TPCG

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

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

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Uruguay Strategy Flash

The BCU lowered the policy rate by 50bp to +8.5%.

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In April's COPOM meeting, board members decided to lower the policy rate by 50bp to +8.5%. The decision came as a surprise, as the market consensus envisaged a 25bp cut, with another significant portion of market participants expecting the BCU to maintain the policy rate at 9% for one more meeting. Even if the very weak March print, in conjunction with the reduction in inflation expectations justify the decision to cut, we also believe the heat the administration is experiencing due to the strength of the FX from the less competitive sectors seeped into the BCU (especially with elections months away), which decided to cut rates more abruptly. With this, the BCU's bias turns slightly dovish, after standing very near the neutral mark since the start of 2024. Even with the strong slowdown in inflation experienced in recent months, the general direction of the monetary policy now turned increasingly supportive, as inflation expectations did decrease, but remain relatively sticky. In this context, we find that the BCU's COPOM abandoned the caution exhibited in recent meetings, as after March's print, it is less worried about inflation making a comeback, undoing its previous efforts to tame inflationary pressures. The BCU press release did give some forward guidance regarding further rate cuts. It indicates the COPOM will maintain the trajectory of the policy rate consistent with aligning expectations to the center of the target range, and with increasing the credibility of inflation remaining inside the BCU's target range. The press release highlighted the convergence of both headline and core inflation to the BCU's target, which stands at 6%-3% since Sept-22. The abrupt descent in the yoy index in March responded mainly to a drop in tradeable prices, which in turn was heavily affected by the strong performance of the FX, which was not compensated by a non-tradeable segment, which remains relatively anchored.

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In its announcement, the COPOM continues to signal the path of the key rate will be conditioned by the evolution of the economic agent's inflation expectations. In turn, the Monetary Policy Committee assessed the local and international contexts and their effect on policy bias. On the international stage, activity is slowing down less than initially envisaged, especially in the USA. In addition, global inflation continues with its slow decline, which would result in the Fed performing fewer cuts than anticipated. In the region, Brazil is now expected to grow at a more robust pace, while the turmoil experienced by neighboring Argentina shows an improvement in the financial context and a deterioration in the indicators of the real economy. In Uruguay, the Gross Domestic Product (GDP) closed 2023 with an average growth of 0.4%. Likewise, short-term projections suggest that the economy will continue to grow in the next two quarters.

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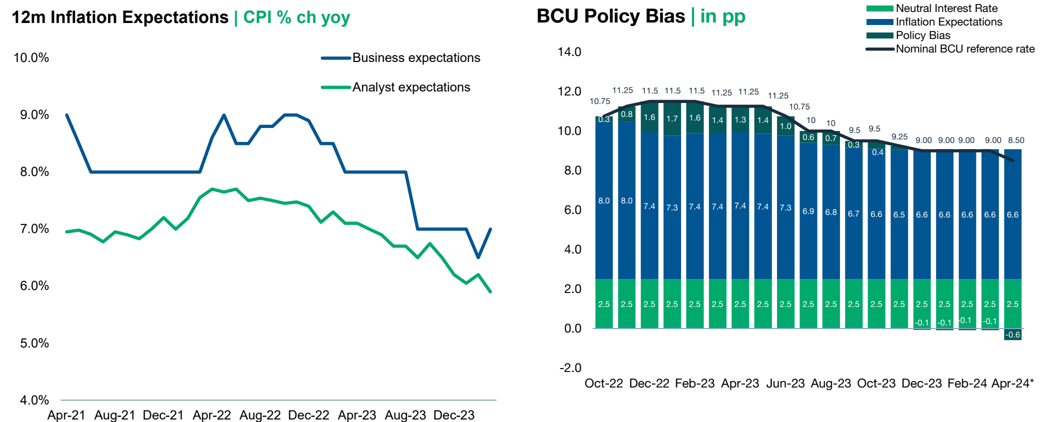
Expectations continue to evolve to the BCU's satisfaction, now mostly converging to the BCU's target range, albeit showcasing significant signs of stickiness. While the BCU survey conveys analysts expect inflation to remain inside the target range, real economy agents still envisage inflation over the 6% mark. The latter now expect a median 12m-running inflation of +7% in March's poll (+0.5pp relative to February), while March's analyst forecasts diminished to +5.90%, showcasing a 30bp tightening relative to February's estimates. So with the BCU's target range standing at 6%-3%, the second survey finally sees inflation inside the target range, something it had failed to do since Dec-21, when the upper range of the target range was 7%. Instead, real economy agents still expect a more stubborn inflationary process. Consistently, the latter see inflation closing the year at +6.2% (-0.30pp vs. February) while market analysts forecast a +5.98% inflation by end-2023 (-0.32pp vs. February). The official forecasts for 2023 see inflation closing the year at +4.9%. Both market analysts and real economy agents project slightly higher

inflation for the year, as they expect the yoy index to stand at or very close to the BCU's target range upper threshold by the end of 2024.

