TPCG

Juan Manuel Pazos
Chief Economist
+54 11 4898 6606
jmpazos@tpcgco.com

Santiago Resico
LATAM Strategist
+54 11 4898 6615
sresico@tpcgco.com

Uruguay Strategy View

The fiscal position plateaued in February at -3.5%of GDP

Uruguay's fiscal position remained stable in February, with increasing income sources matching the slight rise in expenditures.

Uruguay's fiscal position remained stable in February, with increasing income sources matching the slight rise in expenditures. The Government's policy agenda continues to concentrate on bolstering disposable income and real wages, after the high inflation during 2022 put a strain on salaries, recently announcing a tax cut of 0.25pp of GDP. Still, the administration continues to consolidate the fiscal position, conveying a strong commitment to balancing government accounts in the medium term. In February, non-financial public sector income printed 27.4pp of GDP (+0.2pp relative to January), with the increase driven by an improvement in Soc. Sec collections and the SOE's primary balance. On the spending side, expenditures came at 28.1pp of GDP (+0.1pp relative to January). Central Government primary outlays increased in February, with the widening coming on the back of Soc. Sec outlays. In this context, the primary fiscal deficit excl. cincuentones came at -0.8pp of GDP, flat since December, after worsening non-stop since Sept-22, as the fiscal balance suffered substantially during 4Q22. February's figure followed prints of-0.8pp in January — -0.8pp in December — and -0.4pp in November—. In this context, the primary position remained flat relative to December, accounted for by a 0.2pp increase in NFPS income, and a 0.1pp increase in NFPS outlays. Consistently, the consolidated public sector deficit excl. cincuentones stood over the 3pp of GDP mark for the fourth month running. February's print came in at -3.5% of GDP— flat from -3.5% in January, but up from -3.4% in December and -3.1% in November—.

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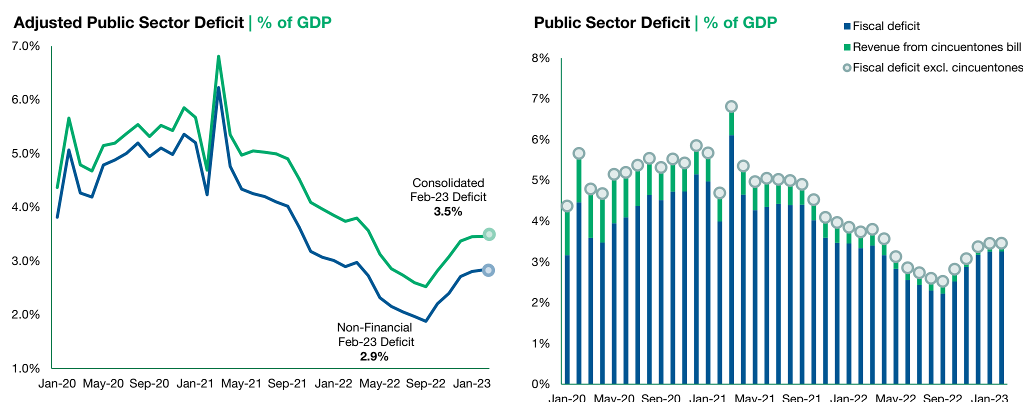
On the spending side, expenditures came at 28.1pp of GDP (+0.1pp relative to January). Central Government primary outlays increased in February, with the widening coming on the back of Soc. Sec outlays. In February, the COVID Fund balance totaled -0.4pp of GDP—dropping by 0.1pp relative to January, and down by 0.2pp YTD. In this context, Central Govt & Soc. Sec. expenditures totaled 25.7pp (+0.1pp relative to January) on the back of a single 0.1pp increase in Soc. Sec. outlays. Public investment lost some momentum at the start of 2023, remaining stable relative to January, standing at 2.4pp of GDP, not influencing the increase of expenditures. With non-financial public sector income rising by +0.2pp, non-financial public sector outlays increasing by +0.1pp, and cincuentones revenues standing at 0.2pp of GDP, the primary deficit excl. cincuentones stood at -0.8pp in February—flat from -0.8pp in January and -0.8pp in December, while down from -0.4pp in November—.

