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Emerging Markets

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Melissa Ochoa Cárdenas
Investment Strategist
Insigneo

Mauricio Viaud
PM and Senior Investment Strategist
Insigneo

Argentina, Mexico, and India: Three Countries with a Promising Outlook for the Year Ahead

Emerging Markets have offered attractive investment opportunities in what has been deemed a challenging investment environment. In this piece, we want to focus on three different alternatives we deem attractive for 2024: Mexico, Argentina, and India. Mexico and Argentina are two very different countries with one important thing in common: the promise of a brighter future ahead. Argentina welcomed a new government last year and Mexico will do the same in 2024.

Both countries' economies could experience lasting positive impacts if they can effectively manage the dynamics at stake. Mexico's potential benefits from nearshoring could meaningfully alter its trade landscape for years to come. Argentina's successful economic liberalization could potentially set the country on a path of prosperity not seen in decades.

Lastly, India has proven to be a magnet for investors looking to get exposure to Asia, but not willing to stay invested in China. In the pages that follow, we share our thoughts on those countries, together with potential ideas on how to profit from them.

Argentina: A Long, Yet Promising Road Ahead

Macroeconomic Overview

The Argentinian economy has maintained a weak stance in terms of activity against a backdrop of rampant inflation and deteriorating social conditions. It is worth noting that before Milei took office, Argentina's poverty rate was 40%, according to the latest figures published by Argentina's National Institute of Statistics and Census – INDEC. Even if the Milei administration was welcomed with positive news on the inflation front, considering that the October print exhibited a brief respite, the November print went back to double-digit figures, and the December print continued down the same path, after posting a 211% YoY variation, mainly due to food prices, the sharp devaluation observed at the beginning of Milei's administration, and the elimination of electricity and transportation subsidies.

Regarding economic activity, the Argentinian economy displayed a slight expansion for October that surprised the markets to the upside, underpinned by a better performance of mining and fisheries. It is worth stressing that agriculture, one of the main economic sectors, posted its first YoY gain in October, cutting short a 19-month streak of declines. This positive reading has led to some upward revisions for the 2023 GDP figure, which is still expected to portray negative growth: according to Bloomberg projections, Argentina's 2023 will stand at –1.8%. Meanwhile, Economy Minister Caputo intends to implement a fiscal and an FX anchor. The first one is aimed at helping balance the budget in 2024 while decreasing the government's reliance on central bank funding, while the FX anchor will be responsible for the 2% monthly devaluation announced by the Milei administration.

Political Update

After newly elected president **Javier Milei took office on December 10, Argentina embarked on a political rollercoaster that has entailed drastic changes in its political and macroeconomic stances. Javier Milei had announced since the beginning of his presidential campaign that his time in office would be filled with harsh measures that would alleviate Argentina's fiscal deficit while deregulating the economy and taking measures as extreme as dollarizing the country and closing the Central Bank.**

As of this writing, President Milei has already started to take measures towards that promised change, even if the wounds it will inflict on the Argentinian population will not be healed quickly. The first measure taken by Milei was to issue a sweeping decree of necessity and urgency – better known as DNU for its Spanish acronym – that entailed 366 articles with effects in sectors as varied as retail, healthcare, pharma, and tourism. That decree also removed key existing regulations on trade and ownership. This DNU is expected to face resistance in the Argentinian Congress, considering that Milei does not hold majorities there; still, new rules took effect on December 29. Since this decree is one of necessity and urgency, Congress needs to vote on whether to ratify or reject it; however, it is worth stressing that among the Argentinian population and according to a poll performed by DC Consultores, Milei's decree was considered a positive measure. Still, protesters were seen on the streets before the DNU was sent to Congress, even if protests did not last long. Milei has also called for extraordinary Congressional sessions that will run until January 31; in those sessions, lawmakers will set up commissions to analyze the proposals, which may include input from experts and government officials, according to Reuters. Moreover, it should be noted that since several of the measures proposed require an absolute majority, the debate and approval process could be slowed down.

