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TPCG LATAM
URUGUAY STRATEGY VIEW

Uruguay – Strategy
December 27, 2023

The 2024 YA: Incoming crossroads

- **IN THIS PIECE.** We present our baseline scenario for 2024, including our view on activity levels, the 2024 election, the BCU's policy bias and inflation, the fiscal path, debt dynamics and the trajectory of the FX, based on our expectations of the external sector flows.

- **OUR KEY TAKEAWAYS**. We expect yearly growth to total +0.4%yoy in 2023, as activity levels were stricken by the drought. However, consumption dynamics remained solid, which should help the economy bounce back in 2024, with our point estimate expecting a +3.7%yoy GDP increase, driven by a supportive external sector. This should allow the CenBank to maintain its current policy bias, which will be pressured to the upside by sticky inflation expectations. With a softer monetary position inflation is poised to bounce back in 2024, after ending 2023 inside the BCU's target range. We believe the pick up in inflation will also respond to the administration's policy bias, especially on the fiscal and income stances, forcing the headline index to the +6.6% mark by Dec-24, spilling out of the BCU's upper bound. We expect the administration's policy bias to remain unchanged in 2024, mainly due to the presidential elections, which are bound to take place in late 2024. The current government coalition does not part as favorite for the bout, with the FA currently standing as top dog in the political spectrum, edging the coalition's voting intention by 5pp (40pp vs 35pp). While competitive, the current administration also has its most polupar figurehead, Mr. Lacalle Pou, sidelined, as he cannot participate in the next presidential race. In addition, this election will host a significant amount of young blood, with most candidates having never participated in a presidential race, adding some extra volatility to the process.
  In the current political context, we envisage the consolidation proposed by the budget review as optimistic, especially as the administration carries a significant deviation from the 2023 target. Specifically, the 2023 budget expected a fiscal position of -3.3% of GDP, whith 12m rolling figures to October point at a -4.5% of GDP fiscal deficit, risking breaching the first pillar of the fiscal rule for the first time in the administration's tenure, and making the targeted -2.7% of GDP mark for 2024 much more difficult to achieve. In addition, our DSA model suggests that the current fiscal path, in conjunction with the complex international scenario, start to strain debt dynamics, even if we don't expect to affect the government's financing strategy, which will, in our view, continue to source funding from local and international markets alike.
  Finally, the FX trajectory will be determined by the cross-efects of an improving current account matching against worsening financial flows. In our view, CA flows should become more supportive, bolstered by the full UPM II production and recovering agri-flows. However, adverse prices might put a cap on the improvement. On the other hand, financial flows are poised to suffer, with UPM II FDIs dropping out of the BoP. We find evidence Uruguay's current developments push towards a structural appreciation of the FX. All in all, we expect the USDUYU to depreciate nominally, ending 2024 at 41.6, with the REER appreciating slightly (-1.3%yoy), with the seasonality favoring a robust 1H23, followed by a weaker second half.

- **STRATEGY IMPLICATIONS.** Under the scenario, we believe spreads vs the UST are at minimums in the HC space, even if the dawn of a more favorable international scenario could trigger a compression of the curve at the pace of the UST, justifying our MW stance. On the LCD side, we upgrade likers to OW, while we downgrade nominals to MW, as we believe inflation should start to pick up in 2024, a scenario that compounds with attractive real rates in the long end.

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The 2024 Year Ahead: Incoming crossroads

After a drought-stricken 2023, perspectives for 2024 look encouraging.

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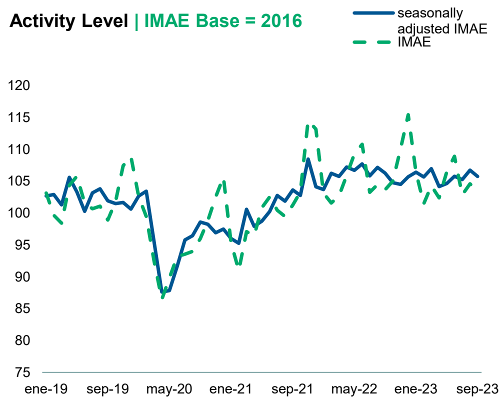
2023 was a weak year for the Uruguayan economy, as it was hit strongly by the drought, with the finalization of the UPM II project hurting construction and investment figures. Only consumption and the services sector maintained relative dynamism. After posting a meager +1.6%yoy growth in 1Q23, growth rapidly turned negative, posting a -2.5%yoy contraction in 2Q23, followed by an improving (albeit still weak) -0.2%yoy print in 3Q23 (for more information, please click here). Most of the underperformance focused on the primary and secondary sectors. Agriculture currently accumulates an -10.9%yoy contraction YTD. Power generation and construction are also the standout underperformers, posting -9.2%yoy and -4.6%yoy drops YTD, respectively. It is clear then that the drought caused significant damage to the yearly print on behalf of the agricultural sector, while the completion of UPM II hurt construction figures significantly, which had been booming since the start of the huge project. On the demand side, the external sector was public enemy N°1, as exports dropped by -2.3%yoy, while imports hiked +7.5%yoy in the first three quarters. Instead, consumption remained healthy, as PCE rose by +4%yoy, while investment suffered (-2.5%yoy), again on behalf of the end of the UPM II pulp mill. In this context, the latest BCU survey conveys analyst expectations for GDP growth this year at +0.69%yoy, while the MEF's budget review estimates suggest a +1.3%yoy GDP increase for 2023. Still, we expect these figures to be revised slightly to the downside, as the former is only consistent with a +3.8%yoy rise in 4Q23, while the latter is compatible with a quarterly increase of +6.2%yoy. With statistical carry presenting a scenario where the economy contracts by -1.9%yoy, we expect positive dynamics to continue during the 4Q23 in the services sector, while the primary and secondary sectors recover. Our point estimate for 4Q growth stands at +2.7%yoy, responding largely to the solid perspectives for the agricultural sector, which should compound with a strong positive baseline effect. In this context, our estimates are consistent with a timid +0.4%yoy growth for the year.

For 2024, we expect the baseline effect to aid GDP figures as the agricultural sector recovers, with the external sector presenting a more supportive stance.

For 2024, we expect the baseline effect to aid GDP figures as the agricultural sector recovers, with the external sector presenting a more supportive stance. In a context where agriflows are projected to rebound by nearly USD1bn, expect both the agricultural sector on the supply side and exports on the demand side to recover the lost ground in 2023. While weaker terms of trade, based on lower international prices, could put a cap on recovery, the increase in quantities should allow Uruguay's growth to rebound to 2.8%yoy in 2024, especially given the weak baseline presented by 2023 figures, and with the additional support provided by UPM II, which is expected to produce at full capacity in 2024, bolstering GDP growth further. We expect consumption to continue being supportive, as the increased disposable income generated by the strong UYU and flattening inflation, in addition to the government's supportive income policy, should aid PCE to maintain its momentum. On a negative note, construction should continue to shrink during 1H24, partly offsetting the strong rebound. While 2024's tourism campaign is likely to be weaker, accounting for a more competitive REER with Argentina, service imports due to outgoing tourism, which boomed in 2023, should also weaken significantly. In this context, we expect imports to slow while exports recover, envisaging a more constructive scenario for the external sector. All in all, we expect growth to rebound back to +3.5% next year, with BCU estimates pointing at a +3.1% growth with MEF estimates envisaging the GDP increase at +3.7%.

Figure 1: Activity indicators suggest a robust rebound in 2024

% yoy	GDP	Industrial Production	VAT (nominal)	Consumer Confidence	Business Expectations	Car Sales
2018	**0.2%**	**11.5%**	**6.6%**	**-7.7%**	**3.0%**	**-19.6%**
2019	**0.7%**	**-1.6%**	**8.6%**	**7.8%**	**-6.5%**	**-6.9%**
2020	**-6.3%**	**-5.2%**	**8.0%**	**-3.5%**	**-12.4%**	**-14.0%**
2021	**5.3%**	**12.3%**	**18.4%**	**6.0%**	**42.5%**	**42.1%**
1Q22	8.4%	8.8%	21.2%	4.1%	48.6%	4.8%
2Q22	8.7%	6.5%	19.7%	1.0%	22.5%	0.4%
3Q22	3.4%	3.6%	19.3%	-1.1%	5.2%	5.6%
4Q22	-0.1%	-3.0%	16.6%	-5.0%	-0.7%	14.6%
2022	**4.9%**	**3.6%**	**13.7%**	**-0.4%**	**15.7%**	**6.4%**
Jan-23	1.9%	0.6%	13.7%	2.1%	2.4%	16.2%
Feb-23	1.8%	1.0%	12.7%	-4.9%	3.9%	6.0%
Mar-23	1.1%	4.1%	11.0%	9.1%	2.5%	-9.0%
1Q23	1.6%	2.0%	12.4%	1.8%	3.0%	1.8%
Apr-23	-2.1%	-3.0%	10.2%	19.2%	4.3%	-9.2%
May-23	-2.7%	0.9%	9.5%	5.4%	5.4%	6.0%
Jun-23	-2.7%	0.4%	8.4%	-5.9%	-1.2%	19.9%
2Q23	-2.5%	-0.5%	9.4%	5.8%	2.8%	5.5%
Jul-23	1.2%	2.0%	7.6%	-2.6%	-1.8%	17.0%
Aug-23	0.3%	2.1%	5.9%	7.4%	0.2%	19.5%
Sep-23	-2.2%	-4.4%	5.0%	15.7%	-0.5%	6.9%
3Q23	-0.2%	-0.1%	6.1%	6.5%	-0.7%	14.1%
Oct-23	-	9.1%	4.8%	16.5%	-	14.9%
Nov-23	-	-	-	-	-	16.7%
Dec-23	-	-	-	-	-	-



Source: TPCG Research estimates based on BCU, INE, CERES, CINVE, CIU, and ACAU

The coalition has its work cut out ahead of the 2024 elections.

