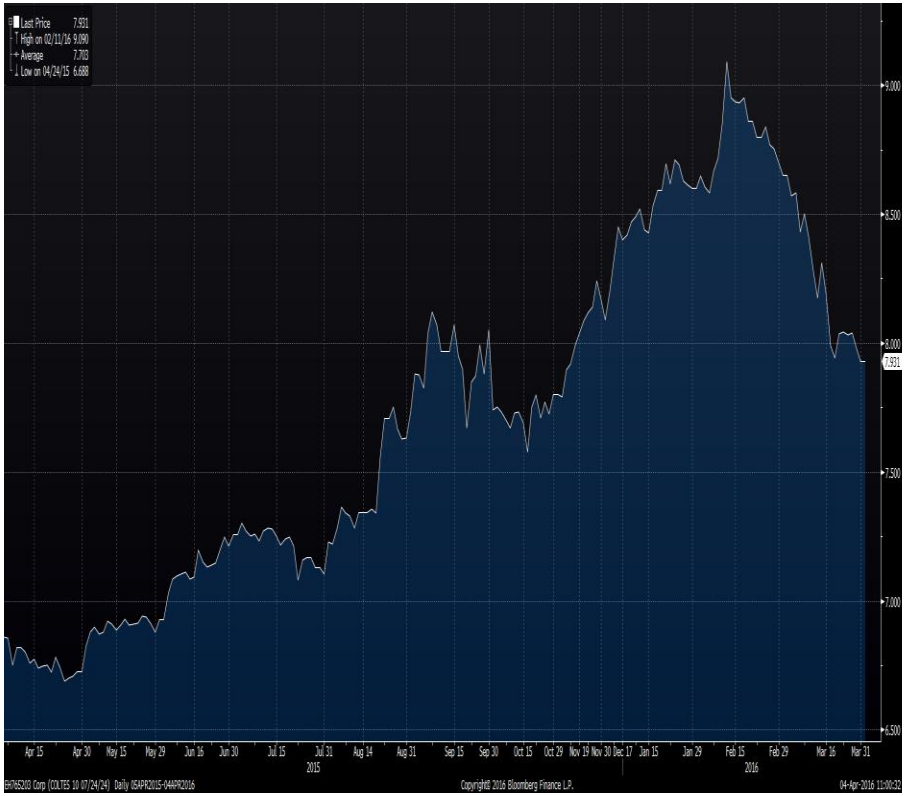
Meeting	Santander Forecast	Market Pricing	Difference bps
29-Apr-16	25	25	0
27-May-16	25	25	0
22-Jun-16	0	0	0
29-Jul-16	0	0	0
31-Aug-16	**0**	**-25**	**25**
30-Sep-16	0	0	0
28-Oct-16	**0**	**-25**	**25**
25-Nov-16	0	0	0
16-Dec-16	0	0	0
27-Jan-17	**0**	**-25**	**25**
24-Feb-17	**0**	**-25**	**25**



Sources: Bloomberg, Santander.

Colombia Markets: Rates—Long End

- Long-end rates have exhibited a highly “risk directional” performance.
- Colombian rates were the worst performer in LatAm until the February 11 S&P and oil bottom; since then, they are the second best performer, nearly tied with Brazil despite the absence of the positive political developments that have characterized the local rates tightening in Brazil.
- Around two months of widening were reversed in a little more than a month (from 9.00% to 8.00% on TES 24), indicating to us that the technical position was highly supportive with many participants underweight.



Sources: Bloomberg, Santander.

- The rally in TES has been driven by around 60 bps in breakeven inflation compression and 50 bps in real rate compression.
- Spread compression of 100 bps vs. MBONO has occurred via real rate compression and BEI compression to the same degree (50 bps tightening in real rates and CDS) and 50 bps of tightening in implied inflation.
- The tightening in CDS began despite S&P's adopting a negative outlook on the Colombian sovereign on February 16, indicating, in our view, that the recovery in oil was the main driver of improving sentiment.

Sources: Bloomberg, Santander.

LatAm Macro, Fixed Income & FX Strategy

Brazil

Key Themes in Brazil

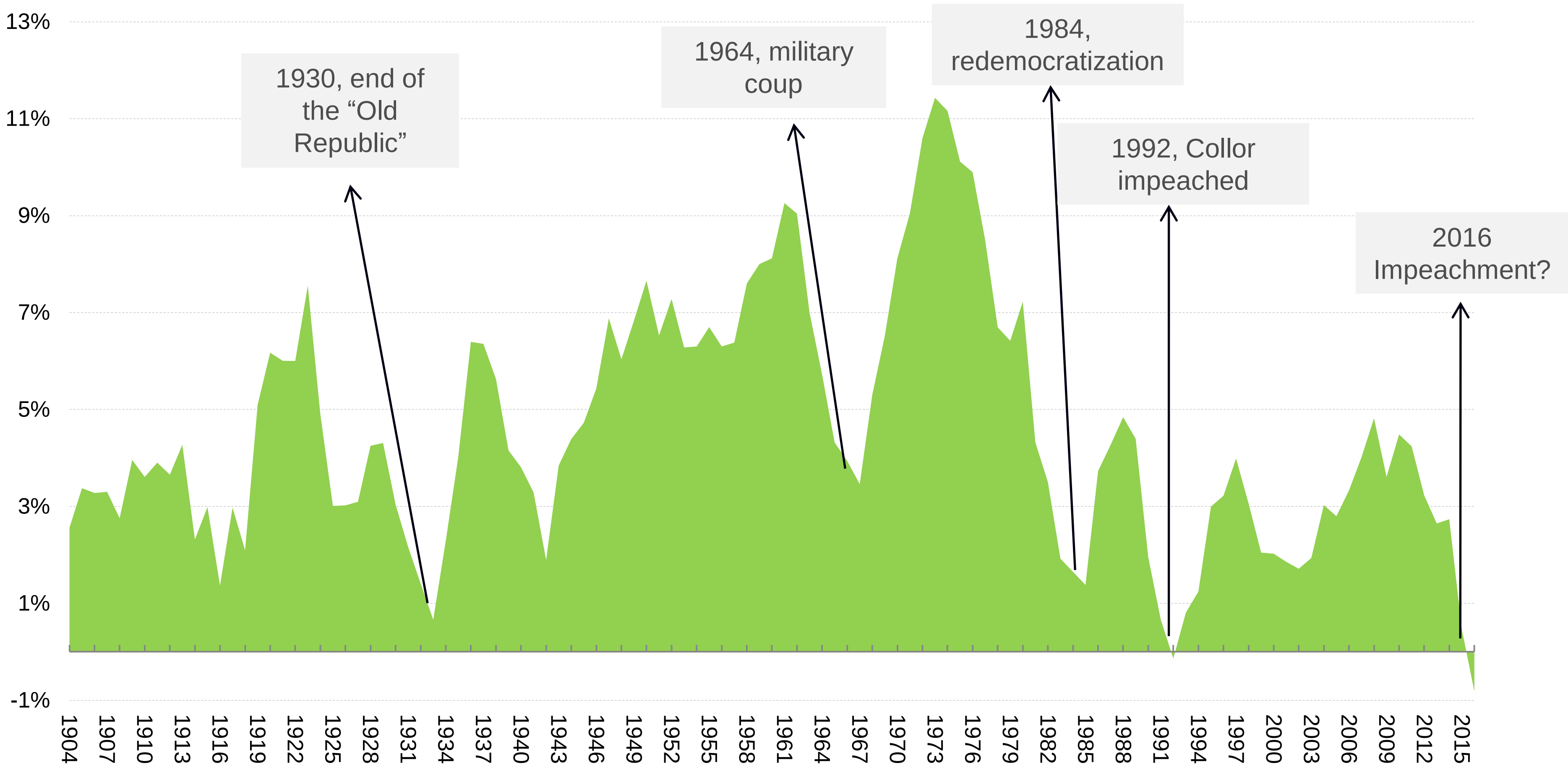
- **Caretaker government:** The change in the political side will help rebuild confidence and resume growth. Not going from one extreme to the other.

- **Turning point?:** Political changes will bring forward the rally and improvements in the margin in economic indicators to help sentiment.

- **Improving expectations, easing to come:** Central bank to start cutting rates in 2H amid strong recession and improvement in inflation expectations. Fiscal policy to continue unsupportive. No SSA reform.

- **Unwinding FX swaps & BRL:** The central bank has been aggressively reducing the size of the FX swaps program. BRL has an appreciation bias.

Brazil: Strong Economical Cycle has Brought Political Changes



■ **Brazil GDP Growth, 5y average annual rate**

Source: Angus Maddison (until 1947), IPEA, Santander estimates

Brazil: Time table for Impeachment Process

The Process in the Senate

Lower House vote

- Lower House representatives vote on whether they authorize the Senate to start an impeachment process; **342 votes (2/3 of the 513 Lower House representatives) required for authorizing it**
  - *Timing: 48h after the approval of the report at the Special Commission level; 1 to 3 sessions*

Likely date: mid- to end-April (best guess: Apr 14 to 18)

Senate receives it

- The President of the Senate receives the authorization of the Lower House and creates a Special Commission to analyze the matter; the report is submitted to a floor vote on which **simple majority** (50% + 1 of those attending) is sufficient to start the impeachment trial
  - *Timing: up to 10 sessions*

Likely date: end-April to early May

Official start

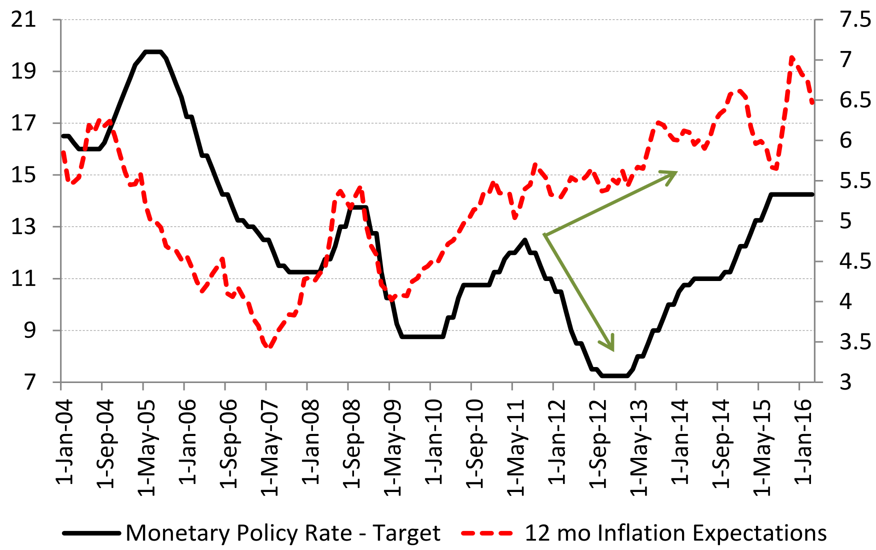
- The impeachment trial is officially started: upon communication by the Senate, **the President leaves office and is replaced by the next-in-line** (Vice-President → Lower House Speaker → President of the Senate → President of the Supreme Court)

