BTMU Focus Latin America

Brazil: macroeconomic performance
(1Q 2015)

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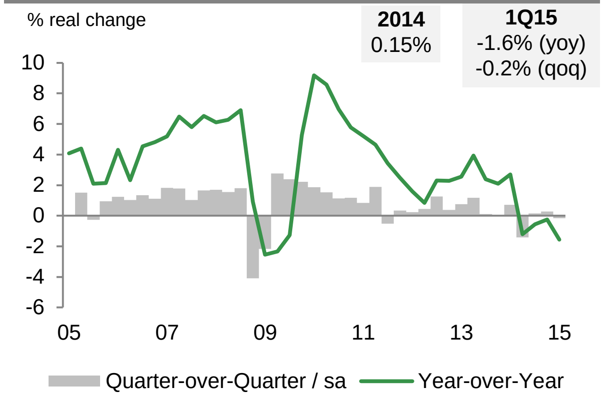
Brazil: Growth Momentum (1)

▪ Economic activity contracted by 0.2% qoq in the first quarter of the year.

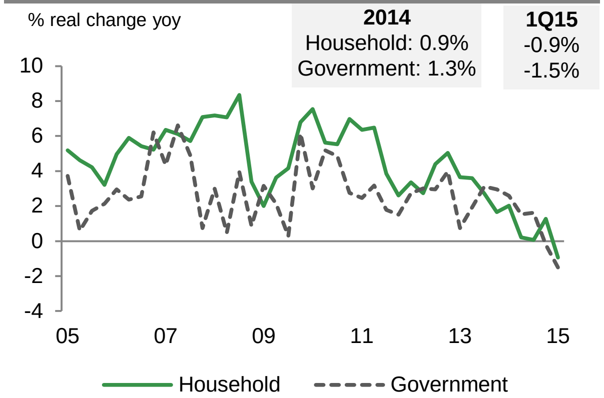
- Latin America's largest economy shrank by 0.2% qoq in the first quarter of the year, as widely expected by the market. The contraction was, however, less severe than most analysts predicted (-0.5%), as better-than-expected performances in mining and agricultural activity helped soften poor results in manufacturing and service sectors. However, household consumption, which makes up about two-thirds of GDP, contracted for the first time since 2004 on a year-over-year basis, as weakening labor market and high inflation keep reducing consumers' level of income and purchasing power. The resolution of Mr. Levy, Brazil's finance minister, to achieve a primary surplus of 1.2% this year, though necessary to get Brazil's fragile public finances in order, is gradually becoming a drag for the economy. Public spending fell by 1.5% yoy in 1Q 2015, the largest drop in more than a decade. Furthermore, gross fixed capital formation (GFCF) slipped by 7.8% yoy, extending the fall for four consecutive quarters. No wonder business confidence is at record lows.

Figure 1: GDP



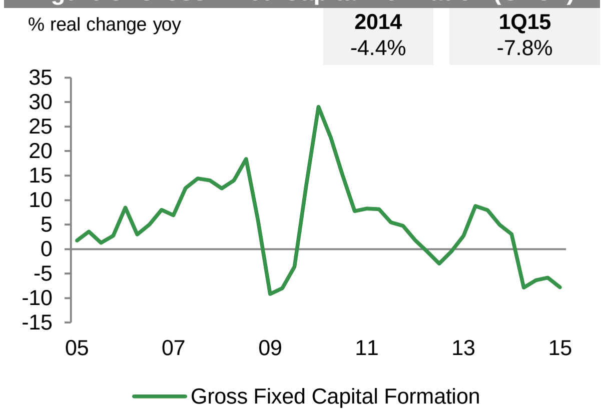
Source: IBGE; BTMU

Figure 2: Consumption



Source: IBGE; BTMU

Figure 3: Gross Fixed Capital Formation (GFCF)