As of the time of this report, it is worth mentioning that the Argentinian Labor Court suspended part of the decree presented by President Milei – more specifically, the part that included his labor reform. This suspension came as a response to an appeal by the General Confederation of Labor and on the back of various appeals that have been sent to court that argue the decree is unconstitutional. The Milei administration said it would appeal the injunction after considering that the Labor Court does not have authority over the matter. Still, the Milei administration is aware that the decree will have to overcome a lengthy legal process.

Another relevant measure recently implemented by the Milei administration was lifting import controls to liberalize trade. This came amid the elimination of an

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import system that forced companies to get manual approval for every shipment. Economy Minister Luis Caputo stated that the old system generated inflationary pressures and shortages. These shortages were cited as the cause for major international players, such as General Motors, suspending production in Argentina.

Moreover, one of the main themes of the Milei administration for 2024 will be the exchange rate unification, which will imply the removal of capital controls. The latter is expected to occur against a backdrop of a targeted 2% monthly devaluation and the urgent need of the Argentinian economy to gather reserves to pay to bondholders, creditors stemming from the nationalization of state-run energy company YPF, and the IMF. This situation will also be a constant throughout this year, considering that President Milei has left his dollarization intentions slide – or at least has let them take a less leading role than at the beginning of his administration; however, market analysts believe that Milei has not entirely let go of that idea – instead, he is simply postponing it.

Lastly, and following up on the pending obligations of the Argentinian government, the Milei administration announced that IMF officials were expected to arrive in Argentina that first week of January to restart talks, which were led by Milei's cabinet chief, Nicolás Posse, and Economy Minister Caputo. As a positive development, Argentina announced it had finalized the details of an agreement with the IMF over Argentina's USD 44bn loan program that, with the initial USD 4.7bn disbursement, would allow the country to honor the December, January, and April maturities that Argentina owes the Fund, as well as the bridge loan provided by the Development Bank of Latin America and the Caribbean – CAF. This new program is expected to be approved by the IMF's executive board in the coming weeks, and its next revision is scheduled for May. **It is worth stressing that Economy Minister Caputo stated that the agreement did not represent a new deal, but that the Fund had expressed willingness to a new debt program and additional funding.**

Currency

The Argentine Peso remains in a very fluid situation. Shortly after coming into office, the Milei administration sharply devalued the official Peso by 54%, bringing it down from close to 350 Pesos/US Dollar to nearly 800. This exercise brought the official rate closer to the "blue chip rate," which is the rate Argentinians could get in parallel markets. According to Minister Caputo, this was needed to "contain repressed inflation," effectively resetting inflation expectations, a move that will be further targeted by the 2% crawling peg that will weaken the currency on a monthly basis. Although talks of dollarization have subsided, Minister Caputo has said that this idea is still on the table, recently stating that "...dollarization and the closing of the Central Bank continue being flags" for the Milei administration. As we mentioned before, the idea of dollarization could simply be postponed.

Citigroup recently conducted a study that compared Argentina's current devaluation scenario with other historical devaluation episodes across the globe, starting with the Mexican Peso devaluation in 1994. The study included Argentina's own past devaluations, specifically those in 2002 and 2015. Interestingly, the country's foreign currency reserves as a percent of GDP, which currently stand at 4.9%, are well below the average of these historical devaluations, which stand near 8.3%. This alarmingly low level of reserves will likely make it more difficult for the Milei administration to effectively implement its desired policies. Reserves are likely to rise this year as a result of the recent agreement with the IMF, yet the amount of growth is likely to prove more modest than initially expected.

