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THE LATIN AMERICA ECONOMIC MONITOR

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Peru's economy ended the year on a strong note; domestic demand is rising, offsetting external woes.

Mining activity likely will gather strength this year, assuming that the global trade war eases.

We expect the PEN to rebound slightly; political risk and copper prices remain the key factors to watch.

Peru's Economic Activity is Improving, Offsetting External Risks

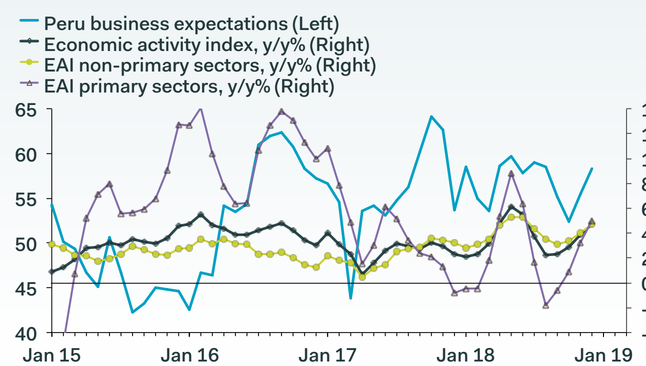
Peru's economic recovery gathered strength late last year. The economic activity index rose 4.7% year-over-year in December, down from 5.2% in November, and the trend has been rising rapidly since Q3. We think the solid performance in recent months will continue, helped by improving fundamentals, including low inflation, low interest rates and resilient labour and credit markets, offsetting the temporary drags associated with the deterioration of commodity price-driven terms of trade. The economy has also been resilient to political noise, which was the main economic drag in recent years.

The economic indicator grew 4.8% year-over-year in Q4, accelerating from a 2.4% increase in Q3. Assuming no revisions, GDP rose by 4.0% in 2018 as a whole, much stronger than the 2.5% increase in 2017. The composition of economic activity is also improving, with non-natural resources sectors performing strongly. The underlying trend is rising, following a challenging Q3, when the economy was hit by the effect of weaker terms of trade and delays of infrastructure projects.

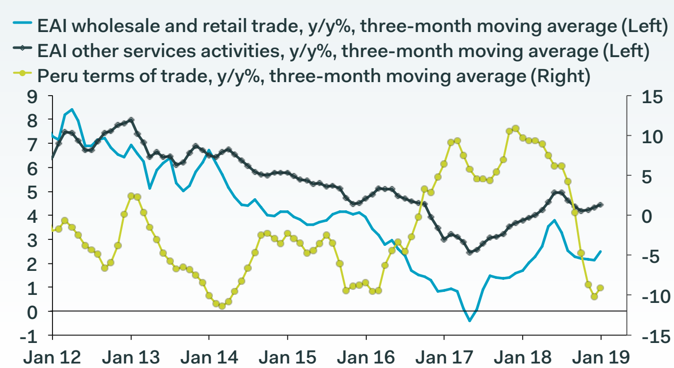
Across sectors, construction was particularly strong, while manufacturing and fishing rebounded, helped by favourable base effects. The fishing season in Q4 2017 was postponed until January 2018, driving the rebound in fishing and manufacturing activity in Q4 2018. Fishing makes only a small *direct* contribution to GDP, but fishmeal production was a solid support for manufacturing, which accounts for about 17% of GDP. We expect a mean reversion in Q1, but the underlying trend will continue to rise. Services output also picked up in Q4, especially in transportation, IT and financial services. Mining/oil output, meanwhile, remained relatively weak, but the trend is improving. Lower mining output was partially offset by rising oil production.

Looking ahead, higher copper and other metals prices will propel a gradual recovery of the resources sector and support capex. This likely will be a key driver of the economy this year, assuming that the global trade war eases. That said, a temporary soft patch will hit in mid-Q1. The truckers' strike announced this week has the potential to hit the sector and the economy as a whole, if it continues for longer.

LEADING INDICATORS REBOUNDED IN RECENT MONTHS



SOLID DOMESTIC DEMAND OFFSETTING WEAKER TERMS OF TRADE



We are keeping a close eye on this development as it has the potential to disrupt activity in key sectors and push inflation higher earlier than we expect.