Likely date: end-April to early May (best guess: May 6)

The Senate has up to 180 days to hold a trial, led by the President of the Supreme Court and with defense and accusation rites, and decide whether the President is in fact impeached and to define any additional sanction (inelegibility for public positions for a period, for instance)

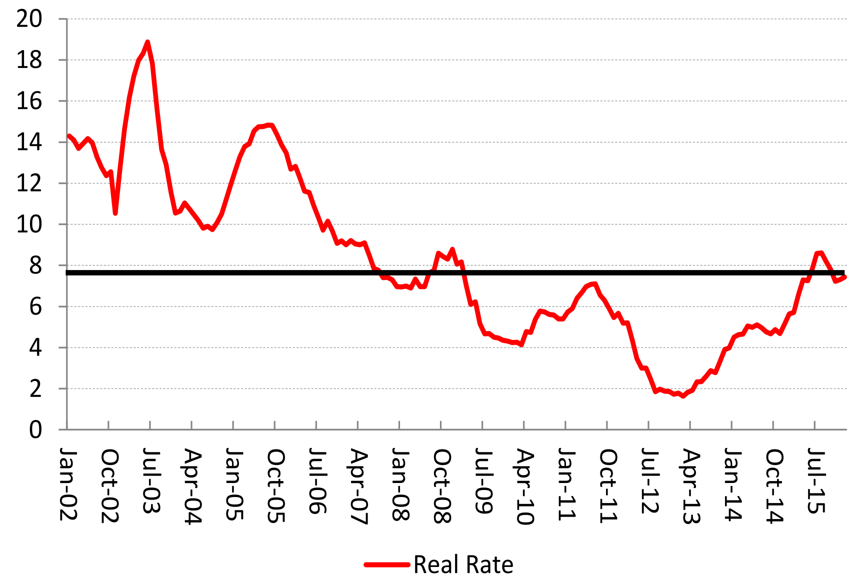
Brazil: Time to Ease, but when?

Expectations starting to align with monetary policy



Source: BCB and Santander

One of the highest real rates in EM

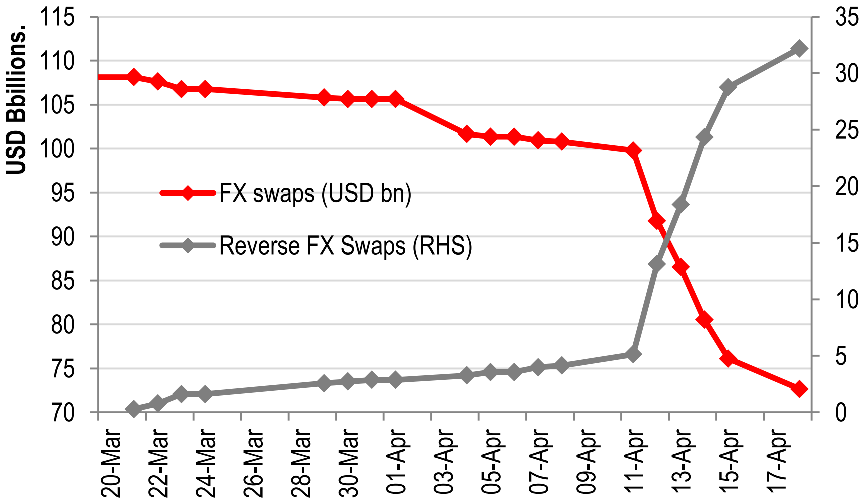


Source: BCB and Santander

- The convergence of expectations will align with the BCB intention to start cutting rates this year. Uncertainty with regards to the timing.
- Fiscal consolidatation is still needed to favor the taks of the central bank.
- With the incoming easing cycle and the contraction in inflation expectations, real rates should start decreasing.

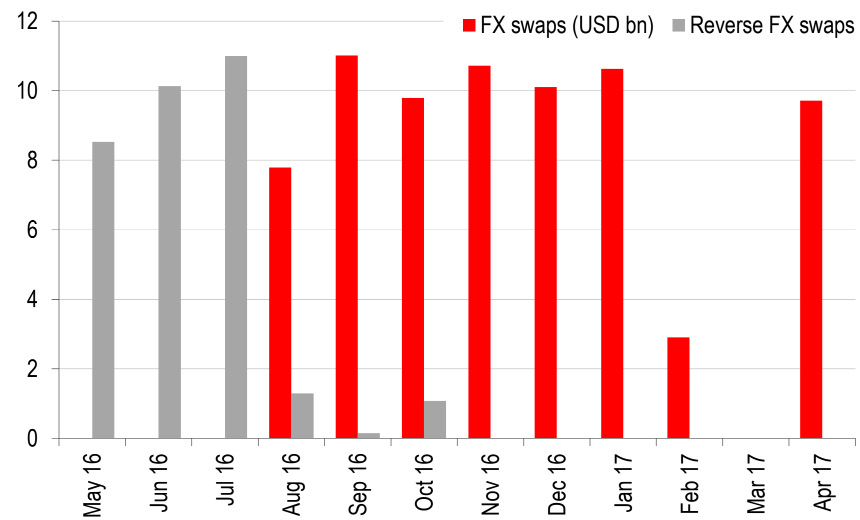
Brazil: Aggressive FX intervention

Time line of USD buying by BCB



Sources: Bloomberg and Santander.

FX swaps maturities outstanding



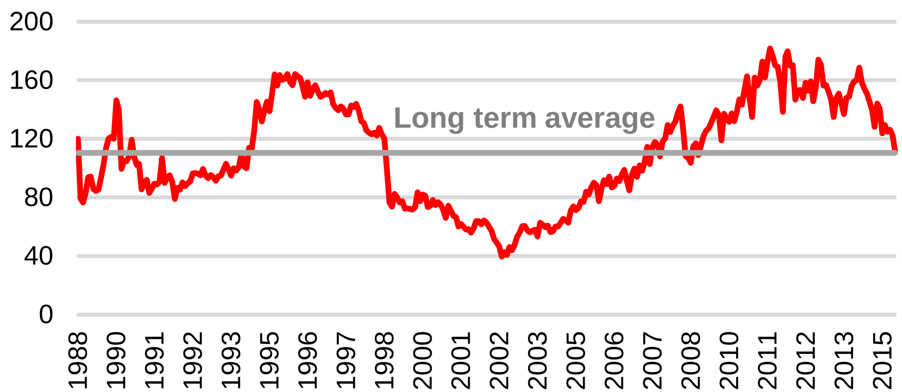
Sources: Bloomberg and Santander.

- We believe the BCB will eventually reduce the pace of its intervention, but this may take some time. In our view, the aggressive USD buying of recent weeks has been opportunistic, designed to reduce the size of the original US$108 billion hedge to US$73 billion.
- The dovish tone of the BCB evidenced by the minutes of the previous COPOM meeting, supported domestic bond buying that has, on the whole, been supportive for BRL.

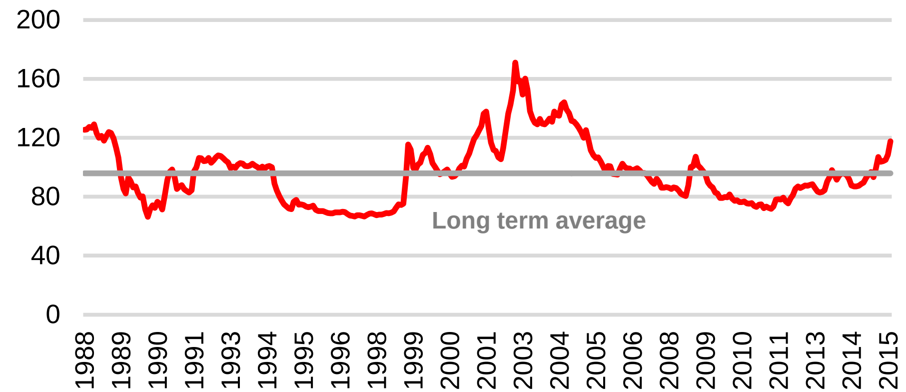
Brazil: Healthy FX correction

BRL may be close to its long term value

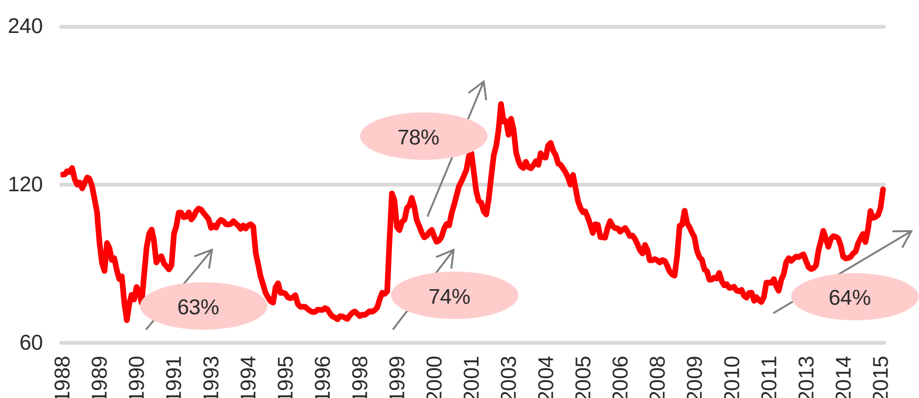
Brazil Unit Labor Costs, USD, Index (Jun'94 = 100)



