Goldman Sachs | Economics Research

16 July 2019 | 12:32PM EDT

Latin America Economics Analyst

Brazil-Mexico Mid-Year Review: Softer Growth to Drive Policy Rates Lower

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Weak Growth Dynamics

With the year past the halfway mark, we reassess the macro outlook for LatAm's two largest economies: Brazil and Mexico. The beginning of the year was unquestionably challenging, particularly so on the growth front. The real business cycle dynamics ended up frustrating earlier expectations to a very significant extent: real GDP growth flattened out in 4Q18, only to dip into outright negative territory in 1Q19. Furthermore, policy and political uncertainty remained high for historical standards. We expect the growth profile to firm gradually in Brazil and anticipate a mild normalization of growth in Mexico to a still sub-trend pace and with the growth profile subject to significant risks, particularly policy risk.

Rate Cuts in Brazil (Starting July) and Mexico (Starting September)

The inflation backdrop has been comfortable in Brazil, but testy in Mexico. The balance of risks for inflation is also admittedly friendlier in Brazil than in Mexico. Given that the pivotal social security reform has cleared the most critical stage (Lower House first floor vote) and with stronger-than-expected political support and solid content, we now expect the first Copom rate cut to take place at the July 31 meeting (-25bp). We continue to expect 100bp of Selic rate cuts before the end of 2019. Despite the manifest conservatism of the central bank in recent years, we expect Banxico to gradually prepare the ground for moderate rate cuts.

Copom and Banxico Face Constraints on How Deep They Can Cut

There are constraints on how much the Copom can cut: the policy stance is already accommodative and BRL/USD carry quite low. Aggressive easing could not only compromise the achievement of the lower targets in 2020-21 but also render the BRL more volatile given the thin carry. In Mexico, despite the weak growth dynamics, the monetary policy stance is likely to remain restrictive (above-neutral) for a while given a number of domestic and external risks to inflation. To insure against some of these risks, we expect Banxico to ease slowly and moderately so that the MXN will continue to offer a relatively high carry in order to entice investors to remain engaged in what is shaping as a slowly deteriorating macro story.

Brazil-Mexico Mid-Year Review: Softer Growth to Drive Policy Rates Lower

"In any moment of decision, the best thing you can do is the right thing. The worst thing you can do is nothing."

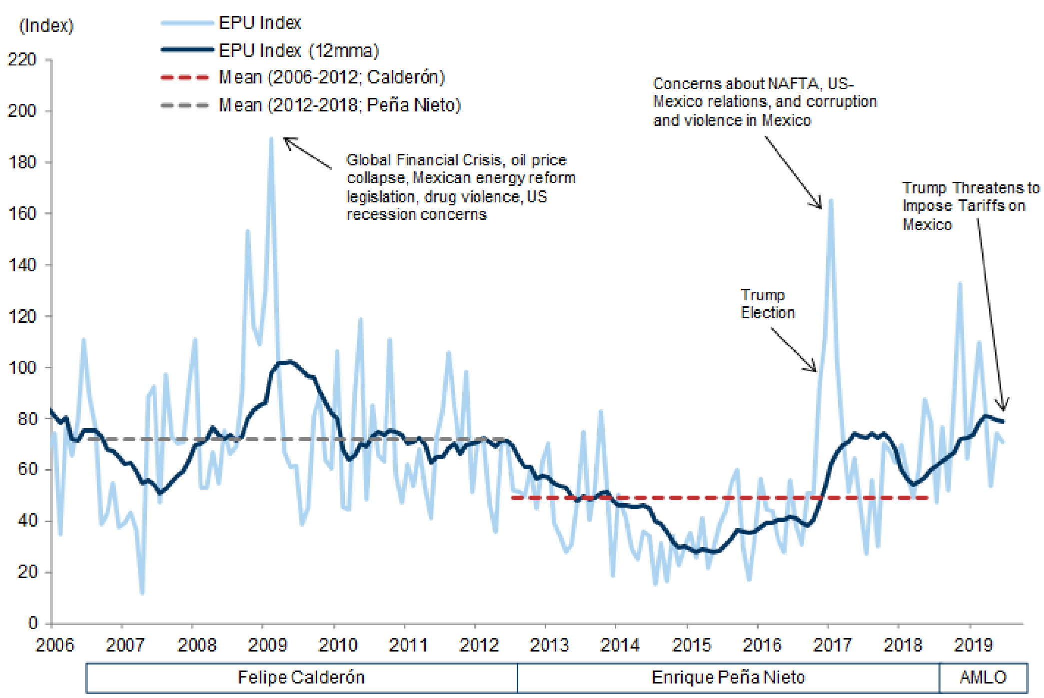
Theodore Roosevelt (1858-1919), American statesman and politician who served as the 26th President of the United States.

Introduction

With the year past the halfway mark, we reassess the macro outlook for LatAm's two largest economies: Brazil and Mexico. The beginning of the year was unquestionably challenging, particularly so on the growth front. The real business cycle dynamics in both Brazil and Mexico ended up frustrating earlier expectations to a very significant extent: real GDP growth flattened out in 4Q2018, only to dip into outright negative territory during 1Q2019.

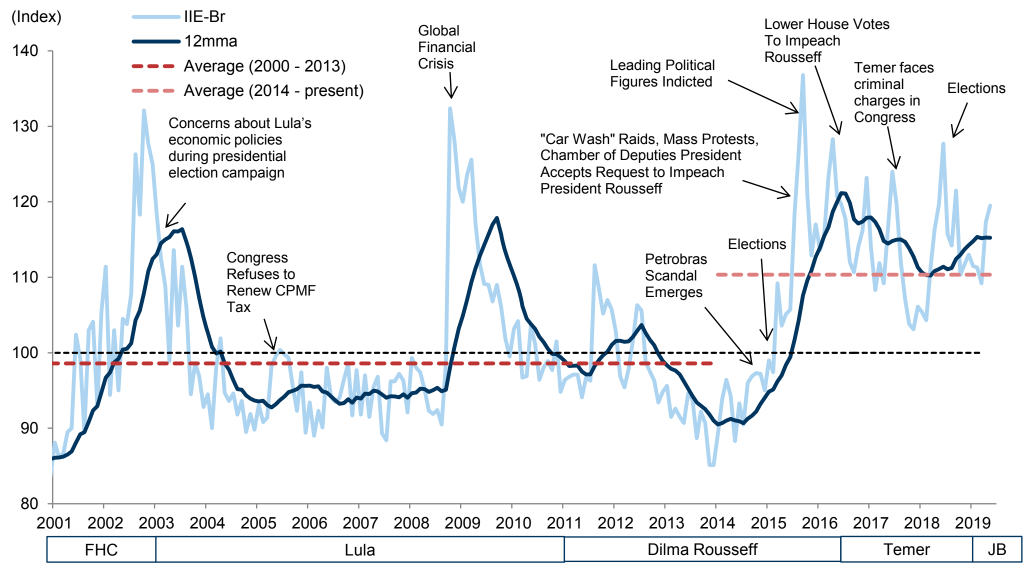
Furthermore, the political and policy environment remained unsettled. Policy and political uncertainty remained high for historical standards (Exhibits 1 and 2), turning consumers more conservative in their spending decisions (particularly with regards to the purchases of durable goods) and firms defensive in their investment decisions.

Exhibit 1: Mexico: Economic Policy Uncertainty Index Tracking at a High Level



Source: policyuncertainty.com, Goldman Sachs Global Investment Research

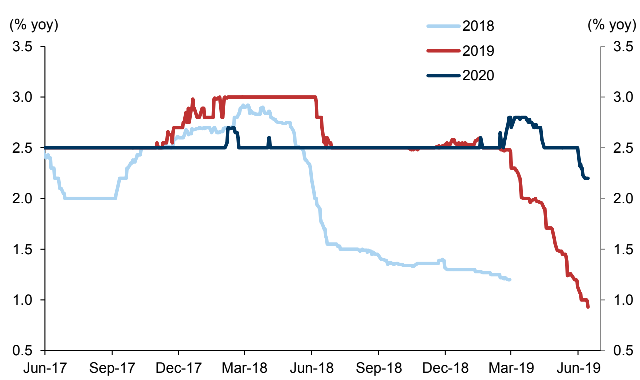
Exhibit 2: Brazil IIE-Br Economic Uncertainty Index



Source: FGV, Goldman Sachs Global Investment Research

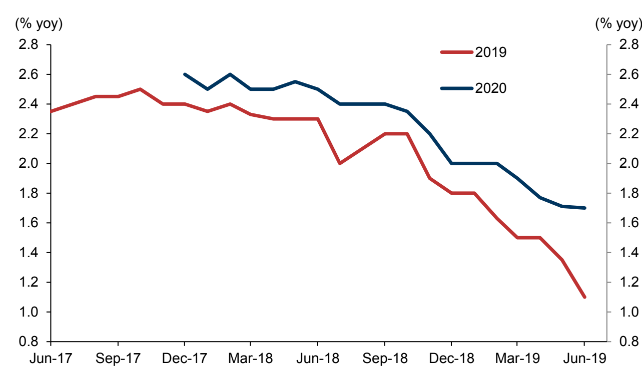
These broad developments, when combined with a number of other domestic factors and developments, led to significant downward revisions to the 2019-2020 growth outlooks for both economies (Exhibits 3 and 4).

Exhibit 3: Brazil: Median Market GDP Growth Expectations



Source: BCB, Goldman Sachs Global Investment Research

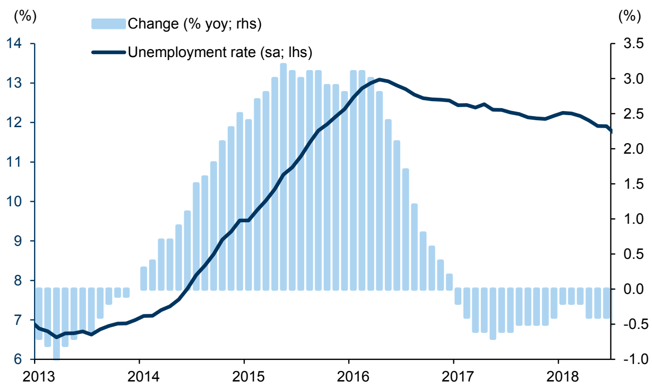
Exhibit 4: Mexico: Sharply Deteriorating Median Market GDP Growth Expectations



Source: INEGI, Goldman Sachs Global Investment Research

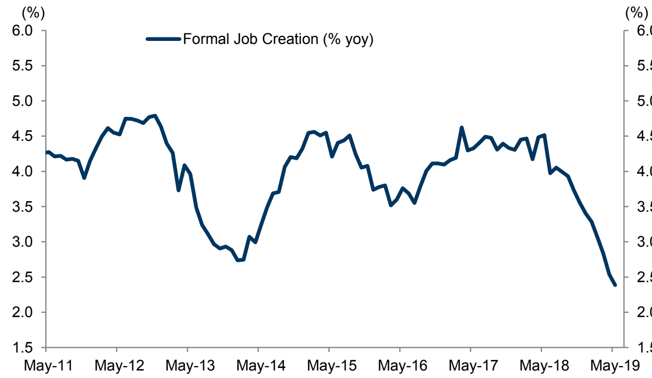
The weak growth dynamics led to further widening of already-negative output gaps. Consequently, the labor market has remained very weak in Brazil (with the unemployment rate more than 4pts above the estimated NAIRU; Exhibit 5) and formal job creation has decelerated significantly in Mexico (an economy that has hitherto been operating at full employment) (Exhibit 6). While credit flows have been gradually strengthening in Brazil—from a very low base following a multiyear credit crunch—in Mexico consumer credit has been on a clear weakening trend, which bodes poorly for a near-term growth rebound (Exhibits 7 and 8).

Exhibit 5: Brazil: Very Slow Labor Market Improvement



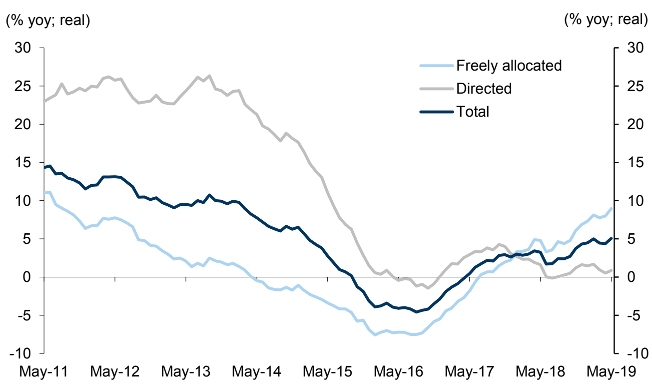
Source: IBGE, Goldman Sachs Global Investment Research

Exhibit 6: Mexico: Declining Formal Job Creation



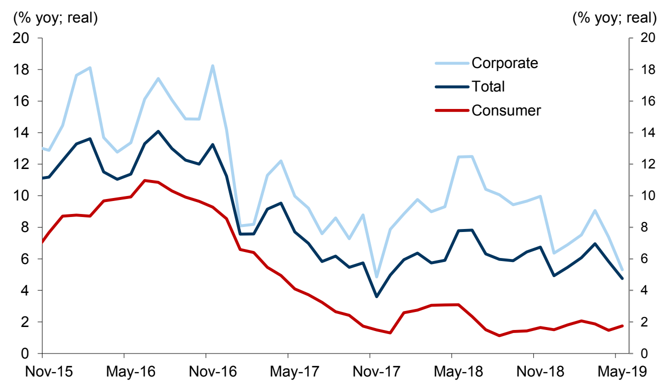
Source: IMSS, Goldman Sachs Global Investment Research

Exhibit 7: Brazil: Firmer Consumer Credit



Source: BCB, Goldman Sachs Global Investment Research

Exhibit 8: Mexico: Soft Consumer Credit Dynamics



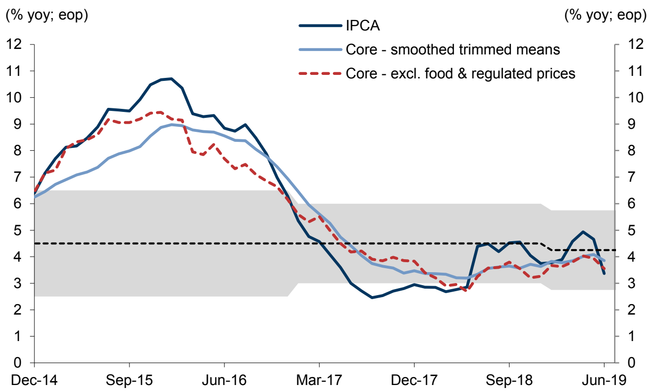
Source: Banxico, Goldman Sachs Global Investment Research

While the real sector dynamics have disappointed and both economies are currently operating with negative output gaps, **the inflation dynamics and the monetary policy stances have been noticeably different.**

The current and prospective inflation backdrop has been benign/comfortable in Brazil, but testy and complex in Mexico. The balance of risks for inflation is also admittedly friendlier in Brazil than in Mexico.