Source: IBGE; BTMU

Figure 4: Exports and Imports

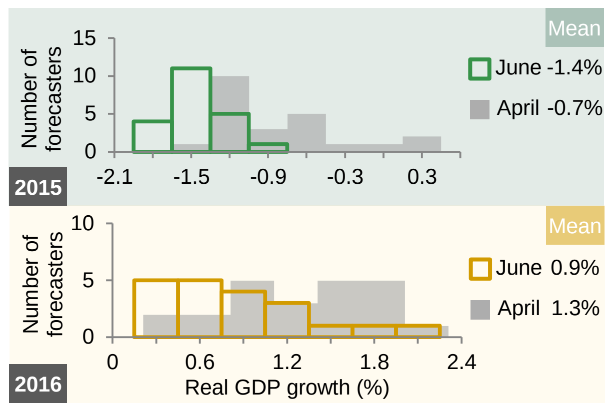
Source: IBGE; BTMU

Brazil: Growth Momentum (2)

▪ The market expects a contraction of 1.4% in Brazil's GDP, down from a 0.7%.

- Brazil's economic outlook has darkened considerably since April, as reflected in the distribution of market forecasts (*see Figure 5*). Now the consensus forecast for this year's GDP growth is -1.4%, down from -0.7%. Some analysts are now betting that this year's contraction would be higher than 1.5%, while at the same time more believe next year's GDP growth would be tepid in the face of a more inflation-wary central bank and a fiscally austere government. True, expectations do not always match the final results, but recent data seem to support the market's view. Brazil's central bank IBC-Br index, a proxy for GDP, plunged by 3.3% yoy in April, which clearly signals that the economy has not hit bottom yet. The activity in the industry and service sectors so far this year appears to point to the same conclusion. Industrial production has slumped by 7.6% yoy in April; while the service sector posted its sharpest downturn (an annualized rate of 3%) in 1Q 2015 since late 2008. All in all, we expect the economy to shrink by around 1.5% this year.

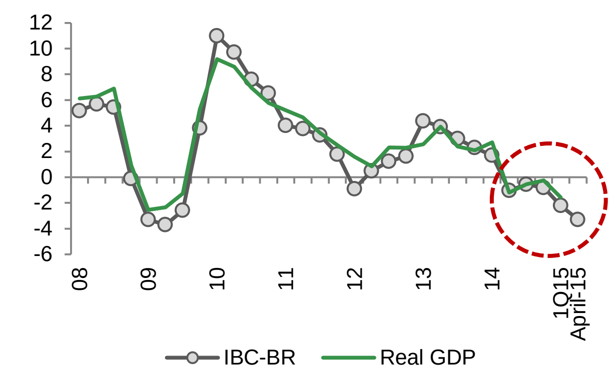
Figure 5: GDP Growth (private forecasts)