Figure 1: February's fiscal figures



12m rolling - as % of GDP	Dec-21	Dec-22	Jan-23	Feb-23	Dec-23*
NFPS Income	**26.7%**	**27.1%**	**27.3%**	**27.4%**	**26.5%**
Central Government	**18.9%**	**19.3%**	**19.5%**	**19.4%**	**19.1%**
Tax Revenues	*15.9%*	*16.5%*	*16.6%*	*16.7%*	*16.3%*
International Trade	*1.1%*	*1.1%*	*1.1%*	*1.1%*	*1.0%*
Others	*1.8%*	*1.7%*	*1.7%*	*1.6%*	*1.8%*
Soc.Sec contributions	6.4%	6.8%	6.8%	6.9%	6.5%
SOE primary balance	1.4%	1.0%	1.0%	1.2%	0.7%
BSE &Munis primary balance	0.2%	0.1%	0.2%	0.2%	0.3%
BCU primary balance	0.0%	-0.1%	-0.1%	-0.1%	-0.1%
NFPS Outlays	**27.5%**	**27.8%**	**28.0%**	**28.1%**	**25.8%**
Central Govt. Primary Outlays	25.8%	25.4%	25.6%	25.7%	24.6%
Personnel spending	*4.6%*	*4.6%*	*4.6%*	*4.6%*	*4.6%*
Non-Personnel spending	*4.3%*	*3.9%*	*3.9%*	*3.9%*	*3.4%*
Pensions	*9.0%*	*8.9%*	*9.0%*	*9.0%*	*8.9%*
Transfers	*7.9%*	*8.0%*	*8.1%*	*8.1%*	*7.7%*
Public investment	1.8%	2.4%	2.4%	2.4%	1.2%
Public Sector Primary Balance	-0.7%	-0.6%	-0.6%	-0.6%	0.7%
Interest payments	2.8%	2.6%	2.6%	2.7%	3.1%
Consolidated Public Sector Deficit	-3.5%	-3.2%	-3.3%	-3.3%	-2.6%
Cincuentones revenues	-0.5%	-0.2%	-0.2%	-0.2%	-0.1%
Adjusted Consolidated Public Sector Deficit	**-4.0%**	**-3.4%**	**-3.5%**	**-3.5%**	**-2.7%**

Source: TPCG Research based on MEF

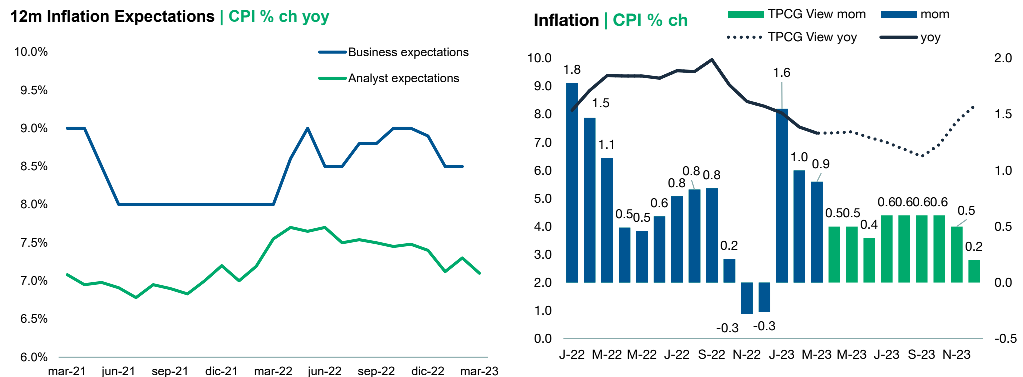
Inflation clocked in at +0.9% in Mar-23, rising to +3.5% YTD

March CPI prints +0.90%mom, coming in 18bp over the +0.72%mom expectations portrayed in the BCU's survey.