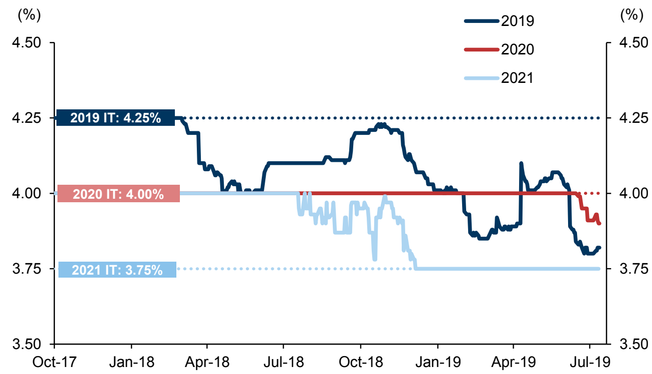
In Brazil, headline and core inflation are tracking visibly below the inflation target (Exhibit 9), short- and medium-term inflation expectations are well aligned with the targets (Exhibit 10), and with the Selic policy rate at a historical low level (6.50%) the monetary policy stance is clearly stimulative. However, given a backdrop of soft below-trend growth dynamics, a large output gap, comfortable current and prospective inflation dynamics, and some progress in the approval of needed macro reforms (e.g., the pivotal social security constitutional reform bill is expected to be approved in the Lower House in early August) we forecast near-term rate cuts in Brazil.

Exhibit 9: Brazil: Benign Headline/Core Inflation Dynamics



Source: IBGE, Goldman Sachs Global Investment Research

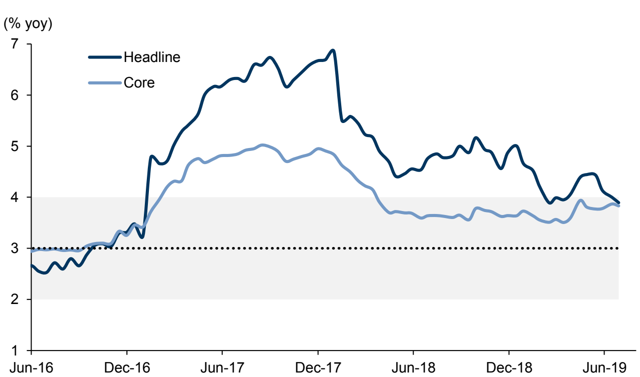
Exhibit 10: Brazil: Median Inflation Expectations



Source: BCB, Goldman Sachs Global Investment Research

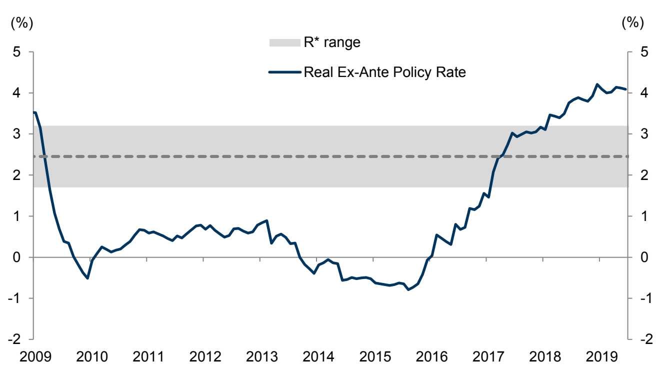
In Mexico the inflation environment, while not threatening it is still far from comfortable and there are a number of domestic and external risks in the background. Inflation continues to track above the 3.0% inflation target midpoint (although within the target band), core inflation has been downwardly sticky despite the weak growth dynamics (Exhibit 11), and short- and medium-term inflation remains misaligned from the target. Against a backdrop of lingering inflationary pressures and a number of domestic and external risks and uncertainties, the monetary authority has been very conservative and pro-active in the calibration of monetary policy. However, at the current high 8.25% level (the highest in a decade) the policy rate is clearly restrictive in both nominal and real terms (Exhibit 12), particularly vis-à-vis the negative output gap and below-trend growth outlook. Hence, despite the near-term inflation challenges and lingering risks we also forecast (moderate) rate cuts in Mexico as the current policy stance appears excessively restrictive given the deterioration of the economy's growth performance and the dovish/accommodative outlook for Fed Funds and global rates.

Exhibit 11: Mexico: Headline and Core Inflation Within Target Band



Source: INEGI, Goldman Sachs Global Investment Research

Exhibit 12: Mexico: Real Ex-Ante Policy Rate Significantly Above Estimated Neutral R* range



Source: Banxico, Goldman Sachs Global Investment Research

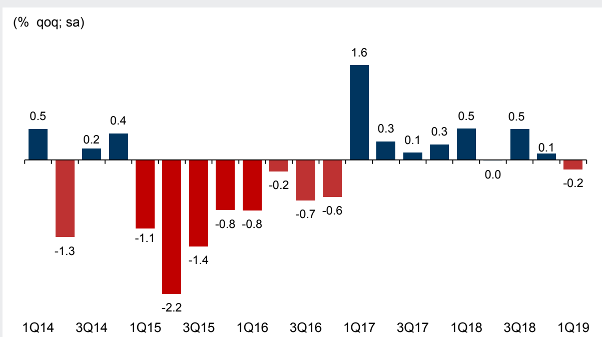
Box 1: Brazil-Mexico Real Activity: From 2H2018 Bad to 1Q19 Worse

Brazil: Weakest Cyclical Recovery on Record

In Brazil, real GDP growth downshifted to -0.2% qoq sa in 1Q2019, from the already-lackluster +0.1% qoq sa variation in 4Q2018. Final domestic demand declined in 4Q2018 (-0.2% qoq sa) and failed to recover in 1Q2019 (-0.002%). Investment ex-inventories was particular weak: declined by a large 1.7% qoq sa, adding to the even large 2.4% mom sa decline recorded in 4Q18. In annual terms, real GDP grew a modest 0.5% yoy during 1Q2019, down from 1.1% yoy in 4Q18.

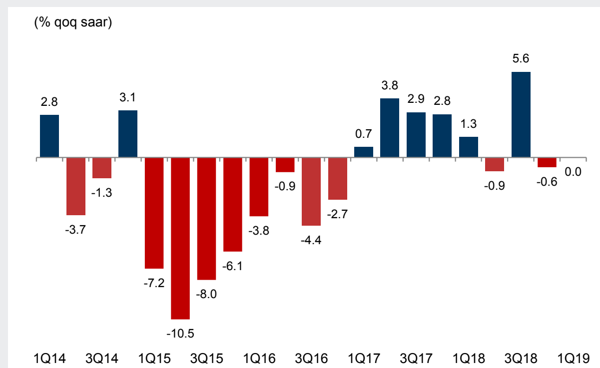
Technically the economy may have just avoided dipping back into a recession (unofficial rule of thumb: two consecutive quarters of negative sequential growth) but to some extent it did feel almost like one as private final domestic demand (excludes government consumption) has contracted for two consecutive quarters (and in three of the last four quarters).

Exhibit 13: Sluggish Recovery Following Deep and Long Recession



Source: IBGE, Goldman Sachs Global Investment Research

Exhibit 14: Weakening Momentum of Final Domestic Demand

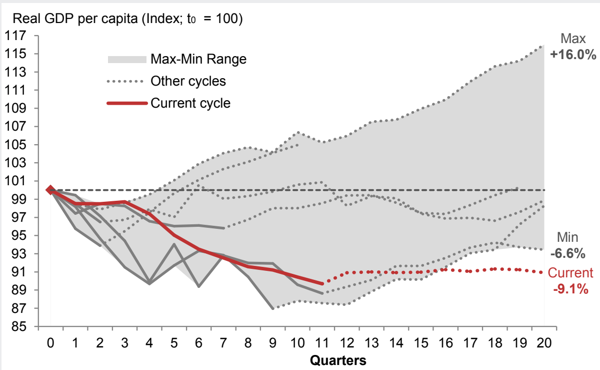


Source: IBGE, Goldman Sachs Global Investment Research

More than two years into the cyclical recovery (9 quarters), the performance of the Brazilian economy has been remarkably sluggish despite the presence of extensive slack in terms of resource utilization, a strong external balance sheet, low inflation, and accommodative monetary and financial conditions. In the current recovery, by 1Q2019 real GDP per capita was still 9.1% below the peak (Exhibit 15) (with per capita private consumption 7.3% below the 4Q2014 cyclical high), making it the weakest recovery on record. Gross fixed investment is currently 28.5% below the 3Q2013 level high. GFI is now at the same level of early 2008 (11 years ago). Overall, compared with previous cyclical recoveries, the current response of investment spending has been remarkably weak.

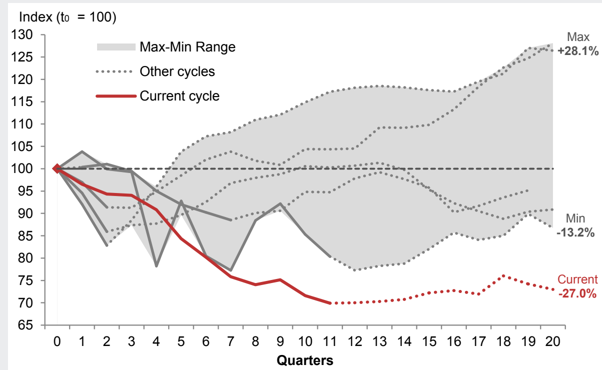
The ongoing very weak cyclical recovery's struggles reflect not only the effects of high and above-average policy uncertainty on spending decisions, but perhaps more importantly, structural damage to the economy's main engines of growth in recent years. In fact, beyond weak sentiment indicators the recovery has been limited by the decline in the capital stock of the economy (lower capital-labor ratio) given the severe decline of investment, high levels of financial leverage (indebtedness) in the system (particularly in the balance sheet of the government and households), and labor market hysteresis (loss of skills given a prolonged period of very high unemployment).

Exhibit 15: GDP per capita still 9.1% below pre-recession peak
(t=0 marks quarter before recession)



Source: IBGE, Goldman Sachs Global Investment Research

Exhibit 16: Investment spending still 27% below pre-recession (-28.5% from 3Q13 peak)



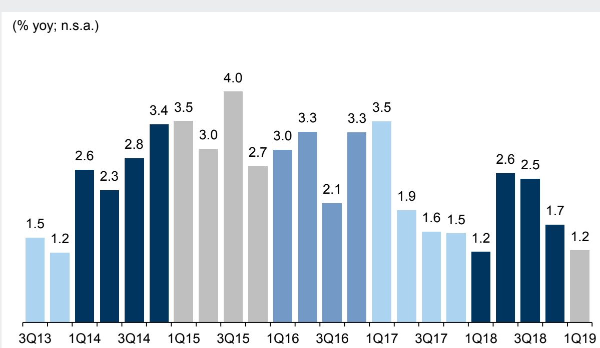
Source: IBGE, Goldman Sachs Global Investment Research

Mexico: Weak Domestic Demand Dynamics

Real GDP recorded a disappointing -0.2% qoq sa variation in 1Q2019, down from the flat 4Q2018 print (0.03% qoq sa). Final domestic demand has been weak for four consecutive quarters (average of -0.2% qoq sa): private consumption has been flat (average of 0.0% qoq sa) and gross fixed capital formation has been declining (average of -0.8% qoq). On the supply side, during 1Q2019 activity was held back by the declines in the secondary (-0.6% qoq sa) and labor-intensive tertiary (-0.2% qoq sa) sectors. The secondary sector has now recorded negative sequential growth in three of the last four quarters.