Argentina's Foreign Currency Reserves Have Been on a Downtrend for Years

The study also evaluated the number of days it took for these devaluations to reach their peaks, settling on an average near 150 days, with close to 120 when it came to Argentina's past devaluations. That is an average of 4 or 5 months, which could be further complicated by the country's low foreign currency reserves. **The key variable will not be how long it will take for the Argentine Peso to stabilize, but how long the local population can endure the effects of the economic burden brought about by the current environment.** President Milei had told the country that short-term pain would be necessary in order to achieve long-term gain. The population appears ready to endure a degree of short-term pain; however, when livelihoods are at stake, let us hope that the people's patience does not run out before significant change can be implemented.

Fixed Income

Regarding the fixed income market, and against an ever-changing backdrop, we continue to prefer Argentinian names that have exposure to sectors that should benefit from the current administration's plans, such as the oil and gas sector and agricultural business.

As we stated on a previous occasion, we continue to believe that Adecoagro (AGRO) could benefit from a better tax treatment proposed by President Milei, as well as from the positive trend observed in sugar prices. Still, the unpredictability of Argentinian climate during

Argentina International Reserves

Source: Bloomberg, BCRA.
Data as of January 9, 2024

the Summer may create a headwind for sugar crops, that being something we need to monitor. Furthermore, the potential prohibition of ethanol imports coming from India is another risk investors need to take into consideration before entering a position in AGRO – even if the bond looks cheap in relative value terms.

Regarding the oil sector, we continue favoring Pampa and YPF, hoping to benefit from the exploitation of Vaca Muerta that the new administration expects to perform. Moreover, the fact that YPF increased its gasoline prices by 26% to reach international levels while succeeding in the development of Vaca Muerta is a positive sign for upcoming company earnings. Meanwhile, YPF announced the tender offer of its 2024 bond while returning to global markets with a seven-year bond, whose proceeds are expected to cover the tender of the 2024 maturity as well as financing the company's.

Investment plan in Vaca Muerta. As of the time of this report, the YPF curve looks fairly valued; however, the belly of the curve exhibits attractive coupons that, for the appropriate level of risk tolerance, could pose a suitable investment alternative. One factor that needs monitoring, specifically for YPF, is a potential privatization of the company that the Milei administration has kept as one of its proposals.

Equities

Argentinian equities paced the Latin American region in 2023, with the Global X MSCI Argentina (ARGT) rising over 50% for the year. To be fair, this ETF is not an exact representation of the country's equity market, as a limited market breadth and volume limits the amount of investable equity securities in the country. As a result, some individual holdings comprise outsized weights in the ETF.

Looking at some of the most traded Argentinian equities, it is safe to say that YPF led the pack, closing over 85% higher for the year. Surprisingly, even after this move, the stock remains approximately 75% below its all-time high. To expect the stock to reach its maximum anytime soon is a lofty expectation, but we do think that there is more upside potential remaining for YPF over the long term. The company is one of the leaders in oil & gas exploration and production in the Vaca Muerta basin in Argentina. Management appears to be focused on growing production to increase earnings, a feat that could be more easily attainable under the Milei administration. In fact, one of the important policy changes that is being touted by the new administration is the liberalization of several industries, particularly the country's energy industry. If passed, this move would ease restrictions on oil and gas exports, as well as allow producers and refiners to set market prices without government intervention. This would allow companies such as YPF to sell their products at prices that are better aligned with global prices, not at the deep discounts that were previously enforced by the government to subsidize artificially low fuel prices. According to the company, oil prices in Argentina were trading at nearly a 50% discount to Brent crude prices at the end of last year. Oil from different regions in the world trades at different prices, but a nearly 50% discount to the global oil benchmark appears excessive. Additionally, as we mentioned before, President Milei has spoken about privatizing YPF, a move that would meaningfully unleash its potential. If the new administration succeeds in de-regulating the energy sector, this change alone could allow the company to achieve its production growth goals.

Energy is one of our favored sectors in the country. Although YPF would likely be the biggest beneficiary of the Milei administration's renewed stance on this industry, other companies would also benefit from increased production potential from the Vaca Muerta region, including Vista Energy. Vista is actually a Mexican oil & gas exploration and production company.