Figure 1: The BCU lowered the policy rate to +8.5%



Source: TPCG Research based on INE & BCU

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In this context, we expect the BCU's decision to hit the FX, weakening it slightly, even if macro fundamentals are still consistent with a robust UYU. Offshore financial flows have been significant in recent months and have played an important role in the solid performance of the USDUYU. This has triggered the alarms of several sectors in the real economy, which in turn made their concerns known to the administration, dialing up their pressure. With the electoral race starting to heat up, the government decided to take action. While SOEs started to purchase USD in order to reduce the pressure on the less competitive sectors of the economy, the BCU was also expected to provide some support. So, while the CenBank adamantly refuses to intervene directly in the FX market, it is not opposed to acting via the policy rate, especially now that most economic agents see inflation inside the target range in 2024, and March's monthly print came in well below expectations. By cutting the policy rates by 50bp, the CenBank is disincentivizing external financial flows to enter the country, which in turn should result in a slightly weaker FX. However, while the policy rate is bound to affect the performance of the UYU negatively, macro fundamentals continue to point at a relatively strong FX, especially in the coming months. The seasonal effect of the strong agriflows that are expected due to the plentiful harvest should keep the FX relatively anchored, in the short run. While the endeavors of the FX in the medium run also depend on global sentiment and on the outcome of the incoming election cycle, we expect the FX to continue to prove relatively resilient in the coming months, even if lower monetary policy rates will shave support from the currency going forward.

TPCG Analysts & Staff

Research

Juan Manuel Pazos	**Chief Economist**	**jmpazos@tpcgco.com**
Paula La Greca	Corporate Research Analyst	plagreca@tpcgco.com
Santiago Resico	Economist	sresico@tpcgco.com
Camila Sanchez Lauria	Research Analyst	csanchezlauria@tpcgco.com

Sales & Trading

Juan Manuel Truppia	**Head of Sales & Trading**	**jmtruppia@tpcgco.com**
Institutional Sales		
Lucia Rodriguez Pardina	S&T Director	lrodriguezpardina@tpcgco.com
Agustina Guadalupe	Sales	aguadalupe@tpcgco.com
Maria Pilar Hurtado	Sales	mhurtado@tpcgco.com
Juan Ignacio Vergara	Sales	jivergara@tpcgco.com
Santiago Baibiene	Sales	sbaibiene@tpcgco.com
Pedro Nollmann	Sales	pnollmann@tpcgco.com
María Ruiz de Castroviejo Salas	Sales	mruizdecastroviejo@tpcgco.com
Santiago Jauregui	Sales	sjauregui@tpcgco.com
Victoria Faynbloch	Desk Analyst	vfaynbloch@tpcgco.com
Trading		
Felipe Freire	Trader	ffreire@tpcgco.com
Homero Fernandez Bianco	Trader	hfbianco@tpcgco.com
Andres Robertson	Trader	arobertson@tpcgco.com

Corporate Finance

José Ramos	**Head of Corporate Finance**	**jramos@tpcgco.com**
Corporate Sales		
Camila Martinez	Corporate Sales Director	cmartinez@tpcgco.com
Fernando Depierre	Corporate Sales	fdepierre@tpcgco.com
Sol Silvestrini	Corporate Sales	ssilvestrini@tpcgco.com
Nicolas Iglesias	Corporate Sales	niglesias@tpcgco.com
Capital markets		
Nicolás Alperín	DCM	nalperin@tpcgco.com
Wealth Management		
Josefina Guerrero	Private Wealth Management Specialist	jguerrero@tpcgco.com

Asset Management

Ileana Aiello	**Portfolio Manager**	**iaiello@tpcgco.com**
Claudio Achaerandio	**Portfolio Manager**	**cachaerandio@tpcgco.com**

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