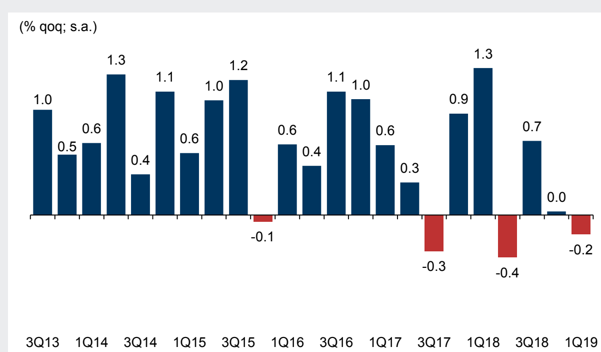
Overall, real GDP growth decelerated to a minor 0.1% yoy sa (1.2% yoy) in 1Q2019, down from 1.6% yoy sa (1.7% yoy) in 4Q2018 and the weakest print since 4Q2009. Private consumption growth downshifted to a low 0.2% yoy sa in 1Q19, the weakest growth profile in 5 years, and gross fixed investment has remained very weak: -3.2% yoy sa. Overall, final domestic demand growth decelerated to -0.7% yoy sa in 1Q19, from 0.6% qoq sa in 4Q18 and 2.9% yoy sa a year ago.

Exhibit 17: Decelerating Annual Real GDP Growth



Source: INEGI, Goldman Sachs Global Investment Research

Exhibit 18: Growth Momentum Softened During 4Q2018 and Turned Negative in 1Q2019



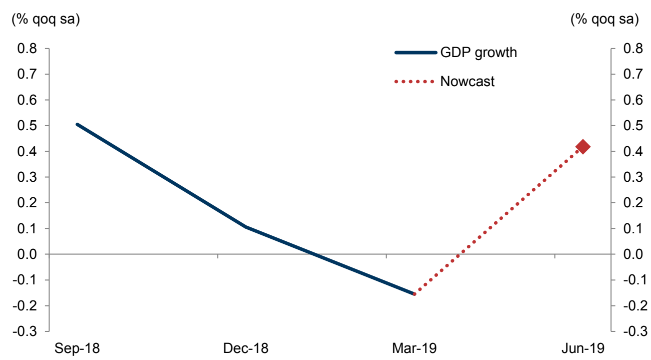
Source: INEGI, Goldman Sachs Global Investment Research

Growth Expected to Firm Slightly from a Dismal 1Q2019: Uncertain and Riskier Profile in Mexico

Following the very disappointing 4Q2018 growth dynamics and 1Q2019 contraction we expect the growth profile to firm gradually in Brazil. We also anticipate a mild normalization of growth in Mexico, but to a still sub-trend pace and with the growth profile subject to significant risks, particularly policy risk.

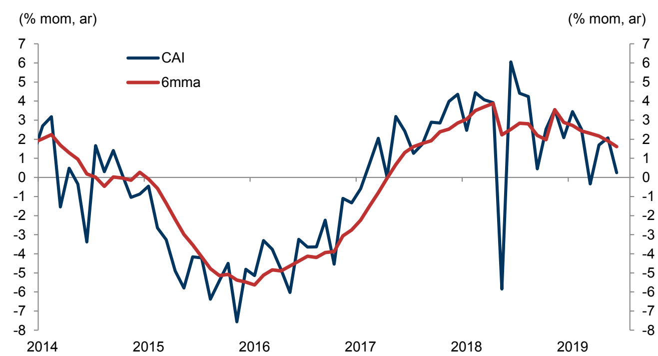
In **Brazil**, with the negative 1Q2019 print the statistical carry-over for 2019 real GDP growth dipped to just 0.2% (i.e., were the economy to remain flat at the 1Q2019 level, real GDP would grow by 0.2% in 2019). Our **Nowcast** framework for Brazil points to firmer growth dynamics in 2Q2019, but the Nowcast and particularly **CAIs** still point to underwhelming forward growth momentum in absolute terms (Exhibit 20).

Exhibit 19: Brazil: Nowcast points to firmer 2Q growth



Source: Goldman Sachs Global Investment Research

Exhibit 20: Brazil: Current Activity Indicator



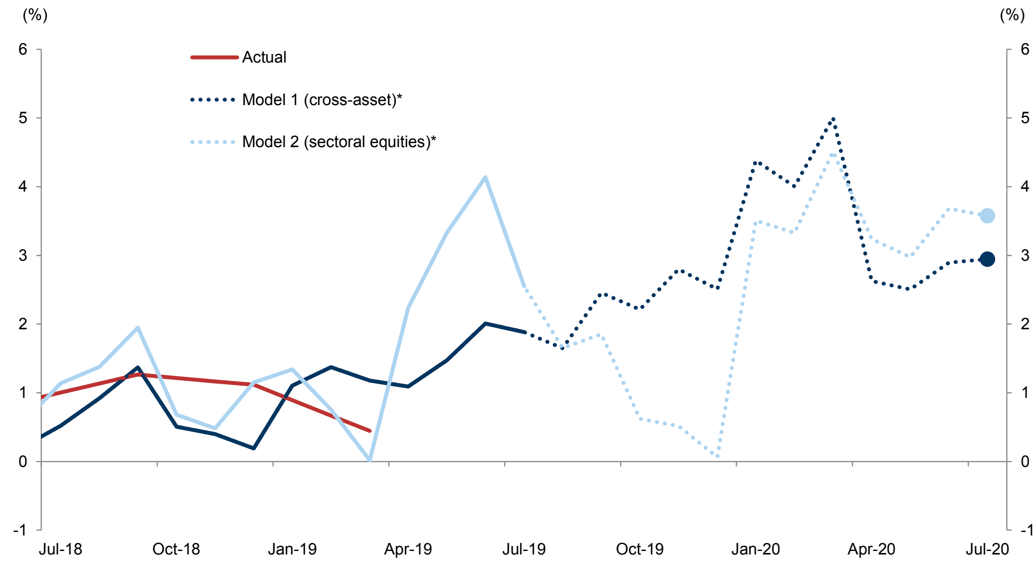
Source: Goldman Sachs Global Investment Research

We expect real activity to firm gradually in coming quarters and to expand a modest below-trend 1.0% in 2019, slightly below the uninspiring 1.1% 2017 and 2018 prints. Real activity in 2019 is expected to be supported by a firmer credit impulse, further accommodation of monetary and financial conditions (we forecast additional moderate Selic rate cuts), and gradual labor market improvement. In addition, progress on the reform agenda (the expected approval of social security reform in the Lower House in early August, and in the Senate floor in October) is likely to contribute to firmer domestic sentiment indicators and easier financial conditions as Brazilian financial asset prices reprice upward to reflect lower risk-premia.

We see upside risk to activity (more for 2020) in case policymakers (government and Congress) succeed in implementing an investment and productivity-enhancing macro and micro agenda and in moving decisively on the fiscal consolidation front. Progress in these areas would contribute to unleash the trapped animal and entrepreneurial spirits of the economy and accelerate the recovery.

Finally, we highlight that asset markets are already discounting an improving growth and macro story in Brazil. In fact, our models suggest that with the recent rally, Brazilian asset prices are currently discounting/pricing a significant acceleration of 1-year forward annual growth to an above-trend pace of 3.0% to 3.5%, with cross-sector equities embedding the most bullish growth signal (by mid-2020; Exhibit 21).

Exhibit 21: Brazil: 1-Year Forward Annual GDP Growth Rate Discounted by Risky Assets



Model 1: FX unhedged interest rate carry, hard currency bond returns (EMBI+), and broad equity returns / Model 2: FX unhedged interest rate carry, hard currency bond returns (EMBI+), and cross-sector equity returns

Source: Goldman Sachs Global Investment Research

In **Mexico**, the economy has been increasingly underperforming and the balance of risks for growth remains skewed to the downside. The growth momentum softened visibly during 4Q2018 (zero sequential growth), and dipped into negative territory during 1Q2019, driven to some extent by a number of idiosyncratic factors (labor strikes and disruptions to fuel supply in a number of states). As such, the output gap widened during 4Q2018, and even more in 1Q2019. With the negative 1Q19 print, the statistical carry-over for 2019 declined to a minor 0.1%; that is, were the economy to remain flat during 2Q-4Q 2019 at the 1Q2019 level, real GDP would grow only 0.1% in 2019.

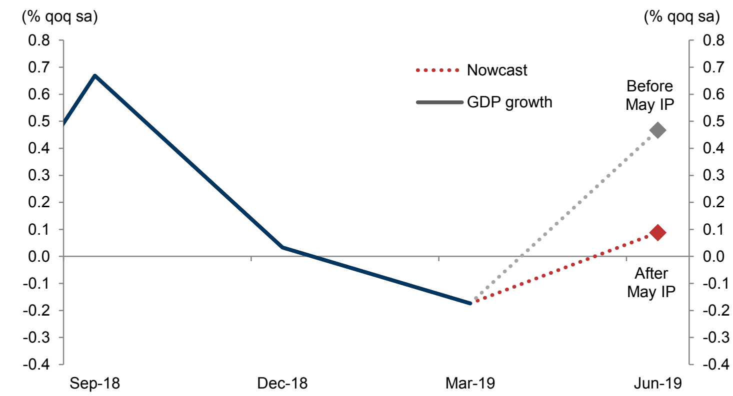
Our ***Nowcast*** model for Mexico points to very weak growth dynamics in 2Q2019: 2Q growth dropped to very close to zero, and we already have more than 60% of the data needed for the quarter (Exhibit 22). Furthermore, the ***CAIs*** have been trending down. That is, **Mexico is on the brink of witnessing 2 consecutive quarters of negative sequential growth, or a technical recession** (Exhibits 23 and 24). The 2Q started with a modest positive impulse but the ***Nowcast*** data-vector z-score for May-Jun has turned negative. The growth signals for June have been particularly weak but we acknowledge that so far most of the June data have been soft rather than hard indicators (Exhibit 22).

Exhibit 22: Mexico: 2Q Nowcast Growth Deteriorated Sharply after Very Weak May IP Release

Mexico: Q2 activity heatmap

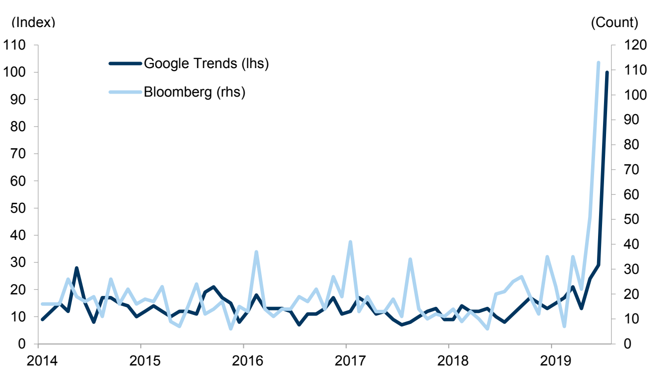
Indicator (z-score)	April	May	June
Private Nonfinancial Credit	-0.31	-0.19	
Consolidated Government Revenue	0.10	0.09	
Consolidated Government Expenditure	0.11	0.11	
Domestic Private Consumption	1.10		
Gross fixed capital formation	1.20		
Economic Activity	-0.15		
Construction Activity	-0.15		
Construction Employment	-1.25		
Industrial Production	1.56	-2.62	
Employment rate	0.06	0.06	
Total Store Sales	1.00	-0.15	-0.38
Retail Sales Volume	0.56		
Manufacturing Sales	-0.65		
Worker's Remittances	0.04	0.32	
Exports	0.68	1.36	
Imports	0.19	0.73	
Manufacturing PMI	0.31	-0.97	-1.16
Non-manufacturing PMI	-0.51	-1.25	-1.62
Leading Index	0.05	0.03	
Coincident Index: Economic Activity	-0.89		
Consumer Confidence	-0.88	-0.84	-0.74
Producer Confidence	0.45	0.36	0.26
Average value	0.12	-0.21	-0.73

2Q nowcast has deteriorated sharply



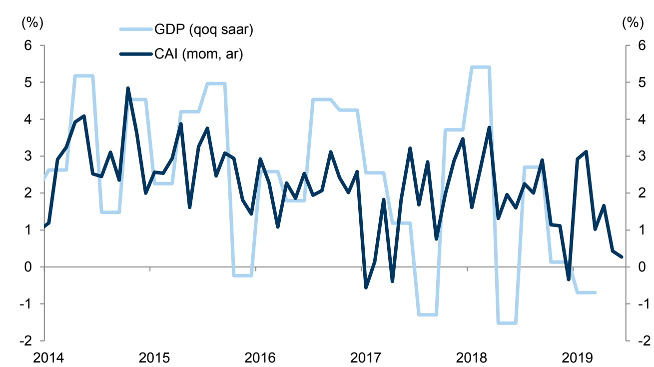
Source: Goldman Sachs Global Investment Research

Exhibit 23: "Recession" search entries are rising in Mexico (Google Trends), as well as the frequency of the world "recession" in Mexican press (Bloomberg)



