Galapagos
CAPITAL

Macro Letter

DECEMBER 2024

Global: Keeping an eye on the new Donald Trump administration

In November, asset price behavior reflected expectations regarding the performance of the U.S. economy under Donald Trump's new administration: positive performance of the S&P, reduced expectations of interest rate cuts, and a strengthening of the dollar. On the other hand, emerging market currencies weakened, a result of the stronger dollar and deteriorating expectations for local economies, such as the cases of the ruble (-8.0% m/m), the Hungarian forint (-3.5% m/m), and the Brazilian real (-1.7% m/m). Currencies of advanced economies also suffered, though to a lesser extent: the euro lost -2.4% m/m, the pound -1.5%, and the Swiss franc -1.3%. We maintain our view that a more aggressive U.S. tariff policy in 2025 poses a risk to emerging market economies that export commodities due to reduced global trade, loss of competitiveness against the U.S., and inflationary pressures. Despite uncertainties, **we expect the new U.S. administration to adopt a cautious tariff approach, considering the adverse effects of 2018-2019, such as reduced aggregate income and inflationary pressures. Thus, we believe the international scenario will be favorable for emerging economies with controlled inflation and solid economic growth.**

To watch: the formation of the new U.S. government, OPEC's production capacity, and the Strait of Hormuz (located between the Arabian Peninsula and Iran – a critical route for oil exports from Arab countries, transporting about 40% of global maritime oil traffic).

Chart 1: Monetary Policy Cycle since May 2024

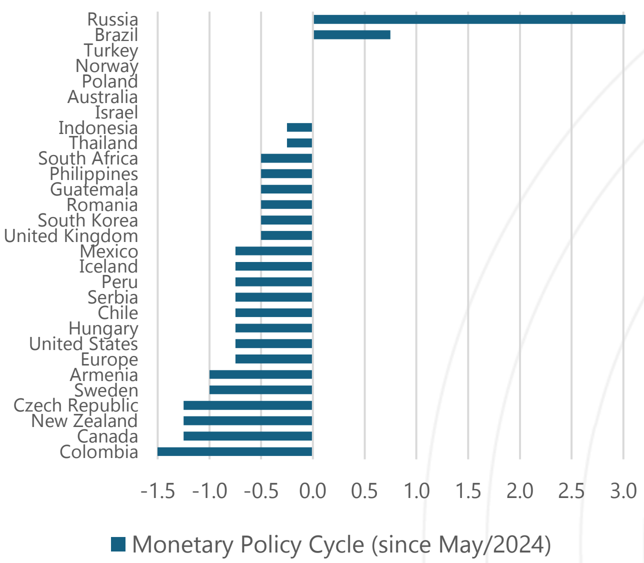
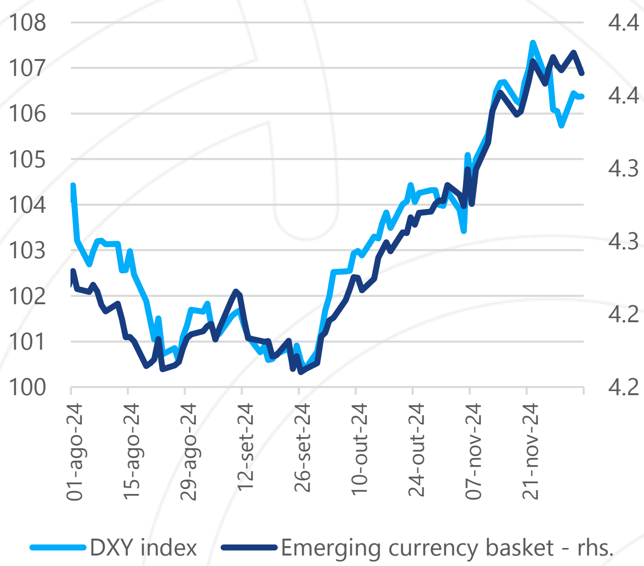


Chart 2: Currencies against the USD



Source: Bloomberg. Prepared by: Galapagos Capital. Currencies included in the Emerging Markets Basket: South Africa, Argentina, Brazil, Bulgaria Chile, China, Colombia, Egypt, Hungary, Indonesia, Malaysia, Morocco, Mexico, Nigeria, Pakistan, Peru, Poland, Dominican Republic, Russia, Serbia Thailand, Turkey, Uruguay, and Vietnam.