However, the vast majority of its production growth potential stems from Argentina's Vaca Muerta basin. Led by a proven management team, the company is intent on shifting from the conventional practice of vertical drilling to unconventional methods of horizontal shale drilling, which should reduce production costs, leading to potentially larger profit margins over time. Consumer-oriented sectors could also stand to benefit from the new Milei administration. Although the Argentinian consumer may be faced with headwinds in the short term as new policies are implemented, it is likely to benefit over the long run from a more business friendly environment. Financial companies like Banco Macro (BMA) and Grupo Financiero Galicia (GGAL) could reap the benefits of a potential increase in consumer spending. As one of the largest financial institutions in Argentina, Banco Macro offers credit card and consumer loans, which could experience an increase in demand in a more stable economic environment. Grupo Financiero Galicia's Banco Galicia is one of the country's largest private banking institutions, which could benefit from a potential influx of capital back into the country, if the new administration is able to stabilize the economy and increase business confidence.

Another beneficiary from a potential increase in demand from the Argentinian consumer would be MercadoLibre (MELI). Most of the company's revenues currently stem from Brazil; however, Argentina comprises its second largest market, accounting for 25% of its revenues. High revenue growth rates, coupled with prudent expense management, have led to increased profitability for Mercado Libre, which could continue to be propelled higher by the potential of increased expansion in the Argentinian market.

The Argentinian equity market, as measured by the S&P Merval Index, currently trades at rich valuations in the range of 30x forward earnings. **Although this valuation appears extended in the short term, pullbacks in this market could create potentially attractive opportunities for investors with a long-term horizon and a high tolerance for risk.**

— "The **Mexican economy proved resilient** and showed signs of recovery after having a setback during the first months of 2023"

Mexico: Reaping the Benefits of the Nearshoring Phenomenon

Macroeconomic overview

The Mexican economy proved resilient and showed signs of recovery after having a setback during the first months of 2023: according to its activity indicator, the IGAE, the Mexican economy grew 4.24% YoY in October, mainly propelled by the construction sector, which contrasted with an observed decrease in mining due to the loss of momentum in the oil and gas sector. This trend of resiliency was also proven by Mexico's quarterly GDP numbers, which remained relatively stable around the 3% handle. For the final quarter of 2023, economists expect Mexico to portray a slight setback in its growth; nonetheless, the output gap should remain on positive ground which, in turn, could pose an issue for Banxico, Mexico's Central Bank. Regarding inflation, December's print exhibited a more gradual price descent that proved stickier due to the end-of-year promotions and discounts and the end of summer electricity subsidies; however, core inflation regained its downward trend after the cyclical high observed in the first half of November.

Banxico welcomed the decrease in core inflation during its latest monetary policy meeting, in which the Committee unanimously decided to maintain its monetary policy rate stable. During that meeting, Banxico stressed that it expects the disinflation process to continue at a more gradual pace while expecting inflation to converge to its target in 2Q25; moreover, even if the press release stated that rate stability should be expected for a certain period, the positive news stemming from the inflationary front have some market analysts already penciling in the first Banxico rate cut during 1Q24. However, the latest Minutes showed a Committee tilting toward rate stability, in line with the forward guidance seen in the last monetary policy meeting. Still, one member of the Committee stated there were conditions to begin discussing the possibility of rate cuts in upcoming policy meetings, citing the observed reduction in inflation as their main argument.

Political Update

Mexico is one of the several countries that will hold elections this year, partially sharing the continental spotlight with the US and, to a lesser extent, El Salvador, Panama, and Venezuela, among others. In a not-so-usual fashion, the presidential race started earlier than on previous occasions, with the two leading candidates – Morena's Claudia Sheinbaum and Xóchitl Gálvez, who represents the opposition parties now gathered in the Frente Amplio por México coalition – having registered their candidacies in September of last year.