Source: Google Trends, Bloomberg, Goldman Sachs Global Investment Research

Exhibit 24: Mexico Current Activity Indicator

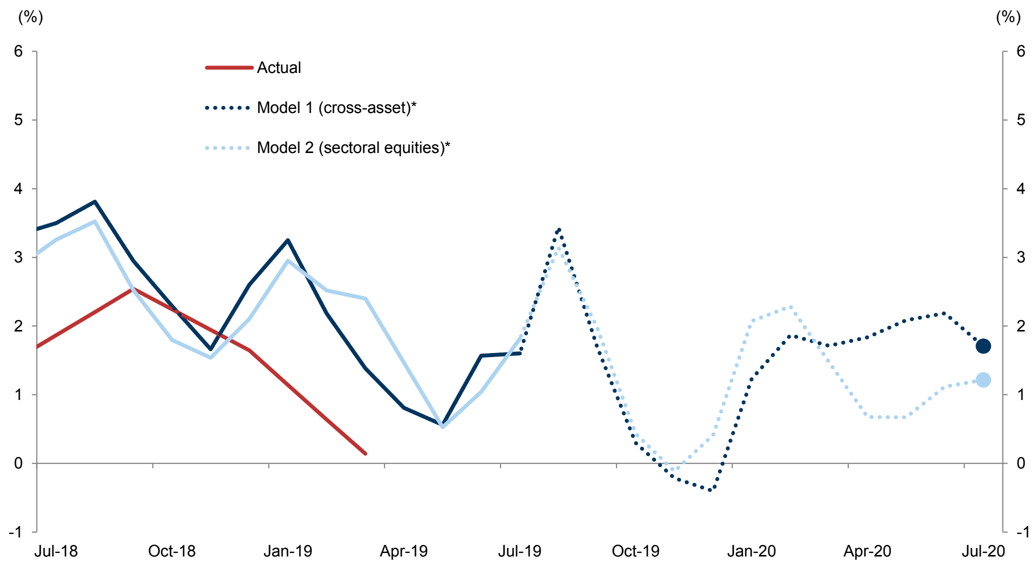


Source: Goldman Sachs Global Investment Research

We expect real GDP growth to downshift from 2.0% in 2018 to just 1.0% in 2019 (downgraded from 1.4% and with risk still skewed to the downside). Tight monetary policy, exigent credit standards/conditions, and lingering uncertainty and risks ahead, are expected to weigh down on the buoyancy of private consumption spending. Furthermore, the outlook for investment spending remains lackluster. High interest rates and exigent domestic financing conditions, as well as an overall modest outlook for final domestic demand should all remain a drag on investment spending. The projected deceleration of the US economy (particularly manufacturing) may also weaken the thrust to activity from exports and foreign direct investment flows. Finally, lingering uncertainty with regard to the ratification of the USMCA and market apprehension with regard to macro and micro policy direction under the López Obrador administration could have a visible dampening effect on activity by tightening domestic financial conditions and by rendering domestic economic agents more defensive in their spending and investment decisions. On the positive side, real wage gains supported by the expected moderation of inflation (partially offset by decelerating employment growth), a competitive currency and a potentially lower drag from declining oil production should cushion the projected real activity deceleration.

In Mexico, the 1-year forward annual real GDP growth rate discounted in financial asset prices is significantly more subdued than in Brazil, between 1.0% and 1.5%, but given the recent increase in political noise and uncertainty with regards to policy direction that may ultimately still prove optimistic. In this regard, we highlight that 1 year ago, asset prices were discounting a much stronger growth outturn for 4Q18 and 1Q19 than the actual hard data ended up revealing.

Exhibit 25: Mexico: 1-Year forward annual real GDP growth projection discounted by risk assets



Model 1: FX unhedged interest rate carry, hard currency bond returns (EMBI+), and broad equity returns / Model 2: FX unhedged interest rate carry, hard currency bond returns (EMBI+), and cross-sector equity returns)

Source: Goldman Sachs Global Investment Research

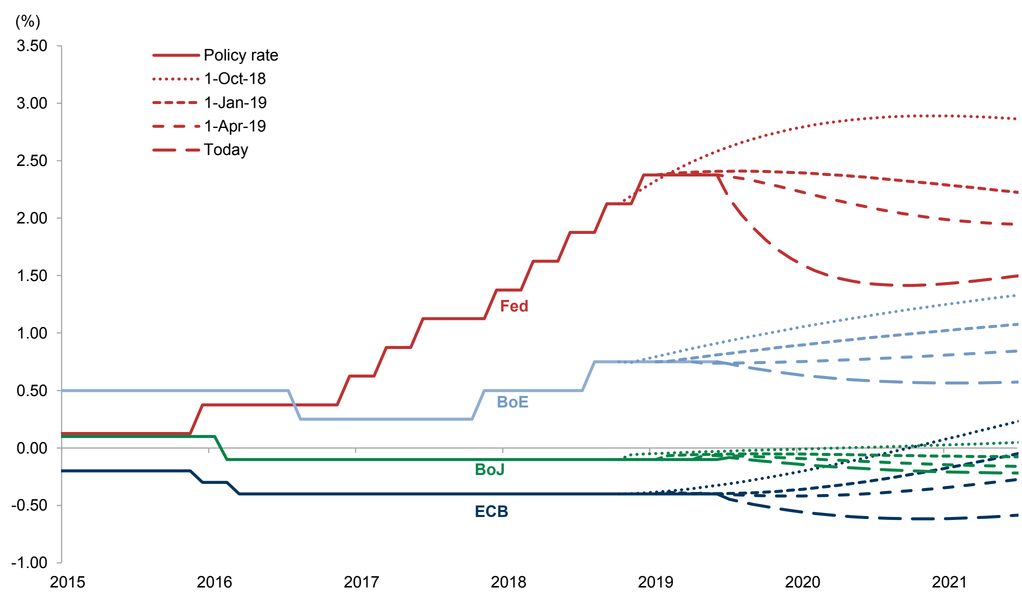
Monetary Easing on the Way: More Accommodation in Brazil, Less Restrictiveness in Mexico

In **Brazil**, the last five years were extraordinarily challenging economically, politically and socially. The economy has been crawling out of a very deep and long recession at a painfully slow pace. Hence, the economy is still operating with a high level of slack (large negative output gap and unemployment rate significantly above the NAIRU).

Given the persistence of a weak below-trend pace of real activity, a large negative output gap and high level of slack in the labor market, subdued confidence indicators, well-anchored and declining near-term inflation expectations, comfortable conditional inflation forecasts over the relevant horizon for monetary policy, favorable evolution of the balance of risks to inflation, and dovish shift in the G4 and EM monetary policy outlook, we expect 100bp of Selic rate cuts before the end of the year.

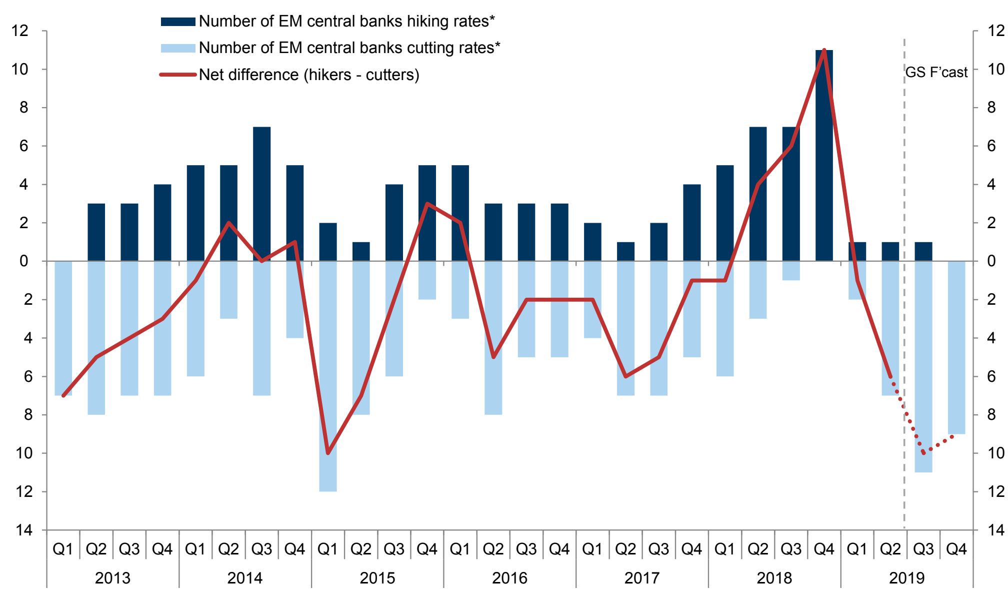
Given that the pivotal social security constitutional reform bill has cleared the most critical legislative stage (first of two required Lower House floor votes) and with larger-than-expected political support and stronger than initially expected content (approximately BRL900bn over a 10-year period), the fact that financial markets have reacted well to the recent domestic developments (e.g., BRL/USD strengthened from 3.90 by mid-June to around 3.75 currently), and given increasingly dovish DM and EM monetary policy dynamics (Exhibits 26 and 27), we now believe that it is **more likely than not (60% probability) that the first rate cut takes place at the July 31 Copom meeting** rather than in September. We continue to expect **100bp of Selic rate cuts before the end of the year** (-25bp at the July, Sept, Oct, and the Dec Copom meetings). We expect the Selic rate to reach a new record-low of 5.5% by December and to remain at that level throughout 2020. We do not rule out a more frontloaded (easing rounds of -50bp) or deeper cutting cycle, particularly if growth fails to firm and the conditional inflation forecast for end-2020 under a path with 100bp Selic rate cuts continues to undershoot the 4.00% target.

Exhibit 26: Market Implied Policy Rate Path for G4 Central Banks Has Fallen Significantly



Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 27: EM Central Banks Moving Towards Cuts

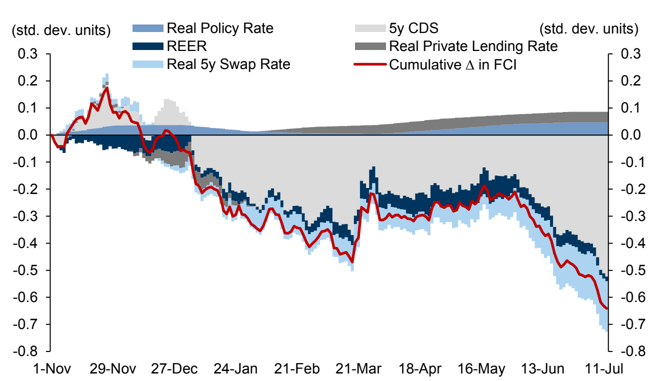


*Excluding Argentina, Venezuela, Nigeria, Singapore, and Hong Kong

Source: Goldman Sachs Global Investment Research

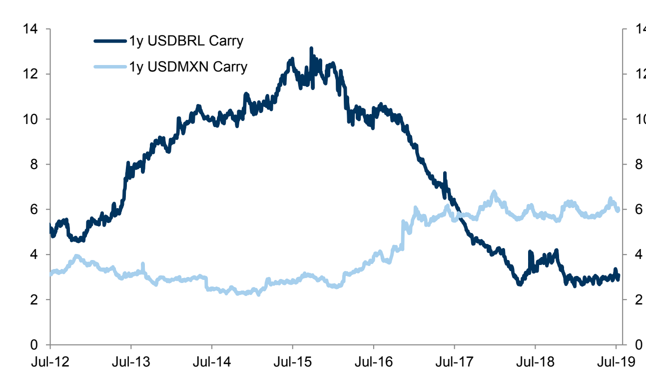
There are however, **limits/constraints on how much the central bank can cut**. Not only is the current policy stance already accommodative, but financial conditions have eased further in recent weeks with the rally in Brazilian asset prices (driven by a more benign external backdrop and, on the domestic side, improving outlook for approval of key reforms) and the BRL/USD carry is already quite low. Hence, aggressive easing could be counterproductive for it could not only compromise the achievement of the lower inflation targets in 2020-21 (4.00% and 3.75%, respectively) but could also render the BRL more volatile given the thin carry.

Exhibit 28: Brazil: Cumulative Change in Daily FCI since Nov 1, 2018



Source: Goldman Sachs Global Investment Research

Exhibit 29: BRL Now a Low Carry Currency

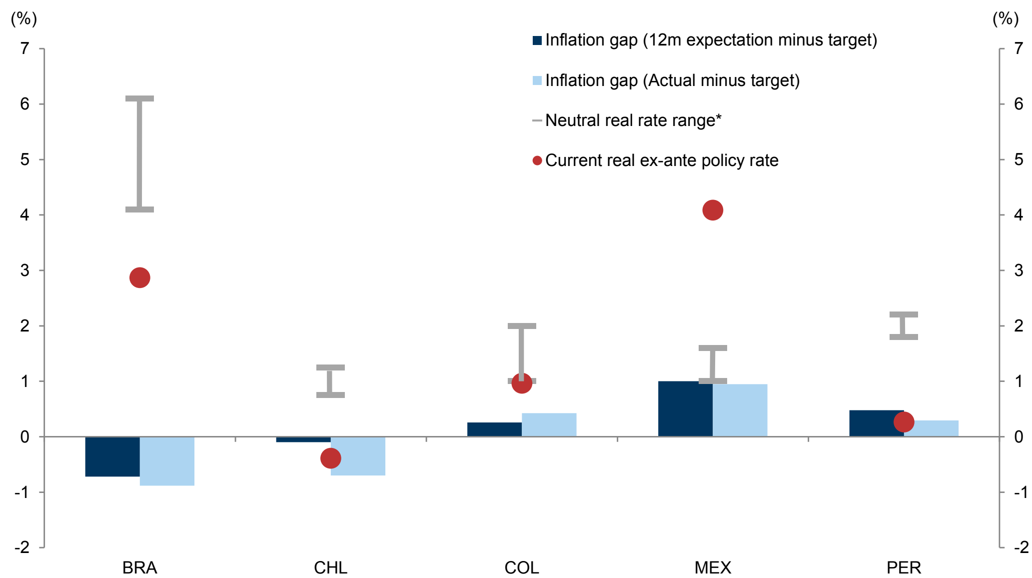


Source: Goldman Sachs Global Investment Research

In **Mexico**, the significant deterioration of the current and prospective growth dynamics and the dovish FOMC shift is likely, in our assessment, to shift the balance of views in the MPC towards (moderate) rate cuts. At the June 27 meeting the MPC held the policy rate unchanged at 8.25% in a split decision: one of the five directors (Gerardo Esquivel) voted for a 25bp rate cut. The policy statement and minutes preserved the vigilant short-term bias of the post meeting policy statement, but beyond the fact that there was already a dissenting vote for a rate cut, a number of dovish twists were added the statement and the minutes that can be construed as a step towards preparing the ground, contingent on incoming data, for monetary easing.