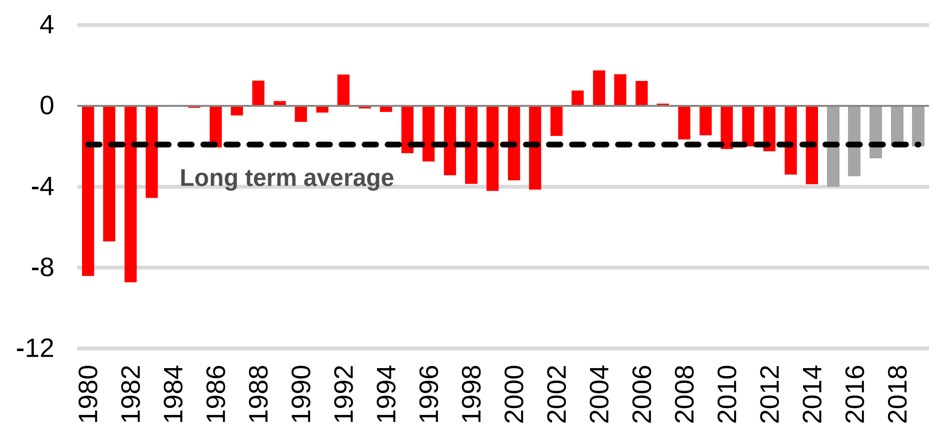
Brazil real effective exchange rate, Index (Jun'94 = 100)



Brazil real effective exchange rate, log scale



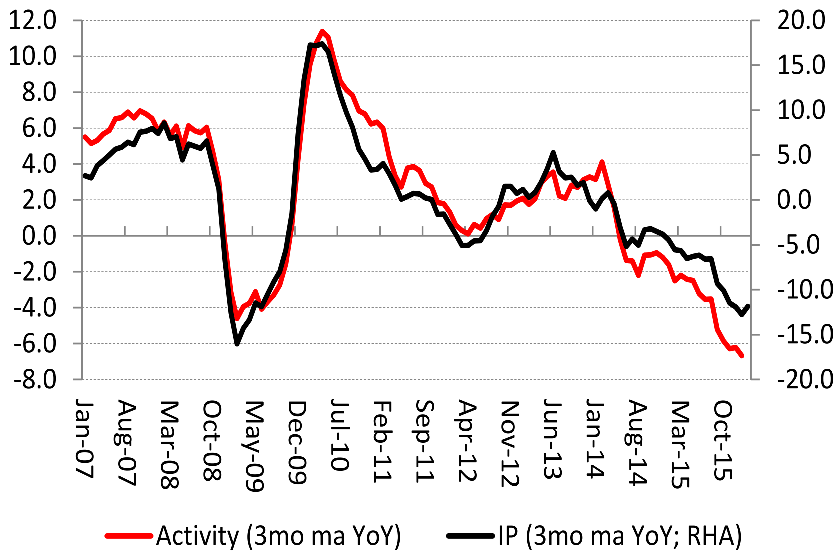
Brazil, current account balance (% of GDP)



Source: Brazil Central Bank, Santander estimates

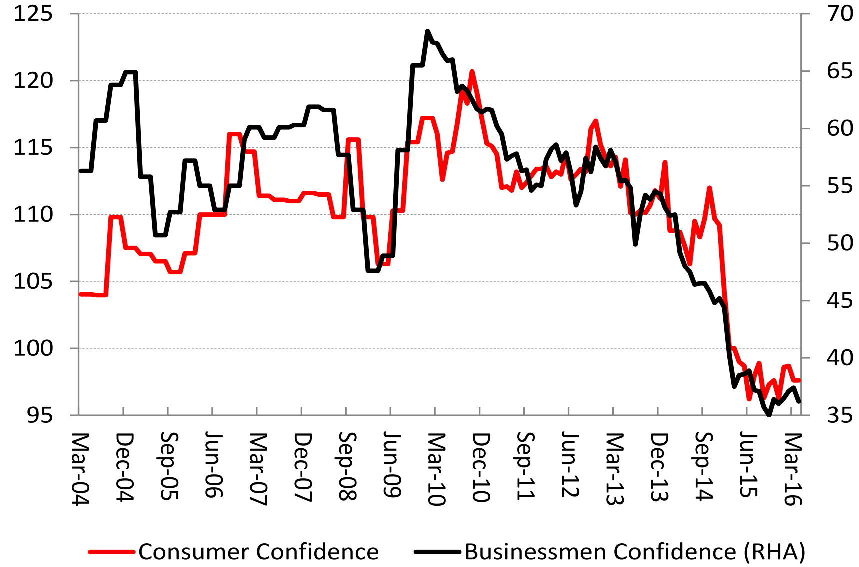
Brazil: Challenge Going Forward Relies in Activity and Confidence Recovery…

Deep contraction in economic activity…



Source: Bloomberg and Santander

Bottoming in confidence?

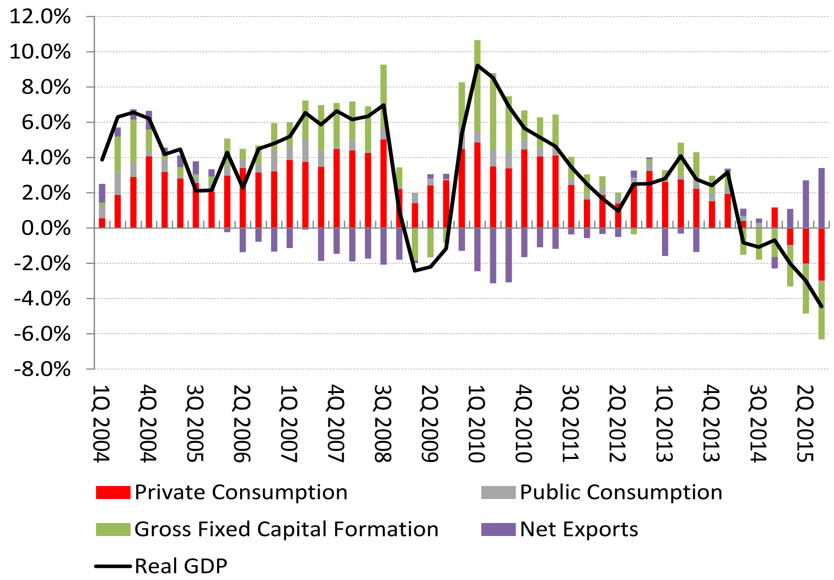


Source: Bloomberg , CNI, FGV & Santander

- Economic activity deceleration is not solely a Brazilian event, it is spread throughout EM economies.
- A fundamental part of the recovery will come from rebuilding confidence and the fiscal adjustment plays a key part. Change in government could provide a rebound in confidence and the recovery of activity.
- Sentiment to improve in 2H 16.

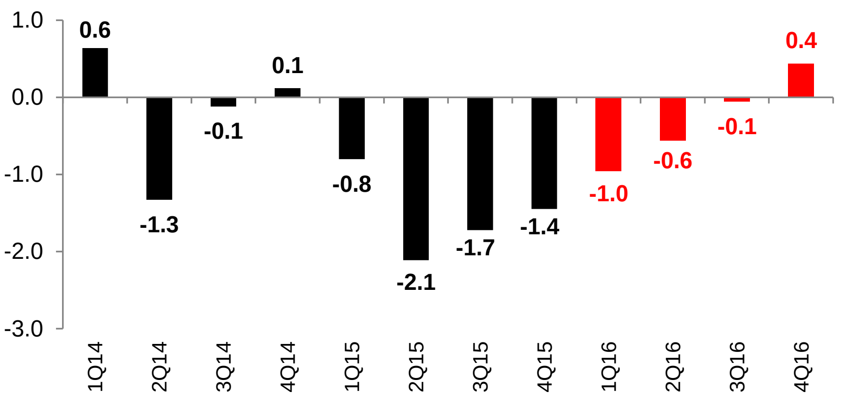
Brazil: Still a bad year in 2016

Deep contraction in economic activity…



Source: Bloomberg and Santander

Activity to pick up only in 2H16

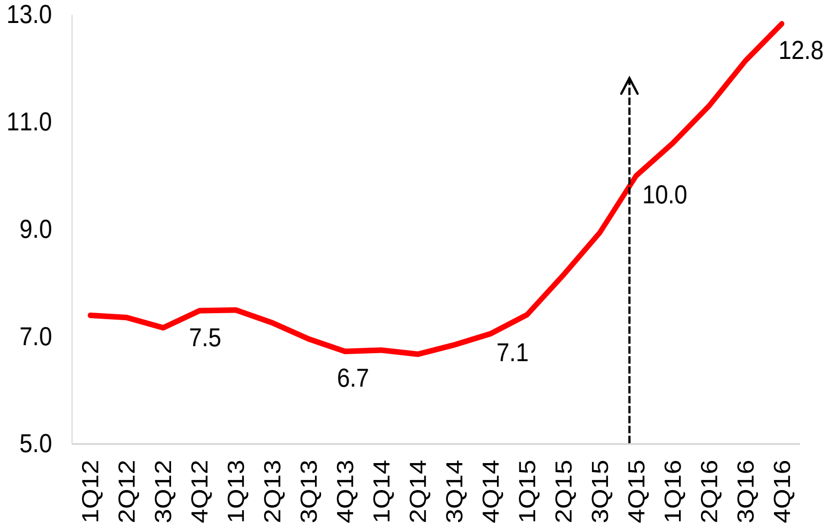


Source: Finance Ministry & Santander

- GDP contracted close to 4.0% in 2015 and is heading towards another 4.0% decline this year, with risks tilted to the downside. Worst recession since the 1930s'
- Activity should bottom by mid year with the potential rebound in confidence and improving expectations to favor activity indicators.
- Market expects GPD to stay below potential in the coming years and to grow 0.2% in 2017, a weak result considering the performance in the previous years.