Source: Consensus Economics; BTMU

Figure 6: Index of Economic Activity and GDP

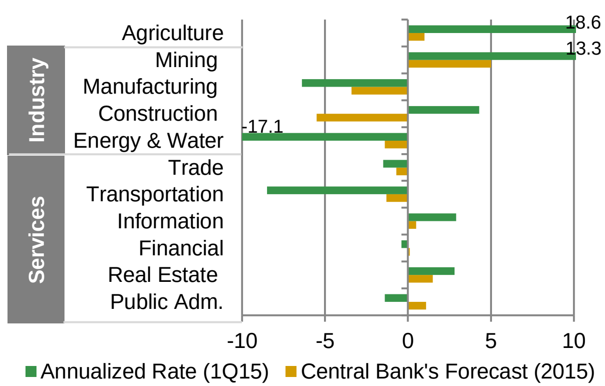
% real change yoy



Source: IBGE ; Banco Central do Brasil; BTMU

Figure 7: GDP by Sector in 2015

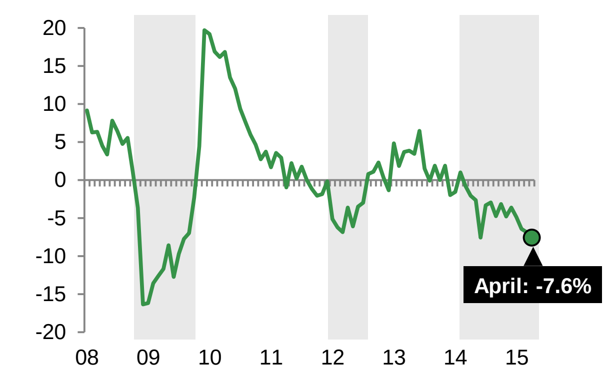
% real change



Source: IBGE ; Banco Central do Brasil; BTMU

Figure 8: Industrial Production

% real change yoy (volume index, 2012=100)



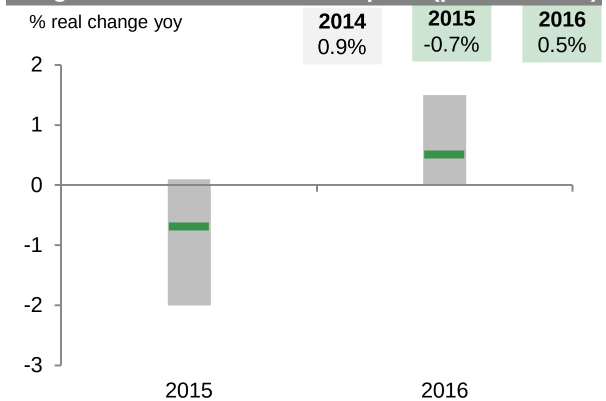
Source: Thomson Reuters; BTMU

Brazil: Growth Momentum (3)

- **Brazil is losing its last engine of growth: private consumption.**

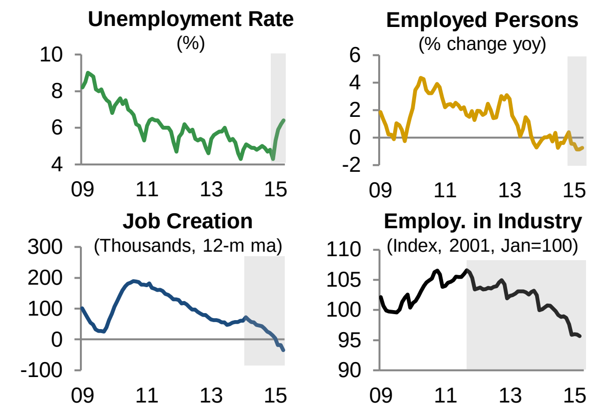
- Consumer spending has been a vital and stable engine of growth for the Brazilian economy over the last decade. Even during the Great Recession, household consumption rose by 4.2%, helping the country mitigate the severe effects of global economic slowdown. In 2014, that engine has begun to sputter: its pace of growth slowed to 0.9% from 2.9% amid rampant inflation and rising interest rates. This year's outlook is even grimmer. The market expects household consumption to decline by 0.7%. It would be the largest fall in more than a decade, but would not be a surprise given the country's weakening labor market. Unemployment rate climbed sharply this year; while employment in the industry has been dwindling steadily for a while. Even more worrying is the number of jobs added to the economy, which has slipped into negative territory since February. Brazil's bleak labor market is clearly dampening consumer spending as reflected in retail sales and imports of durable consumer goods, which tend to be more cyclical than non-durable goods.