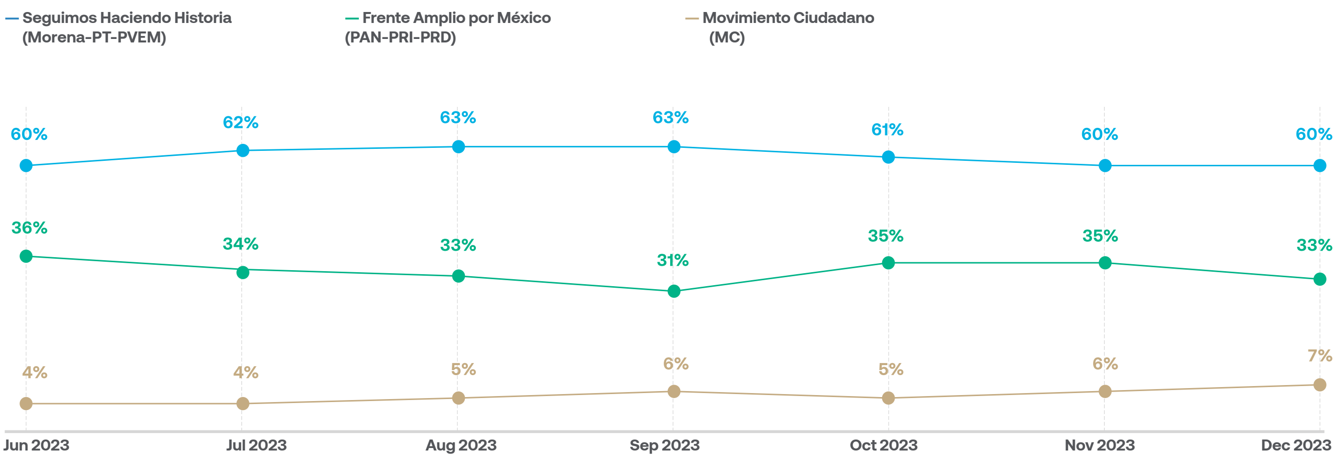
According to the last available polls at the time of this writing, the advantage that Sheinbaum has amassed over Gálvez is still present, with the third option – a still-to-be-defined candidate from the Movimiento Ciudadano party, since Samuel García withdrew his candidacy – lagging.

Most analysts continue to pencil in a Sheinbaum victory, mainly because of AMLO's popularity and, according to the Economist Intelligence Unit – EIU – the opposition's inability to present clear policy alternatives. Moreover, it should be noted that Morena currently controls two-thirds of the regional governments after the June 2023 gubernatorial elections, which also bodes well for a Sheinbaum victory in this year's presidential elections.

Against this backdrop, it is worth stressing that AMLO's administration has not been one without controversies, with his attempt to eliminate funding for the National Electoral Institute, or INE for its Spanish acronym, as well as his attempt at modifying the country's security policy standing out as the most controversial developments. Regarding the INE, the Supreme Court partially struck down the law that attempted to reduce its funding, but this attempt at reforming the INE was seen as hurtful to Mexico's democracy. The INE defunding also comes on the back of AMLO's attempt to shutter the Institute for Information Access and Transparency – INAI – in April of last year.

Furthermore, it should be stressed that AMLO has been increasing government expenditure during his last year in office, thus reaching the highest levels of fiscal deficit since 1988 by increasing the allocated budget to social spending programs. This observed spending is a radical change from AMLO's usual, more austere administration. These changes to the spending budget also include triple the amount for external debt as well as additional support for Pemex, which was included in the 2024 budget. The increase in external debt materialized early in 2024, with Mexico being the first emerg-

Sheinbaum consolidates as the frontrunner candidate for the June elections



Source: Americas Society/Council of the Americas - Oraculus.
Data as of December 14, 2023

ing market to issue USD-denominated bonds in the year, which were aimed at garnering resources for the spending programs in need of financing.