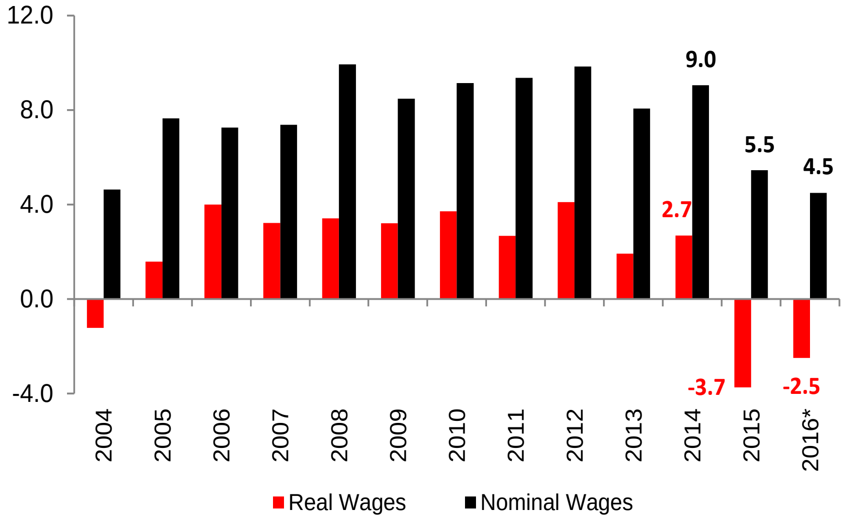
Brazil: Deterioration in Labor Market to Continue

Not bottoming yet



Source: IBGE and Santander

Second year of contraction in real wages



Source: IBGE and Santander

- The adjustment will be completed by the end of 2016
- We expect unemployment rate to continue deteriorating amid two years of consecutive declines in real wages.
- The lack in the labor market along with the negative output gap will help the convergence of inflation, most particularly, service inflation.

LatAm Macro, Fixed Income & FX Strategy

Argentina

Key Themes in Argentina

- **Managing Expectations:** First months will be key for the government to keep expectations on their side. Over-delivery in expectations. Positive on infrastructure plan.

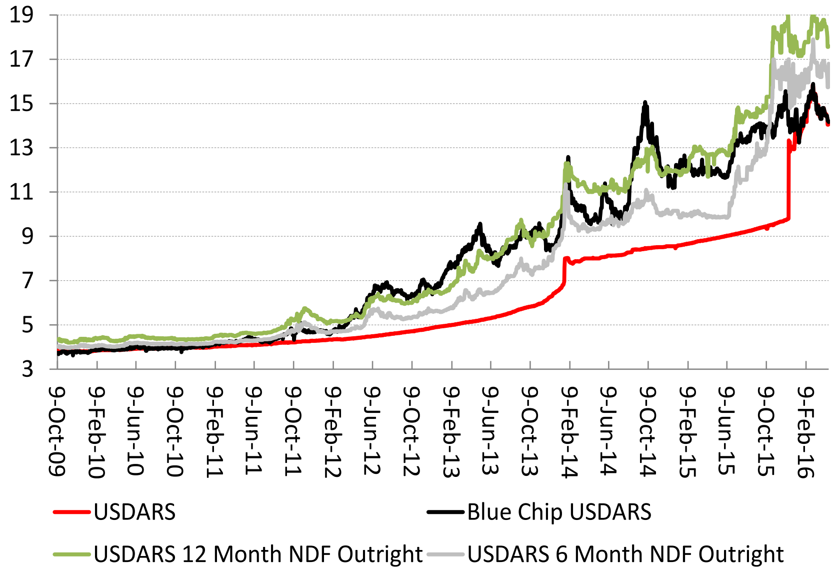
- **Holdout agreement:** The government issued a record amount with record demand for emerging markets, leaving behind the defaults and paving the way for investments. Improvement in credit ratings.

- **Prices realignments and (high) inflation:** Normalization in regulated prices to keep inflation high in 1H. Inflexion point likely in May-June. Curve inversion to ease.

- **Fiscal and Monetary Policy:** Focus will now turn on fiscal and monetary policy plans, now that holdout agreement has been set up.

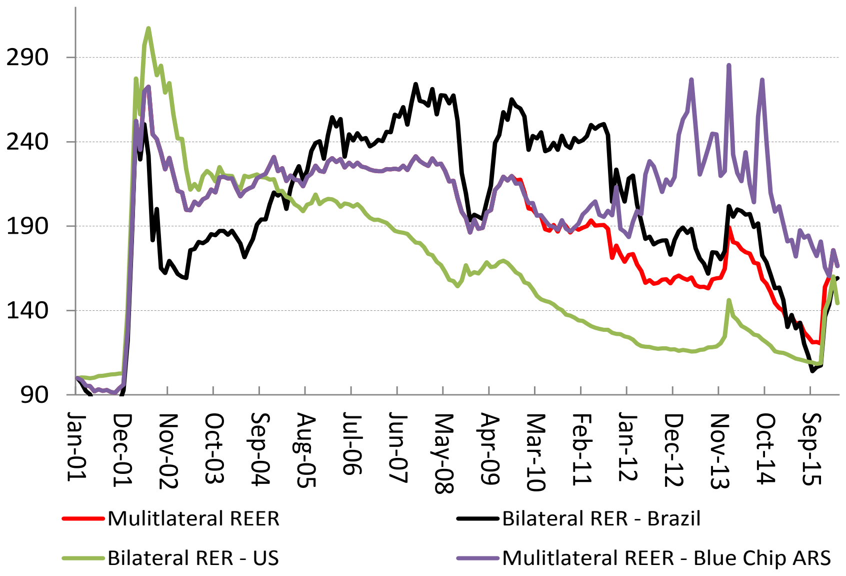
Argentina: ARS Normalization

FX normalization, a credit to this administration



Blue Chip USD/ARS is the implied rate in equities trading both onshore and offshore. Sources: Bloomberg, Central Bank of Argentina and Santander.

Closing the gap



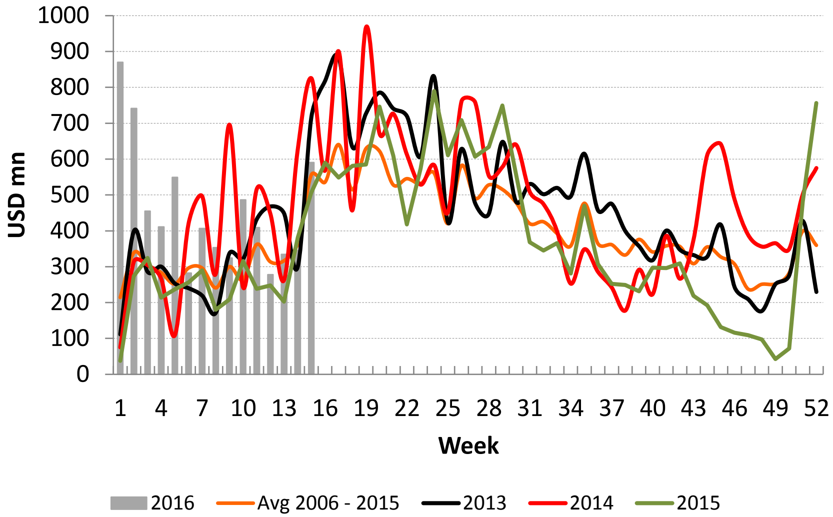
Multilateral real exchange rate. The difference between the two indices is the measure of inflation. Sources: Central Bank of Argentina, FIEL and Santander.

- The successful exit of currency controls on December last year has been a key beneficial factor for expectations.
- CB wants to give volatility to the ARS trading. The holdout agreement will pave the way for (strong) inflows to come. Appreciation risks.
- Looking at simple metrics, like a long-term average of the real exchange rate, the recent correction has taken the peso closer to its 20-year average, but it is still 9% overvalued when compared to the average since 2003.

Santander

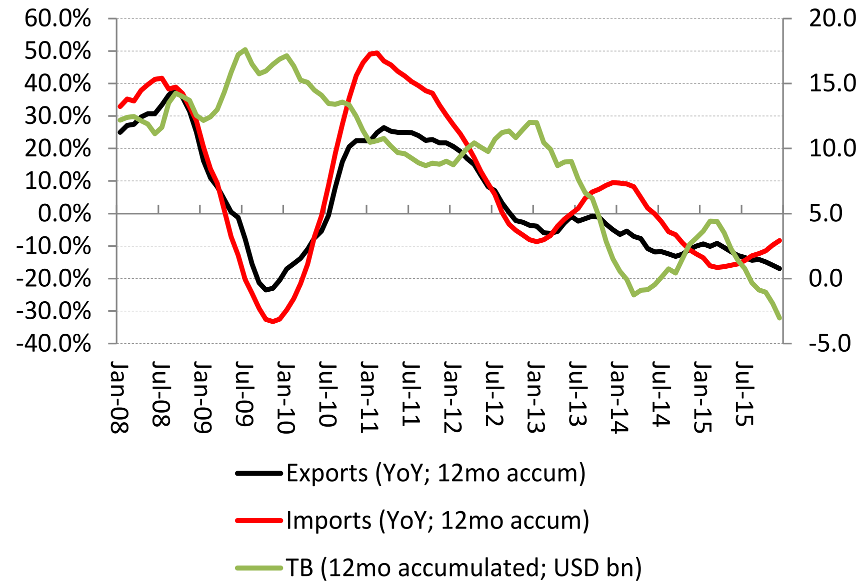
Argentina: High seasonality, normal inflows

ARS seas



Private estimates of inflation after INDEC intervention. Sources: FIEL and Santander

…FX stability is key for inflation expectations

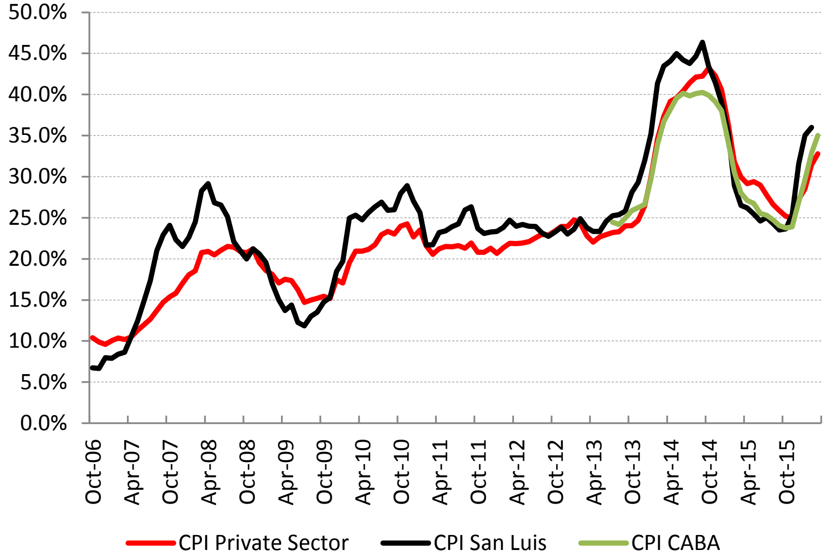


12mo inflation expectations. Sources: UTDT and Santander

- As we get closer to April, the peso should start to get stronger support from the agricultural exports seasonality that traditionally sees more solid USD sales between April and August each year.
- Although the peso is favouring from high export seasonality, the extraordinary agricultural related exports in the first few weeks of 2016 are starting to converge to normal patters.
- However, exports are unlike to provide the same support as they did in the past provided the depressed terms of trade.