Figure 9: Household Consumption (priv. forecast)



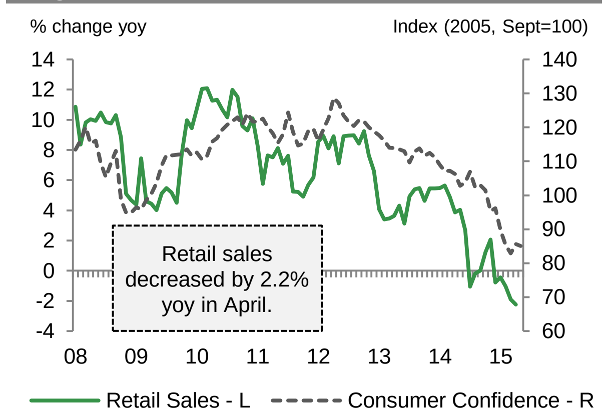
Source: Consensus Economics; BTMU

Figure 10: Labor Market



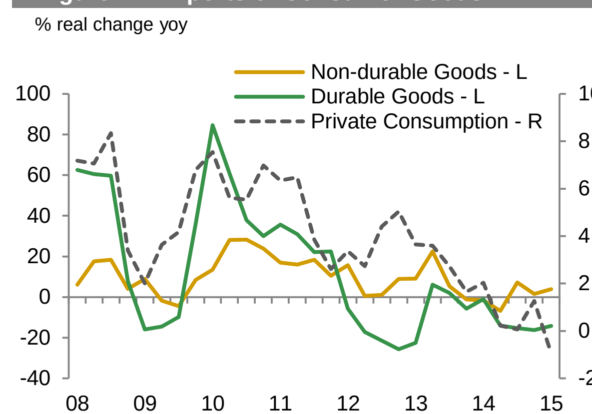
Source: IBGE ; Ministerio do Trabalho e Emprego; BTMU

Figure 11: Retail Sales and Consumer Confidence



Source: IBGE; Fundacao Getulio Vargas; BTMU

Figure 12: Imports of Consumer Goods



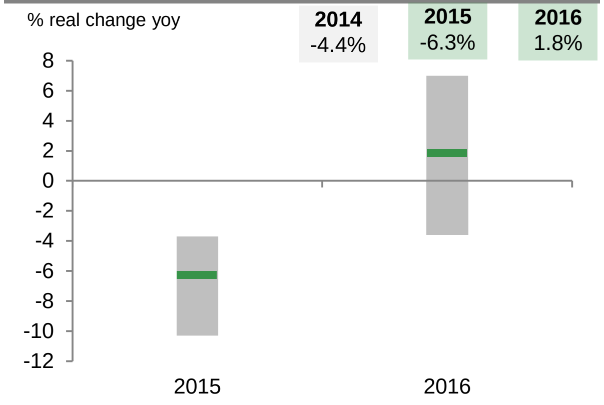
Source: IBGE; FUNCEX; BTMU

Brazil: Growth Momentum (4)

▪ Investment is likely to drop further this year despite the government's infrastructure plan.

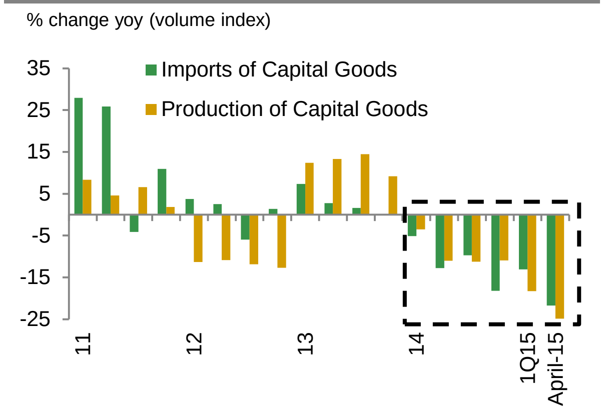
- The contraction in GFCF is likely to be deeper this year than in 2014, despite the announcement of infrastructure concessions worth $64.1 billion. First off, the success of this infrastructure plan cannot be taken for granted as many of Brazil's construction companies are now engulfed in a bribery scandal around Petrobras. Even if the government were to overcome the hurdles, there is still the question of whether it could bid and approve the projects fast enough to make a meaningful impact on this year's investment figures. The answer is likely to be no: production of capital goods, a major component of GFCF, has already plummeted by about 20% yoy in the first four months. Next year's outlook for GFCF is more encouraging, but there is still a lot of uncertainty around the government's capacity to put the necessary reforms in place. Finally, exports might picked up this year in real terms thanks to a weaker real, but because of weaker demand from Brazil's main trading partners and falling commodity prices, they will probably not be a key engine of economic recovery as in 2009.