Currency

The Mexican Peso will most likely be affected by two important variables this year: The economic outlook in the United States and the direction of interest rates domestically. The U.S. economy is proving to be more resilient than originally expected. Inflation continues to trend down while the labor market remains strong, increasing expectations that the elusive soft landing will become a reality. Although achieving a soft landing is certainly possible, we believe that this goldilocks scenario is not the most likely outcome. The possibility of recession, in some form or another, remains on the table. At the same time, Mexico's strong commercial ties with the United States have only strengthened with the onset of nearshoring. Mexico's exports to the United States constitute approximately 15% of the

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latter's total imports, higher than China in the 13% range. In fact, according to the Federal Reserve Bank of Dallas, Mexico became the top trading partner for the United States at the beginning of last year, surpassing both China and Canada. Undoubtedly, the economic performance and ensuing demand from its northern neighbor will have an impact on the Mexican Peso. Arguably more important for the Peso will be Banxico's monetary policy decisions, specifically the pace and direction that it sets for domestic interest rates. Over the past year, the governing body's conservative monetary policy led to the Peso's outperformance in the region. With one of the most favorable carry trade profiles in Latin America, the Peso posted a return close to 15% in 2023 on a spot price basis, making it one of the best performing currencies in the region.

Although interest rate cuts will most probably happen in 2024, Banxico's balanced, even hawkish, stance on the direction of interest rates could mean that rate cuts may not happen in the first quarter, as the market expects, and may even happen in a more surgical, or "as needed" approach.

We would not be surprised if the Mexican Peso's incredible performance of 2023 would give back some gains as interest rates in the country drop throughout the year. However, regardless of the direction of rates or outlook for the US economy, we believe that the Mexican Peso will not be as volatile as it was in past years. The growing stability of the Mexican economy, coupled with an increase in Foreign Direct Investments (FDI) into to the country as a result of nearshoring, as well as a relatively conservative central bank continue to decrease the volatility in this currency. **This does not mean that the Peso will be immune to periodic price swings, it just means that, over the long term, it is likely to be less volatile than in years past.**

Fixed Income

As previously mentioned, Mexico was the first emerging market economy that tapped the markets in 2024 with a USD-denominated bond issuance in three different tranches that was well received by investors. The three tranches exhibited attractive spreads to their corresponding US Treasury references, and books were oversubscribed.

When looking at opportunities from the corporate bond perspective, we have favored having exposure to issuers that may benefit from the nearshoring opportunities that should blossom in Mexico, as well as other companies we consider to have solid balance sheets and healthy credit metrics.

As vehicles to take advantage of the nearshoring phenomenon, we have been favoring Cemex, Fibra Uno, and Banorte. Cemex, as a supplier of materials, has been benefitting from the construction boom Mexico has experienced, Fibra Uno as a vehicle to invest in the Mexican real estate sector, against a backdrop of increased demand for real estate from international companies interested in investing in Mexico, and Banorte as one of the main financial institutions that has invested in expanding its presence in the northern part of the country – where the nearshoring phenomenon is expected to expand the most. Moreover, another issuer we have favored and whose fundamentals remain strong – even amid challenging macroeconomic conditions – is Grupo Bimbo. For 3Q23, the company reported solid operations across Mexico, but those were offset by a decrease in its regional sales; still, the company was able to maintain improvement trends across its net sales and EBITDA margin. Here it is relevant to highlight that Grupo Bimbo tapped the fixed income markets by issuing two new tranches of USD-denominated debt: a reopening of its 2029 bond, and a 12-year new reference. The issuance was well received by the markets, with a 5.8x oversubscription. We have favored the bond maturing in 2044; however,

> — "**A diversified approach to investing in the Mexican equity market** will likely prove to be the best way to get risk-adjusted exposure to this promising market over the long term."

the new, shorter-dated references should be monitored since they could offer a more attractive coupon and are fairly valued when compared to their corresponding regression curve.