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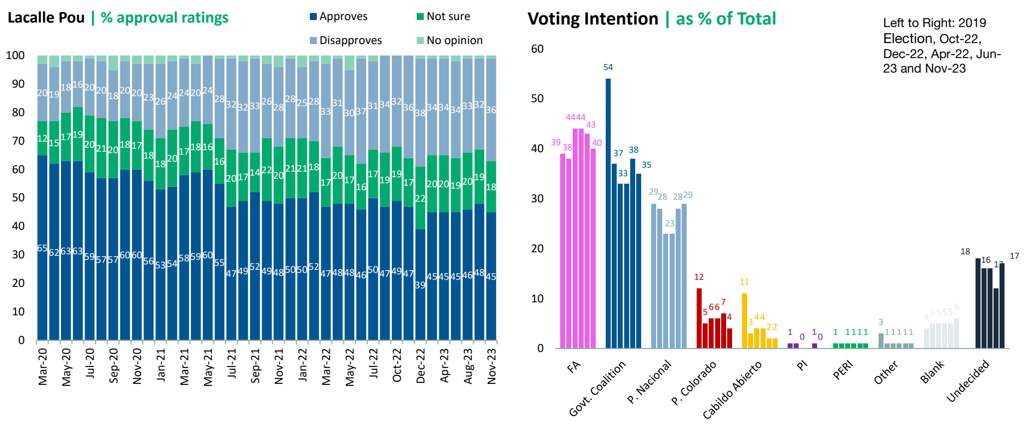
While Mr. Lacalle Pou's popularity ratings remain strong, the government coalition has lost its top-dog status ahead of the 2024 elections, with the FA currently enjoying a slim lead. With elections closing in, recent polls show that the Frente Amplio has recovered some ground since 2019's elections (+1%), with the government coalition going in the other direction, losing significant support, now standing at 35%, -19% below 2019's ratings. This means the FA currently stands 5pp ahead of the Government Coalition, making the opposition a slight favorite entering 2024. The weak metrics of the ruling coalition respond mainly to a massive loss in voting intention for its minor members (the President's National Party -Blanco- currently performs as in 2019), which reflects, on some level, the strained relationship inside the coalition. The government coalition has endured the wear and tear of the tenure, with some internal rifts starting to materialize, the clearest being the tense negotiation behind the Pension system law. While its continuity does not seem at risk, the tense relationship between partners could negatively influence the campaign and the cohesion of the front ahead of the elections and has disenchanted the smaller parties' voter base. In this context, the Colorado Party currently polls at 4% (-8% vs. 2019), with Cabildo Abierto mirroring this performance, currently standing at 2% voting intention, having lost nearly 9pp relative to the last presidential elections. Instead, the senior coalition partner, the Partido Nacional, enjoys roughly the same ratings, at 29% voting intention. Undecided voters amount to 17pp of the polled, which suggests the race is still wide open. These voters could be undecided between voting for the FA or the Govt. Coalition, or in between different coalition members. At this point, Mr. Lacalle Pou's ratings come into play. The President has maintained strong support throughout its tenure, with its approval ratings currently at 45%. Recently, the Administration was on the receiving end of heavy flak in the last couple of months due to political scandals, which forced the resignation of several ministers, leading to a 3% drop in approval ratings since October (+48%), and spiked disapproval to 36% (+4pp). Still, his ratings currently exceed those of the Govt. Coalition voting intention by 10pp, which could mean a sizable portion of the undecided camp sympathizes with the Govt. coalition but cannot pick their preferred member. However, with Mr. Lacalle Pou sidelined for the 2024 election (no reelection in Uruguay), the Administration may fail to capture the goodwill the current President enjoys.

Figure 2: Even with Mr. Lacalle Pou enjoying solid approval ratings, the FA stands as the top dog ahead of the presidential race



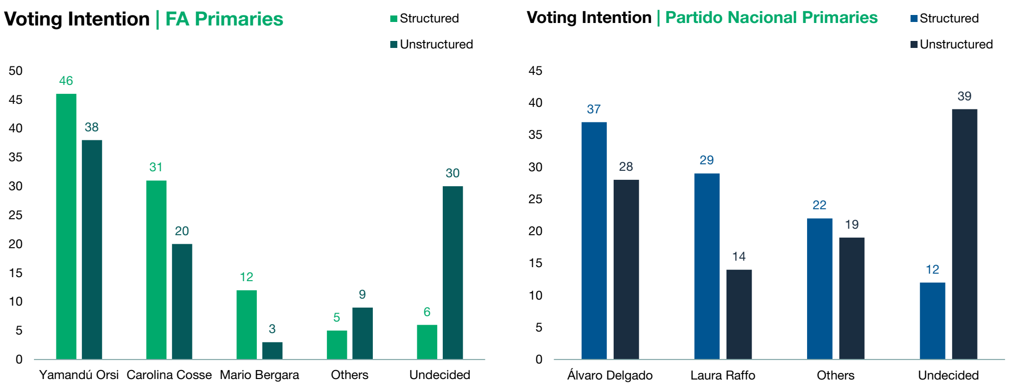
Source: TPCG Research based on Equipos Consultores

The presidential race will see a significant amount of young blood this time, with most rumored candidates poised to throw their hats in the ring for the first time.

The presidential race will see a significant amount of young blood this time, with most rumored candidates poised to throw their hats in the ring for the first time. In a refreshing turn of events, most of the expected candidates are entering the presidential race for the first time, adding some extra uncertainty to the political scenario. On the FA side, the two main competitors seem to be Mr. Orsi, mayor of Canelones, and Mrs. Cosse, mayor of Montevideo, with Mr. Bergara, former economy minister and BCU president in past FA administrations, coming in at a far third. The first currently stands as the front runner, leading the structured and unstructured polls (in the former, the interviewed chose from a set list of candidates, while in the latter, they express their unconditional preferences). Currently, Mr. Orsi is polling at 46% in the structured polls (38% unstructured), followed by Mrs. Cosse at 31% (20%) and Mr. Bergara standing at 12% (3%). So, the FA primary is poised to become a two-horse race between Mr. Orsi and Mrs. Cosse. While Mr. Orsi presents a more moderate alternative, being supported by the MPP, relative to Mrs. Cosse, who enjoys the support of more radical groups inside the FA, including the Communist Party, neither represents the usually stronger social democratic wing of the FA, which has lost significant traction in recent years (especially since the passings of former President Tabaré Vázquez and Mr. Astori), leaving the FA to pivot towards a more left-leaning agenda. On the other side, with Mr. Lacalle Pou sidelined, his replacements stand to be Mr. Delgado, the current Government secretary and very close-knit with the President, and Mrs. Raffo, who, after making a solid campaign for Montevideo major in 2019, is now offering a second, somewhat more critical option of the Partido Nacional. However, Mr. Delgado also enjoys a significant lead, polling 37% (28% unstructured) against Raffo, who has a 29% (14%) voting intention. While the minor coalition members are also bound to have primaries to choose their candidate, their lack of voting intention suggests that the next president will emerge from the figureheads mentioned above, with the coalition candidate most likely being Mr. Delgado or

Mrs. Raffo. In this context, primary elections, where voting is optional, are bound to occur on the 30th of June, 2024.

Figure 3: Mr. Orsi and Mr. Delgado must consolidate their place as the main candidates behind each coalition.



Source: TPCG Research based on Equipos Consultores

The election cycle will test the new macro-fiscal institutions, as most of the current Administration's reforms are in their infancy and could be subject to revision.

The election cycle will test the new macro-fiscal institutions, as most of the current Administration's reforms are in their infancy and could be subject to revision. Many of the policies implemented in the current tenures have been beneficial to Uruguay's macroprudential development and economic stability. The independence of the BCU, its shift to an interest rate framework, and its unrelenting efforts to see inflation drop into the target range, in addition to the fiscal rule and the pension reform, have been key institutional building blocks that have improved Uruguay's credit ratings and sovereign spreads. However, most of these changes are still in their infancy, which in turn means they are vulnerable, both to a regime change or undermining by the current Administration. If the FA manages to emerge victorious in the 2024 elections, many of these reforms could be cut short, especially the ones referred to the BCU and the pension reform, which is already being challenged via referendum attempt (for more information, please click here). While we do not expect a possible FA administration to make radical changes in economic policy, we do expect the BCU to lose some of its independence, in addition to a more hands-on FX market, including more CenBank intervention, while inflation should return to historic numbers, closer to the 10% mark. Furthermore, fiscal discipline is bound to be relaxed so that the fiscal rule could become wobbly even before the change in Administration. In this context, if the macro-fiscal framework is to endure, the current Administration must comply with it in the coming months. Failure to do so in 2023, in addition to changes in the 2024 targets or further deviations, would undermine the fiscal rule in such a way that it would start to become irrelevant, especially if there are no palpable consequences for failing to comply with the targets, or to a very accommodative target setting policy. Finally, the FA has voiced concern regarding the pension reform law, which could suffer additional modifications. So, all in all, an FA victory could undo a significant portion of the advances implemented by this Administration. On the other hand, policy continuity, or an FA respectful of the changes made during this term, could see policies such as the fiscal rule or the independence of the Central Bank solidify, securing them as state policies and maintaining the advantages they present to the country. Any reversal in this sense is bound to affect sovereign spreads and credit ratings in the medium run. And, in turn, this largely depends on the next Administration's government plan. In this context, the recent pivot of the FA further to the left is not good news for solidifying Uruguay's institutional macroeconomic framework.

Inflation: After a volatile 2023, reflationary risks increase, with our baseline challenging the 6%yoy upper bound in 2024.

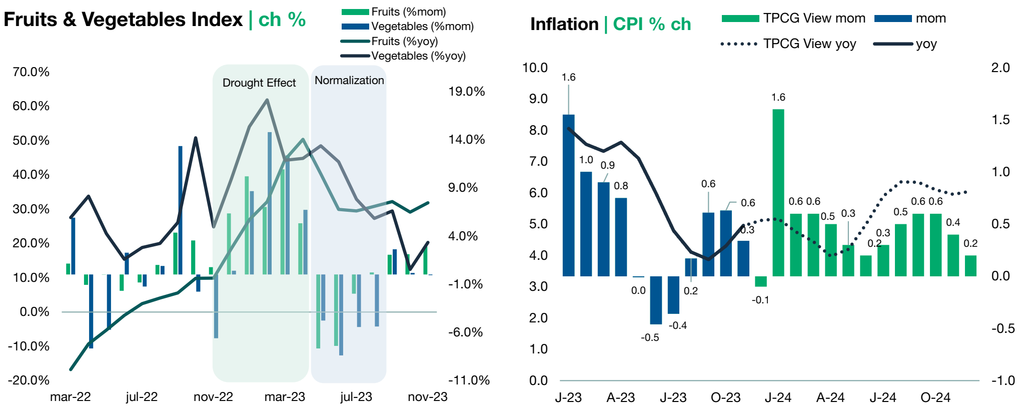
After a very volatile first nine months, inflation finally troughed in September and is now slowly

After a very volatile first nine months, inflation finally troughed in September and is now slowly reaccelerating at the rhythm of higher core prints. The inflationary process was extremely volatile during the first nine months of the year. In particular, there were strong decouplings between the core and headline indexes throughout 2023. The headline index moved at the pace of the Food & Non-alcoholic Drinks chapter, which posted an average +1.9% monthly

reaccelerating at the rhythm of higher core prints.

print in the first four months of the year, followed by four back-to-back negative variations, averaging monthly price reductions of around -1%mom during the May-August period. The extreme volatility was mainly driven by the effects of the drought, which pushed Fruit and Vegetable prices up wildly (+37.7% and +49.5% in the Jan-Apr period, respectively) due to the supply shock, which later reversed, as the effects of the lack of water evaporated, causing drops of -16% and -21.9%, respectively. This strained the spread between core and headline prices, which returned to more normal levels in September. Since then, the Food and non-alcoholic Drinks segment has slumped, clocking in at +0.01%mom in October and +0.07%mom in November, suggesting that food prices have normalized. In turn, the yoy gauge remained stubbornly high in the first months of the year due to the unfavorable, drought-stricken 1Q23 prints. However, the year-on-year index collapsed during the second half of the 2Q and the 3Q due to the reversal in monthly prints, which was aided by a strong tailwind from the baseline effect, which ensured the headline index moved inside the BCU's target range, even sliding below the +4% mark in September. With the drop in yoy figures being mostly artificial since September, the index has accelerated, clocking in at the +5%yoy mark in November. With a new edition of "UTE premia" in December, inflation is poised to end near the +5% mark in 2023.

