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LATAM Strategy – Uruguay

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URUGUAY: Notes from our talks with officials and market participants

The drivers behind the FX appreciation should lose steam

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Most of our talks pivoted around the FX market dynamics, with both local policymakers and market participants showing substantial concern over the UYU's performance. Starting with government players, we found the BCU to be the most comfortable agent with the UYU dynamics. Cenbank officials were adamant in pointing out that BCU is happy with its involvement in the exchange rate market and is implementing additional systems to reduce its role in it. Intervention should be minimal, with only a serious exogenous event threatening its no-intervention policy. In addition, they expect the real exchange rate to depreciate in an orderly fashion throughout the year, as they find the current REER to be slightly appreciated relative to Uruguay's fundamentals. Instead, the MEF showed some concerns regarding the FX but mostly concentrated on the effect it could have in the real economy, dampening growth prospects and therefore affecting tax collection. Finally, market participants are worried that a sharp REER correction could threaten their long-UYU position. The dollarization in local portfolios stands near historic lows, leaving local players vulnerable to FX shocks.

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We believe three main drivers are bound to determine the path of the nominal exchange rate from now on: (i) the BoP flows, (ii) the BCU's policy stance, and (iii) The Treasury's issuance strategy. Market participants expect current account and FDI flows to turn from heavily supportive to neutral/slightly unsupportive in 2023. Looking at the trade balance, its composition is bound to be heavily altered relative to the last year. Reviewing the negatives, the drought and weaker international prices are bound to cause a drop of nearly USD1200mn in agri-flows, with the first affecting the summer crops, while the second should nudge meat exports downwards. In this context, the effect should be relatively even, with the soy campaign and the ranching sector expected to experience USD600mn in losses each. Furthermore, the FDI flows should drop significantly, with UPM II capital inflows grinding to a halt, and could even reverse as loans related to its construction are repaid. On the sunny side of the street, UPM II is expected to come online by 2H23, and the gradual ramp-up in production should contribute between USD600mn and USD800mn in exports, neutering the weak soy campaign. A reduction in Imports should partially compensate for the stop to FDI inflows as the need to supply the construction of the UPM II plant fades. In addition, the services balance is poised to overperform in 2023. This comes on the back of two driving factors. The first is the provision of software and consulting services, which have proven to be a strongly growing economic sector. In addition, the tourism sector is expected to close its best season since 2019, nearly returning to pre-pandemic levels. However, this effect should be dampened slightly by an increase in the outflow of Uruguayan tourists on the back of the high wages in USD. We estimate foreign currency inflows should drop by around 0.7bn-1bn this year. However, this does not automatically translate to a depreciation in the FX, as last year's balance was heavily supportive, now pointing to a slowdown in inflows rather than outflows. This is also hinted at by the solid performance of the current account deficit, which continued to compress during 2023 even in the face of the nominal appreciation. All in all, this scenario forces the BoP to move from an extremely supportive stance to a more neutral position.

The BCU's bias is expected to remain hawkish, with nominal rates dropping slower than inflation expectations.

The BCU's bias is expected to remain hawkish, with nominal rates dropping slower than inflation expectations. Looking at the monetary policy, the CenBank expects the policy bias to continue to be contractive. However, this does not mean the policy rate will stay flat. The BCU is banking on inflation expectations to continue their current trend and deaccelerate, ergo allowing them to lower the nominal key rate, maintaining (or even widening) the real rate. We expect the CenBank to maintain real rates around the +3% mark, conserving its hawkish bias, as Uruguay's natural interest rate stands near the +2% mark. In this context, we expect the CenBank to ride out the inflationary pressures in the Food & Drink index derived from the drought before lowering the nominal rate during 2Q23.

In addition, the Treasury expects to maintain its two-pronged financing strategy, tapping both the local and global markets.

In addition, the Treasury expects to maintain its two-pronged financing strategy, tapping both the local and global markets. Government officials pointed out that the financing strategy for 2023 would be similar to that of previous years, balancing local and global issuances. On the local front, the Treasury and BCU held an extraordinary auction, tapping local markets for USD0.9bn in local NT notes. In addition, the scheduled auction calendar throughout the year can issue another 0.5bn, possibly doubling the figure. With this in mind, the Treasury is bound to finance itself, raising USD 1.4-1.9 bn from local markets. With the Treasury planning to fund its GFNs with USD3.7bn in bond issuances, that would leave roughly USD2bn to be issued. The conundrum the treasury faces regarding the remaining issuances is that tapping local markets further would mean higher financing costs, while going to the global market for funding should push the FX to appreciate. We believe the administration will pick the latter poison. In this scenario, the Treasury would tap global markets for roughly half its planned issuances. Even if the administration offers UI or UYU-denominated bonds, given that they will come in the global market, most subscriptions will come in USD. This means the Treasury becomes a net supplier of foreign currency, as it now faces liabilities and expenditures in UYU, and so it must exchange the USD received in the global market for UYU, putting some pressure on the FX to appreciate. A scenario where the MEF continues to tap local markets would avoid said strain, but with a cap on the size of the local market, that would force it to pay higher rates to source its financing needs. We find it is unlikely the administration will accept the said trade-off, but a higher proportion of local taps could play in favor of decompressing the FX.