United States: Resilience amid uncertainties

In the U.S., Q3 GDP showed that activity remained robust, sustained by the resilience of household consumption and, to a lesser extent, stronger growth in government defense spending. For the fourth quarter, we expect growth

TATIANA PINHEIRO
CHIEF ECONOMIST
tatiana.pinheiro@galapagoscapital.com

MARIAM DAYOUB
SENIOR ECONOMIST
mariam.dayoub@galapagoscapital.com

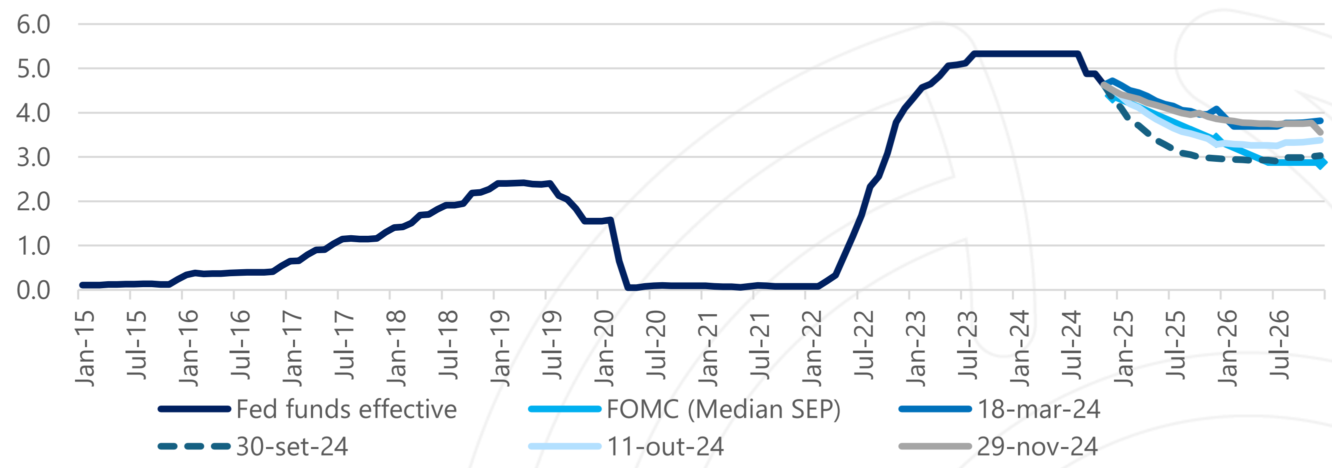
SOFIA BARBUZZA
ECONOMIST
sofia.barbuzza@galapagoscapital.com

VALENTINA GUIDA
ECONOMIST
valentina.guida@galapagoscapital.com

between 2.25% and 2.50%. The labor market has slowed but remains solid. Inflation, after significant progress, has entered a phase of stabilization with marginal increases in 12-month accumulated readings. The main factor behind this is the base effects of falling inflation in Q4 2023 and the impacts of hurricanes. **Monetary policy continues in a recalibration process, and we expect a 25 basis point cut at the December 18 meeting, although it remains highly dependent on November labor market data.** Overall, looking toward 2025, the word summarizing expectations is "uncertainty." While the scenario remains benign, there are many uncertainties regarding the implementation of economic policy by President Donald Trump, elected with a clear mandate in November. In the economic area, the individuals nominated by the President-elect are more moderate, pointing to a baseline scenario of a milder government compared to the heated campaign rhetoric. Trump's comments, particularly on tariffs and immigration, should be taken seriously – though not literally. In this environment of uncertainty, it is plausible that the Fed will act more cautiously, even as interest rates remain about 150 basis points above the median level considered neutral by Monetary Policy Committee participants.

To watch: the Fed's interest rate decision, the press conference by Chairman Jerome Powell on the monetary decision, and comments from President Donald Trump.