Figure 4: Fruits and vegetables were the subsections driving volatility in 2023

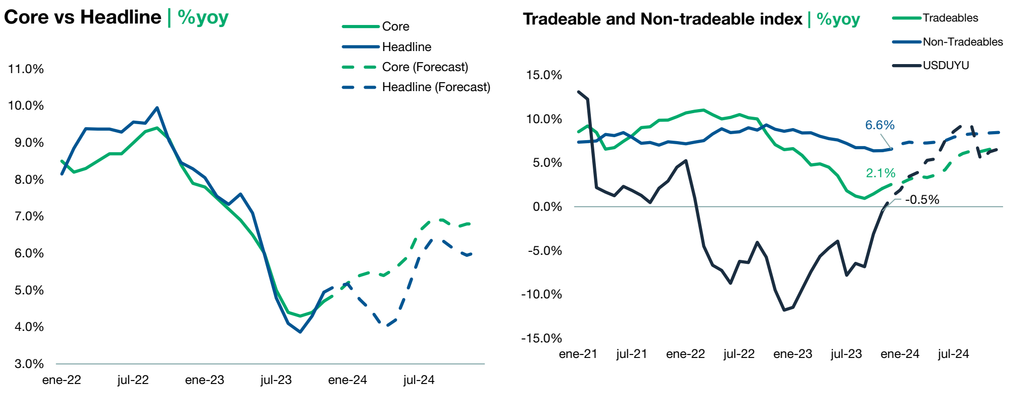


Source: TPCG Research based on INE & CINVE

For 2024, we expect inflation to continue accelerating throughout the year, breaching the BCU's upper range in 2H24.

For 2024, we expect inflation to continue accelerating throughout the year, breaching the BCU's upper range in 2H24. The BCU's battle to reign in the inflationary process has been mostly successful. However, the CenBank had the help of favorable BoP flows, which enabled the FX anchor to reinforce the monetary program and benefitted from heavily depressed 2H23 prints and a strong baseline effect, which favored the collapse of the headline index. Having endured high monthly prints during 1Q23, this means that for 2024, we expect the baseline effect to play heavily in favor of the BCU, which should be consistent with headline inflation remaining inside the target range of the BCU throughout the 1H24. So, while the current context presents a favorable scenario for early 2024 in terms of the yoy prints, we believe the BCU is becoming increasingly isolated in its fight against inflation. The general policy bias of economic policy is pivoting to dovish, especially in the income and fiscal departments. Fiscal figures convey that the Administration has lost part of the fiscal discipline it exhibited during the 2021-22 period. This compounds with the guidelines it provided for the salary negotiations in 2H23, which suggest real wage increases for workers, in addition to the customary inflation adjustments, to compensate for the weakening of real wages during the pandemic, responding to its campaign promises. Both biases should put upward pressure on non-tradeable prices. Given the electoral calendar, we do not expect the government to change its income or fiscal policy bias during 2024 significantly. In addition, tradeable prices exhibited a strong deacceleration, with the USDUYU holding fast during 2023. If the FX weakens nominally in 2024, tradeable prices should also accelerate, adding extra pressure to the headline index. All this compounds with a BCU, which currently holds a neutral monetary bias, which is unlikely to tighten in a context where the CPI sits comfortably within the target range, the FX seems slightly overvalued, and the rest of economic policy remains dovish. All in all, we expect a relatively quiet 1H24, with the acceleration in monthly inflation being offset by the baseline effect. For 2H24, with an increasingly strained non-tradeable index and a waning baseline effect, we expect inflation to slip out of the CenBank's target range, ending Dec-24 near the +6.6%yoy mark.

Figure 5: We expect headline inflation to catch up with core levels, while tradeables should tighten their gap with the non-tradeable index.



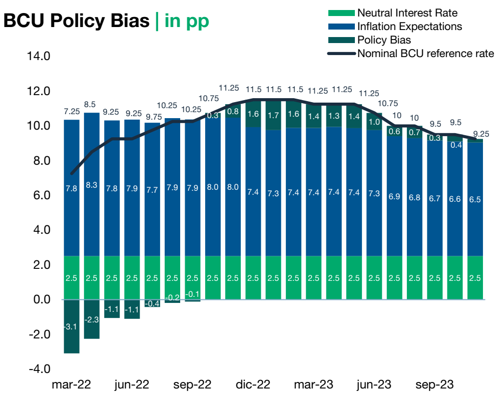
Source: TPCG Research based on INE & CPA Ferrere

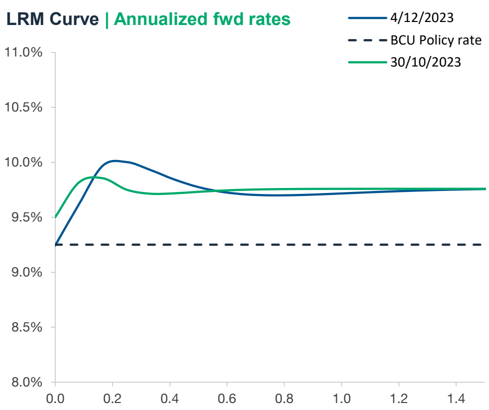
Monetary Policy: Not much juice left in the BCU cutting cycle

In November's COPOM meeting, the BCU announced that the cutting cycle is coming to an end as it approaches a neutral bias.

In November's COPOM meeting, the BCU announced that the cutting cycle is coming to an end as it approaches a neutral bias. On the contrary, the LRM forward curve prices the key rate to hike in the next months. In its latest meeting, the Monetary Policy Committee hinted at the end of the tightening cycle after November's cut. The COPOM anticipated that the policy rate was at levels consistent with the economic agent inflation expectations and that further cuts in the rates would respond to a tightening in said estimates. The BCU uses a composite indicator to measure inflation expectations, which averages business expectations, BCU analyst expectations, and implicit expectations in market rates. With the monetary horizon set at 24 months, the BCU uses this tenor as the relevant inflation expectation. So, by adding the neutral policy rate to this indicator and comparing it to the current policy rate, we can pinpoint the BCU's policy bias. After the last cuts in October and November, the policy bias turned neutral after standing in hawkish area for at least a year, coming down from 0.4pp to 0.2 above our estimate of the NRIR in November. This means the CenBank has an additional 20bp to go before entering a neutral phase of the monetary policy. While inflation expectations have come down significantly in the last months, they continue to prove inflexible to the downside, which means that with inflation picking up a little bit of momentum, their positive convergence should become even more sluggish. So, without further compression in inflation expectations, further cuts do not seem likely in the medium run, apart from a mild 25bp cut before the tightening cycle ends. In addition, it is unlikely that the BCU would shift stances into a supportive bias without a relevant cause, as it would be out of character for this Administration, especially if reflationary pressures start accumulating. In this context, we expect the policy bias to remain roughly neutral, with the BCU responding to shifts in inflation expectations to maintain a neutral ex-ante real rate. On the contrary, the market is pricing a 25bp hike in December and two more in 2024, with the eop rate hovering around the 10% mark by March. Expect a much more hawkish central bank from that moment on. By year-end, the market view implicit in the LRM curve points at a policy rate of roughly 9.25%-9.5%, inconsistent with BCU's forward guidance. We believe the policy rate should clock between 9% and 9.25% by end-December. For 2023, the market forecasts the tightening cycle to spill over to the 1Q24, putting the BCU rate at 10% by end-March, implying another 50bp worth of hikes during the first quarter.

Figure 6: The BCU bias stands very close to the neutral position



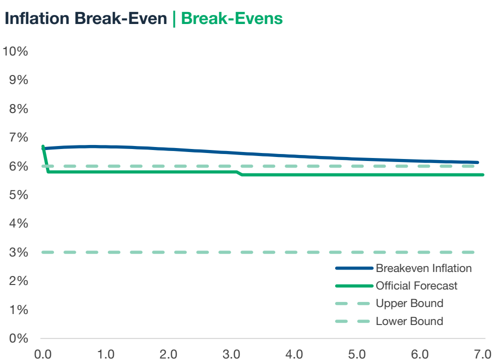


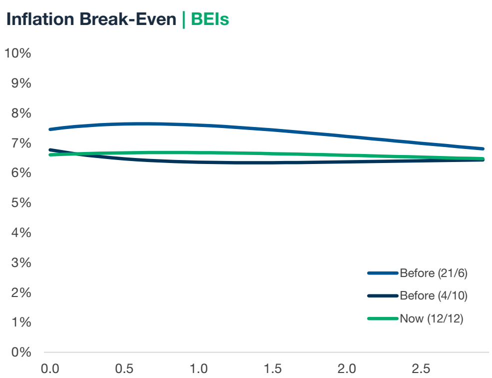
Source: TPCG Research based on BCU, INE & BEVSA

Market BEIs now expect inflation to exit the BCU's target range, standing stubbornly above the upper bound. Estimates also put long-term inflation over the CenBank's targets.

Market BEIs now expect inflation to exit the BCU's target range, standing stubbornly above the upper bound. Estimates also put long-term inflation over the CenBank's targets. Short-term BEIs put inflation 60bp over the BCU's target range of 3-6% in a context where inflation has stood below the upper bound for nearly 6 months. In addition, markets continue to present a skeptical view on inflation converging inside the BCU's range, as long-term BEIs point to inflation levels slightly higher than the target range, even by 2030. Still, the slowdown in inflation seeped into prices, as BEI's have tightened significantly relative to mid-2023, now pricing inflation to remain roughly at 6.5% for the foreseeable future. On the front end, market expectations now price inflation to hover around the 6.6% mark, 93bp under July BEIs. The tightening has also affected the belly, albeit not the long end of the curve. The market now expects a slowdown to 6.4% for the former, an average 50bp below July forecasts. The latter, however, shows no variation relative to July, which showcases that the long-term path view of inflation has not changed significantly in the eyes of the market. Therefore, while tempered, market expectations forecast the inflationary levels to plateau slightly above the 6% mark. In this context, the market does not expect inflation to dip into the Administration's target. However, both the government and the BCU expect inflation to remain within the target by the end of 2024. The government expects prices to increase by +5.8% in 2024 and 2025 and by +5.7%yoy beyond 2025. On the other hand, BEIs point at eop figures of +6.7% for 2024 and +6.5% in 2025, converging to the 6.1% mark after that.