The GDP Q4 report slated for tomorrow is likely to confirm the relatively robust performance of domestic demand. We expect consumers' spending to increase about 3.6% year-over-year, and the trend is rising. Strong services and non-durable goods demand probably will be the main drivers. Private investment likely jumped 7.5%, accelerating from 1.4% in Q3. Government consumption and public investment also likely accelerated in Q4, boosted by the rebound of infrastructure investment, following a delay in the execution of projects in previous quarters. If we are right, solid growth in investment and consumption became the main pillar of support for the economy in Q4. *Leading indicators suggest that these drivers will continue to grow at a robust pace over the next three-to-six months.*

Finally, net exports probably fell in Q4, due to a jump in the import of intermediate goods and finished transport and construction equipment, at the same time as goods exports—particularly metals—slowed. Overall, the GDP Q4 report likely will be strong, highlighting that domestic demand is finally gathering strength, offsetting the weakness of the mining sector.

We expect the Peruvian economy to grow about 4.2% this year, thanks to accommodative policy, favourable terms of trade—assuming that copper prices rebound as we expect—and the development of already planned public works projects, including the Lima Airport. Moreover, the contributions from a few important investment projects, including the US5.5B Quellaveco copper project will also help. Regional and local government investment likely will slow, as it is usually the case when new authorities take office.

The major risk to this relatively benign scenario is the global trade war and the performance of both the Chinese and U.S. economies, Peru's main trading partners. But we remain relatively upbeat on this front. Peru's relatively solid domestic fundamentals will be able partially to offset a potential global economic slowdown. Indeed, the country's external and fiscal positions have improved in recent quarters, helping to keep financial metrics under control. The fiscal deficit was about 2.9% of GDP, better than the 3.1% deficit in 2017. Government spending has fallen as a share of GDP, and revenues have been gradually improving on the back of solid tax revenues as domestic demand has been improving. We expect a fiscal deficit of around 2.5% of GDP this year, thanks mainly to stronger revenues. Under these circumstances, and coupled with a "patient" Fed, this all suggests to us that the BCRP is in no hurry to hike rates, even if economic activity gathers further strength over the coming months, pushing inflation slightly higher. Our core view is that rates will gradually start to rise in late Q3 or Q4, assuming the trade war is over.

If we are right and external and domestic conditions remain favourable for Peru, we look for the PEN to gradually rebound over the coming months towards 3.28 and remain relatively stable at around 3.26 per USD over the second half of the year. We expect the BCRP to ramp up intervention in the market if volatility increases significantly, but this is not our base case. We are assuming relatively low political risk, but that doesn't mean that it is zero risk.

In a country in which four former presidents have been embroiled in corruption scandals, is not unusual to experience huge bouts of political volatility. A congressional committee has opened an investigation into a possible link between a company, in which President Vizcarra was part-owner and the Brazilian Odebrecht construction firm. We see relatively limited risk here, as this event happened more than a decade ago, in addition the opposition is now more restrained and fragmented than in recent months. Moreover, President Vizcarra's approval rating remains close to highs and enjoys solid political capital. But, this is LatAm and risks remain.

COPPER PRICES ARE GRADUALLY IMPROVING

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, February 18

• No significant data released.

Tuesday, February 19

• Colombia Consumer Confidence (1)/No set time

The confidence index increased to **-2.8** in January, from -8.3 in December. Confidence is on the mend.

Wednesday, February 20

• No significant data released..

Thursday, February 21

• D: Brazil IBGE Inflation IPCA-15 (2)/9:00 Local

The index likely rose **0.3%** unadjusted month-to-month, due mainly to higher school tuition fees—normal at this time of the year—and food prices. Other key components likely fell marginally or rose only at a modest pace. In year-over-year terms, inflation probably fell to **3.7%** from 3.8% in January. If we are right, this will be a good inflation report, underscoring that pressures are well under control. We expect inflation to remain close to its current rate this year. Upward pressures driven by an improving labour market and stronger economic growth will be offset by a still-ample output gap and a favourable base effect. Moreover, favourable inertia/indexation and subdued expectations will help contain inflation. **Consensus: 3.8%.**

• Peru GDP (Q4)/No specific time

We think GDP rose **4.9%** year-over-year in Q4, from 2.3% in Q3, marking a solid end to the year. If we are right, this will be a strong report, confirming that the economic recovery gathered momentum in Q4, after a relatively soft Q3. Improving confidence, a solid labour market, the boost from low interest rates and low inflation, and solid investment, have offset the hit from external threats. Falling metals prices are a big threat, but it seems that the trade-war rhetoric is easing. **Consensus: 4.8%.**