March CPI prints +0.90%mom, coming in 18bp over the +0.72%mom expectations portrayed in the BCU's survey. Monthly inflation printed +0.9%mom— coming in under February's +1%mom and January's +1.55%mom albeit well over the average print of the 4Q22, as the 1Q23 is riddled with seasonal factors pressing the inflationary process on the upside. In March, again the monthly hike came in heavily influenced by the Food & Non-Alcoholic Beverages segment, as the drought affecting agricultural production drove the prices of fruits and vegetables up. The subsection clocked in at +2.24%, maintaining a strong inflationary impulse, coming over February's (+1.84%mom) and January's print (+1.85%mom), marking a very strong start to the year. The segment accumulated a 6% rise in 1Q23. This confirms the reversion of the trend showcased during 4Q22, when food prices dropped in November (-0.71%mom) and October (-0.14%mom). The segment spearheaded the increases jointly with Education (+3.85%mom) and to a lesser extent, Hotels&Restaurants (+0.48%mom). The rest of the segments had little influence on the monthly print. On the yearly gauge, consumer prices rose by +7.33%yoy marking the sixth decrease in a row for the index, following prints of +7.55%yoy in February, +8.05%yoy in January and +8.29%yoy in December. The yearly index was influenced by a strong baseline effect, as 2022's prints for the 1Q were especially high. In this context, the yoy variation now surpassed the +6%yoy upper bound of the BCU's target

range for the twenty-second month in a row. With March's inflation clocking in at +0.9%mom, YTD inflation currently stands at +3.5%.

Figure 2: The drought pressures food prices on the upside



Source: TPCG Research based on BCU and INE

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March's CPI print came mostly on the back of the Food & Non-Alcoholic Beverages segment, as the drought affected agricultural production, which compounded with the seasonal increase in Education prices. The Food & Non-Alcoholic Beverages continued with February's trend, posting a +2.24%mom rise. In March, subsection performance was also marked by volatility, with most sub-indexes experiencing large increases, albeit with some notable exceptions. The always volatile Fruits segment experienced a +10.9%mom increase, as did Vegetables, which rose by +12.35%mom, with production hampered by the current drought. Instead, Meat prices reverted February's -0.61%mom drop, albeit rising at a slower trend than the general index, jumping by 0.52%. This could respond to the dry climatic conditions, which are possibly affecting meat supply, and to the lower international prices which saw exports crash during 4Q22. Dairy products also lagged the general index, increasing by +0.5%mom. In this context, Food & Non-Alcoholic Beverages' contribution singlehandedly explained nearly two thirds of the monthly print, coming in at 59bp. The only other subsection that affected prices significantly was Education, which increased by +3.85%mom. The hike came on the back of the start of the school year, which saw several increases in most subsections, including Preschool (+5.01%mom) Primary School (+5.17%mom) and Secondary School (+4.95%mom). This subsection contributed another 13bp to the monthly print. Restaurants&Hotels (+0.48%mom) and Entertainment (+0.69%mom) contributed 4bp each to the print, as the residual impulse of the tourism season wears off. Finally, the rest of the sectors experienced increases mostly in the -0.1%mom — +0.5%mom range, contributing the remainder of the March print.

4Q BoP flows turned unsupportive with Meat exports plummeting

In other news, the combination of weak meat exports and UYU appreciation seems to have caught up with BoP flows, as Uruguay's 4Q22 current account deficit clocked in at USD1.09bn vs USD0.46bn in 4Q21.

In other news, the combination of weak meat exports and UYU appreciation seems to have caught up with BoP flows, as Uruguay's 4Q22 current account deficit clocked in at USD1.09bn vs USD0.46bn in 4Q21. Dissecting the widening, the trade balance was the segment with the largest impact, as the latter dropped by nearly USD0.66bn relative to 4Q21. This can be explained mostly by the poor performance of the agricultural sector during 4Q22, that resulted in a -21.5%yoy drop in the segment's GDP during the last quarter of 2022. The winter crops (wheat) performed mostly in line with last year, as most of the underperformance came on the side of the Meat, with the combined effects on ranching and processed meat exports amounting to a USD390mn drop. This strongly impacted general exports, which experienced a quarterly yoy fall of USD485mn, explaining most of the underperformance. This compounded with a 15-day technical maintenance stop in the UPM plant, which was also responsible for the dip in exports. Imports on the other hand benefited from the FX trend and the PCE dynamics, rising by USD176mn. All in all, the performance of the trade balance was underwhelming, albeit came in line with the weak quarterly GDP print. However, the services balance managed to offset part of the deterioration in its commercial counterpart, was Exports rose by USD404mn, resulting in a net improvement of 170mn, as services imports widened by USD235mn. Primary income also contributed to the deficit widening, as its deficit increased by

USD130mn. All in all, the Current Account balance experienced a 630mn deterioration, with the weak agricultural campaign being the main driver. In yearly terms, the current account deficit came in at -3.2% of GDP (-USD2.2bn), worsening by 0.7pp relative to 2021 (-2.5% of GDP; -USD1.5bn).