Figure 7: Market BEIs do not see inflation remaining inside the BCU's target range.





Source: TPCG Research based on BEVSA

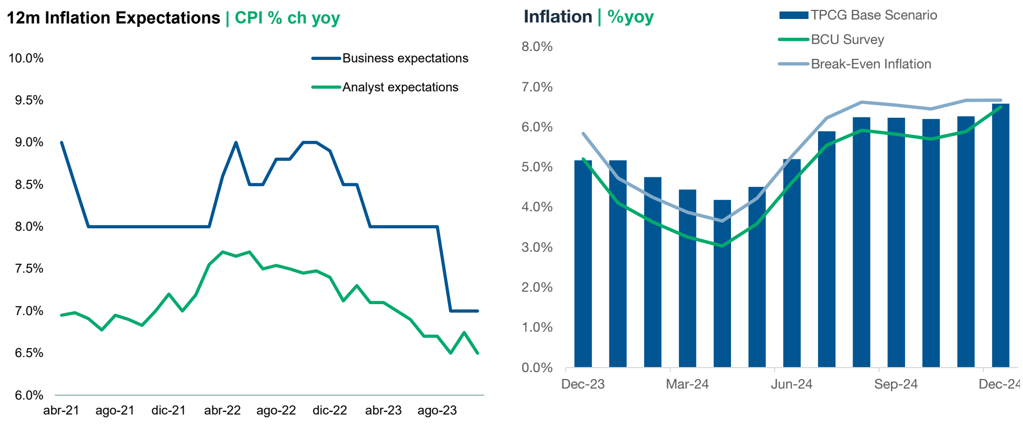
Both real economy and analyst expectations also assume that inflation is likely to linger persistently

Both real economy and analyst expectations also assume that inflation is likely to linger persistently above the BCU's target range, albeit by a tight margin. The financial analysts' 12m inflation expectations currently stand at +6.5% after starting the year at +7.1%. In addition, they expect 2023 to end with a +5.2% rise in prices, showcasing a 1.9pp compression relative to Jan-23 estimates. Real economy agents, however, envisage a scenario with some

above the BCU's target range, albeit by a tight margin.

dissimilarities relative to analyst expectations, as their 12m rolling estimate puts inflation at +7%. This estimate shows a significant variation from February's high of +8.5%, albeit it remains relatively sticky, unwilling to converge to other measures of expectations. With both metrics tempering significantly, we find further expectation compression more difficult. Firstly, because inflation has rebounded in terms of the yoy index, and also because the Administration is not running a monetary, income, or fiscal policy bias consistent with inflation continuing with its decline. In this context, both metrics still forecast non-compliance with the BCU's target range by the end of 2024.

Figure 8: Expectations have compressed significantly



Source: TPCG Research based on BCU, INE & BEVSA

Fiscal Policy: The best of the fiscal consolidation is behind us

The Administration's more dovish bias and the effect of distinct exogenous shocks botched the 2023 fiscal consolidation, bloating the fiscal position.

The Administration's more dovish bias and the effect of distinct exogenous shocks botched the 2023 fiscal consolidation, bloating the fiscal position. Looking at the YTD performance of the 12m-rolling figures, we notice that, in terms of GDP, income sources remained relatively constant, with the growth of expenditures outpacing the former significantly. Of the two aforementioned causes of the underperformance, exogenous shocks mainly affected revenues, as both income sources and GDP were harshly affected by the drought. The latter severely affected the agricultural sector, hitting revenue sources and activity levels. In addition, the extremely favorable REER between Uruguay and neighboring Argentina incentivized frontier settlements to perform most of their purchases of goods and services abroad, which also hurt activity levels and tax revenues in the areas near the frontier. Still, in terms of GDP, the contraction in activity levels maintained revenue sources mostly plateaued. In this context, Tax revenues exhibited no variation YTD, while international trade revenues suffered mildly (-0.1pp), in conjunction with the SOE primary balance (-0.1pp) and the BSE and Munis primary position (-0.2pp). The rise in SocSec contributions partly offset this (0.3pp), closing an unfavorable year for revenues. On the other hand, the Administration's more dovish income policy, compounded with the softening in GDP, saw most Outlays increase YTD. Personnel spending rose by +0.2pp, with Pensions (+0.4pp), Transfers (+0.3pp), and Capex (+0.1pp) following suit. Only Non-personnel spending experienced a mild decrease (-0.1pp) due to the phasing out of the remainder of the COVID fund. A 0.1pp drop in cincuentones revenues also favored the final fiscal position. All in all, YTD, the primary deficit widened by 1.1pp of GDP, which translated directly into the Adjusted consolidated public sector deficit. The former clocked at -1.7% of GDP, while the latter did so at -4.5% of GDP in October, significantly above the 2023 targets.

Figure 9: The Administration carries a significant deviation from the established 2023 targets.

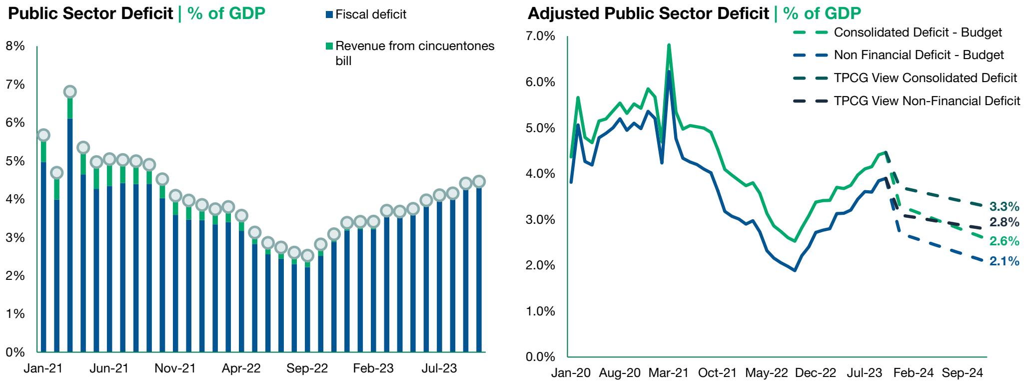
12m rolling - as % of GDP	Dec-21	Dec-22	Sep-23	Oct-23	Dec-23*	Dec-24*
NFPS Income	**26.7%**	**27.1%**	**27.4%**	**27.2%**	**25.8%**	**26.0%**
Central Government	**18.9%**	**19.3%**	**19.3%**	**19.2%**	**18.9%**	**19.0%**
Tax Revenues	*15.9%*	*16.5%*	*16.5%*	*16.5%*	*16.1%*	*16.2%*
International Trade	*1.1%*	*1.1%*	*1.1%*	*1.0%*	*1.1%*	*1.1%*
Others	*1.8%*	*1.7%*	*1.7%*	*1.7%*	*1.7%*	*1.8%*
Soc.Sec contributions	6.4%	6.8%	7.1%	7.1%	6.9%	7.0%
SOE primary balance	1.4%	1.0%	1.0%	0.9%	0.1%	0.3%
BSE &Munis primary balance	0.2%	0.1%	0.0%	0.0%	0.1%	0.1%
BCU primary balance	0.0%	-0.1%	0.0%	0.0%	-0.1%	-0.1%
NFPS Outlays	**27.5%**	**27.8%**	**29.0%**	**28.8%**	**26.6%**	**26.3%**
Central Govt. Primary Outlays	25.8%	25.4%	26.3%	26.3%	25.3%	25.2%
Personnel spending	*4.6%*	*4.6%*	*4.8%*	*4.8%*	*4.6%*	*4.6%*
Non-Personnel spending	*4.3%*	*3.9%*	*3.8%*	*3.8%*	*3.5%*	*3.5%*
Pensions	*9.0%*	*8.9%*	*9.3%*	*9.3%*	*9.1%*	*9.1%*
Transfers	*7.9%*	*8.0%*	*8.4%*	*8.3%*	*8.1%*	*8.0%*
Public investment	1.8%	2.4%	2.6%	2.4%	1.2%	1.1%
Public Sector Primary Balance	-0.7%	-0.6%	-1.6%	-1.7%	-0.8%	-0.3%
Interest payments	2.8%	2.6%	2.7%	2.7%	2.4%	2.3%
Consolidated Public Sector Deficit	-3.5%	-3.2%	-4.3%	-4.4%	-3.2%	-2.5%
Cincuentones revenues	-0.5%	-0.2%	-0.1%	-0.1%	0.0%	0.0%
Adjusted Consolidated Public Sector Deficit	**-4.0%**	**-3.4%**	**-4.4%**	**-4.5%**	**-3.3%**	**-2.6%**

Source: TPCG Research based on MEF

The weakened fiscal position by October conveys that the government will have trouble complying with the first pillar of the fiscal rule for the first time in its tenure.

The weakened fiscal position by October conveys that the government will have trouble complying with the first pillar of the fiscal rule for the first time in its tenure. As mentioned above, the Administration is carrying a significant deviation from this year's fiscal targets, which already proposed no additional fiscal consolidation, leaving the fiscal position flat relative to 2022. In this context, the government envisages the fiscal deficit to total -3.3pp of GDP, now carrying nearly a 1.2pp deviation from year-end targets. After complying with all three pillars of the fiscal rule since its creation, it seems these are increasingly under pressure. While the government should be able to meet the requirements regarding the cap for the increase in primary expenditure and the net indebtedness cap, the first pillar, the binding structural balance, seems more difficult to accommodate. The budget law establishes a -2.7% of GDP structural deficit for 2023. Notably, the binding target refers to the structural deficit, which accounts for and brushes off cyclical effects in the balance. However, the targets were updated in July's budget review, well after the brunt of the drought shock. In other words, the estimations included the impact of this event on fiscal metrics, with the difference between the structural target (-2.7% of GDP) and the headline estimate (-3.3% of GDP), surely accounting for some of the cyclical drop in revenues and expenditure increases. The YTD execution shows that the Administration is currently 1.2pp deviated from the headline target that accounted for most of the effect of the drought. Therefore, it is difficult to envisage these headline fiscal figures being consistent with a structural balance of 2.7% of GDP, as it would mean roughly a 1pp correction due to cyclical effects. For context, due to COVID-19 (a substantially larger shock, the cyclical adjustment in 2020 amounted to 0.6pp of GDP. The only silver lining for the Administration in the last months of the year is that fiscal metrics should improve once Nov-22 and Dec-22 drop off from the 12-rolling figure, as the 4Q22 was very expenditure-heavy, collecting significant one-off capex outlays. This should compress headline figures by around 0.3%-0.4% of GDP, leaving the year-end figures closer to the target. In this context, we expect the fiscal deficit to close near the -3.6% mark in 2023.