All in all, we believe the FX is bound to depreciate slightly in nominal terms this year, as a structural change in the Uruguayan economy will be dampened by the weak agricultural campaign.

All in all, we believe the FX is bound to depreciate slightly in nominal terms this year, as a structural change in the Uruguayan economy will be dampened by the weak agricultural campaign. Having discussed the BoP flows for the year, we find that the lack of dollars relative to 2022 should cut the prospects for further appreciation of the UYU but should not be a driver for a depreciation of the nominal exchange rate. In addition, the BCU is expected to maintain its hawkish stance looking at the real rate, which should not fuel further capital inflows but should neither result in outflows either. And the Treasury is expected to maintain its stance as a net supplier of USD, pointing at a stable FX for 2023. In this scenario, we hold a more constructive view of the UYU depreciation relative to the market consensus, which envisages the FX rate to hover around the USDUYU42 mark. In our view, the nominal rate should end the year hovering around the USDUYU40/41 mark, with the REER continuing its appreciation. We do not expect the FX to suffer a sharp correction during the year, as both foreign currency inflows and the BCU's lack of intervention should prevent the UYU from gapping. However, the chances of nominal appreciation this year look limited, and the probability of the USDUYU dropping close to the USDUYU37 mark looks low. For 2024 however, with UPM II fully operational and a recovering harvest, we believe the prospects for further FX appreciation are high, as the structural changes experienced by the Uruguayan economy should no longer be offset by the drought, putting BoP flows in a much favorable position relative to the current year.

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Inflation expectations fall mostly between the +6.5% and +7.5% marks. Convergence with the BCU's target could be achieved in 2024 but requires a stiffer hand in salary negotiations. In our view, yearly inflation should come near the +7% mark. However, we believe the scenario is tilted to the downside, as we assign a higher probability of occurrence to inflation coming in slightly under our estimate rather than over. The current inflationary process is marked by a decoupled Tradeable index, which stands substantially below the headline index (+5.4%yoy) due to the reduction in international prices and FX appreciation. Instead, the Non-tradeable index is anchoring the general index at a high level, remaining stubbornly flat, over the +8.5%yoy mark. Given the intrinsic characteristics of the Non-Tradeable process, which presents a heavier trend than its tradeable counterpart, if the former is nudged down and starts to converge to the BCU's target range, then inflation could end the year under the +7% mark. However, it is paramount that salary negotiations come near the 7%-7.5% mark. The issue comes in the form of the government's promises, as the administration has the objective of returning real wages back to their 2019 level. This should cause the salary negotiations to clock in closer to the 7.5%-8% mark, which in turn should dampen the prospect of inflation compression this year. Still, with limited passthrough and only a slight transitory effect from the drought to push prices upwards, the chance of inflation gaining substantial momentum looks slim.

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Fiscal perspectives look solid enough, albeit we found little evidence to support the prospect of further consolidation. Even with the fiscal deficit widening since Sept-22, the administration managed to comply with 2022's fiscal rule. However, real expenditure ex-COVID fund did increase over the administration's cap (+2.1%yoy), rising by +3.3%yoy fueled by a strong focus on public investment, which rose by +43.7% relative to 2021, instead of the budgeted +7.7% rise. While the widening of the deficit since September has been substantial, it could also be tied to the administration's strategy, which implemented a balancing act to smoothen spending over time. With the fiscal balance firmly in control by September and the administration widely complying with 2022's target, it decided to accelerate public expenditure to avoid doing so in 2023, where the fiscal constraints are significantly tighter. In this context, the government could have preferred to ramp up capex, forcing much tighter compliance with the target, to have some additional wiggle room this year. Still, this strategy forces the administration to regain some hard-won ground this year. A flatter trajectory for the deficit since September would have presented a much better starting point, albeit at the cost of capping the administration's spending capabilities. On positive news, the administration's recent announcements regarding tax cuts were mostly immaterial. However, structural cuts justified by a cyclical rebound in activity do raise some questions regarding the future health of fiscal figures. Overall, the government still has 0.5pp of GDP left to trim from the COVID fund this year. Still, we expect consolidation to slow down substantially as this buffer is exhausted and the administration is forced to tackle additional structural cuts in spending.

Income policy should continue to be supportive, even at the cost of a marginal increase in unemployment.