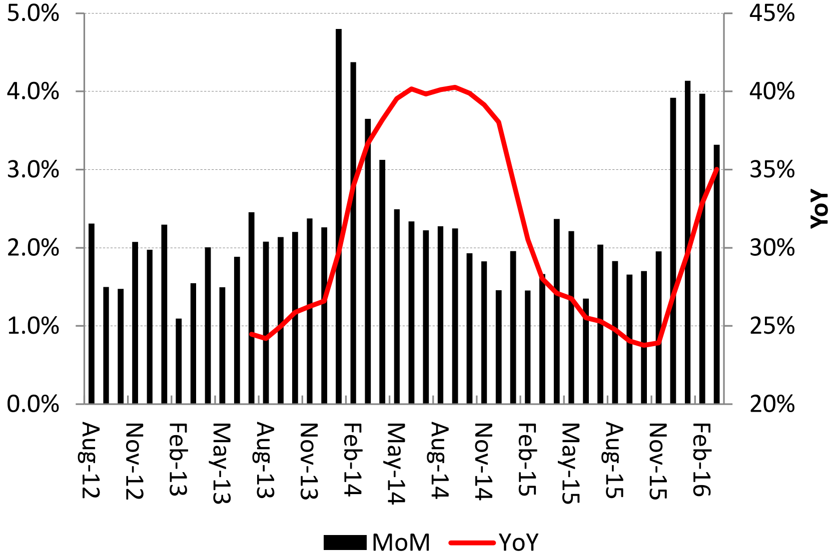
Argentina: Realignment in prices driving inflation high in short term

Spike in inflation to continue up to 2Q



Private estimates of inflation after INDEC intervention. Sources: City of Buenos Aires, FIEL, Province of San Luis, and Santander

Similar path as in 2014? Not entierely…

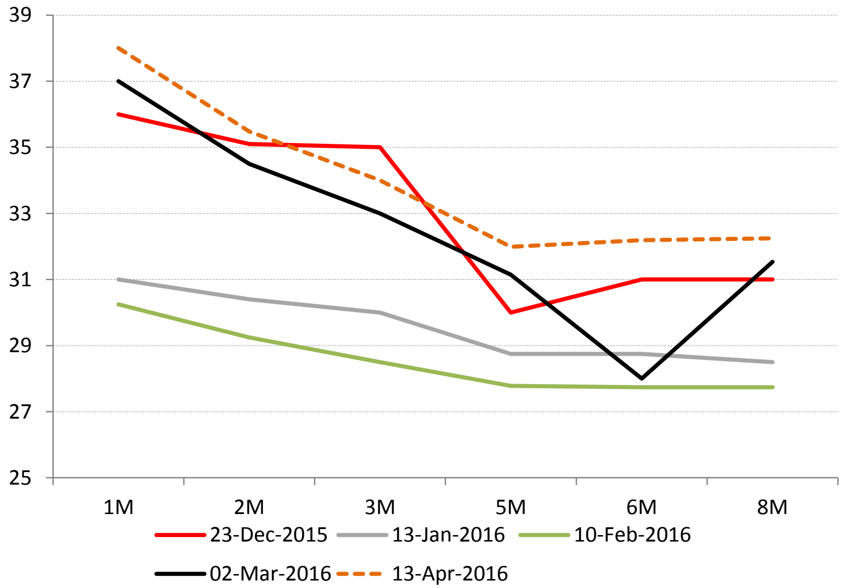


City of BA's inflation. Sources: City of Buenos Aires and Santander

- Inflation is going to be affected by the realignment in the exchange rate and regulated prices (electricity bill, residential gas and transportation).
- Until the overhaul in national bureau of statistics is finished, City of BA and province of San Luis inflation indices will be taken as reference for inflation. Each shows YoY gains of 35% and 36%, respectively as of March and February.
- We deem unlikely to see inflation below 30% this year on the realignment in prices.

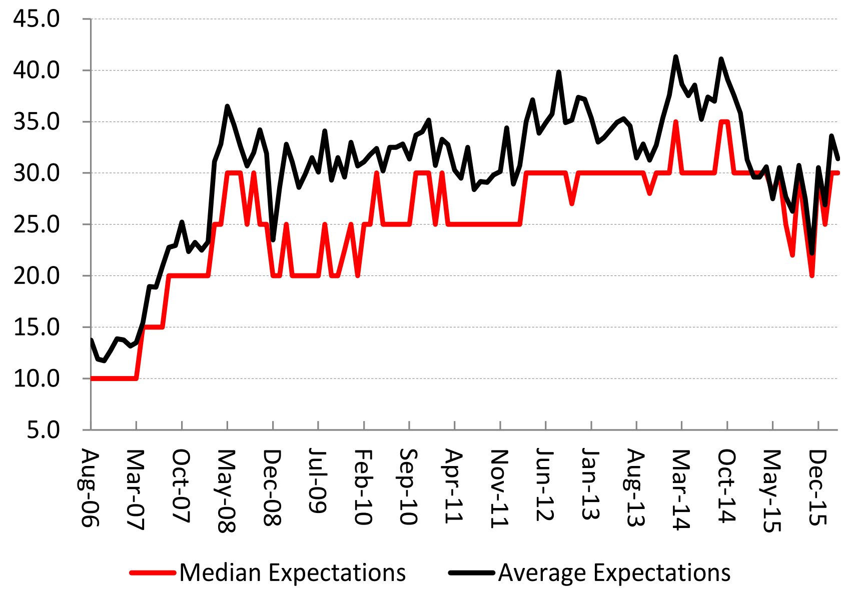
Argentina: Rates to remain high in the inflation fight

Positive real rates needed to control inflation…



Short term CB papers (LEBACs). Sources: BCRA and Santander

…as expectations will remain under short term strain

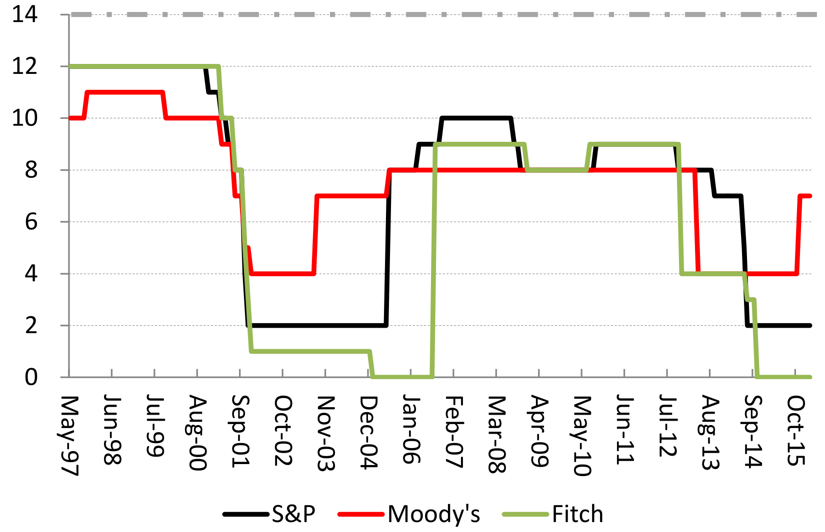


12mo inflation expectations. Sources: UTDT and Santander

- The Central Bank has been taking money out of the market in order to reduce inflation pressure. YTD CB sterilized ARS 85bn. Monetary base stands at ARS 550bn.
- Central bank moving from managing monetary aggregates to an inflation targeting regime. Expectations will be key in this juncture.
- Inflationary shocks are going to keep expectations at 30% but evolution of expectations after 2Q will start to mark the real success for inflation to start showing convergence.

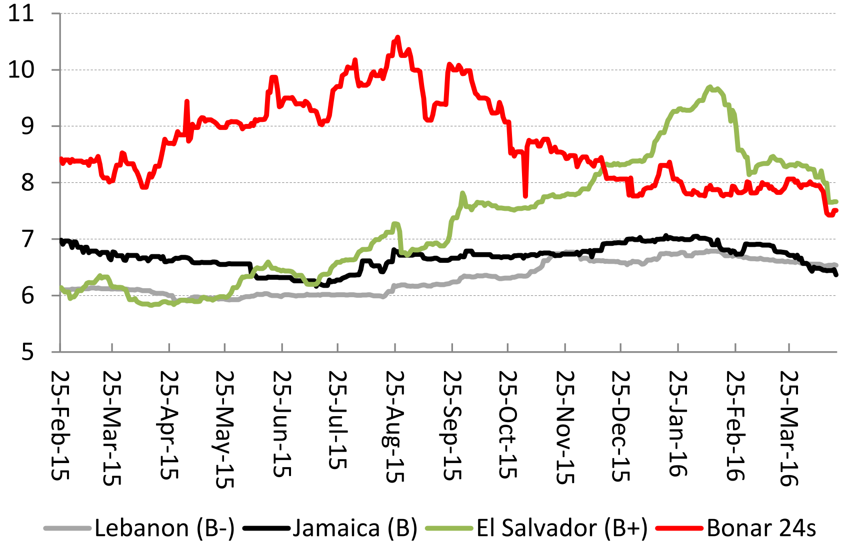
Argentina: Ending the default

Sovereign rating history



Sovereign ratings (LT FC debt) converted to numeric scales. The lower the number, the lower the rating. 8 is S&P and Fitch's B-, Moody's B3; 10 is S&P and Fitch's B+, Moody's B1. Sources: Bloomberg and Santander

Compressing rates

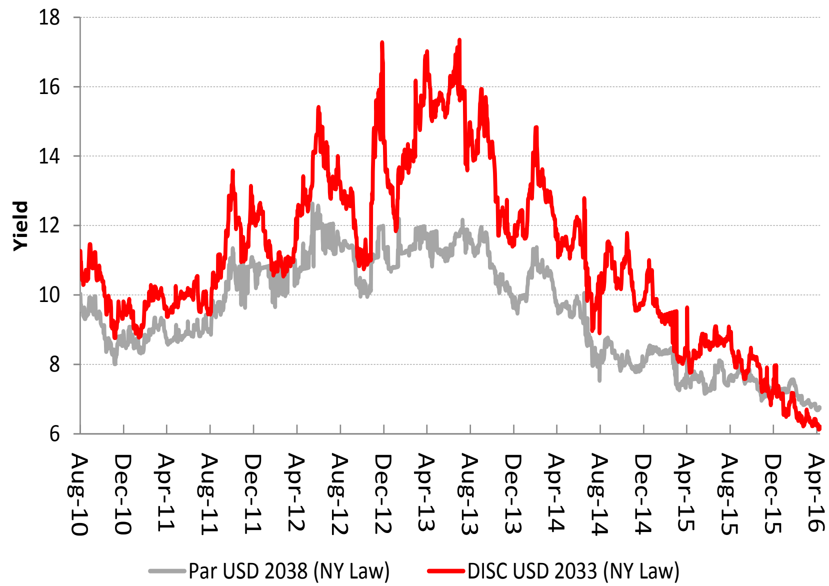


Sources: Bloomberg and Santander.