Friday, February 22

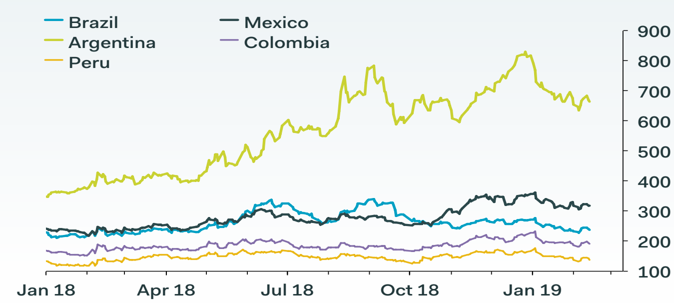
• Mexico Bi-Weekly Inflation CPI (2/15)/8:00 Local

Mexico's CPI likely was **unchanged** month-to-month in the first part of January, due mostly to higher energy tariffs, offset by falling food prices. On a year-over-year basis, we expect the headline rate to fall to **4.0%**, from 4.2% in January. Core prices likely increased 0.2%. We think the headline inflation rate will continue to fall towards 3.6% over the first half of the year. Favourable base effects, the relatively stable MXN, and modest demand-related pressures will help to bring inflation down over the next three-to-six months. The gradual fall in headline inflation likely will push inflation expectations lower, allowing policymakers to ease their hawkish bias. Threats remain, however, as the MXN likely will come under temporary pressure in Q2, due to risks associated with the USMCA ratification process and AMLO's policies, which are still an unknown factor. We believe that AMLO is now settling into a more pragmatic policymaking mode, but risks remain. **Consensus: Headline 4.1%.**

PANTHEON'S LATAM FINANCIAL CONDITIONS DASHBOARD

	Currency			Benchmark Stock index		
	Value	Week, %	YTD, %	Value	Week, %	YTD, %
Argentina	38.60	-2.0	-2.4	37,470	2.2	23.7
Brazil	3.70	0.8	4.9	97,526	2.3	11.0
Chile	663.9	-0.7	4.5	5,400	0.4	5.8
Colombia	3,134	-0.6	3.8	12,099	1.7	8.6
Mexico	19.25	-0.9	2.1	42,989	-0.4	3.2
Peru	3.33	-0.1	1.3	20,391	0.4	5.4
Venezuela	--	--	--	5,057	-8.5	215.0

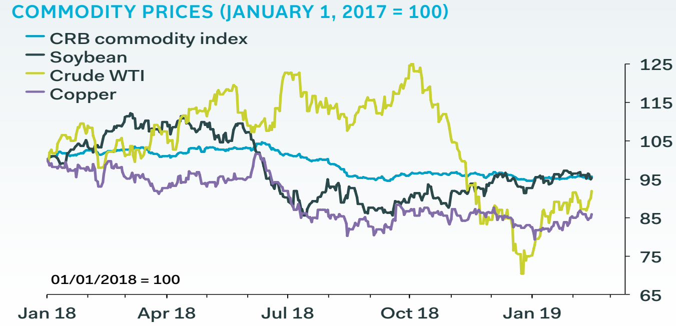
INDEX EMBIG SPREAD LATAM HISTORY



PANTHEON'S ECONOMIC FORECASTS

	Real GDP, y/y%		Inflation, Avg.		Interest rate, Q4	
	2018	2019	2018	2019	2018	2019
Argentina	-2.4	-0.4	33.8	35.0	59.25	30.00
Brazil	1.2	2.2	3.7	3.7	6.50	6.50
Chile	4.0	3.4	2.4	2.8	2.75	3.50
Colombia	2.9	3.1	3.2	3.2	4.25	4.75
Mexico	2.1	1.7	4.9	4.2	8.25	8.00
Peru	3.9	4.2	1.3	2.5	2.75	3.25
Venezuela	-17.0	-20.0	1.3M	25M	--	--

COMMODITY PRICES (JANUARY 1, 2017 = 100)



PANTHEON'S FINANCIAL FORECASTS

	Currency			Benchmark Stock index		
	Q1F	Q2F	Q3F	Q1F	Q2F	Q3F
Argentina	38.5	39.1	39.8	32,100	32,900	33,100
Brazil	3.79	3.67	3.65	88,100	89,200	89,500
Chile	680	676	672	5,120	5,240	5,480
Colombia	3,130	3,080	3,010	1,320	1,480	1,510
Mexico	19.5	19.2	19.0	42,310	43,500	44,300
Peru	3.34	3.28	3.25	20,050	21,200	22,500
Venezuela	--	--	--	--	--	