Figure 3: the CA closed 2023 with a -3.2% of GDP deficit

USDmn	2021 1H	2021 2H	2022 1H	2022 2H	2021	2022	Δ
Current account	-901	-640	-978	-1,290	-1,541	-2,268	-728
Goods & Services	2,139	2,361	2,230	1,659	4,500	3,889	-611
Goods	2,183	2,306	2,092	1,449	4,489	3,541	-948
Exports	7,058	8,642	8,553	8,603	15,700	17,156	1,455
Imports	4,875	6,336	6,461	7,154	11,211	13,615	2,403
Services	-44	55	137	211	11	348	337
Exports	1,634	2,064	2,508	2,941	3,699	5,449	1,751
Imports	1,678	2,009	2,371	2,731	3,687	5,101	1,414
Primary Income	-3,070	-3,049	-3,279	-3,014	-6,119	-6,292	-173
Secondary Income	30	48	71	64	78	135	57
Capital account	-13	-17	0	0	-30	1	31
Financial Account	332	-1,063	422	-2,597	-731	-2,174	-1,444
Direct Investment	-1,087	-677	-1,271	-2,003	-1,764	-3,274	-1,510
Portfolio Investment	-630	1,492	1,744	-203	862	1,541	679
Derivatives	124	341	611	224	466	835	370
Other Investment	1,133	-2,271	246	56	-1,138	301	1,439
Errors & Ommisions	1,246	-406	1,401	-1,307	840	93	-747
Reserve Assets	792	51	-907	-671	843	-1,578	-2,422
GDP (USDmn)	**61,422**		**71,199**		**61,422**	**71,199**	**9,777**
Balance as % of GDP	-1.5%	-1.0%	-1.4%	-1.8%	-2.5%	-3.2%	-0.7%

Source: TPCG Research based on BCU

Looking ahead, we expect the bad performance of the agricultural sector to seep further into the FX dynamics.

Looking ahead, we expect the bad performance of the agricultural sector to seep further into the FX dynamics. While we continue to find the price of the USDUYU at relatively fair levels, we believe the reversal of the BoP flows should hamper further compression prospects and contribute to a steady depreciation of the FX in nominal terms during the year. With the BCU letting the exchange rate float, we do believe the FX should not be prone to gap, but the drop in exports will slowly erode the exchange rate. Even as we believe said effect is transitory, and largely caused by the drought straining agri-flows, we find this year will be momentarily challenging for the UYU, especially during the end of 2Q22 and the start of the 3Q, as it could compound the effect of the drying up of weaker agriflows with a UPM II plant which is not fully operational, slightly straining the USDUYU. In this context, we now believe the eop USDUYU for 2023 should hover around the 41.5 mark, instead of standing near 41 USDUYU.

LCD Strategy: Despite March's inflation surprise, nominals are poised to edge linkers as inflation tempers after the drought

We remain OW in nominals in a context where they just edge linkers, as the real rates in UYU securities are prone to stay high.

We remain OW in nominals in a context where they just edge linkers, as the real rates in UYU securities are prone to stay high. Our baseline scenario currently expects the FX to clock in at the 40USDUYU mark by the end of 1H23, while for Dec-22 we envisage the exchange rate to stand near the 41.5USDUYU level. Looking at inflation, we expect the current pressures on the upside to subside as the effect of the drought starts to wane. In this regard, the Food&Drink index experienced a 6%YTD variation, mostly fueled by the more volatile subsections, as Vegetables and Fruits spearheaded the monthly increases. This transitory effect, combined to the residual increases caused by last year's salary negotiations caused the annualized inflation rate for 1Q23 to spike near the +15% mark. We expect said trend to revert starting April, and we expect the annualized rate to come close to the +6.4% for 2H23, slowing down significantly. In a context where the start of the year was negative for inflation prints, the probability of yearly inflation for 2023 coming in below or close to the 7% mark looks slim. In this context, we do