In the minutes, the change in the outlook for the global - and in particular the FOMC - policy rate dynamics was given a lot more prominence than in previous documents. In this regard a key reference was, in our assessment, that for the majority of directors the "*expectation of a more accommodative FOMC monetary policy stance provides Banxico with greater room for maneuver*".

Exhibit 30: Restrictive Policy Stance in Mexico vs. Easier Conditions in the rest of LatAm



*Neutral real rate estimates available in the IMF's 2018 Regional Economic Outlook for Latin America

Source: Goldman Sachs Global Investment Research

Issues related to the very recent weak domestic demand conditions, further deterioration of the already downwardly skewed balance of risks for activity, and widening slack conditions in the economy (including the labor market) also became more prominent in the minutes and concerns with regards to the weak real business cycle were shared by virtually all directors. In fact, it was unanimous among directors that domestic economic activity has shown a deeper-than-expected deceleration and for the majority of directors growth in 2019 could be lower than anticipated and the downward bias of the balance of risks has increased due to domestic and external factors.

Furthermore, the balance of risks to inflation was no longer judged as biased to the upside as the MPC now just flags in a more neutral/balanced way the "*persistence of high uncertainty regarding the risks that might affect inflation*". Concerns about cost-push pressures on inflation and a number of lingering domestic and external risks that could impact inflation and the exchange rate are still alive but for some directors are now to a very significant extent mitigated, if not dominated, by the weak growth dynamics.

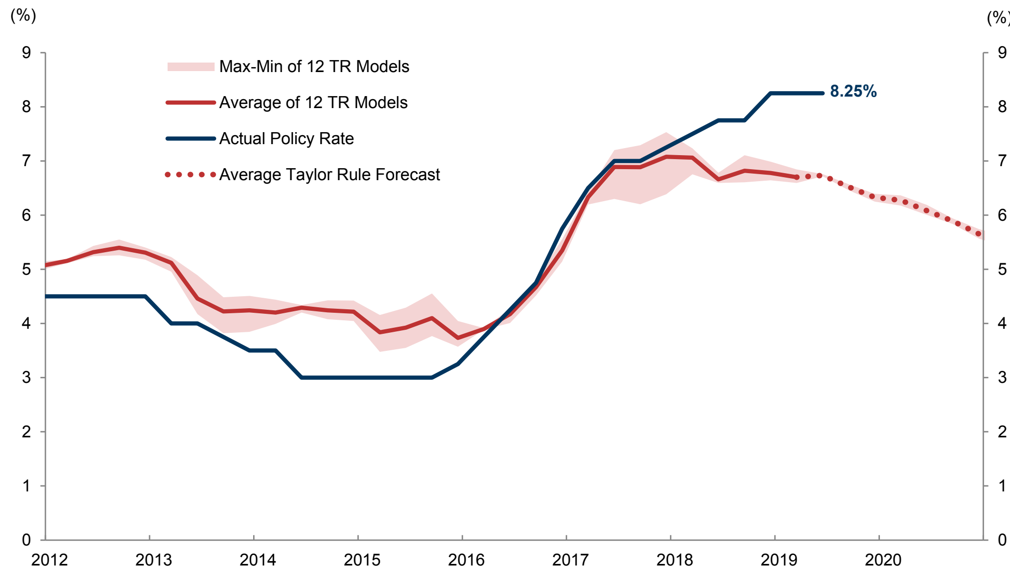
Finally, inflation convergence to the target and anchoring of inflation expectations are seen as work in progress, and while concerns with the downward rigidity of core inflation have not disappeared for the majority of directors both headline and core inflation are, nevertheless, expected to trend down in coming months.

Overall, the balance of views within the MPC has been shifting and becoming gradually less defensive/conservative. **In our assessment, the current mapping of views within the MPC can best be described as: Two Hawks, Two Doves, and One Uncommitted Sitting on the Fence**.

- ***Two Hawks***: Some directors (likely 2, for 3 would be described as the majority of directors) argued that it "*would not be convenient to ease the monetary policy stance if inflation does not show a clear trend towards the 3% target*".
- ***Uncommitted***: One more neutral director highlighted the possibility of weak economic growth coupled with persistent inflationary pressures and the complexity that would add to the calibration of monetary policy.
- ***Two Doves***: On the dovish side director Esquivel argued that "*a 25bp cut is necessary, given inflation's favorable evolution, unfavorable expectations regarding economic growth and the outlook of a monetary policy easing in the US*"; and another director stressed that "*if inflation remains consistent with a convergence path to the target, it will be necessary to begin an easing cycle in a relatively short horizon*" pointing to growth and fiscal risks of "*maintaining a tight monetary policy for a prolonged period*". However, on a cautious note this director underscored that "*given the inflation risks, the decision to begin a cycle of policy rate cuts must be taken very prudently and cautiously*" as premature easing could generate financial market volatility and compromise financial stability.

We expect ***Banxico*** to gradually prepare the ground for moderate near-term rate cuts. Despite the manifest conservatism of the central bank in recent years, rate cuts are, in our assessment, warranted by the fact that the ex-ante real policy rate is in clearly restrictive territory and the policy rate is well above what a traditional Taylor Rule framework would dictate (Exhibit 31), while the trend and balance of risks for activity are biased to the downside (the output gap is expected to widen further in 2019), credit flows and formal job creation have been weakening, soft activity indicators have softened in recent months (consumer and business confidence and PMIs), and external demand has been weakening at the margin (the US economy forward momentum has been slowing, driven by the manufacturing sector which are the sectors with the strongest linkages and spillovers to the Mexican economy).

Exhibit 31: Mexico: Actual Policy Rate Significantly Above Optimal Taylor Rule Estimate



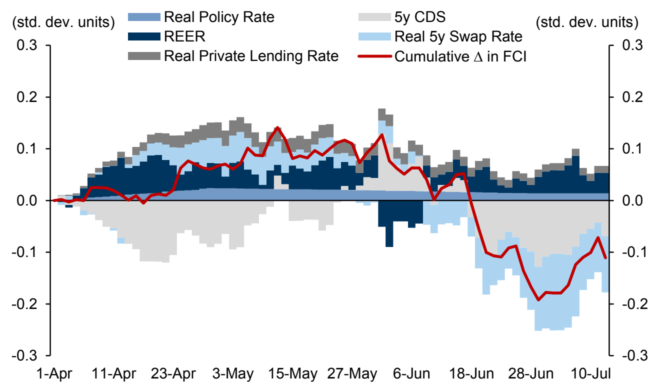
Source: Goldman Sachs Global Investment Research

In addition, the FOMC and ECB have both decisively signaled a willingness to ease and a number of both DM and EM central banks have either already cut rates or sent dovish forward guidance easing signals. The market-implied path for the federal funds rate through 2020 has shifted down markedly and our modal expectation remains an FOMC 25bp cut at both the July and September meetings. This reduces the risk that moderate rate cuts in Mexico to lessen (not reverse) the current restrictive monetary stance would trigger FX market volatility or significant portfolio reallocation away from Mexican assets.

Against this backdrop, **we expect the MPC to deliver three 25bp rate cuts (at the September, November and December meetings) driving the policy rate to a still above-neutral 7.50%.** We see a non-minor probability of the first easing move taking place as soon as the August meeting, particularly if the real activity data remain weak. Finally, we highlight that rate cuts are highly conditional on broad currency stability: a big MXN dislocation could rekindle inflationary pressures and reduce the scope for the central bank to cut rates without exposing the capital account to potential pressures.

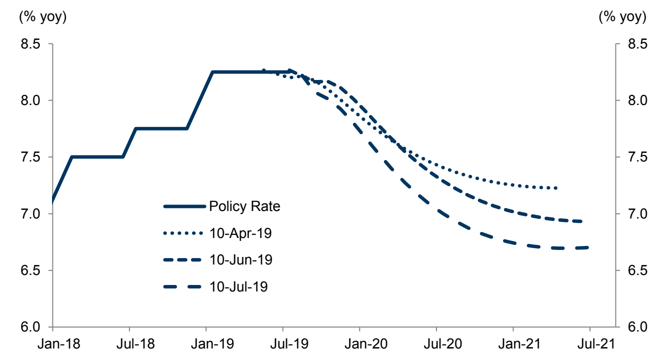
The noise created by the recent unexpected resignation of Finance Minister Urzua and the issues highlighted in his resignation letter moved asset prices and tightened financial conditions (Exhibit 32). Furthermore, as the Mexican local yield curve already prices some degree of easing (Exhibit 33), failing to deliver on the current market expectation would likely lead to further tightening of financial conditions, which would not, in our assessment, be warranted given the clearly below-trend growth dynamics.

Exhibit 32: Mexico: Cumulative Change in Daily FCI since Apr 1, 2019



Source: Goldman Sachs Global Investment Research

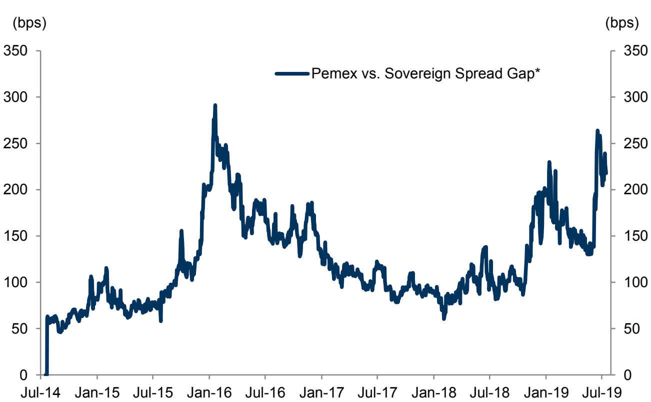
Exhibit 33: Mexico: Market-implied policy rate path has shifted downwards



Source: Goldman Sachs Global Investment Research

Despite the weak growth dynamics, as in the case of Brazil, we also see some clear constraints/limits for a deep easing cycle in Mexico. Ultimately, the monetary policy stance is likely to remain restrictive (above-neutral) for a while given a number of risks to inflation, ranging from cost-push upward pressures on inflation from the recent large increase in the minimum wage, to likely growing pressures on the federal budget given the low growth backdrop and ambitious new social and infrastructure spending programs, and the latent risk of a Pemex debt rating downgrade with negative systemic implications for the budget and FX and financial markets.

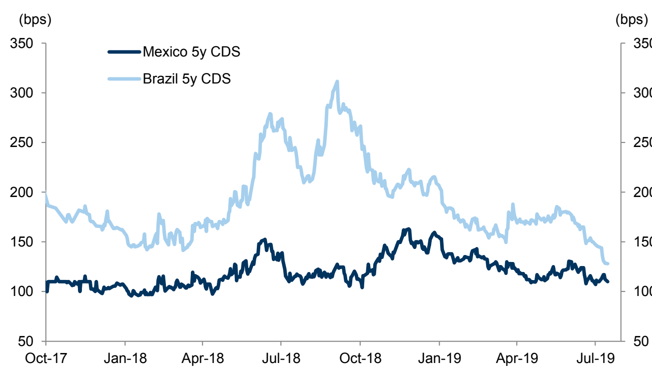
Exhibit 34: Wide Spread between Pemex and Sovereign USD-denominated Bonds



*USD-denominated bonds maturing in 2023.

Source: Bloomberg, Goldman Sachs Global Investment Research

Exhibit 35: Brazil 5y CDS Spreads Now Tracking on Top of Mexico



Source: Bloomberg, Goldman Sachs Global Investment Research

That is, to guard or insure against some of these risks, **we expect the central bank to ease slowly and moderately so that the MXN will continue to offer a relatively high carry in order to entice investors to remain engaged in what is shaping as a slowly deteriorating macro story.**

Alberto M Ramos

Gabriel Fritsch

LatAm and Global Macroeconomic Outlook

Consolidated Latin America Selected Economic Indicators

	2011	2012	2013	2014	2015	2016	2017	2018	2019F	2020F	2021F	2022F
I. Economic Activity and Prices												
Nominal GDP (US$bn)	5,083	5,078	5,223	5,182	4,366	4,171	4,651	4,500	4,575	5,031	5,483	5,850
Real GDP growth (% yoy)	4.6	2.6	2.8	1.3	0.3	-0.2	1.7	1.4	1.1	2.4	2.7	2.9
CPI Inflation (% yoy)	7.3	6.6	7.0	8.7	9.0	8.9	6.5	8.9	7.7	5.6	4.5	4.0
Domestic Demand (% yoy)	6.0	2.8	3.0	1.0	-0.8	-1.0	1.9	1.6	0.8	2.4	2.9	3.1
II. External Sector (US$bn)												
Current Account Balance	-111.0	-131.9	-157.8	-168.7	-136.2	-84.6	-77.2	-89.0	-76.5	-93.0	-112.4	-132.5
Trade Balance	64.9	46.7	9.8	-3.6	-10.7	34.1	56.9	45.4	49.1	41.8	34.5	23.9
Gross International Reserves	663.6	722.6	715.9	737.9	705.2	729.3	751.7	763.2	786.3	804.2	819.4	834.9
Change in Reserves	109.2	59.0	-6.8	22.0	-32.7	24.1	22.4	11.6	23.0	17.9	15.2	15.6
Net Capital Inflows	220.2	191.0	151.1	190.7	103.5	108.7	99.6	100.6	99.5	110.9	127.6	148.1
Foreign Direct Investment	148.4	155.4	167.8	168.1	150.0	146.0	144.2	163.8	164.9	175.3	185.3	195.3
III. Public Finance and Indebtness (% GDP)												
Primary Fiscal Balance	1.3	0.8	0.4	-1.0	-1.7	-1.8	-1.0	-0.8	-0.4	-0.3	-0.1	0.0
Overall Fiscal Balance	-2.1	-2.1	-2.5	-4.3	-6.3	-5.6	-4.7	-4.5	-4.2	-4.0	-3.8	-3.6
Total Public Sector Debt	41.4	42.0	42.1	46.2	51.3	55.1	55.8	58.3	59.5	60.0	60.3	61.2
Total External Debt	22.2	24.7	26.1	29.1	34.4	36.8	34.8	37.7	39.3	39.0	38.3	38.2

Note: Aggregates weighted by nominal GDP in US$ at PPP exchange rates.