Chart 3: Effective Fed Funds, Futures and FOMC (%)



Source: Bloomberg. Prepared by: Galapagos Capital

Eurozone: Political risks amid tariff uncertainties

Qualitative surveys for the Euro Area showed negative surprises in November, indicating that activity has lost momentum, particularly in Germany and France, amid a significant rise in uncertainties. Politically, Germany is set to hold early elections in February 2025, while Emmanuel Macron's fragile coalition in France failed to reach an agreement on the 2025 budget. As a result, French risk premiums and interest rates soared, weighing on the currency. Inflation rose by 30 basis points in November to 2% YoY, in line with the expectations of the European Central Bank (ECB). Within the Euro Area, the inflation figure was influenced by base effects related to energy prices in Q4 2023. In the month, service inflation declined, while energy inflation was positive. The labor market's strength continues to surprise, with the unemployment rate remaining at a historic low of 6.3% in October, despite qualitative surveys indicating employment contraction in the region. **In this context, the ECB is expected to continue**

TATIANA PINHEIRO
CHIEF ECONOMIST
tatiana.pinheiro@galapagoscapital.com

MARIAM DAYOUB
SENIOR ECONOMIST
mariam.dayoub@galapagoscapital.com

SOFIA BARBUZZA
ECONOMIST
sofia.barbuzza@galapagoscapital.com

VALENTINA GUIDA
ECONOMIST
valentina.guida@galapagoscapital.com

gradually lowering rates by 25 basis points per meeting toward the neutral rate, which we estimate to be around 2%.

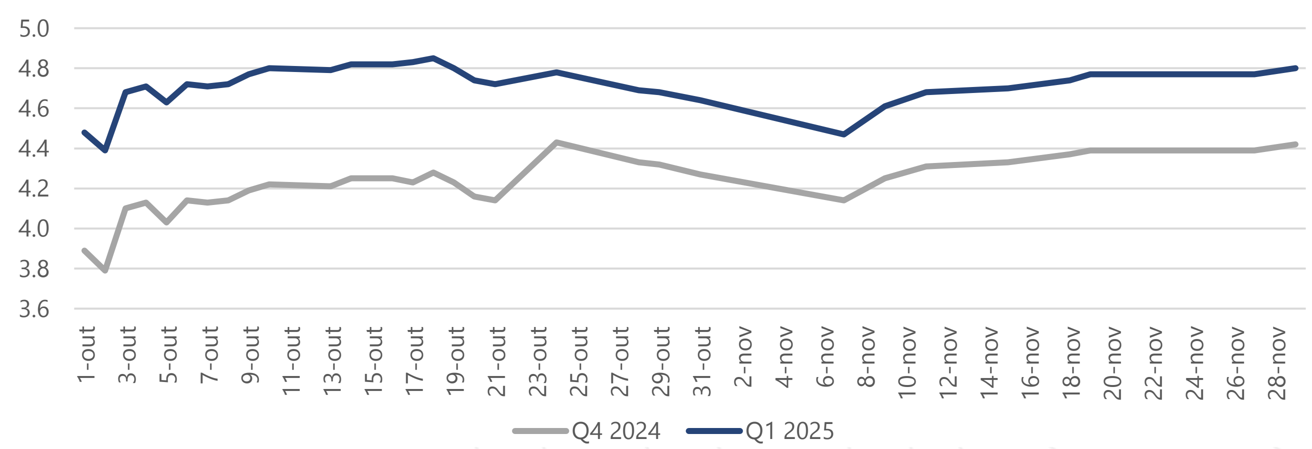
To watch: activity data, France's 2025 budget, ECB interest rate decisions, and the press conference by its president, Christine Lagarde.

China: Cyclical stabilization of the economy amid elevated uncertainties following Trump´s election

Last month, the Chinese economy showed additional signs of cyclical stabilization. Both qualitative and quantitative activity indicators positively surprised expectations. In retail, there was a positive surprise in sales during the "Golden Week" and "Singles' Day," with a highlight on electronics and vehicles, driven by the government's subsidy program for replacing these goods. The manufacturing industry also experienced growth, with notable increases in the production of chemicals, vehicles, and smartphones, although it fell short of consensus forecasts. In the real estate sector, signs of stabilization emerged, with a strong moderation in the decline of property sales, while housing prices continued to fall more sharply in the 12-month cumulative figures. The external sector remained robust, with significant trade surpluses and a notable increase in exports. This growth is expected to continue in the short term as U.S. customers anticipate purchases due to the expected trade war under President-elect Donald Trump's administration. Despite the positive signs in economic activity, the labor market remained weak, reflecting persistent deflationary risks and low household confidence. **We believe the Chinese government will announce additional stimulus measures throughout 2025 in response to tariffs imposed by the new U.S. administration.** In this context, market expectations point to new announcements in mid-December, when the Politburo is scheduled to hold a meeting on economic policy.