Figure 10: An ambitious 2024 consolidation plan will be made more difficult by the 2023 deviation.

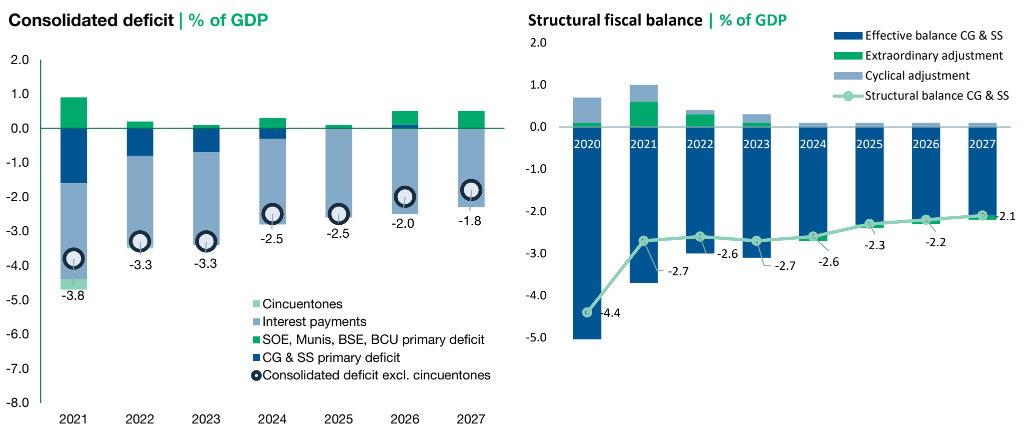


Source: TPCG Research based on MEF

With the consolidation plan for 2024 already looking overly aggressive for an electoral year, further deviation from the 2023 starting point could strain the fiscal path further.

With the consolidation plan for 2024 already looking overly aggressive for an electoral year, further deviation from the 2023 starting point could strain the fiscal path further. This year's budget review envisaged a consolidation plan that punted most compression down the field, leaving the 2023 deficit flat with 2022 figures, mostly due to the drought. To compensate, it expected the headline deficit to total -2.6% of GDP in 2024 (a 0.7pp consolidation), followed by another 0.7pp compression in the 2025-27 period, leaving the fiscal position with a -1.9% of GDP deficit by 2027. Even if the qualms with the second tranche of the adjustment are obvious, as they are poised to take place under another administration, the 2024 consolidation also looks unfeasible. For starters, given a -3.6% GDP deficit in 2023, the gap to compress widens to 1pp of GDP, making the Administration's task more difficult. In addition, 2024 is an electoral year, with the govt. coalition putting its continuity on the line. This could be concerning given that the Administration's chances of executing a considerable fiscal consolidation in the context of elevated political stakes are already low, especially as the government. The Multicolored Coalition is trailing behind the FA in voting intention. We believe that, under severe political strain in 2024, the need to win back voters will likely be the primary focus, trumping any planned consolidation effort. This problem could compound with the possibility of a bloated 2023 deficit. However, the Administration will count on some tailwind to reorder fiscal figures, given that, with improving activity metrics, revenues should regain some ground in 2024, as should GDP, shrinking the fiscal deficit. In addition, the Administration is poised to revise the 2024 fiscal target next year in the Budget review, possibly giving itself some leeway to comply with the fiscal rule. All in all, we expect the fiscal deficit to clock in near the -3.2% of GDP mark in 2024, compressing due to the favorable tailwind but with a fiscal consolidation effort that seems, by nearly all means, halted. In this scenario, we believe the slow but steady deviation from the fiscal targets is credit-negative, even if we don't expect it to affect valuations in the short run.

Figure 11: The structural deficit for 2023 was targeted at -2.7% of GDP



Source: TPCG Research based on MEF

In 2023, GFNs responded to the widening fiscal deficit and are now estimated to total USD5.3bn while funding sources pivoted toward local financing due to a less supportive international scenario.

In 2023, GFNs responded to the widening fiscal deficit and are now estimated to total USD5.3bn while funding sources pivoted toward local financing due to a less supportive international scenario. The upward correction since the start of the year was significant, and current figures showcase a USD365mn increase relative to the statistics presented in the Budget review in July. On the needs side, this rise responds primarily to two factors. Firstly, the wider-than-expected fiscal deficit was responsible for USD128mn worth of additional needs. Secondly, principal payments rose by USD554mn, mostly due to the LMO the Administration greenlighted with the issuance of the UYU33 in mid-July. These increased needs were offset by reduced estimations for both interest payments (-USD49mn) and the change in financial assets (-USD269mn). The increased needs, compounded with constrictive market conditions (because of a deteriorating outlook in the EM space), also forced the Administration to source funding from multilateral lenders, which replaced bond issuances in the international markets. The Administration was able to issue roughly USD4bn, considering scheduled auctions in the local market (USD1bn), unscheduled local auctions taking place early in the year (USD0.9bn), the nominal issuance in international markets (USD1.35bn), and finally, the re-tap of the hard currency SSLB (USD0.7bn). So, by the end of November, the Administration was still USD0.7bn behind in bond issuances relative to its baseline, with a tapped-out local market and few remaining windows to issue internationally in a complex international scenario. Therefore, bond issuances were slashed significantly from August's estimates to November's, being cut by USD418mn to USD4269mn. In this context, the Administration opted to replace some of the programmed bond issuances with IFI credit lines, also looking to reduce financing costs. The Administration secured a USD350mn loan with the World Bank, which is tied to environmental indicators (as the recently re-tapped SSLB), allowing for a step-down in interest given Uruguay manages to overperform with its Paris Agreement commitments. In this context, the government was forced to re-route funding sources from its IFI lines, faced with a wider-than-envisaged fiscal deficit, compounded with the inability to raise additional financing in international markets at the MEF's preferred rate. This issue, in turn, responded to the complex global scenario and the fact that the Administration backloaded the international taps, which came in 2H23.

Figure 12: GFNs for 2024 amount to USD4.4bn

USDmn	2022	2023	2023 (Revised)	2024	2024 (Revised)	2025	2026	2027
Financing Needs	**5,140**	**4,898**	**5,263**	**4,355**	**4,438**	**4,827**	**4,190**	**4,704**
Primary Deficit	722	588	716	234	243	-26	-60	-16
Interest Payments	1,667	1,945	1,896	2,043	2,062	2,086	2,096	2,135
Principal Payments	2,604	2,288	2,842	2,109	2,068	2,800	2,189	2,608
Change in Financial Assets	147	78	-191	-31	65	-34	-35	-24
Secure Financing Sources	**5,140**	**4,898**	**5,263**	**4,355**	**4,438**	**4,827**	**4,190**	**4,704**
IFIs	571	450	987	250	325	250	250	250
Bond Issuance	3,992	4,285	4,269	3,993	4,015	4,464	3,826	4,336
Other (net)	576	164	7	112	98	113	114	118
Net Indebtness	**1,860**	**2,860**	**2,860**	**2,300**	**2,300**	**-**	**-**	**-**

Source: TPCG Research based on MEF

For 2024, GFNs are estimated at 4.4bn, experiencing a marginal upward correction from the Budget estimates.

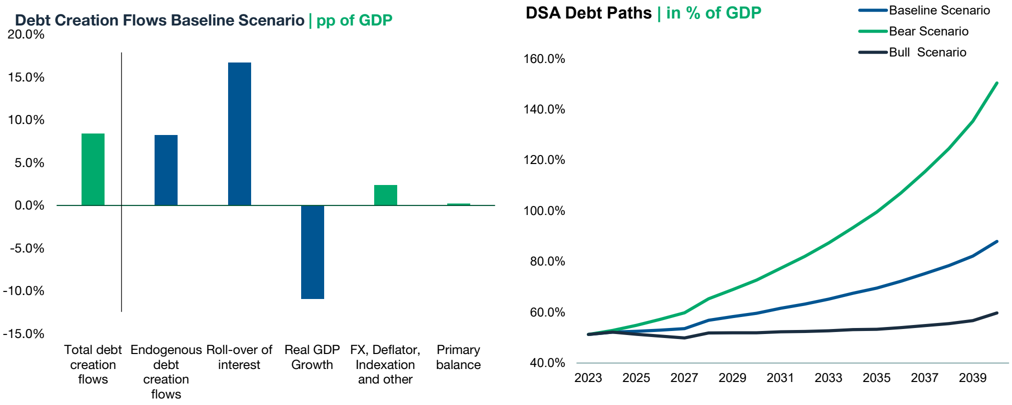
For 2024, GFNs are estimated at 4.4bn, experiencing a marginal upward correction from the Budget estimates. Regarding the Administration's needs, interest and principal payments take the front seat. The former is expected to clock in at USD2bn, while the latter is estimated at USD2.1bn. Completing the picture, the Treasury primary deficit is forecasted at USD243mn, while the change in financial assets is expected at USD65mn. The only yellow light in the Administration's estimations comes from the primary treasury deficit. The projected figure showcased nearly no variation relative to the Budget review, consistent with a -0.3% GDP primary deficit. Currently, the Administration is running a -1.7% of GDP primary deficit and looks likely to miss the -0.8% of GDP mark targeted for end-2023. In this context, we expect the Administration to deviate from the 2023 targets and to fail to compress the primary deficit significantly in 2024, meaning we believe GFNs in 2024 will exceed the Administration's estimates on the back of the deviation from the forecasted fiscal path. On the sources side, the MEF exhibits its usual preferences, maintaining IFI financing at minimum levels (USD325mn), and relying strongly on bond issuances, expecting nearly USD4bn in private funding, with the remaining USD112mn coming from other sources.

Debt sustainability is threatened by fiscal slippage and the possibility of a hostile UST curve.

With a complex international scenario and a structural deficit, with sovereign spreads near minimums, we run a DSA model to analyze the sustainability of the debt path going forward.