- Argentina is already trading like a "B" credit. Moodys' rose the credit rating to B3, S&P to B- and Fitch (the issuance) to B.
- The pace of developments regarding the holdout agreement has been faster than our expectation.
- No more external issuance this year as the remainder of the financing needs will come from CB, government agencies and domestic issuances.

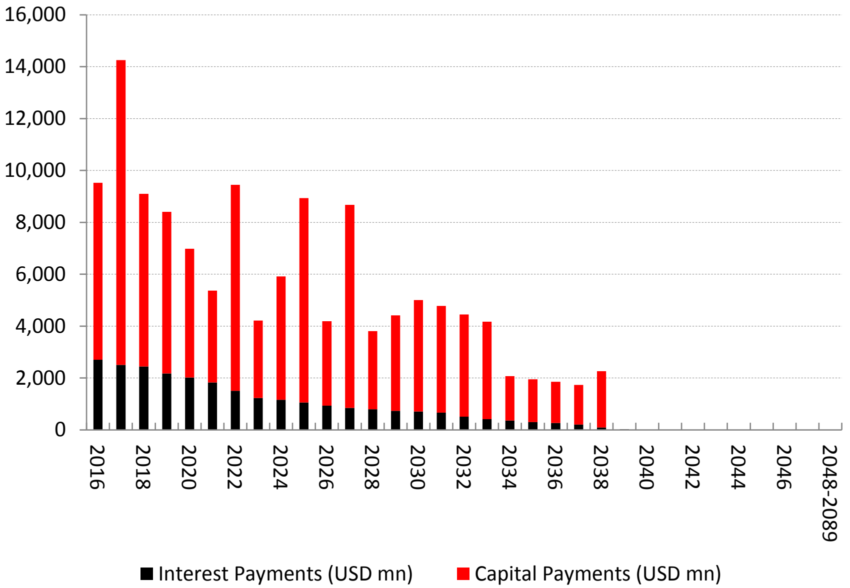
Argentina: Debt management to come after the holdout deal

NY Law – Too tight



Sources: Bloomberg and Santander.

No tapping international markets again in 2016



Foreign currency payments (IFIs + government bonds). Sources: Finance Ministry and Santander

- The government launched an unsuccessful Bonar 17 swap at the beginning of the year to reduce debt payments in 2017 and gain bargaining power with holdouts.
- The swap could be re-launched once market conditions improves and the holdout deal is sealed.
- High payments in 2017.

LatAm Macro, Fixed Income & FX Strategy

Mexico

Key Themes in Mexico

- **Growth story:** Domestic demand remains a concern, in our view, despite the recent catch-up in private consumption.

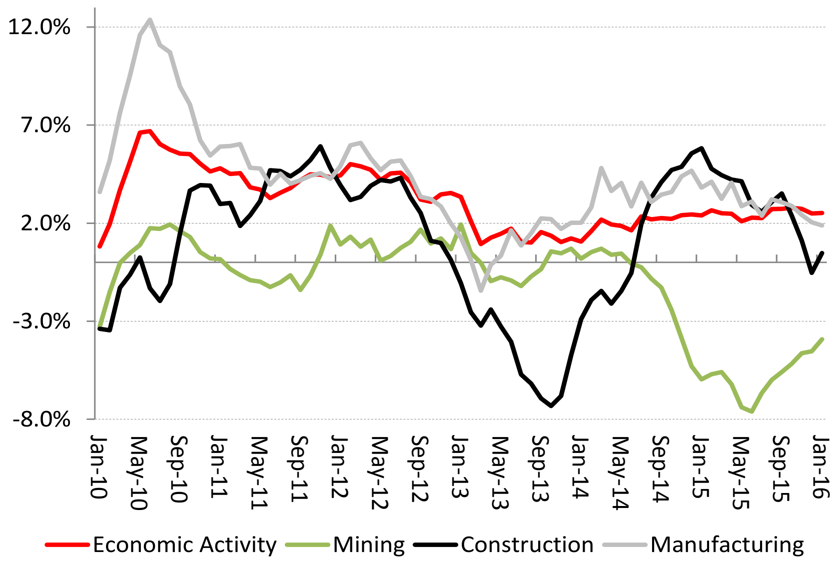
- **Oil risks:** More important than the fall in oil prices has been the decline in crude output, in our view.

- **Pemex:** State owned company in the eye of the storm. Government support worth of 0.4% of GDP positive. Systemic risks remain alive and are likely to see a gradual improvement.

- **Monetary policy:** Banxico uncomfortable with the mispriced MXN. Rebound in oil prices easing peso concerns but the FX could drive Banxico’s deviations away from FED’s action.

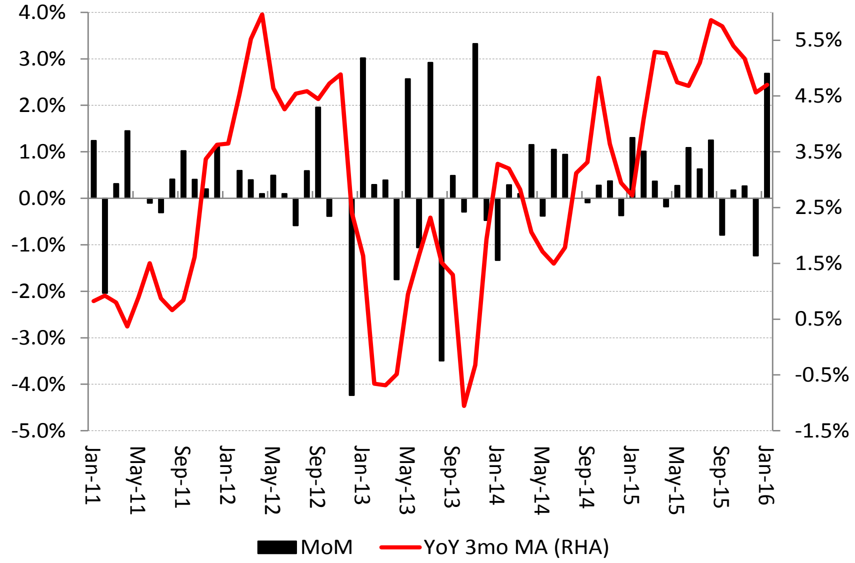
Mexico: Growth Forecasts Slowing

Rebound in mining production



Note: 3mo ma YoY; Sources: NEGI and Santander.

On demand side, retail sales providing a push

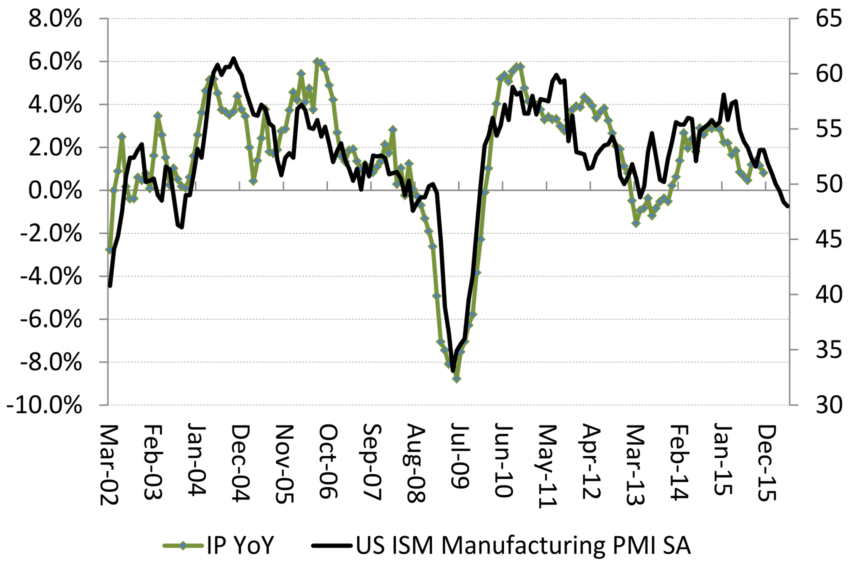


Note: Retail Sales Sources: INEGI and Santander.