To watch: development of activity data, Politburo meeting in the first half of December, and the Central Economic Work Conference in the second half of December.

Chart 4: China GDP Tracking



Fonte: CEIC. Prepared by: Galapagos Capital.

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tatiana.pinheiro@galapagoscapital.com

MARIAM DAYOUB
SENIOR ECONOMIST
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SOFIA BARBUZZA
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VALENTINA GUIDA
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valentina.guida@galapagoscapital.com

Brazil: Waiting for more spending cuts

Inflation accumulated inflation over the last 12 months up to 1st half of November 4.8%, while the annualized core inflation average was 4.9%, both above the upper tolerance limit of the inflation target (4.5%). Inflation in labor-intensive services continues to range between 5% and 6% annually, while the unemployment rate continues to decline, from 6.4% in September to 6.2% in October. Both formal and informal labor income are maintaining real growth. Furthermore, inflation expectations continue to diverge from the target, with projections of 4.71% for 2024, 4.40% for 2025, and 3.81% for 2026, despite expectations of monetary tightening. In our opinion, the risk perception, driven by inflation acceleration and fiscal uncertainty, caused the exchange rate to reach BRL 6 per dollar in December.

After several weeks of waiting, public spending cut measures were finally announced. In our view, these measures are insufficient to stabilize the public debt/GDP ratio (chart 5) or ensure compliance with fiscal framework targets as of 2027. Thus, uncertainty about the long-term fiscal policy remains, although there is a chance the government may not need to significantly cut discretionary spending in an election year (2026) or abandon the fiscal framework if the measures are fully approved and accompanied by reductions in parliamentary amendments.

The announcement of the cuts was accompanied by the intention to propose an income tax reform to Congress in 2025. The plan is to exempt Income Tax (IR) for 78% of people who file tax returns, resulting in a revenue loss of BRL 35 billion (0,3% of GDP), according to calculations by the Ministry of Finance. This loss would be offset by: 1) a 10% tax on earnings of "super-rich people", which are currently not taxed at source, and 2) the end of income tax exemptions for "super-rich people" with severe illnesses.

The early announcement of the income tax reform highlighted the government's internal political difficulties in discussing spending cuts, increasing pessimism in the scenario and removing any optimism regarding the announcement of the spending reduction measures. Market consensus anticipates the risk of a partial approval scenario, where the government approves income tax exemption but fails to implement effective measures to offset the revenue loss.

It is important to note that negotiations between the government, legislature, and judiciary for the approval of the spending cuts are taking place under pressure, as the parliamentary recess begins in the second half of December. As for the income tax reform, there is still no defined proposal or forecast for when the issue will be debated in Congress in 2025. As a result, BRL was one of the worst performing currencies among emerging markets, ending November at R$ 6.05 per dollar, while the interest rate hike expectation reached 14.75%, and Ibovespa fell 3.1%.

We believe that in this environment of uncertainty about the sustainability of the debt dynamic, inflationary pressures due to the weakening exchange rate, and increasing risk perception, the terminal interest rate has increased, which will accelerate the pace of rate hikes in each meeting. We expect the Copom to raise the pace from 50bps to 75bps in the December 11 meeting, bringing Selic to 12% p.a., and maintain this pace in the monetary policy decision on January 29. We project that the terminal rate for this rate hike cycle will be 13.50% p.a., to be reached in the first half of 2025. After that, we foresee the possibility of rate cuts only at the end of 2025 if further fiscal adjustment measures are announced throughout the year.