believe the CenBank will be forced to maintain the policy rates at high real levels, but starting to reduce the nominal rate, possibly as soon as 2Q23. With a slightly more strained FX, inflation tampering during 2H23, and a high policy rate, we believe UYU securities will present a better real rate than the linkers curve. However, we do find the real rates in the back-end of the linkers curve attractive, albeit the carry in the nominals give them a slight edge at the moment. We calculate the future total returns for UI and UYU denominated securities with our baseline scenario and expecting the UI curve to compress by nearly 30bp and the UYU space by 50bp, for both the end of 1H23 and 2H23. We find the UI40 to be an interesting play in the short term, especially if inflation remains stubbornly high. However, widening the scope up until the end of the year, then nominal securities presently have a slight edge, even as the UI40 continue to be a competitive choice in this scenario.

Figure 4: In the linkers space the UI40's look as the best pick

	30/6/2023				30/12/2023			
	Carry	Δ Clean PX (bps)	Inflation	TR	Carry	Δ Clean PX (bps)	Inflation	TR
Linkers								
UY27	98	-326	195	-33	300	-714	485	71
UY28	98	-341	193	-50	300	-693	480	87
UY37	84	-202	195	78	258	-463	493	288
UY40	87	-178	196	104	265	-425	495	335
Nominals								
UY28	213	-178	-	35	632	-313	-	319
UY31	208	-85	-	123	618	-138	-	481

Source: TPCG Research based on TPCG Trading Desk

TPCG Analysts & Staff

Research

Juan Manuel Pazos	**Chief Economist**	**jmpazos@tpcgco.com**	**+54 11 4898-6606**
Paula La Greca	Corporate Research Analyst	plagreca@tpcgco.com	+54 11 4898-6638
Federico Martin	Strategist	famartin@tpcgco.com	+54 11 4898-6633
Santiago Resico	LATAM Strategist	sresico@tpcgco.com	+54 11 4898-6615

Sales & Trading

Juan Manuel Truppia	**Head of Sales & Trading**	**jmtruppia@tpcgco.com**	**+54 11 4898-6659**
Juan Martin Longhi	S&T Director	jlonghi@tpcgco.com	+54 11 4898-6656
Lucia Rodriguez Pardina	S&T Director	lrodriguezpardina@tpcgco.com	+54 11 4898-6614
Agustina Guadalupe	Sales	aguadalupe@tpcgco.com	+54 11 4898-6682
Maria Pilar Hurtado	Sales	mhurtado@tpcgco.com	+54 11 4898-6616
Juan Ignacio Vergara	Sales	jivergara@tpcgco.com	+54 11 4898-1936
Santiago Baibiene	Sales	sbaibiene@tpcgco.com	+54 11 4898-6648
Pedro Nollmann	Sales	pnollmann@tpcgco.com	+54 11 4898-6617
María Ruiz de Castroviejo Salas	Sales	mruizdecastroviejo@tpcgco.com	+54 11 4898-6643
Victoria Faynbloch	Desk Analyst	vfaynbloch@tpcgco.com	+54 11 4898-6635
Felipe Freire	Trader	ffreire@tpcgco.com	+54 11 4898-1921
Homero Fernandez Bianco	Trader	hfbianco@tpcgco.com	+54 11 4898-6667
Andres Robertson	Trader	arobertson@tpcgco.com	+54 11 4898-6693

Corporate Banking

José Ramos	**Head of Corporate Banking**	**jramos@tpcgco.com**	**+54 11 4898-6645**
Camila Martinez	Corporate Sales	cmartinez@tpcgco.com	+54 11 4898-6621
Fernando Depierre	Corporate Sales	fdepierre@tpcgco.com	+54 11 4898-6636
Sol Silvestrini	Corporate Sales	ssilvestrini@tpcgco.com	+54 11 4898-6641
Nicolas Iglesias	Corporate Sales	niglesias@tpcgco.com	+54 11 4898-6612

Capital Markets

Fernando Lanus	**Head of Capital Markets**	**flanus@tpcgco.com**	**+54 11 4898-6632**
Nicolás Alperín	Investment Banking Analyst	nalperin@tpcgco.com	+54 11 4898-6604

Asset Management

Ileana Aiello	**Portfolio Manager**	**iaiello@tpcgco.com**	**+54 11 4898-6611**
Claudio Achaerandio	**Portfolio Manager**	**cachaerandio@tpcgco.com**	**+54 11 4898-6618**

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