With a complex international scenario and a structural deficit, with sovereign spreads near minimums, we run a DSA model to analyze the sustainability of the debt path going forward. Over the current term, the Administration has capitalized significantly on the results generated by its macro policies, which have caused sovereign spreads to collapse, allowing the Treasury to source cheap funding in both the local and international markets, especially during the low-rate cycles flowing the COVID pandemic. In addition, during the recent Fed hiking cycle, the UST curve stood at high levels, which made even historically low spreads result in rates that do not seem as sustainable over the long run when combined with a structural deficit larger than the trend GDP growth rate. While the tightening Fed cycle seems to be on its last legs, auguring a more favorable international scenario, the fiscal risk in the US stll presents a complex context for the Administration. While Uruguay's payment profile on its outstanding securities and IFI payments is well balanced and spaced, debt beyond the 2030 period starts to pile up and, with current rates, could lead to unfavorable dynamics, especially if the next administration fails to compress the primary position back to a surplus. Our baseline model considers all outstanding Uruguay debt, including locally issued notes, of all classes, hard currency, linkers (UI), UP linked, UR linked, fixed-rate UYU, and IFI debt. We assume that all maturities (and their corresponding interest payments) in one given year are either paid via primary surplus or rolled over by a bullet bond replicating each asset class's current structure. We assume a ten-year issuance for fixed-rate UYU and HC debt, a 15-year for UI, UP, and UR-linked bonds, and 10-year loans for multilateral agreements. In case the Administration needs to finance a primary deficit, it does in the following conditions: 35% with hard currency issuances, 29% with UI-linked issuances, 12% in UP, another 12% with IFIs, 8% in fixed rate UYU and 3% in UR. Our macro assumptions follow the ones provided by the Administration in its Budget review, which include long-term inflation stabilizing at 5.8%, with growth standing near the 2.5% mark. In addition, we model a neutral primary position, accompanied by a sovereign spread of 100bp, over the current treasury curve, also assuming a stationary 2% inflation rate for the US in the long term. Under the assumption that Uruguay's structural changes favor an appreciation of the REER, we expect a nominal depreciation of 4.6% in a steady state. Gross public debt starts at 51.3%, and according to our baseline estimates, it will increase to nearly 59.7% by 2030 before increasing to 88% by 2040 in a context where a primary balance and a 2.5% yearly growth is not enough to compensate for the growing interest expense bill.

Figure 13: Widening spreads, in conjunction with a soft fiscal stance, could increase the leverage ratio over the next 15 years.



Source: TPCG Research based on MEF

In a more adverse scenario, assuming wider financing spreads, a persistent primary deficit fiscal discipline, and inflation stabilizing above the BCU targets, the leverage ratio's trajectory becomes substantially steeper.

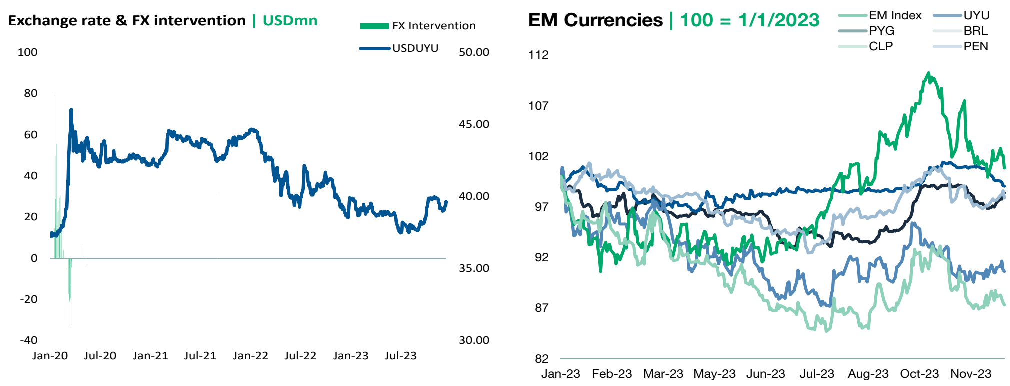
In a more adverse scenario, assuming wider financing spreads, a persistent primary deficit fiscal discipline, and inflation stabilizing above the BCU targets, the leverage ratio's trajectory becomes substantially steeper. On the other hand, a more favorable scenario stabilizes the debt path but requires a drop in the UST rates (which now seems more feasible than two months ago) and further fiscal discipline. In our modeling for the bear case, we assume a running primary deficit of 1%, accompanied by an increase in sovereign spreads to 250bp, with the current UST curve as the benchmark and inflation returning to an 8%-per-year level. In addition, we assume the REER steadily depreciates slowly, with nominal depreciation barely edging inflation. We believe that these assumptions for the bear case are moderate in the case where the next administration opts to abandon the current policy mix, especially considering that the modeled fiscal figures and spreads are more robust than the historical average for Uruguay. In such a context, Gross debt will rise to 72.7% by 2030 and balloon to 150.4% by 2040. In an alternative bull scenario, where the primary position achieves a 1% surplus, and the UST curve returns to values closer to the 3 - 3.5% mark, debt levels stabilize, hovering around current stocks. Such a scenario maintains the assumptions behind our baseline scenario, just altering the UST benchmark and primary position. In this case, Gross debt stabilizes very close to current levels, posting a 51.9% of GDP mark in 2030 and 59.8% in 2040. This highlights that Uruguayan debt stocks are very sensitive to both the UST levels and the primary position, making Uruguay's sovereign spread endogenous to the UST rates. If rates remain at these levels for an extended period, debt sustainability might come under question again, as in 2016-19, eventually widening sovereign spreads relative to Uruguay's peers. However, this does not seem to be the case, as the international scenario has evolved positively, potentially giving Uruguay a respite in terms of its financing costs. Relative to the fiscal path, our baseline scenario already includes a return to a neutral position, which is not foreseeable in the short term, with the Administration already poised to miss its 2023 fiscal targets and having to make a sizable consolidation effort to achieve a neutral position. In turn, we expect HC debt to be more sensitive to these issues in terms of financing costs, as LCD securities have a strong off-taker in the local pension system, which is over USD20bn in size, and with its monthly subscriptions bolstering its AUM, it should allow to maintain LCD funding costs reasonably anchored. However, this means that pension system funds are not likely to be allowed to deploy funds abroad, as widening sovereign spreads could turn the Administration heavily reliant on local funding to maintain relatively cheap financing.

The external sector: A tale of two cities

The performance of the FX in 2023 was not as stellar as in 2022, albeit robust enough to force a significant REER appreciation, with the USUYU still below end-2022 levels.

The performance of the FX in 2023 was not as stellar as in 2022, albeit robust enough to force a significant REER appreciation, with the USUYU still below end-2022 levels. However, the behavior of the Uruguayan peso diverged significantly during the year. During 1H23, the UYU maintained the momentum it had accumulated during the last months of 2022, ending June having appreciated by 6% against the USD. However, during the 2H23, it gave up most of the ground it had won in the first half of the year, depreciating by 6%. Overall, the FX still appreciated in nominal terms this year, standing at 0.4% below the start-of-the-year levels after appreciating by 10.5% in 2022. We believe the not-as-robust performance of the USDUYU this year had to do with several factors. Firstly, current account flows proved to be less supportive this year. Due to the drought, the extremely weak agricultural campaign forced a significant drop in exports, reducing USD inflows. In addition, the bilateral REER with Argentina caused a massive flock of Uruguayan tourists to the neighboring country, which skyrocketed tourist outflows to levels of nearly 87% over the first three quarters of 2022, causing the tourism balance to turn negative for the first time in the last five years. On the other hand, the financial account did provide some support during the first half of the year, with FDI flows peaking at historic heights in 2Q23. Finally, with the monetary policy stance of the BCU watering down, financial inflows also lost some steam. Beyond idiosyncratic factors, we also find that the performance of the USDUYU was significantly correlated to its EM peers. Even if the magnitude of the shocks impacted more moderately on the UYU, which outperformed its peers, the trend's direction strongly accompanied the LATAM currencies. This also explains the strong UYU in 1H23, where the EM strengthened vis-a-vis the USD, whereas in 2H23, the international scenario favored a steep depreciation of the EM currencies. All in all, 2023 proved to be yet another year of nominal appreciation for the USDUYU, albeit at much more moderate levels than in 2022. Still, even with tempering inflation, the overperformance of the FX caused further REER appreciation, which now stands grazing historical minimums.

Figure 14: The USDUYU closed another year without losing any ground

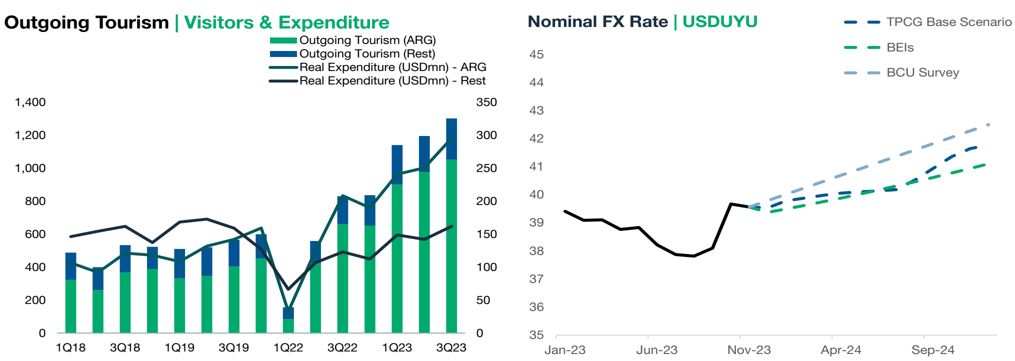


Source: TPCG Research based on BCU & TPCG Trading Desk

Looking at 2024, we expect the USDUYU to lose some ground nominally, accounting for a softer MonPol stance and weakening FDI flows, with export recovery capped by lower international prices. Still, we continue to expect some real appreciation of the currency. In the short run, we expect seasonal factors to hit the USDUYU, forcing it to depreciate to near the 40 level before the end of the year as banks readjust their foreign currency positions before 2023 closes. Beyond December, we expect the recovering agricultural campaign to provide significant flows during the 1H24. This should allow the USDUYU to remain relatively strong, even if the end of the UPM FDI will start to hit the BoP. In addition, pulp exports should rise, accounting for UPM II producing at full capacity, even if weak prices should offset the rise partially. So, after a solid 1H24, we expect the USDUYU to lose some ground as the softer MonPol stance and weaker FDI flows start to weigh on the BoP balance. In addition, the risk caused by the elections is bound to affect the pricing of the UYU. Finally, another non-trivial factor that should affect the trajectory of the FX is the Treasury's financing strategy. After tapping in hard currency in 2H23, the more likely financing strategy, given the authorities' preferences, would be a 1Q24 LCD tap in the international market. With most subscriptions to such issuances generally coming in USD and being used to finance primary expenditure in UYU, said foreign currency inflows should, at one point, be traded into the local FX market. In 2023, the Treasury tapped more heavily during the 2H23, which tilted USD flows later into the year. So, an early issuance should add to the FX trend seasonality, favoring a stronger UYU during 1H24. While international conditions seem to be improving, alternatively a return to a more complex international scenario might nudge the MEF into reshuffling its financing strategy, tapping the local market more heavily, and bringing less USD into Uruguay. Even if we do not expect the Administration to stray heavily from its usual 50/50 split, such a scenario should result in a weaker USDUYU. Currently, BEIs are pricing an FX of 41 by the end of 2024, which, in our view, is somewhat rich, while the analysts surveyed by the BCU estimate an FX of around 42.5 by the end of next year. Our point estimate for 2024 stands at 41.60, which results in a 5.2% depreciation.

Looking at 2024, we expect the USDUYU to lose some ground nominally, accounting for a softer MonPol stance and weakening FDI flows, with export recovery capped by lower international prices. Still, we continue to expect some real appreciation of the currency.