Income policy should continue to be supportive, even at the cost of a marginal increase in unemployment. In a context where the administration has lost a significant portion of its positive image on the back of the recent scandals surrounding Mr. Lacalle Pou's security detail, it will probably keep to its promises regarding the recovery of real wages. Looking at Jan-23 figures, the index stands at -1.7% below Jan-19's level. So, with inflation probably coming in the 6.5% -7.5% bracket, it isn't easy to envisage salary negotiations below the 7.5%-8% mark, as the government is now pressed to fulfill its promises. Still, from a macro standpoint, the real economy's growth is now well above 2019 levels. Therefore, real wages returning to their 2019 level should not threaten competitiveness from a technical point of view. However, the quid of the issue can be found in real wages in USD. With last year's strong appreciation, wages in USD skyrocketed. This presents a difficult conundrum for the administration, as further increases in the wage department could trigger higher unemployment rates, which could harm electoral prospects going into an election year.

The political space is facing a reconfiguration ahead of the 2024 elections

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The current political scenario puts the Frente Amplio as the slight favorite going into the 2024 elections, with both coalitions still having some issues in the candidates' department. The problem that cruxes both fronts ahead of the elections is that none of the potential candidates command a significant amount of power inside the party structures of their respective political organizations. Starting with the government coalition, its obvious problem is that it will be unable to capitalize the popularity of Mr. Lacalle Pou, who would probably be its strongest candidate, and must now watch the electoral race from the sidelines. In the Partido Nacional, the coalition's senior partner in voting intention, the two candidates bound to compete for the candidacy are Mr. Alvaro Delgado and Mrs. Laura Raffo. The first is closely tied to Mr. Lacalle Pou's tenure, being the Secretary of the Presidency, while the latter stands slightly further away from the current administration and can present a slightly more critical view from inside the coalition. As the current scenario stands, Mr. Delgado is expected to edge Mrs. Raffo in the race for the candidacy of the Partido Nacional. However, presenting two candidates to the primary elections inside the coalition could cause some competitiveness issues relative to the rest of the members of the coalition, which would probably present only one candidate. In the FA, Mr. Yamandú Orsi and Mrs. Carolina Cosse look to be the strongest candidates ahead of the preselection. Both are currently majors in Canelones and

Montevideo, respectively. The former is expected to count on the support of the MPP (Movimiento de Participación Popular), while the latter is expected to enjoy the support of the Communist Party. While the political platform of the FA still must be discussed, Mr. Orsi currently seems like the strongest candidate head of Mrs. Cosse. With a slightly weaker administration, currently, the FA looks like a slight favorite to take the next electoral bout in 2024. This comes on the back of the robust voter base the FA has and due to the fact that the government coalition has lost some public image. In addition, Cabildo Abierto, a current member of the coalition, has voiced their discontent with the government and might consider running outside the coalition in the next elections, which could turn it into a pivotal party to secure a legislative majority beyond the elections.

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A possible FA victory should test the mettle of the institutional framework established by the current administration, which still must solidify. The improving perspectives behind Uruguay in recent years have come due to the clear framework established by the new administration and the institutional order it created. The BCU's transparency and shift in the monetary policy management must be highlighted and have been instrumental to the administration's successful tenure. In addition, the fiscal rule created by this government has also been another of the pillars sustaining Uruguay's improving metrics. The issue is that this newly instituted framework is still young and could be relatively easy to overturn. The BCU's shift did not stem from a change in its charter but from the public officials placed by the new administration. And the fiscal rule has only been used to shore up one budget (2020-25). So, the FA could be able to root out the instated law to a relatively small (but not irrelevant) political cost. The BCU also lacks the institutional mandate to sustain its current modus operandi in the face of a hostile administration. Suppose the fiscal rule survives one more tenure. In that case, the political cost of dissolving it turns almost unacceptable, which is also true (albeit slightly less so) for the BCU and would solidify the administration's reforms as structural.

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All in all, after our latest round of talks, we believe there is value in the LCD securities, with nominals slightly edging linkers based on better compression prospects. With inflation expectations converging, the BCU maintaining the real rate near the 3% mark, and a stable FX, we believe the UYU-denominated securities could be a better play for 2023. With nominals standing near the 10% mark, a stable FX during the year would maximize the space's carry. Looking at compression, with linkers standing near the 3% mark, it isn't easy to envisage a scenario where the real rate goes well beyond that mark, with the BCU intending to keep it near that level. This should dampen the compression prospects for the linkers curve. On the other hand, even as the real rate is expected to remain flat, the nominal rate is expected to drop, with the BCU following the decrease in inflation expectations with key rate reductions. In this context, rate drops should trigger further compression in the nominal space, compounding with a juicy carry.

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