Figure 13: Gross Fixed Investment (priv. forecast)



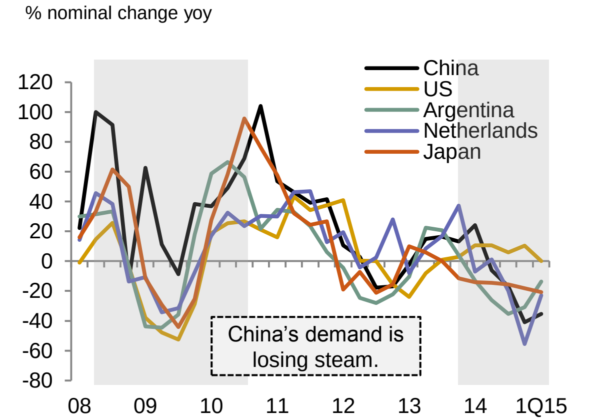
Source: Consensus Economics; BTMU

Figure 14: Production & Import of Capital Goods



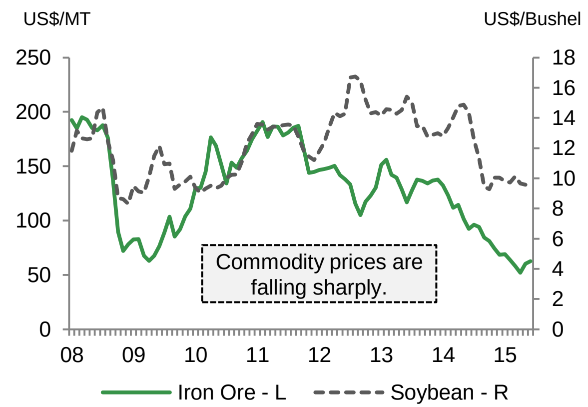
Source: IBGE; FUNCEX; BTMU

Figure 15: Brazil's Exports to Main Destinations



Source: IMF - Direction of Trade Statistics; Trade Map; BTMU

Figure 16: Soybean and Iron-ore Prices



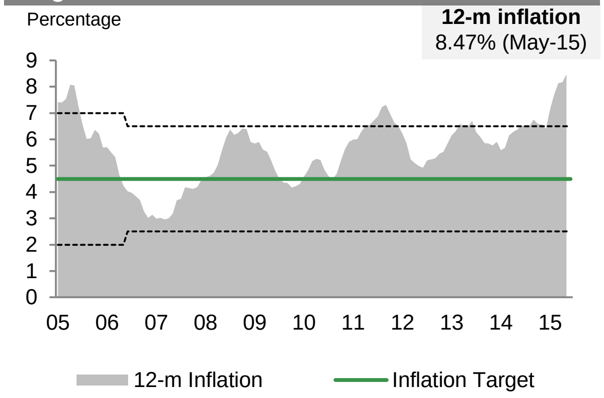
Source: Steel Home; Thomson Reuters; BTMU

Brazil: Prices, Exchange Rate and Current Account (1)