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SOFIA BARBUZZA
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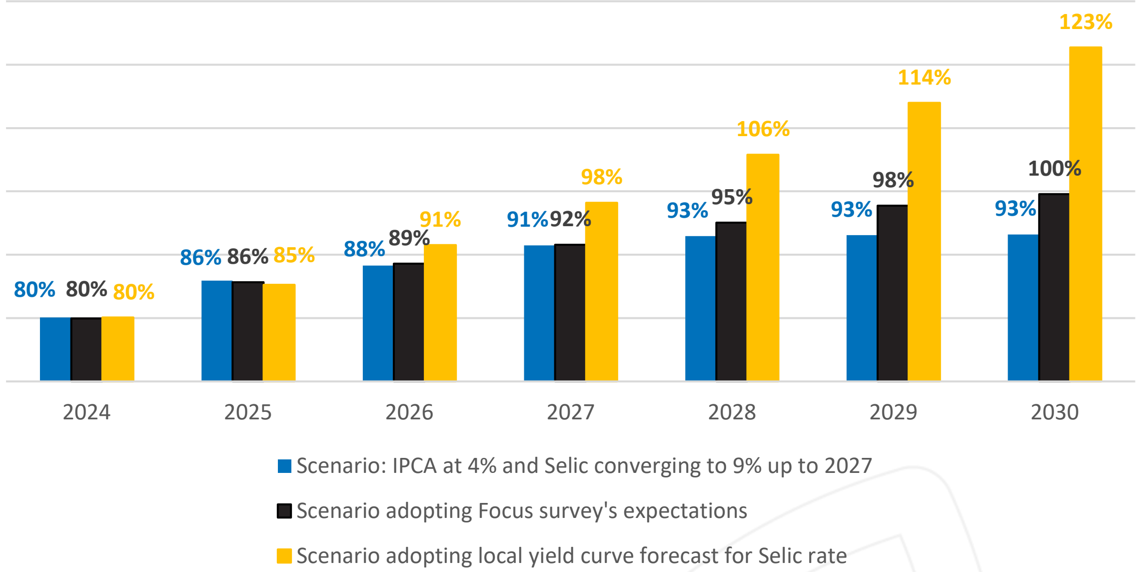
VALENTINA GUIDA
ECONOMIST
valentina.guida@galapagoscapital.com

To watch: the debate on the 2025 Budget Bill in the Joint Congressional Committee, the progress of the spending cuts measures package in the Lower House and the Senate, as well as the economic activity and inflation data for Q4.

Chart 5: Gross Debt ratio-to-GDP Dynamic



Prepared and estimate by: Galapagos Capital.

Latam: Aligned with global monetary policy

CHILE: In Chile, contrary to the September Monetary Policy Report (IPoM), inflation accelerated to 0.97% m/m and 4.70% y/y, partly driven by an 18.9% m/m increase in electricity prices. However, discounting the impact of rising electricity prices, the CPI would be 0.50% MoM, still above the 2024 average of 0.45% MoM, signaling inflationary pressure in other prices. The October inflation rebound casts doubt on the extent and pace of future interest rate cuts and increases uncertainty about whether the Central Bank of Chile (BCCH) will meet the September IPoM promises: achieving the 3% inflation target by early 2026 and maintaining growth between 2.25% and 2.75%. **In our opinion, the weaker activity data**, with the IMACEC Economic Activity Index for September recording 0% year-on-year compared to +2.3% year-on-year in August, **and inflation acceleration, justify maintaining the rate of 25 basis points cuts in the last meeting of the year (December 17), bringing the interest rate to 5% per year.**

COLOMBIA: The Colombian economy faces fiscal challenges, with the government overestimating revenues for 2024 and 2025 and proposing increases in transfers to regional governments without cutting national expenses. Despite fiscal adjustments, the government will need further cuts to avoid breaching the fiscal rule, which has pressured the peso and was highlighted as justification for prudence in monetary decisions. **We expect Banrep to maintain the interest rate cut at 50 basis points, bringing the rate to 9.25% in a non-unanimous vote, as occurred in the October meeting.** The deflation of 0.13% in October, with the core at 0.01% and the diffusion index (percentage of prices with inflation) at 53%, indicating that inflation is slightly below 4%, should support votes

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MARIAM DAYOUB
SENIOR ECONOMIST
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in favor of accelerating the cut pace to 75 basis points. However, economic activity exceeding expectations, fiscal uncertainties, and the issue of price indexation should lead the majority to vote for maintaining the 50 basis point cut.

MEXICO: In line with expectations, the Central Bank (Banxico) cut the interest rate by 25 basis points to 10.25%. In its decision statement, Banxico reiterated the upside risks to inflation and downside risks to growth. However, it added a new risk: the possibility of a reversal in global economic integration**. We expect a 25 basis point cut at the December 19 meeting. If President-elect Trump imposes tariffs on Mexican products, we believe the monetary authority may bring the rate-cutting cycle to an early end.** Meanwhile, the Mexican government has advanced constitutional changes, including indexing the minimum wage to past inflation and abolishing autonomous institutions that regulated economic sectors and ensured government transparency. Since the elections in June, the Mexican peso has depreciated by 20% amid an environment of heightened uncertainties for investments, which is likely to weigh on the prospective growth of the economy.

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MARIAM DAYOUB
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