- Banxico's growth forecast for 2016 is at 2.5-3.5% and 3.0-4.0% for 2017.
- Santander's forecast for 2016 and 2017 GDP growth is 2.5% y/y and 3.0%, respectively.
- We believe that above-trend growth in Mexico remains highly dependent on the U.S. generating steady 2.0-2.5% growth and further consolidation of the benefits from recent structural reforms

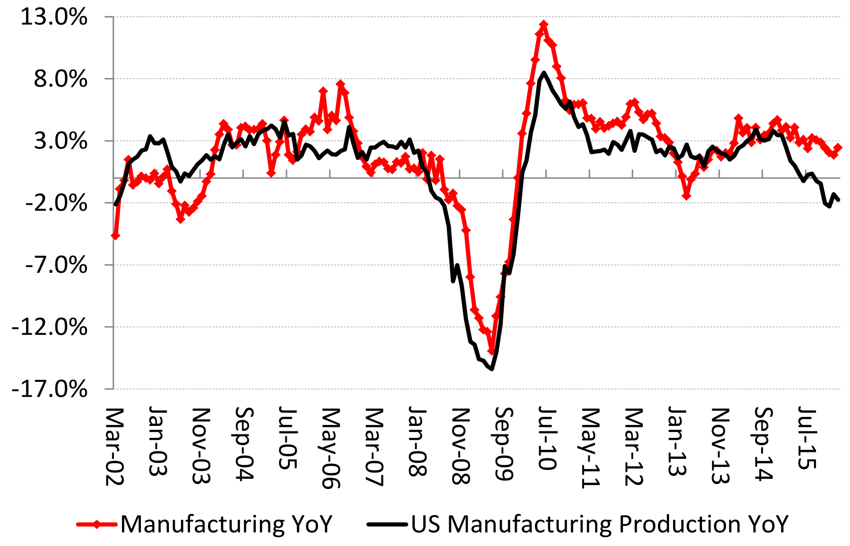
Mexico: A Slowdown in Manufacturing?

US manufacturing not providing support to Mexico



Sources: Bloomberg, NEGI and Santander.

Pressuring production to the downside

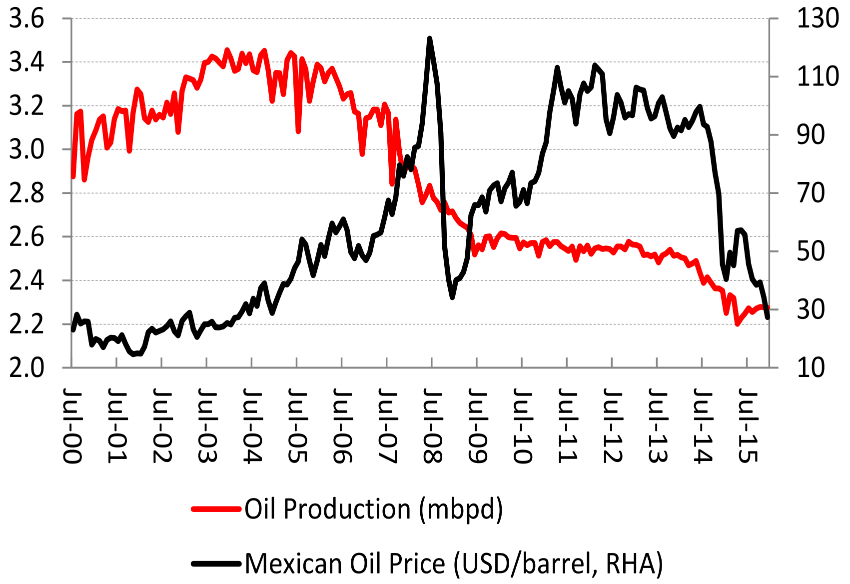


Sources: Bloomberg, INEGI and Santander.

- Manufacturing, while no longer outperforming GDP growth, is performing better than its U.S. counterpart and most EM peers.
- Latest US data adds downward pressure to Mexican industry, which represents close to 20% of GDP (Services represents 2/3 of GDP).
- Mining production, which peaked in mid 2015 will be under pressure as oil prices continues to dive down without a floor. Construction, a key component to IP recovery, started to edge downward by the end of 2015.

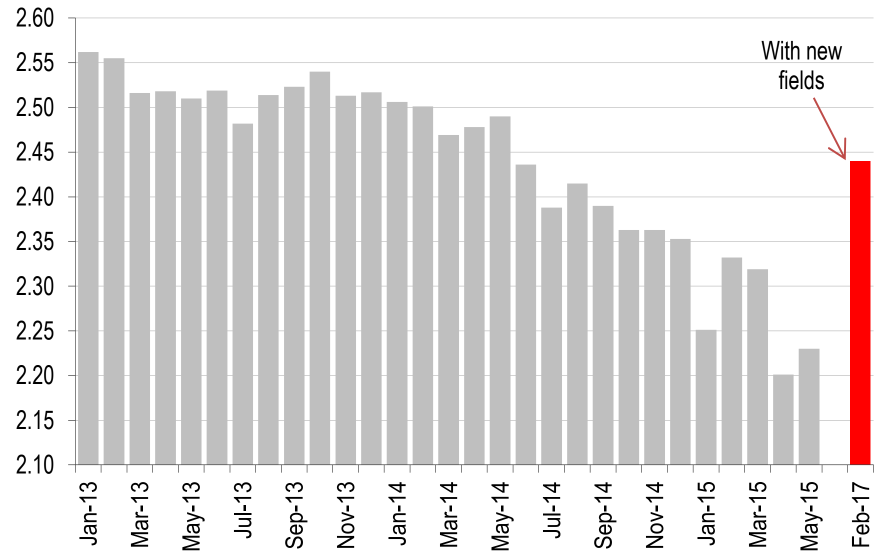
Mexico: Oil Production

Oil output is at its low



Sources: Haver, INEGI, and Santander.

Pemex's crude oil production (MMbbl/d)

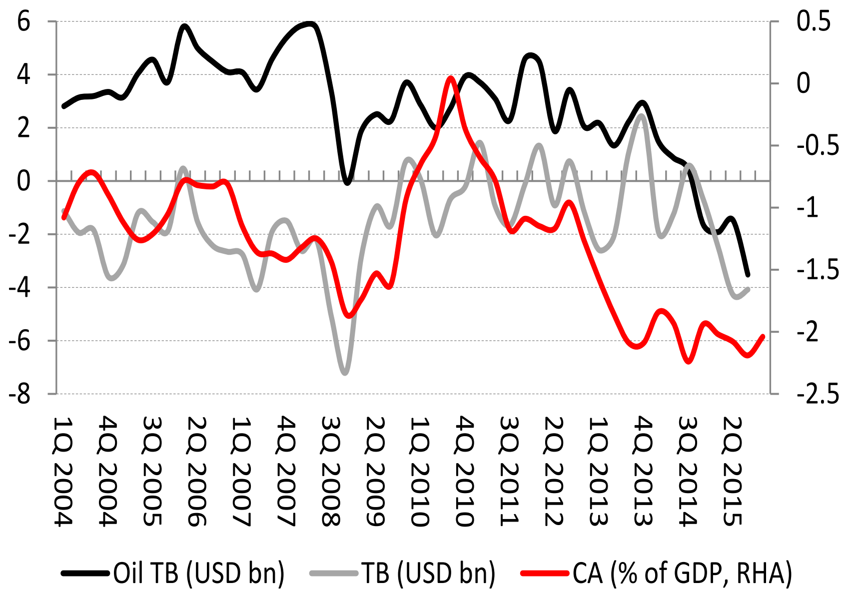


Sources: Bloomberg, PEMEX, and Santander.

- Crude oil production bottomed in 2Q 15 at 2.20 mb/d on average in April but weak oil prices and the delay in the oil reform execution will prevent a strong pick up in the short term.
- Cost cut in Pemex could led to underperformance in oil production, dragging down activity.

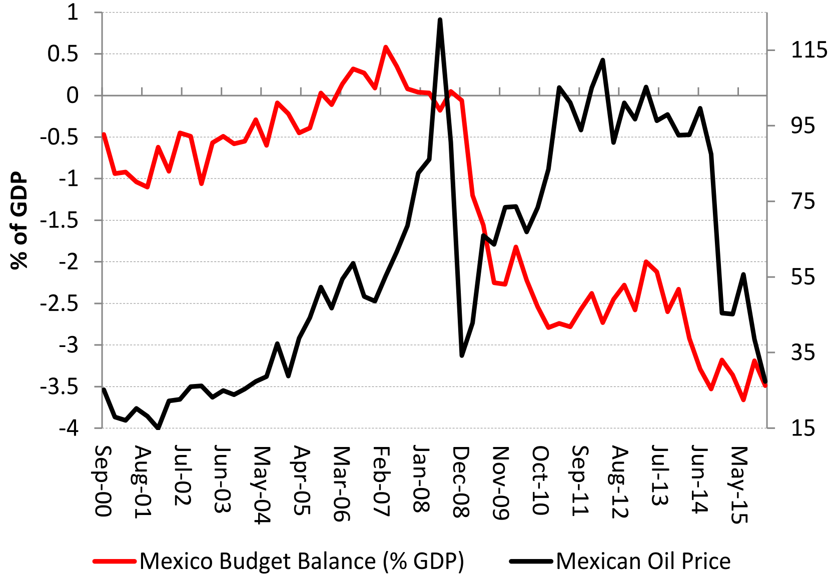
Mexico: Oil hurting Mexican accounts

Oil output is at its low



Sources: INEGI, and Santander.

Oil and government finances

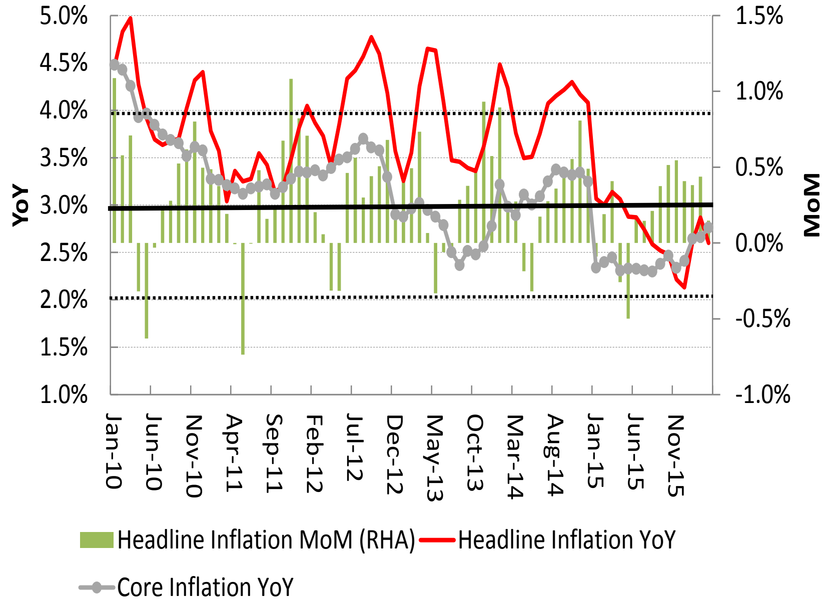


Sources: Bloomberg and Santander.