Source: Goldman Sachs Global Investment Research

Global Macroeconomic Framework

						2018				2019F			
	2016	2017	2018	2019F	2020F	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F
Real GDP Growth (%, yoy)													
United States	1.6	2.2	2.9	2.5	2.1	2.6	2.9	3.0	3.0	3.2	2.5	2.1	2.1
Euro Area	1.9	2.5	1.8	1.1	1.3	2.4	2.2	1.6	1.2	1.2	0.9	1.0	1.1
Japan	0.6	1.9	0.8	0.8	0.6	1.3	1.5	0.1	0.3	0.9	0.4	1.4	0.6
World Economy	3.1	3.7	3.8	3.5	3.6	4.0	4.0	3.6	3.6	3.5	3.4	3.6	3.6
CPI Inflation (%, yoy)													
United States	0.9	2.1	2.2	1.8	2.2	2.2	2.7	2.6	2.2	1.6	1.8	1.7	2.1
Euro Area	0.2	1.5	1.8	1.3	1.2	1.3	1.7	2.1	2.0	1.7	1.4	1.1	1.0
Japan	-0.1	0.5	1.0	0.4	0.8	1.3	0.6	1.1	0.9	0.3	0.4	0.2	0.6
Interest rates (%, e.o.p)													
Fed Funds	0.54	1.30	2.27	1.88	2.13	1.51	1.82	1.95	2.27	2.41	2.38	1.88	1.88
UST 10-Year	2.44	2.41	2.68	1.75	2.10	2.74	2.86	3.06	2.68	2.41	2.00	1.85	1.75

Source: Goldman Sachs Global Investment Research

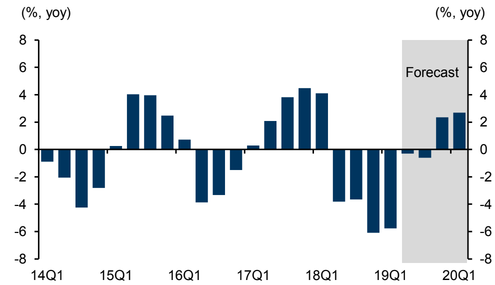
LatAm Country Data Tables

Argentina

	2017	2018	2019F	2020F
Activity and Prices				
Real GDP Growth (% yoy)	2.7	-2.5	-1.1	2.3
Nominal GDP (US$bn)	642	538	474	512
Consumer Prices, IPC (yoy, e.o.p.)*	24.8	47.6	37.7	20.3
Consumer Prices, IPCBA (yoy, e.o.p.)*	26.1	45.5	37.1	15.8
External Sector				
Current Account (% GDP)	-4.9	-5.1	-1.2	-1.9
Trade Balance (% GDP)	-0.9	-0.2	3.4	2.4
Exports (% yoy)	1.2	5.1	7.1	3.6
Imports (% yoy)	19.7	-2.5	-20.1	12.5
Exchange Rate ($/ARS, e.o.p.)	18.6	37.6	51.9	56.0
Gross International Reserves (US$bn)	55.1	65.8	68.8	69.8
Monetary Sector				
Monetary Base (% yoy)	24.7	36.0	18.0	20.0
Credit to the Private Sector (% GDP)	16.0	15.9	12.4	11.2
Reference Interest Rate	28.75	57.00	48.00	-
Fiscal Sector **				
Federal Govt Primary Balance (% GDP)	-3.8	-2.4	-0.5	0.6
Federal Govt Overall Balance (% GDP)	-6.0	-5.2	-4.0	-3.2

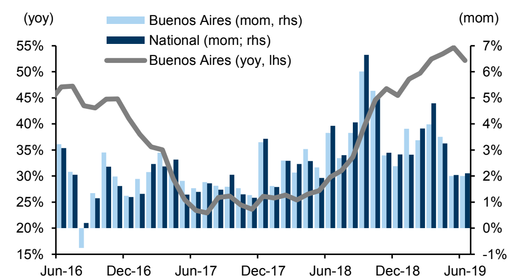
*IPC computed by INDEC, IPCBA by Statistical Institute City of Buenos Aires. **Before Rents from CB and Anses. Accumulated 4Q. *** Including non-performing debt.

Sharp Contraction since 2Q18



Source: INDEC, Statistical Inst. City of Buenos Aires, Goldman Sachs Global Investment Research

Deteriorating Inflation Dynamics



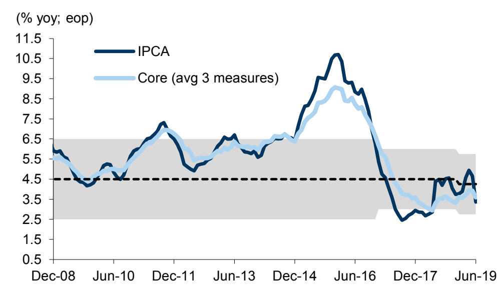
Source: INDEC, Statistical Inst. City of Buenos Aires, Goldman Sachs Global Investment Research

Brazil

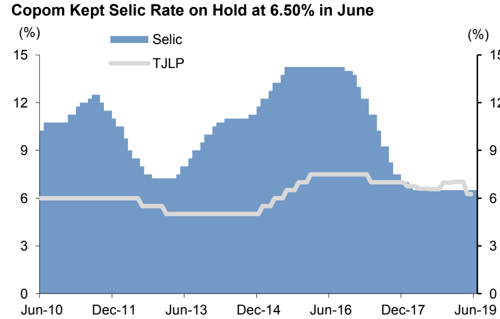
	2017	2018	2019F	2020F
Activity and Prices				
Real GDP Growth (% yoy)	1.1	1.1	1.0	2.4
Nominal GDP (US$bn)	2053.4	1875.9	1880.4	2036.1
IPCA Inflation (yoy e.o.p)	2.9	3.7	3.8	4.0
External Sector				
Current account (% GDP)	-0.4	-0.8	-1.3	-1.7
Trade balance (% GDP)	3.1	2.9	2.5	2.2
Exports of goods (% yoy)	17.8	10.0	3.5	5.0
Imports of goods (% yoy)	9.9	21.0	7.8	8.0
Nominal Exchange Rate ($/BRL e.o.p.)	3.3	3.9	3.8	3.8
Net International Reserves (US$bn)	374	375	390	405
Monetary Sector				
Monetary base (% yoy)	9.8	1.8	8.0	6.0
Credit to the Private Sector (%GDP)	43.9	44.5	46.7	49.9
SELIC rate (e.o.p)	7.00	6.50	5.50	5.50
Fiscal Sector				
Public Sector Primary Balance (% GDP)	-1.7	-1.6	-1.2	-0.8
Public Sector Nominal Balance (% GDP)	-7.8	-7.1	-6.8	-6.4
Debt Indicators				
Gross general govt debt (% GDP)	74.1	77.2	79.0	81.0
Domestic public debt (%GDP)	70.6	73.3	75.4	77.3
External public debt (%GDP)	3.5	3.9	3.6	3.7
Total external debt (% GDP)	26.7	29.8	31.5	31.7

Source: Goldman Sachs Global Investment Research

Headline/Core Inflation Back to Target Range



Copom Kept Selic Rate on Hold at 6.50% in June



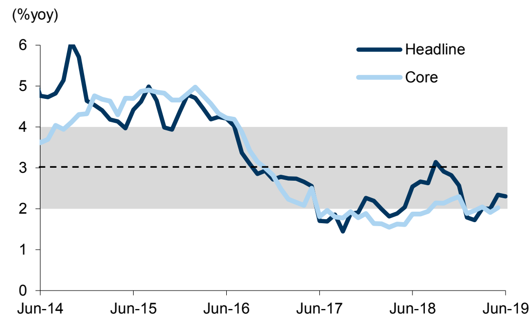
Sources: Bloomberg, Goldman Sachs Global Investment Research, Haver Analytics, IBGE

Chile

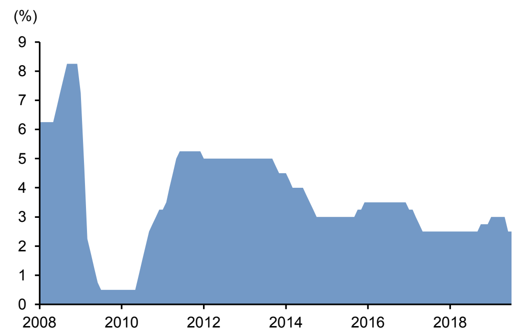
	2017	2018	2019F	2020F
Activity and Prices				
Real GDP Growth (% yoy)	1.3	4.0	2.5	3.5
Nominal GDP (US$bn)	278	299	298	337
Consumer Prices (% yoy, e.o.p.)	2.3	2.6	2.9	3.0
External Sector				
Current Account (% GDP)	-2.1	-3.1	-2.7	-2.2
Trade Balance (% GDP)	2.6	1.6	1.7	1.7
Exports (% yoy)	13.4	9.6	0.1	4.0
Imports (% yoy)	10.1	15.1	-0.5	3.6
Exchange Rate ($/CLP, e.o.p.)	615	696	670	600
Gross International Reserves (US$bn)	39.0	39.9	33.6	33.6
Monetary Sector				
Broad Money (M3, % yoy)	4.8	9.0	9.0	9.0
Credit to the Private Sector (% GDP)	80.0	81.5	83.1	84.2
Policy Rate (e.o.p.)	2.50	2.75	2.00	2.50
Fiscal Sector				
Central Gov't Primary Balance (% GDP)	-2.5	-2.1	-0.6	-0.4
Central Gov't Overall Balance (% GDP)	-2.7	-1.7	-1.5	-1.3
Debt Indicators				
Central Govt Debt (% GDP)	23.5	25.6	26.1	26.2
Domestic (% GDP)	19.1	20.3	20.6	20.2
External (% GDP)	4.4	5.3	5.5	6.0
Total External Debt (% GDP)	65.3	62.7	64.8	58.9

Source: Goldman Sachs Global Investment Research

Headline/Core Inflation Below Target



Central Bank Cut Policy Rate by 50bp in June



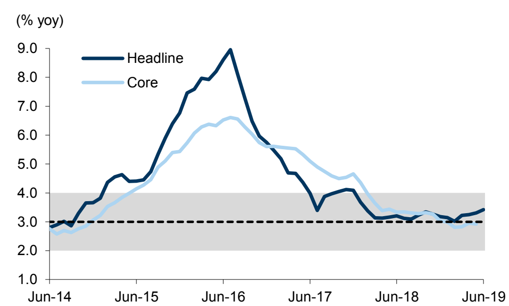
Source: Haver Analytics, INE, Central Bank of Chile

Colombia

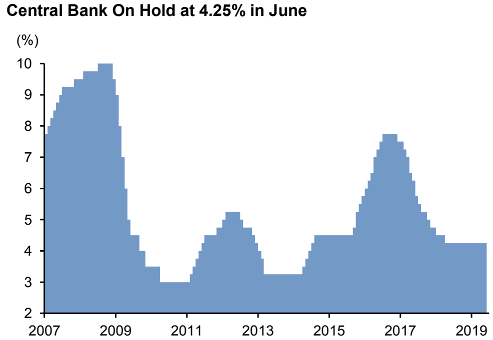
	2017	2018	2019F	2020F
Activity and Prices				
Real GDP Growth (% yoy)	1.4	2.6	3.0	3.5
Nominal GDP (US$bn)	312	331	328	371
Consumer Prices (% yoy, e.o.p.)	4.1	3.2	3.2	3.0
External Sector				
Current Account (% GDP)	-3.3	-3.9	-4.5	-4.2
Trade Balance (% GDP)	-1.5	-1.6	-3.1	-2.7
Exports (% yoy)	16.4	11.8	-1.1	5.1
Imports (% yoy)	2.3	12.1	9.1	3.9
Exchange Rate ($/COP, e.o.p.)	2984	3250	3050	2900
Gross International Reserves (US$bn)	47.1	47.7	55.1	57.1
Monetary Sector				
Monetary Base (% yoy)	5.0	7.0	9.0	9.0
Credit to the Private Sector (% GDP)	51.3	53.0	54.5	55.8
Policy Rate (% e.o.p.)	4.75	4.25	4.25	4.75
Fiscal Sector				
Central Government Primary Balance (% GDP)	-0.8	-0.2	0.2	0.4
Central Government Overall Balance (% GDP)	-3.7	-3.1	-2.7	-2.3
Debt Indicators				
Gross Non-fin. Public Sector Debt (% GDP)	54.4	57.6	59.1	59.7
Domestic (% GDP)	32.2	34.5	36.6	37.7
External (% GDP)	22.3	23.1	22.5	22.0
Total External Debt (% GDP)	40.0	39.6	38.0	38.0