Figure 15: We envisage a stronger UYU in 1H24, then losing ground to weaker seasonal flows and political uncertainty.



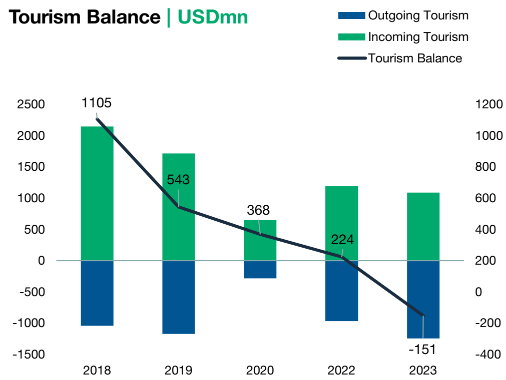
Source: TPCG Research based on Tourism Ministry, BEVSA & TPCG Trading Desk

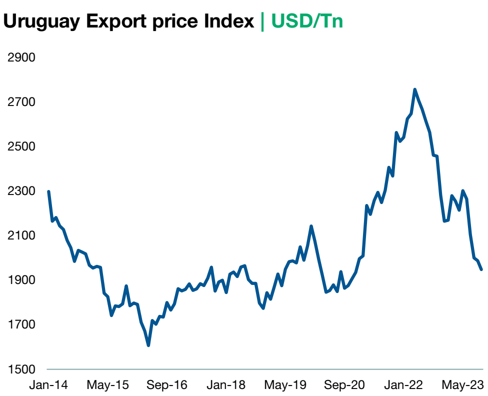
Current account flows should become more supportive in 2024, even if the weak international prices on Uruguay's leading exports should cap the recovery.

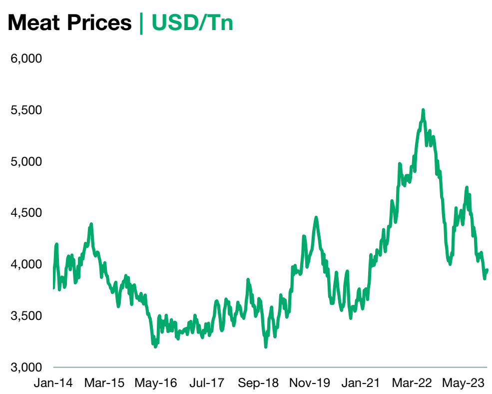
Current account flows should become more supportive in 2024, even if the weak international prices on Uruguay's leading exports should cap the recovery. After the extremely weak 2023 agricultural campaign, quantities are poised to recover strongly, as the 2024 harvest is bound to be plentiful, with substantial rains aiding all crops. However, commodity prices have tanked in the last months, so while favored by climatic conditions, the international scenario is turning more adverse for Uruguay. We estimate that prices could fall up to -15%, a drop which will be more than compensated by a 100% increase in production. In this context, the 2024 agri-flows are bound to add USD1bn in extra exports. In addition, with UPM II producing at full capacity, pulp exports are also bound to increase, given that the plant started producing in mid-2023. However, cellulose prices are at their lowest since 2019, nearly 38% below the 2022 average, an issue that will cap the increase in exports. We expect cellulose exports to increase by USD100mn if market conditions continue as they currently stand. However, increasing prices could allow Uruguay to capitalize on the nearly 40% increase in production it will experience next year as UPM II comes fully online. Meat exports are bound to remain relatively level, even if they will be slightly weakened by downward corrections in prices, a reversal which is also true for dairy products, albeit not for rice. The development of the tourism balance in 2024 is uncertain, as it will largely depend on the events in neighboring Argentina. On the one hand, The neighboring country has abruptly corrected its REER and is headed towards significant drops in activity levels and relative price corrections, so incoming tourism should suffer. On the other hand, a more competitive REER means that, after receiving the lion's share of the increase in Uruguay's outgoing tourism, this trend should significantly reverse. Which effect primes depends on two factors. The first is how strong the corrective measures are back in Argentina and how the bilateral REER develops. On the other hand, the elasticity of both incoming and outgoing tourism to Argentina´s REER. The huge spike in outgoing tourism due to the bilateral REER suggests outgoing tourism is more sensitive to corrections in the real exchange rate than incoming tourism, which could mean, given a strong enough correction, a return to a moderately positive balance next year.

Figure 16: Improving export quantities will be faced by falling prices

	Total Value (USDmn)	Production			Price
		Total (thousand tn)	Sowed Area (thousand ha)	Yield (tn/ha)	
Soybean					
2020	626	1990	916	2.17	315
2021	905	1708	908	1.88	530
2022	1632	2776	992	2.80	588
2023	356	648	1010	0.64	549
2024	1321	2643	1081	2.44	500
Corn					
2020	100	763	117	6.5	131
2021	180	770	143	5.4	233
2022	246	878	152	5.8	280
2023	69	266	188	1.4	258
2024	138	722	114	6.3	191
Wheat					
2020	154	776	238	3.3	199
2021	216	936	224	4.2	231
2022	346	976	245	4.0	354
2023	334	1283	302	4.3	260
2024	229	1059	280	3.8	216
Total					
2020	880	3529	1271	-	249
2021	1300	3414	1275	-	381
2022	2224	4631	1389	-	480
2023	758	2197	1500	-	345
2024	1688	4423	1475	-	382





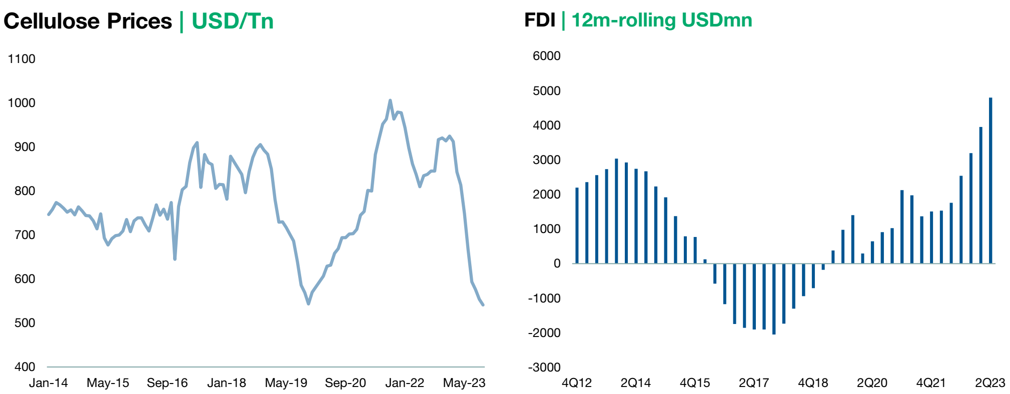


Source: TPCG Research based on DIEA, Tourism Ministry, INAC & TPCG Trading Desk

The financial account is poised to suffer in 2024, accounting for the drop in FDI, while the Administration's financing mix could strain it further.

The financial account is poised to suffer in 2024, accounting for the drop in FDI, while the Administration's financing mix could strain it further. FDI flows peaked in 2Q23 as the construction of the UPM II plant ended. We expect figures in the 3Q and 4Q to reflect such a pattern, which will surely impact the figures of 1H24 more strongly. 12-rolling FDI currently amounts to USD4.8bn, the largest inflow in the last decade. A substantial amount comes from the UPM II project, which cost around USD2.7bn, with its construction starting in mid-2020. So, on the one hand, with construction over, Uruguay will stop receiving funds, while, on the other, the repayment of the loan to the central house in Finland will mean a steady increase in outflows in the next years, as the firm cashes out utilities. All in all, we expect FDI to decline significantly in 2024, a negative driver for FX appreciation. A possible positive news comes in the shape of the project announced by the Administration recently, which would see a green hydrogen plant being constructed. The project would see a Chilean firm, HIF Global partner with ANCAP's subsidiary ALUR to build the green fuel plant. Said infrastructure is poised to be built in the Paysandú department and should cost around USD2bn. Another USD2bn will be invested in supplying power to the plant via eolic and solar parks, making the initiative completely green. The plant is expected to use green hydrogen and the residual CO2 generated by ALUR to produce nearly 256mn liters of synthetic green fuel, which is expected to be exported to Europe, rather than consumed locally. This additional USD4bn in FDIs could plug the gap left by UPM II financing, if needed. However, it is key to highlight that the project is still very green and in the feasibility phase. Before the project starts, the companies would have to secure the contracts to sell the hydrogen abroad, and, if it is greenlighted, the project would start in mid-2025, leaving a year and a half to bridge with faltering FDI flows. Finally, as mentioned above, the financing strategy of the Administration will also determine the destiny of the financial account flows, with our expectation being roughly a 50/50 split between local and external financing, with two external issuances coming, one in 1H24, with the remaining in the 2H24.

Figure 17: FDI flows should turn against the financial account in 2024



Source: TPCG Research based on BCU & TPCG Trading Desk

We find evidence that the Uruguayan peso is poised to overperform its EM peers in the medium run, with some significant structural factors driving the appreciation of the real exchange rate.

We find evidence that the Uruguayan peso is poised to overperform its EM peers in the medium run, with some significant structural factors driving the appreciation of the real exchange rate. In our view, the Uruguayan economy has traversed a considerable change in the last few years, having developed very dynamic sectors that are strong suppliers of USD into the economy, leaving a less dynamic, traditional sector of the economy to lag. The new UPM II project consolidates the existing trend of a very strong export sector, as the current three pulp mills, in addition to all their derivative products, the agricultural sector, and the newly developing consulting, financial, IT industries, and to some extent, tourism, provide significant USD inflows and mostly enjoy a differentiated tax regime (especially pulp mills and the services industries located in the tax-free zones), which allow them to operate at lower FX rates that the rest of the legacy economy, which at said levels becomes severely uncompetitive. This is also magnified by the current BCU policy of not intervening in the FX market, which does deepen the appreciation bias caused by the export sector. In addition to very strong FDI flows, that is causing the UYU to periodically outperform its EM peers. We identify three factors that could put an end to these developments. Firstly, an FA win in next year's election cycle could come with a more protective BCU, which intervenes more actively in the FX market, trying to bridge the excess USD provided by the dynamic sectors with the weaker productivity of the legacy economy. If the situation persists, an FA administration could also revise the tax benefits offered to the industries operating in tax-free zones. Finally, if Uruguay fails to secure new projects to fuel its FDI, then the financial flows in the BoP could start to offset the dynamic sector's export potential. In such a context, we believe, under current conditions, the FX is poised to overperform its EM peers in the medium run, even if that means slight nominal depreciations.