- **Inflation continues to escalate amid tight monetary policy.**

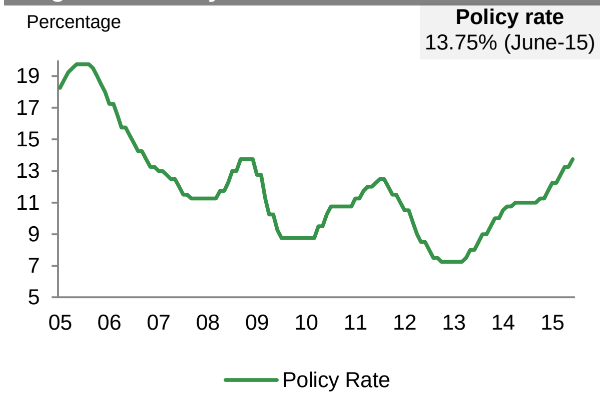
- **Inflation**: 12-m inflation hit 8.47% in May, the highest rate since 2004, despite the Central Bank's hawkish monetary policy to ease upward pressures on prices. The bank's monetary policy committee, known as Copom, has raised its benchmark Selic rate by 275 basis points from 11% to 13.75% over the last eight months, a much more aggressive stance than the market expected. But food and beverage prices, which account for around 25% of a typical consumer's basket, have continued to soar at an annual rate above 8%. To make the Central Bank's job even harder, housing-related and transportation prices ramped up dramatically so far this year due to energy subsidy cuts as part of government's efforts to rein public spending, and a severe drought in Brazil's southeastern region that has crimped water and electricity supplies. The monetary authorities see inflation hovering above 8% for the rest of the year, but they also believe inflation will gradually converge to the target of 4.5% at the end of 2016, as temporary upward pressures start to dissipate next year.

Figure 17: Inflation



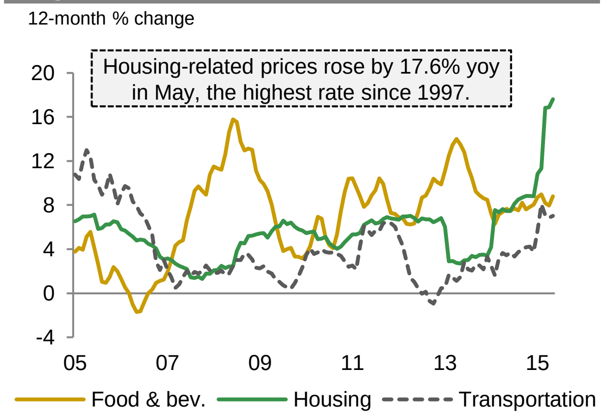
Source: IBGE; BTMU

Figure 18: Policy Rate



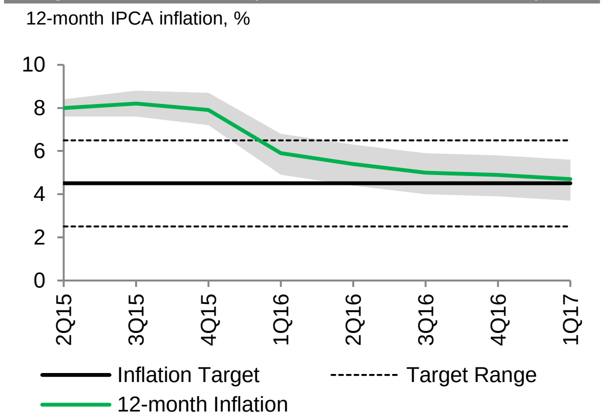
Source: Banco Central do Brasil; BTMU

Figure 19: Consumer Price Index



Source: IBGE; BTMU

Figure 20: Inflation (Central Bank's Forecast)



Source: Banco Central do Brasil; BTMU

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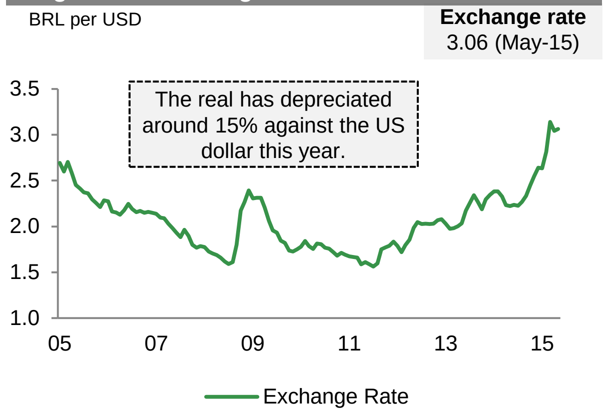
Brazil: Prices, Exchange Rate and Current Account (2)