Equities

Mexican equities posted a strong year in 2023, with the iShares MSCI Mexico ETF (EWW) rising 39% for the year. A large portion of these gains can be attributed to the nearshoring phenomenon and increasing stability in the Mexican economy, as the Consumer Staples, Financials, Materials, and Industrials sectors led the way in terms of positive returns. Supply chain restructuring, geopolitical tensions in Asia, and friendly trade policies between the United States and Mexico are leading to increased Foreign Direct Investment in the country.

As we have mentioned in previous publications, we continue to believe that due to its geographic proximity to the United States, Mexico should prove to be the biggest beneficiary of nearshoring in Latin America. Both the quantity and quality of exports from Mexico to the U.S. continues to rise. As we mentioned before, the share of global imports by the United States continues to rise in Mexico's favor. At the same time, approximately two-thirds of Mexico's exports to the U.S. now consist of technology-oriented, value-added products that require highly skilled labor, such as transportation equipment, electronic products, appliances, and electrical equipment components. This represents a move away from agricultural and commodity-oriented exports that had traditionally dominated trade in the past.

We believe that companies associated with the benefits of nearshoring are likely to continue to post gains in the year ahead. Despite its strong year, the Mexican equity index Mexbol currently trades close to 15x forward earnings. This represents a premium to other peers in the region, but it stands near the average of its valuation range and below the S&P 500, which trades near 22x forward earnings.

Additionally, a reduction in interest rates expected throughout the year would also benefit the Mexican stock market. Higher consumer spending engendered by lower rates and the continued effects of near-shoring could propel the Consumer Staples and Discretionary industries higher, benefiting companies like Walmart de Mexico, Kimberly Clark de Mexico, and Fomento Economico Mexicano. At the same time, lower rates and increased nearshoring could also benefit companies in the Materials and Industrials sectors, that could potentially have cheaper access to capital. Companies like Cemex could be well positioned to benefit from both lower rates and increased construction activity.

Additionally, Financial companies such as Grupo Banorte, could continue to reap the gains associated with nearshoring, as this company continues to expand its presence in Northern Mexico.

A diversified approach to investing in the Mexican equity market will likely prove to be the best way to get risk-adjusted exposure to this promising market over the long term.

India: Not the Next China, but it is Still Great

India is emerging as a bright spot in the global economy, distinguishing itself as the world's fastest-growing major economy. Its recent GDP growth of 7.6% YoY is a testament to this, although its progress is not without challenges. Despite fiscal limitations and labor market rigidity, which might prevent it from reaching the high growth levels of some East Asian economies, India's growth trajectory is still impressive and offers attractive opportunities for investors, particularly those seeking alternatives to China.

India's economy, nearly USD 4tn in size, is growing rapidly, with projected real growth rates of 6-7% annually. This growth rate outpaces many of its emerging market peers but does not quite hit India's full potential growth rate of 8-9%. India's development model differs significantly from East Asian economies like the "tigers" (Hong Kong, Singapore, South Korea, Taiwan), the "tiger cubs" (Indonesia, Malaysia, Philippines, Thailand), and China. It relies more on services and is less resource-intensive than China, which means it should not mirror China's global growth impact. However, this does not dampen the outlook for Indian assets, which are expected to continue outperforming.

The rise in domestic investors and Western investors' interest in diversifying away from China is likely to buy Indian equities.

Looking at specific investment opportunities in India, both bonds and equities appear attractive, although the Indian rupee may present less potential due to the country's relatively high inflation and external deficits. However, India still faces several challenges. Private sector investment remains subdued, and there is a significant challenge in creating enough jobs for its expanding working-age population. Additionally, India's dependence on energy imports makes it susceptible to external shocks. Lastly, current valuations for MSCI India are high, nearly 22x, which is 1.4 standard deviations above the 10-year mean. ■

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