Figure 18: In this context, improving CA flows will face weakening financial flows

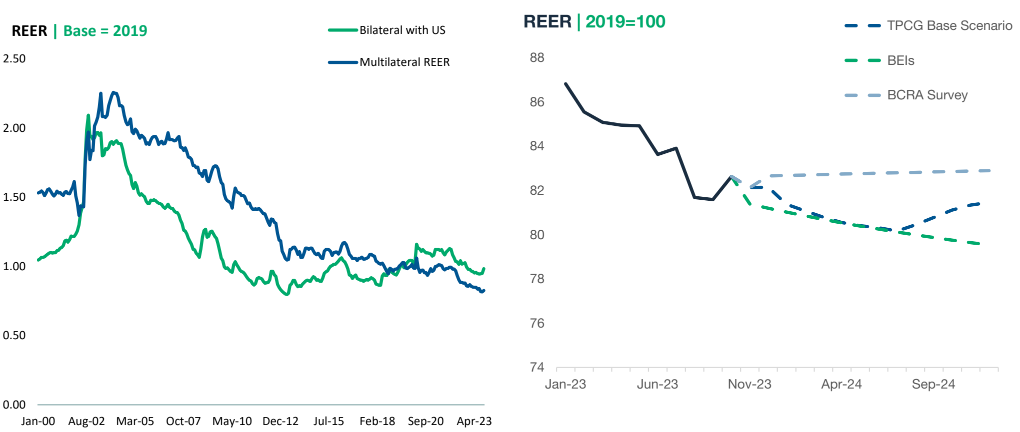
USDmn	2021	2022	2023(f)	2024 (f)
Current account	-1,555	-2,620	-2,824	-1,641
Goods & Services	4,402	3,670	3,441	4,816
Goods	4,616	3,501	3,128	4,135
Exports	15,827	17,062	16883	18,234
Imports	11,211	13,561	13755	14,098
Services	-214	169	313	681
Exports	3,700	5,503	6,297	6,486
Imports	3,914	5,334	5,985	5,805
Primary Income	-6,035	-6,421	-6,395	-6,587
Secondary Income	78	130	130	130
Capital account	-30	3	0	0
Financial Account	-183	-2,319	-2,846	-1,507
Direct Investment	-1,493	-3,175	-4,546	-3,637
Portfolio Investment	1,084	1,877	1,721	1,635
Derivatives	435	378	345	345
Other Investment	-1,053	180	444	399
Errors & Ommisions	1,402	299	-22	134
Reserve Assets	843	-1,578	-810	-250
12m-rolling GDP (USDmn)	**61,422**	**71,199**	**75,268**	**78,053**
Balance as % of GDP (12m)	-2.5%	-3.7%	-3.8%	-2.1%

Source: TPCG Research based on BCU

Regarding the REER, we expect the nominal depreciation not to exceed the pace of inflation, meaning the real exchange rate should appreciate marginally.

Regarding the REER, we expect the nominal depreciation not to exceed the pace of inflation, meaning the real exchange rate should appreciate marginally. As described above, the external flows entering Uruguay in 2024 are reshuffling significantly. The improvement in the current account is bound to be offset by the drop in the financial account flows, which should result in a moderate depreciation of the FX rate. However, we believe the acceleration in inflation metrics should be able to outpace the nominal depreciation. In this context, we expect the REER to appreciate by -1.3% in 2024, with BEI's pricing at -2% appreciation and the analysts surveyed by the BCU expecting a +0.3% depreciation. While the REER is close to historically low values (especially looking at the multilateral REER), the bilateral with the US looks at relatively healthy levels. The sluggish multilateral index is mainly explained by the REER with Argentina, which has appreciated nearly 11% YTD. In this context, we believe the REER excluding Argentina mostly stands at healthy levels, and any upward correction will respond mainly to adjustments in the neighboring country.

Figure 19: The REER should stop gaining ground in 2024

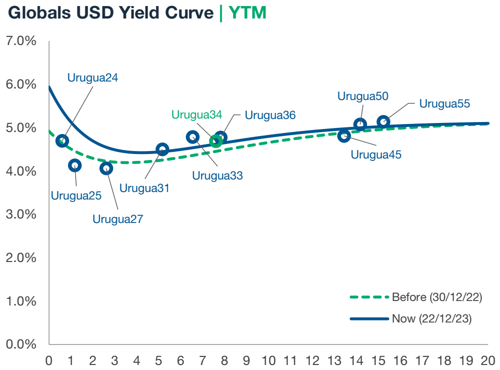


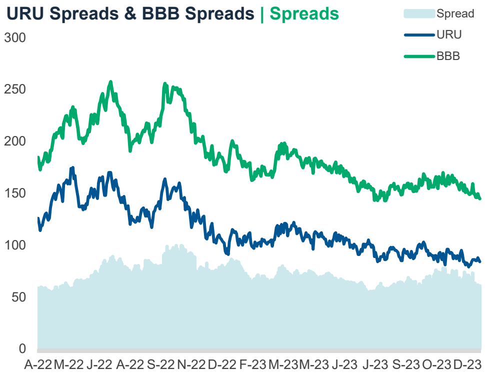
EXD Strategy: we mantain HC debt at MW

Even with idyosincratic factors potentially starting to seep into very tight spreads, we believe Uruguay's HC curve could be an adequate EM vehicle to capitalize an improvement in international conditions.

Even with idyosincratic factors potentially starting to seep into very tight spreads, we believe Uruguay's HC curve could be an adequate EM vehicle to capitalize an improvement in international conditions. While Uruguay's hard currency debt has performed well in recent years, especially against peers and UST, spreads seem somewhat too tight accounting for the Administration's fiscal bias and the debt sustainability path. In addition, the political risk caused by the 2024 elections, which can undo a substantial portion of the current Administration's institutional framework, also suggests spreads against the UST are on the tighter side of the spectrum. In fact, YTD performance showcases that Uruguay's HC debt is no longer able to gain any more ground in terms of spread, showcasing little price variation in the last year. The country's idiosyncratic risk has had a slightly negative bias in price variations, even if the curve's shape is relatively similar to the end of 2022. In our view, Uruguay's HC debt has found its ceiling in terms of spread tightness vs the US, and we believe idiosyncratic factors in 2024 should push those spreads back to wider figures, even if we do not expect the weaker idiosyncratic factors to translate into lower prices at least until 2H24, where the political risks could start to bring these issues into the spotlight. However, we do believe that a more supportive international scenario, which seems to be dawning, could trigger a significant compression of the URUGUA curve. In such a context, the duration of the HC curve could potentially transform it into an interesting vehicle to capitalize tighter rates in the US, inside the EM space. So, our MW stance is justified by both the fact that spreads seem to be somewhat too tight with fundamentals and politics seemingly taking a slight turn for the worse in the medium term, albeit the improving scenario might trigger a compression in the HC curve, which could rpvinde an interesting opportunity to benefit for its extended duration.

Figure 20: The space performed mostly in line with the UST





	22-dic.-23			YTD				
	MD	Yield	Price (Conv.)	Carry (bps)	Δ Clean PX (bps): Δ US Yield Curve	Δ Clean PX (bps): Δ URU Spread	Δ Clean PX (bps): Total	Total Return (bps)
URUGUA24	0.6	4.57	99.95	147	45	-60	-15	132
URUGUA25	1.2	4.20	103.21	448	353	-32	321	769
URUGUA27	2.6	4.05	100.86	423	14	-46	-32	391
URUGUA31	5.2	4.50	99.35	430	51	-73	-21	409
URUGUA34	7.7	4.69	108.39	519	1	-1	0	519
URUGUA36	7.8	4.78	124.48	588	-70	-116	-186	402
URUGUA45	13.5	4.81	91.06	434	59	-251	-192	242
URUGUA50	14.2	5.08	100.35	506	51	128	179	685
URUGUA55	15.3	5.13	97.57	506	63	80	143	648

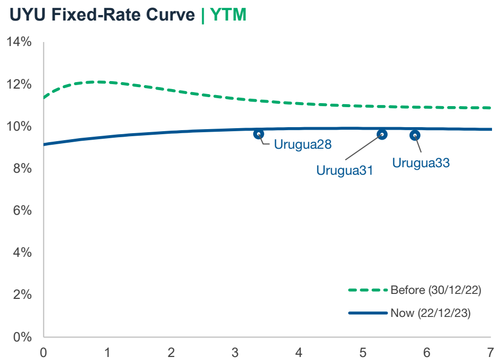
Source: TPCG Research based on BEVSA and TPCG Trading Desk

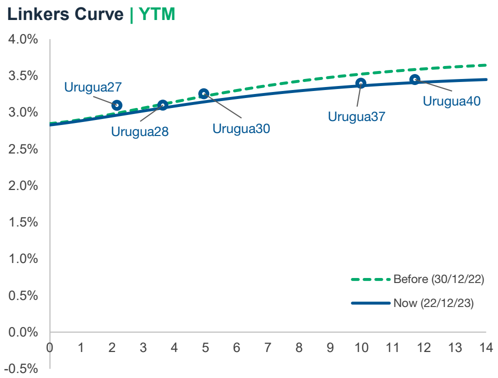
LCD Strategy: we upgrade Linkers to OW and downgrade nominals to MW

On the LCD side, we upgrade likers to OW while downgrading nominals to MW, as we believe inflation should start to pick up in 2024, a scenario that compounds with attractive real rates in the long run.

On the LCD side, we upgrade likers to OW while downgrading nominals to MW, as we believe inflation should start to pick up in 2024, a scenario that compounds with attractive real rates in the long run. As discussed above, the Administration's policy bias won't prevent a rebound of inflation throughout 2024. It is difficult to envisage a much tighter fiscal deficit for the incoming electoral year, suggesting that the general bias of fiscal policy will continue to be supportive. In addition, income policy and salary negotiations are also bound to strain non-tradeables to the upside. At the same time, a relatively weaker UYU, especially in 2H24, should also put additional upside pressure on tradeables, which have been key for the BCU's strategy to contain inflation. Furthermore, the policy bias of the CenBank stands roughly at neutral levels, and it is difficult to envisage a return to a tightening bias by the BCU in the short run. In addition, we believe the entry levels for linkers, especially in the back end, look attractive. In terms of timing, we expect the UYU to show some extra volatility during the end of 2023, which should stop as agriflows start to come in early 2024, while inflation carry should begin to pick up in early February. In addition, with the MEF rumored to issue a global linker in 1Q24, real rates should continue at relatively high levels, at least until the issuance, replicating the market behavior with nominal bonds pre and post-issuance of the UYU33, providing solid purchasing opportunities by the end of 1Q23. On the nominal side, we believe long-end break-evens look tight, and compression prospects seem damper, as the BCU has little room to continue cutting rates, even if carry in USD could still be attractive in the short run. However, for 2H23, political risks are more consistent with a more defensive, CPI-linked position, especially if the FA remains the front-runner in polls.

Figure 21: Looking at 2024, linkers are poised to edge nominals





Source: TPCG Research based on BEVSA and TPCG Trading Desk

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