- **First interest rate hike by the Fed could put renew pressure on the real.**

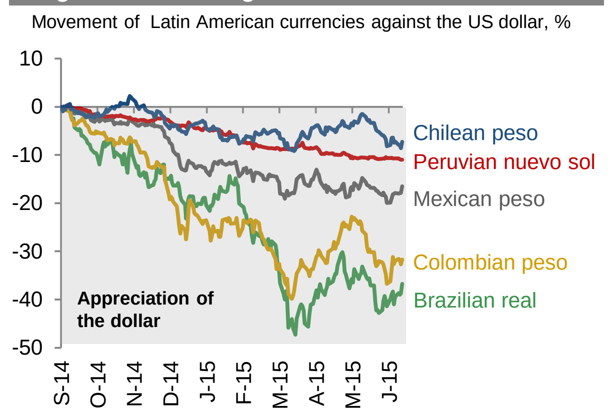
- **Exchange rate**: the real has depreciated steadily against the US dollar since September 2014, very much in line with other currencies of the region. Although the real has somewhat strengthened over the last three months, a possible interest rate hike by the Fed is likely to put extra pressure on the real again. In that scenario, the Central Bank would probably use its reserves to smooth the volatility in the foreign-exchange market.
- **Balance of payments**: Brazil's external accounts improved marginally in 1Q 2015 on a year-over-year basis. The nation's current account deficit narrowed by 8.3% to $25.6 billion, thanks to a meaningful reduction in its income account deficit (from $10.9 to $9.2 billion), and a smaller trade deficit. Despite those progresses and the amount of international reserves held by the Central Bank (around 16% of GDP), the imbalances remain large enough to make the country less resilient to possible sudden shifts in investors' sentiment in the aftermath of the expected normalization of US monetary policy (market expects within this year).

Figure 21: Exchange Rate



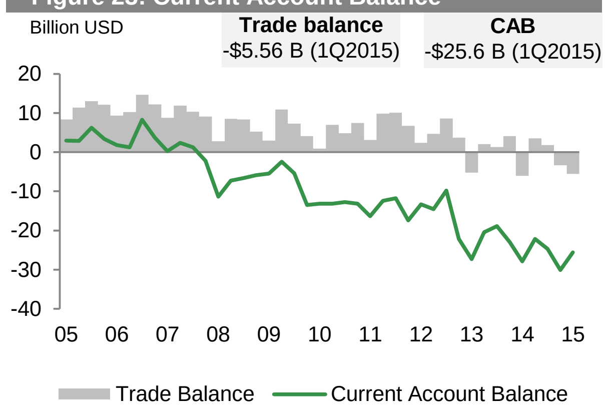
Source: Banco Central do Brasil; BTMU

Figure 22: Exchange Rates



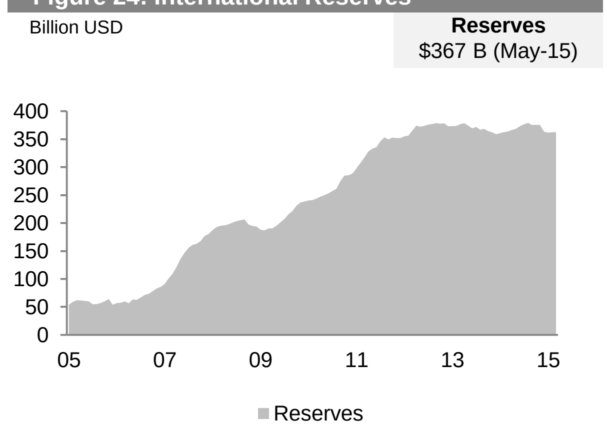
Source: Thomson Reuters; BTMU

Figure 23: Current Account Balance



Source: Banco Central do Brasil; BTMU

Figure 24: International Reserves



Source: Banco Central do Brasil; BTMU