- The drop in oil prices is pressuring external accounts but most importantly fiscal numbers. CA deficit and financing is not a source of concern in Mexico, like it is in Colombia, another oil exporting country.
- Mexico is better prepared to withstand lower oil prices as it hedges oil production every year. In 2015 it got USD 6.0bn from the hedge placed in late 2014. Further downside in crude may lead to more belt tightening in the government's account.

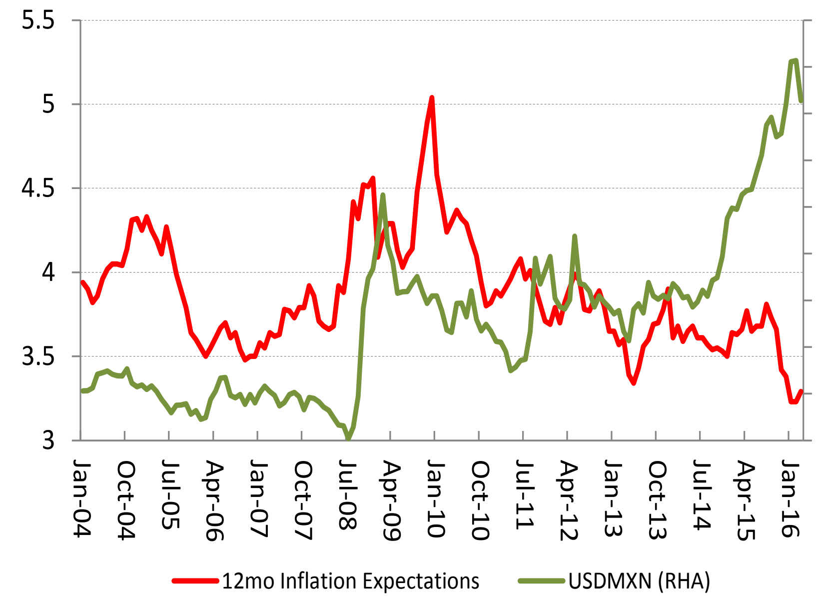
Mexico: Inflation Not a Problem in Mexico, Although it Will Pick Up

Rebound (but contained) inflation



Sources: NEGI and Santander.

Expectations resilient to FX woes

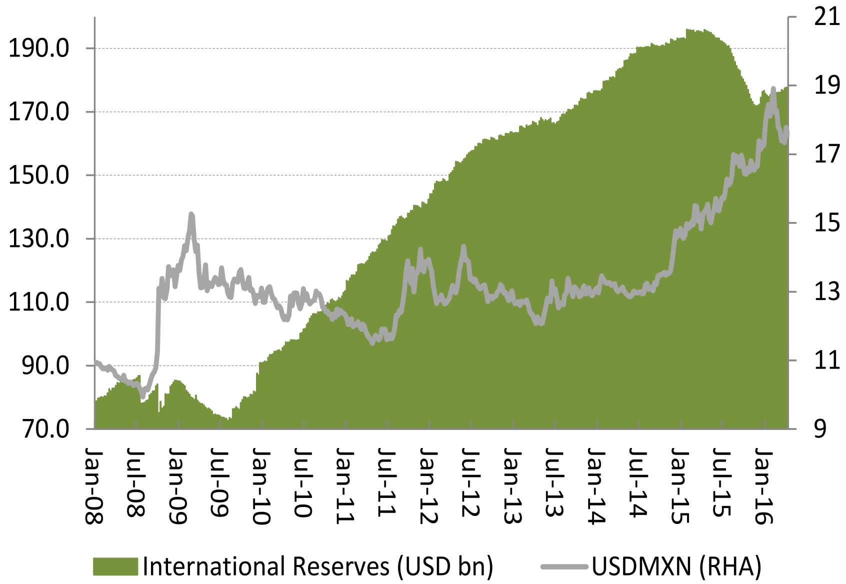


Sources: Banxico, Bloomberg and Santander.

- Inflation dropped last year to the lowest on record helped by the telecommunications reform and lower energy prices. We expect inflation to pick up from 2.1% in 2015 to close to 3.0% this year.
- Pass through has not been an issue in Mexico like in other Latam countries. Despite sharp MXN moves, expectations remained range bound, helped by muted headline inflation.
- From a pure Taylor rule perspective, Banxico is in no rush to hike, they have room to go in tandem with the FED

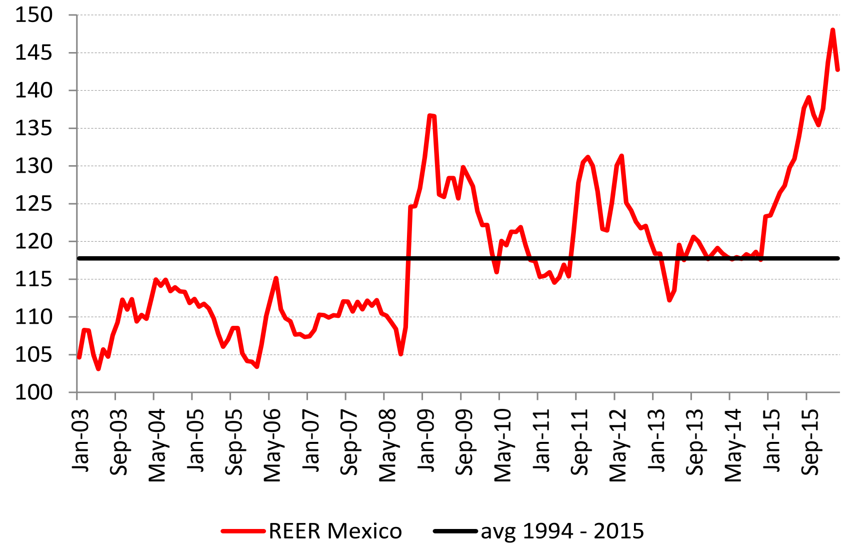
Mexico: Suspending Intervention; Banxico Unconfortable with MXN

Reducing (but keeping some) FX intervention



Sources: Banxico, Bloomberg and Santander.

Undervalued MXN



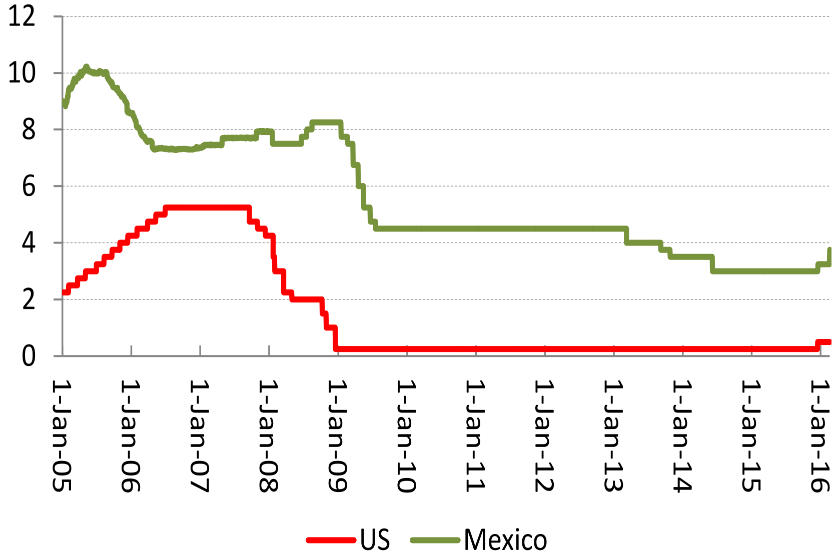
Sources: BIS, Bloomberg and Santander.

- Mexican authorities unconfortable with the MXN trading away from fundamentals.
- Rebound in oil prices has eased concerns for the time being.
- The intervention bill so far has $30bn USD in 2009, $25bn USD between nov-2011 and apr-2013, plus another $21bn USD paid over the last 13 months, also the past 4 years have seen more months with intervention than without it.

Santander

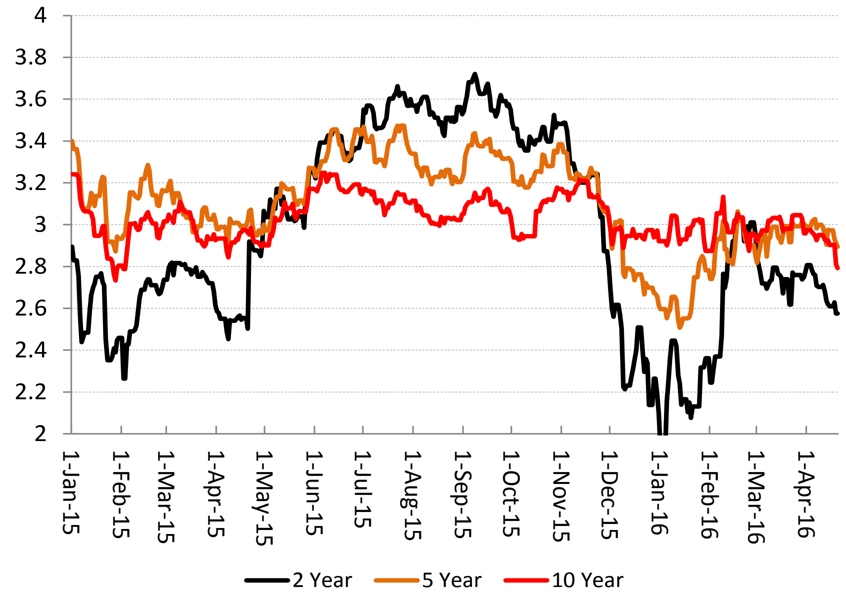
Mexico: Surprise!

Mexico not follow ing the FED



Sources: Bloomberg and Santander.

Breakevens aligned in the target



Sources: Bloomberg and Santander.

- Banxico's surprise with the rate hike shows their disagreement with the level of the MXN although inflation has not been contamined by the pass through.
- The central bank will continue to look at the FED for the next move but the MXN and its potential impact on inflation expectations will enter into their equation.
- Inflation acceleration (moderate) in 2016 to pressure breakevens

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