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Uruguay Strategy Flash

The BCU presented its updated base scenario in its quarterly IPOM

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Recently the BCU published its quarterly monetary policy report, which highlighted the CenBank will continue enforcing a tight monetary policy throughout 2023. In its report, the BCU presented its adjourned scenario for growth and inflation up until the end of 2024, consistent with its monetary policy horizon. Regarding the former, the CenBank expects 4Q growth to come in line with the increase in GDP exhibited during 3Q22, which totaled +3.7%yoy and -0.1%qoq. This would result in a +5.4% growth in 2022, which is consistent with our YA forecasts. For 2023, the BCU expects growth to total +2.5%, which would be followed by a +3% GDP increase in 2024. Growth in 2022 and 2023 would be largely explained by domestic factors, including the start-up of UPM scheduled for this year and the evolution of internal demand (consumption and investment). On the other hand, the aggregate impact of international shocks would be negative throughout the monetary policy horizon, in a context of more restrictive financial conditions and worsening the terms of trade. Finally, and in line with the COPOM decisions, the monetary impulse would show a contractive impact during 2023 and to a lesser extent during 2024.

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Looking at inflation, the CenBank is focused on nudging agent expectations downwards, forcing them to converge to the target range. The BCU believes inflation peaked during 3Q22 and would now show a downward trajectory until the end of 2024, as the contractive monetary policy generates the desired effects. In this framework, by Dec-24 the BCU expects inflation to stand at +5.6%yoy, finally entering the target range, while inflation should deaccelerate to around 7%-7.5% by end-2023. This is consistent with the Cenbank's policy rate estimate. The latter sees the key rate stable throughout 2023, or even marginally higher during the first months of the year, beginning to decline as 2023 comes to an end. Regarding the FX, the BCU expects the REER to continue to appreciate during the first quarter of 2023, before depreciating up until 2024, as the capital inflow for the construction of UPM II ends, and as the international scenario creates worse terms of trade for Uruguay. In addition, the BCU identifies several internal and external risks to their baseline scenarios. The former include a de-aligning of inflation expectations relative to the target range, which carries the risk of derailing, or slowing the convergence of the inflationary process, and the political cycle, to which the BCU assigns less probability of interfering with the drop in inflation. Instead, external risks continue to refer to the persistence of the war between Russia and Ukraine, developments in the contractionary phase of the monetary policy in developed countries and the regional financial situation.

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In our view, a protracted hawkish monetary policy, in addition to an unrelenting FX make us change our positioning to OW in the LCD space. With inflation poised to end the year over the 7% mark, and the prospect of the BCU maintaining its policy rate at +11.5% throughout most of the year, we believe that real rates are likely to remain attractive in the short run. In addition, the CenBank seems to have changed its weapon of choice in the inflationary battle. With the Policy rate plateauing at high levels, the BCU will probably use the appreciating FX as its main firepower to combat inflation, targeting it via passthrough. And we believe the Uruguayan economy should be able to withstand the current exchange rate, and even further appreciation. Looking at 2022, even with a substantial tightening in the nominal FX, economic activity enjoyed positive momentum, and driving our belief that believe current FX levels do not pose a macro threat in the medium term. Furthermore, the BCU has maintained its non-intervention policy in the FX market, leaving the exchange rate to float. The current account deficit has continued to perform positively, tightening by 0.5pp of GDP in the year closed in Sep-22, and is bound to improve even further once UPM II comes online. So the FX still has some ground to gain in our view, and could continue its appreciation in real terms with both the BCU's policy bias and the external sector favoring an appreciation, which we believe the Uruguayan economy should be able to withstand. However, this should be an issue for some less competitive-labor intensive- sectors, which could in turn flare up some conflict between the administration and the BCU. All in all, with a tight policy bias, attractive real rates, and an FX which has some space to appreciate in the medium term, we believe the LCD space looks very attractive, especially for carry trades, as the high rates combined with an appreciating FX should make carries in USD extremely attractive.

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