Source: Goldman Sachs Global Investment Research

Headline/Core Inflation Converged to 3% Target



Central Bank On Hold at 4.25% in June



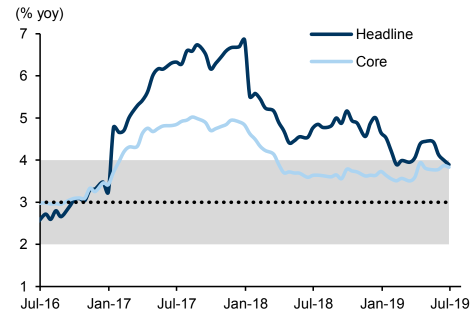
Source: Banco de la Repœblica

Mexico

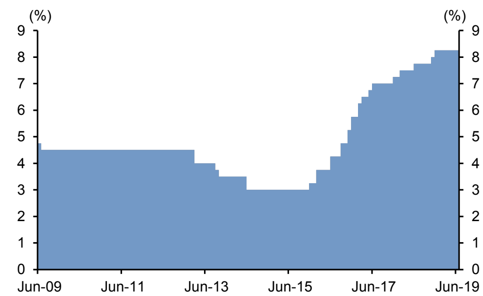
	2017	2018	2019F	2020F
Activity and Prices				
Real GDP Growth (% yoy)	2.1	2.0	1.0	1.5
Nominal GDP (US$ bn)	1157	1222	1287	1357
Consumer Prices (yoy, e.o.p.)	6.8	4.8	3.6	3.2
External Sector				
Current Account (% GDP)	-1.7	-1.8	-1.5	-1.5
Trade Balance (% GDP)	-0.9	-1.1	-1.2	-1.2
Exports (% yoy)	9.5	10.1	4.9	6.1
Imports (% yoy)	8.6	10.4	5.1	6.1
Exchange Rate ($/MXN, e.o.p.)	19.79	19.68	19.30	19.00
Net International Reserves (US$ bn)	172.8	174.8	176.0	175.0
Monetary Sector				
Monetary Base (% yoy)	8.8	8.3	10.3	10.0
Credit to the Private Sector (% GDP)	18.5	18.9	19.3	19.5
Tasa de Fondeo Rate (e.o.p.)	7.25	8.25	7.50	6.75
Fiscal Sector				
Public Sector Primary Balance (% GDP)	1.4	0.9	0.5	-0.1
Public Sector Overall Balance (% GDP)	-1.1	-2.0	-2.4	-3.0
Debt Indicators				
Gross Federal Govt Debt (% GDP)	45.8	44.9	45.2	45.9
Domestic (% GDP)	28.9	28.5	29.1	29.8
External (% GDP)	16.9	16.4	16.1	16.0
Total External Debt (% GDP)	37.7	37.2	37.1	38.0

Note: *Public Sector Borrowing Requirements
Source: Goldman Sachs Global Investment Research

Headline Inflation Has Likely Peaked



Banxico On Hold at 8.25% in June



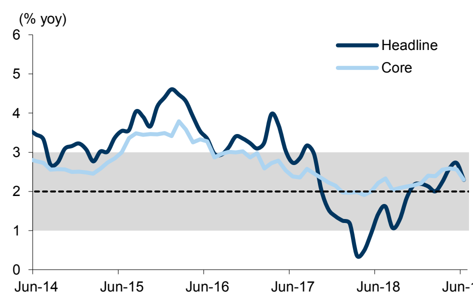
Source: INEGI, Goldman Sachs Global Investment Research

Peru

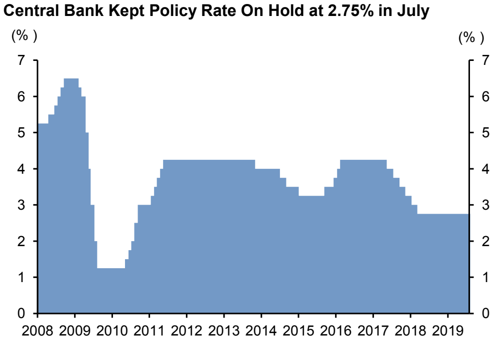
	2017	2018	2019F	2020F
Activity and Prices				
Real GDP Growth (% yoy)	2.5	4.0	3.0	3.6
Nominal GDP (US$bn)	214	225	235	257
Consumer Prices (% yoy, eop)	1.4	2.2	2.5	2.5
External Sector				
Current Account (% GDP)	-1.2	-1.5	-2.0	-1.7
Trade Balance (% GDP)	3.1	3.1	2.5	2.4
Exports (% yoy)	22.1	8.1	3.1	6.6
Imports (% yoy)	10.2	8.2	6.6	6.7
Gross International Reserves (US$bn)	63.7	60.3	62.7	63.6
Exchange Rate ($/PEN, e.o.p.)	3.24	3.37	3.26	3.15
Monetary Sector				
Monetary Base (% yoy)	7.2	7.3	3.5	9.3
Credit to the Private Sector (% GDP)	28.8	30.2	29.0	30.0
Reference Interest Rate (e.o.p.)	3.25	2.75	2.25	2.75
Fiscal Sector				
Non-fin Pub. Sector Primary Balance (% GDP)	-1.9	-1.1	-1.0	-0.5
Non-fin Pub. Sector Overall Balance (% GDP)	-3.1	-2.5	-2.1	-1.7
Debt Indicators				
Total Federal Govt Debt (% GDP)	24.9	25.0	25.6	25.8
Domestic Public Debt (% GDP)	16.1	16.0	16.1	16.0
External Public Debt (% GDP)	8.8	9.0	9.5	9.8
Total External Debt (% GDP)	35.9	36.7	38.2	38.3

Source: Goldman Sachs Global Investment Research

Headline Inflation Back to Target Range

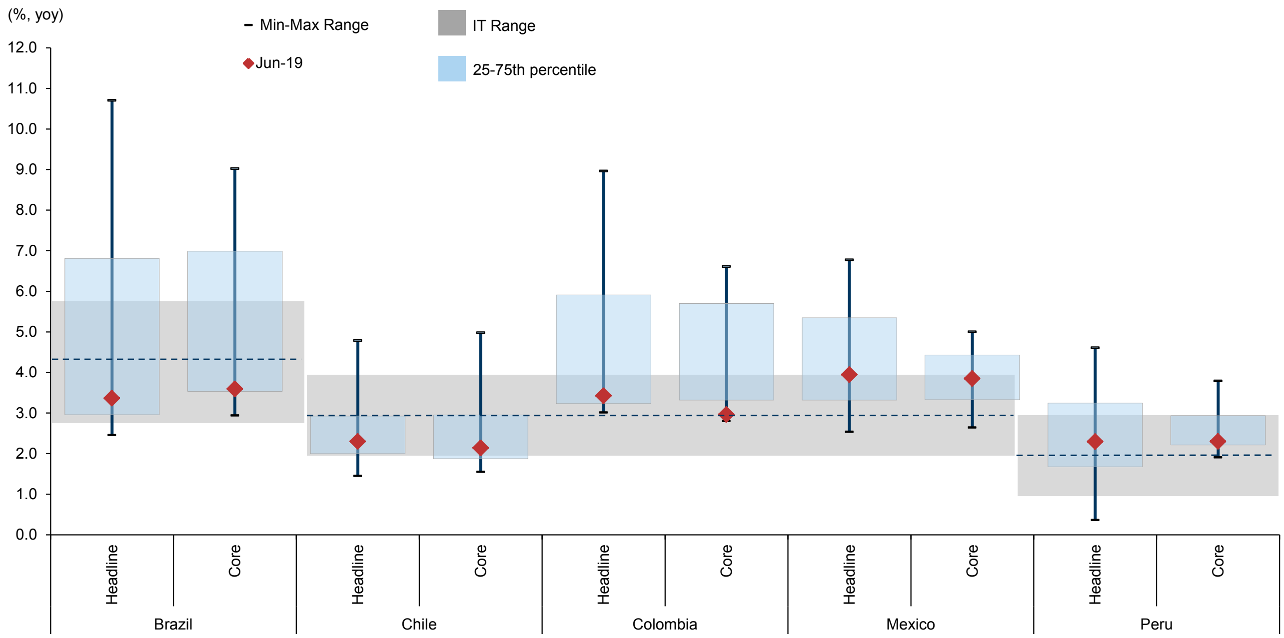


Central Bank Kept Policy Rate On Hold at 2.75% in July



Source: BCRP, INEI, Goldman Sachs Global Investment Research

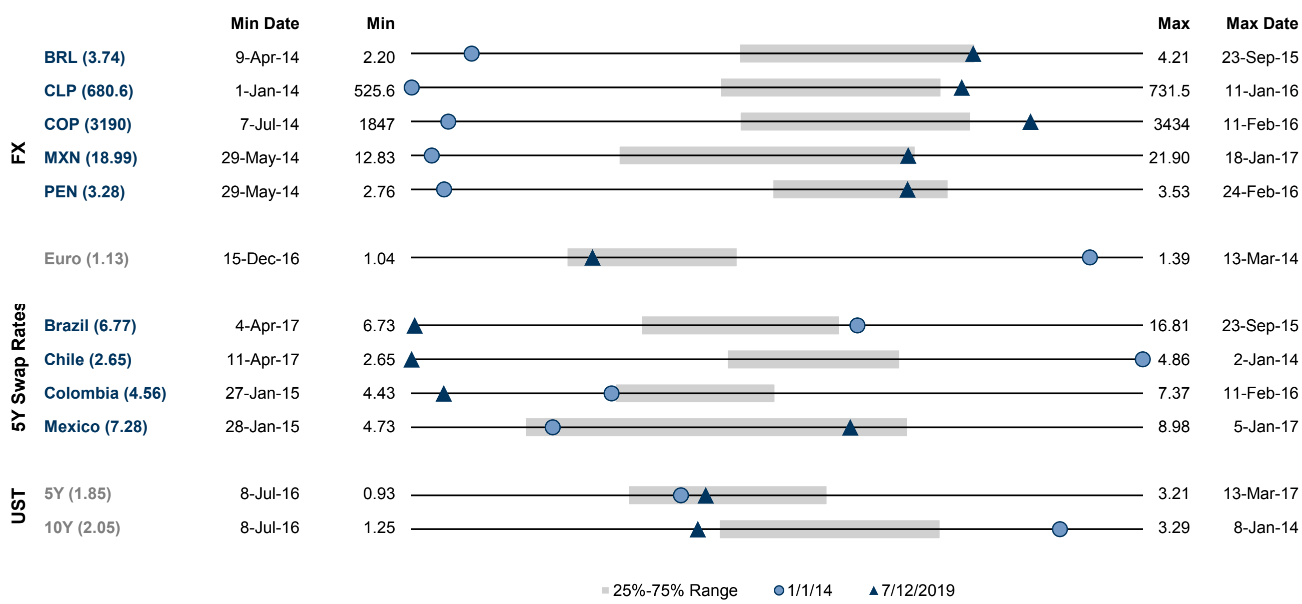
LAIT-5 Annual Headline and Core Inflation Dynamics Since January 2016



Source: Haver Analytics, Goldman Sachs Global Investment Research

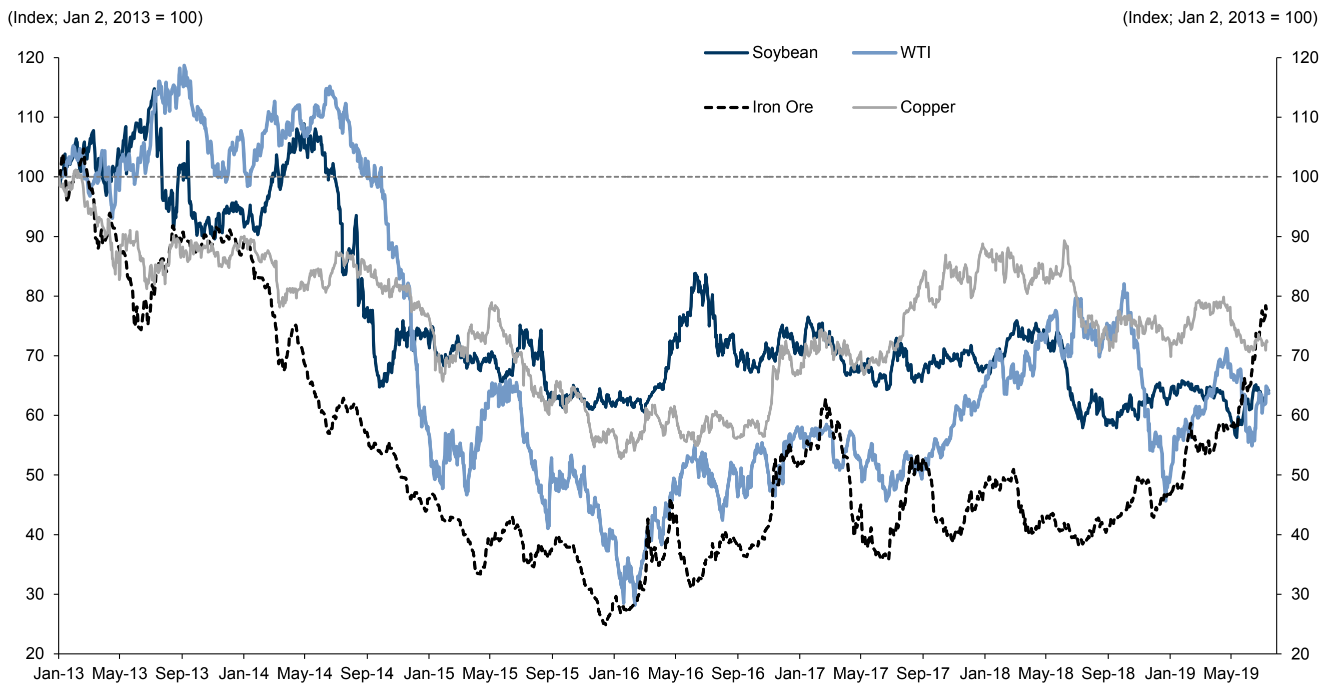
LatAm Financial Markets Outlook

LatAm Financial Markets Indicators (2014-2019)



Source: Goldman Sachs Global Investment Research

Key Commodities Prices



Source: Goldman Sachs Global Investment Research

Latin America Swap Rates

					Change Since (bps)	
		End-2017	End-2018	Current (07/12/2019)	End-2017	End-2018
Swap Rates (%)	**Brazil**					
	2y	8.06	7.36	7.28	-79	-8
	10y	10.78	9.57	9.15	-162	-42
	Chile					
	2y	2.84	3.29	2.25	-60	-105
	10y	4.24	4.06	3.15	-110	-92
	Colombia					
	2y	4.46	4.62	4.09	-37	-53
	10y	6.10	6.11	5.28	-81	-83
	Mexico					
	2y	8.02	8.61	7.46	-56	-115
	10y	7.98	8.84	7.57	-42	-127
	United States					
	2y	2.07	2.66	1.88	-19	-77
	10y	2.42	2.74	2.07	-35	-68

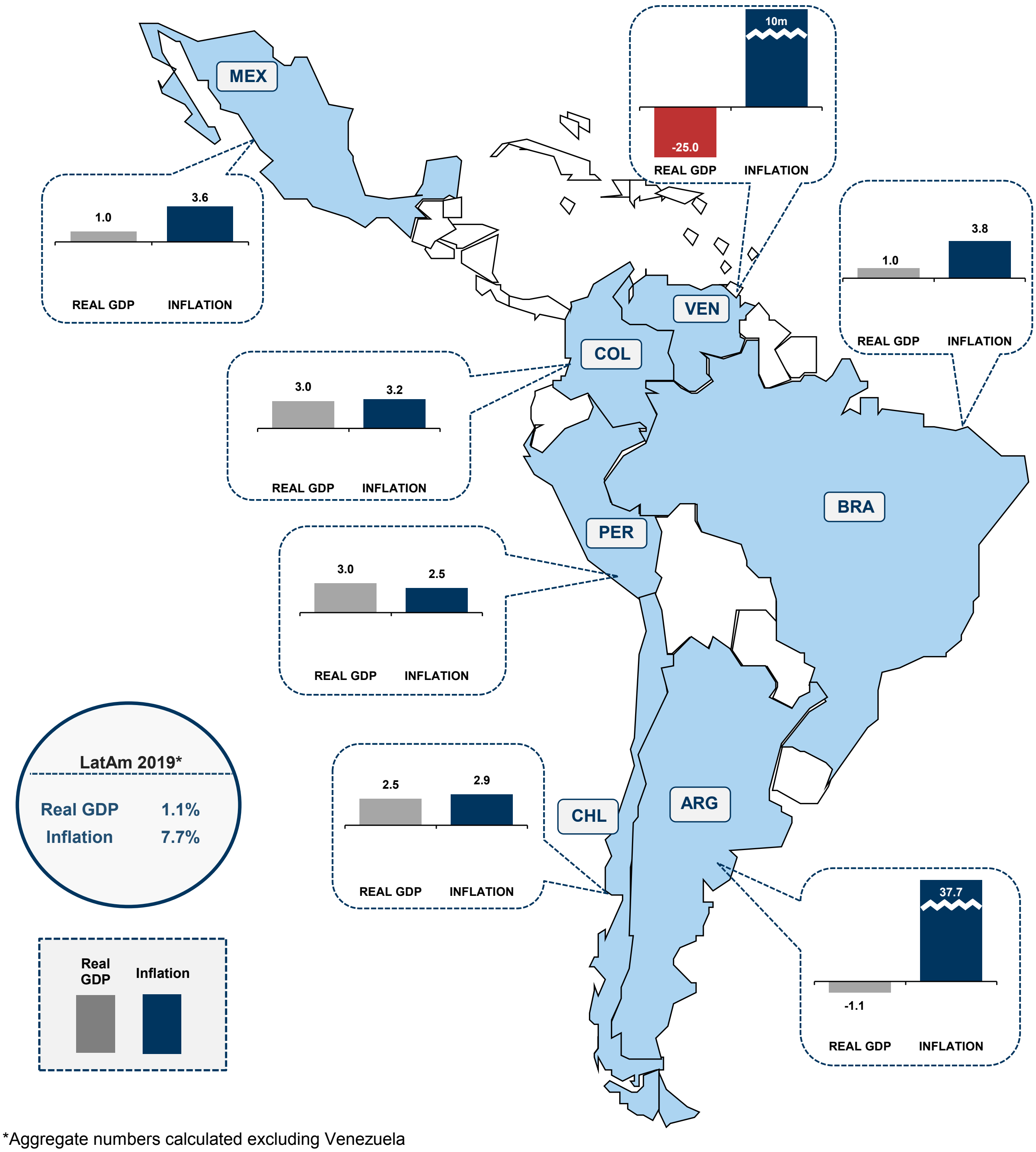
Source: Goldman Sachs Global Investment Research

Latin America Forecasts

		Policy Rates and FX Levels (End of Period)						Implied Change (Policy Rate in bps; FX in %)				
		Current	3Q2019	4Q2019	1Q2020	2Q2020	3Q2020	3Q2019	4Q2019	1Q2020	2Q2020	3Q2020
Policy Rate (%)	**Brazil**	6.50	6.25	5.50	5.50	5.50	5.50	-100	-100	-100	-100	-650
	Chile	2.50	2.25	2.00	2.00	2.00	2.25	-50	-50	-50	-25	-250
	Colombia	4.25	4.25	4.25	4.25	4.25	4.50	0	0	0	25	-425
	Mexico	8.25	8.00	7.50	7.25	7.25	7.25	-75	-100	-100	-100	-825
	Peru	2.75	2.50	2.25	2.25	2.25	2.25	-50	-50	-50	-50	-275
FX (Local / USD)	**Argentina**	42.40	48.87	51.87	52.88	53.91	54.96	15.2%	22.3%	24.7%	27.1%	29.6%
	Brazil	3.76	3.75	3.75	3.75	3.75	3.75	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%
	Chile	679.4	700.0	670.0	660.0	650.0	625.0	3.0%	-1.4%	-2.9%	-4.3%	-8.0%
	Colombia	3190	3125	3050	3025	3000	2950	-2.0%	-4.4%	-5.2%	-6.0%	-7.5%
	Mexico	18.98	19.30	19.30	19.23	19.15	19.08	1.7%	1.7%	1.3%	0.9%	0.5%
	Peru	3.28	3.27	3.26	3.25	3.22	3.18	-0.4%	-0.7%	-1.0%	-2.0%	-3.1%

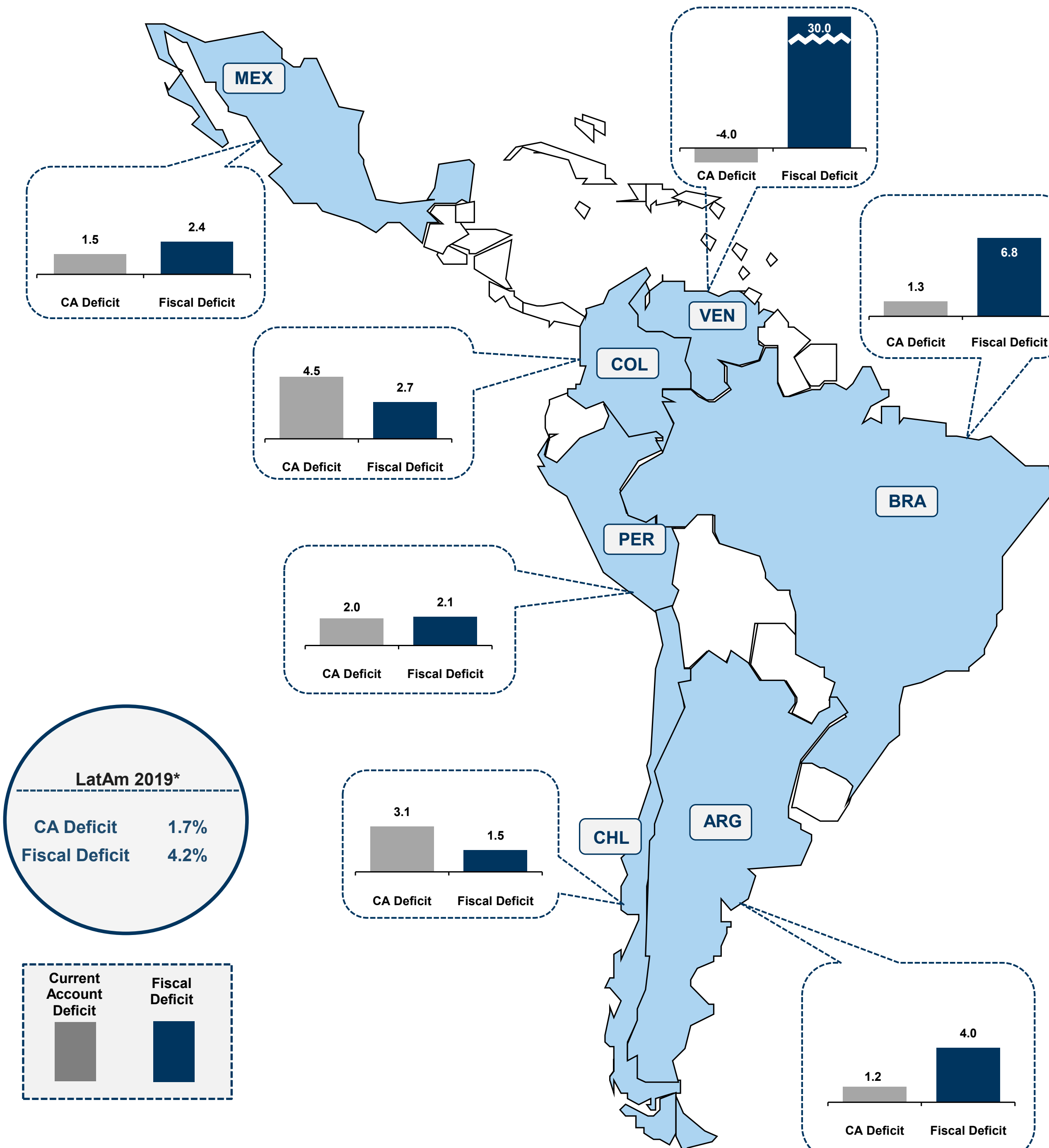
Source: Goldman Sachs Global Investment Research

LatAm Outlook for 2019: Real GDP Growth and Inflation (YoY, %)



Source: Goldman Sachs Global Investment Research

LatAm Outlook for 2019: Current Account and Fiscal Deficit (% of GDP)



*Aggregate numbers calculated excluding Venezuela

Source: Goldman Sachs Global Investment Research

Calendar of Economic and Political Events

Date	Forthcoming Events	Comment
Argentina		
11-Aug	National Open and Mandatory Primaries (PASO)	Primary elections to define party candidates. Citizens may vote for any candidate of any party, but may only cast a single vote.
27-Oct	Presidential Election (First Round)	On October 27, Argentines will elect a new president. Mauricio Macri is expected to seek re-election.
24-Nov	Presidential Election Runoff (if needed)	The two leading candidates will face a run-off on November 24 if no candidate wins more than 45% of the vote in the first round or over 40% of the vote with a >10pp lead over the second candidate.
Brazil		
31-Jul	COPOM Meeting	We expect 100bp of Selic rate cuts before the end of the year, with the first 25bp cut taking place in July and consecutive meetings thereafter (Sep, Oct, and Dec) and the Selic reaching a record-low 5.50% by year-end and remaining at that level through 2020.
Chile		
18-Jul	MPC Meeting	We expect the BCCh to remain on hold at 2.50% and cut the policy rate by an additional 50bp in 2H19, likely split into two 25bp cuts in the September and December meetings.
Colombia		
26-Jul	MPC Meeting	We expect Banrep to keep the policy rate at 4.25% through the remainder of 2019.
Mexico		
27-Jun	MPC Meeting	We expect the Banxico to keep the policy rate at 8.25% in August and to deliver 75bp in cuts starting in September, contingent on no new negative shocks to inflation and broad currency stability.
Peru		
8-Aug	MPC meeting	We expect BCRP to cut the policy rate by 25bp to 2.50% given very weak real GDP growth figures in past months and recent dovish signalling from the central bank. We also expect a second 25bp cut to 2.25% before year-end, with risks skewed toward a third cut to 2.00% if domestic activity fails to recover more substantially.

Source: Goldman Sachs Global Investment Research

Disclosure Appendix

Reg AC

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