BTMU Focus Latin America

Brazil: Macroeconomic Performance

(2Q GDP and Current Monthly Indicators)

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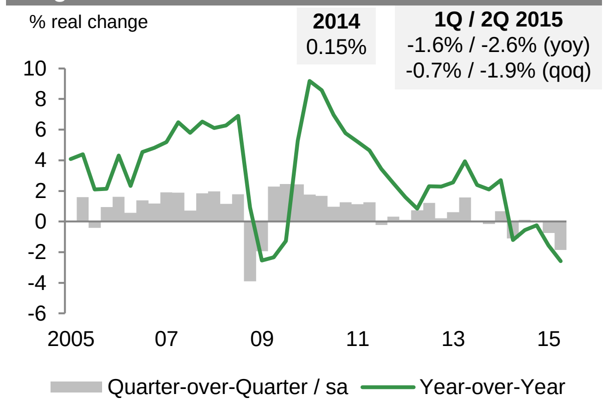
I) Brazil: Growth Momentum (1)

▪ Brazil's economy posted a record year-over-year contraction in 2Q 2015.

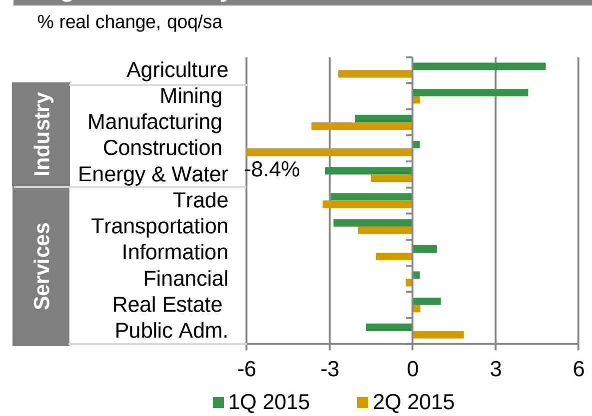
- The economy shrank 2.6% yoy in 2Q 2015, the largest dip since Brazil started to publish quarterly numbers. Yet not so long ago, market analysts and Brazilians alike thought that the largest country in Latin America was on the brink of development. Optimism was on the rise as the economy grew at an average annual rate of more than 4% in 2005-10. But now, the picture is quite different. Brazil is deeply mired in a severe economic recession amid an escalating political crisis triggered by massive corruption scandals involving Petrobras, the state-controlled oil company. On the demand side, gross fixed capital formation (GFCF) dipped qoq again, extending the fall for 8 quarters in a row. To make matters worse, consumer spending plunged by 2.7% yoy, as households started to adjust to this new gloomy environment. Still, not all is bad news, net exports contributed positively to GDP growth. As to the supply side, all sectors except mining and public administration contracted in the second quarter, portending that the recession will not only be severe but also widespread across all sectors.

Figure 1: GDP



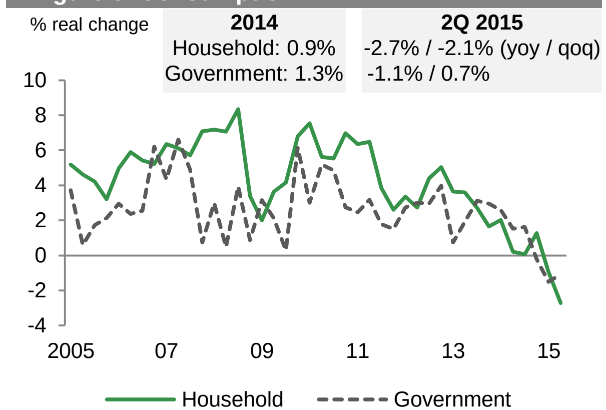
Source: Instituto Brasileiro de Geografia e Estatistica (IBGE); BTMU

Figure 2: GDP by Sector



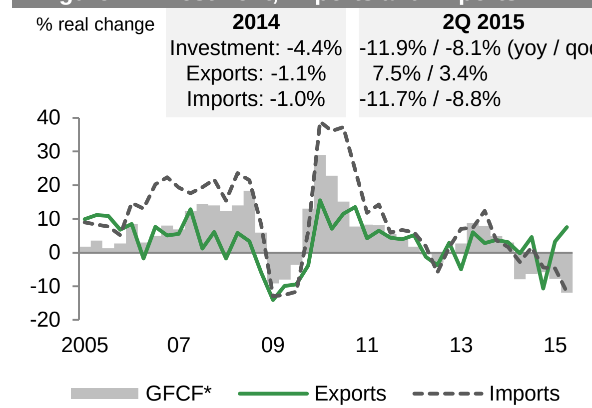
Source: IBGE; BTMU

Figure 3: Consumption



Source: IBGE; BTMU

Figure 4: Investment, Exports and Imports



*Gross fixed capital formation
Source: IBGE; BTMU

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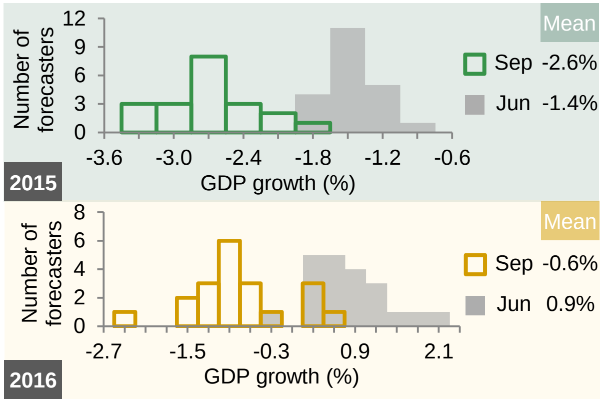
I) Brazil: Growth Momentum (2)

▪ This recession will probably be more severe and longer than the 2008 recession.

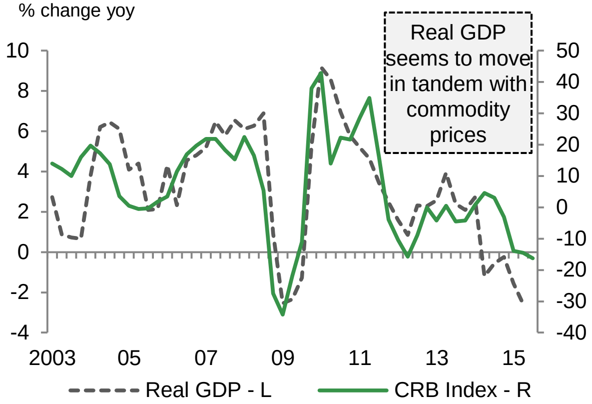
- Brazil's economy will certainly shrink this year as it did in 2009. Only this time, the recession will likely be more severe and prolonged. Why? Unlike 2009's recession, this time the economy is being dragged down by a triple whammy of a sharp fall in commodity prices; an unsustainable fiscal deficit that has led S&P to downgrade Brazil's debt rating to junk status; and a deepening political crisis that has undercut President Rousseff's grip on power and her ability to get Congress to pass unpopular fiscal measures. More importantly, Brazil needs to restrain the excess demand in the economy (gap between domestic absorption and real GDP) that was arguably a direct outcome of the country's bloated public sector and years of undue monetary stimulus. The government has started to make the adjustments in public finances, prices and balance of payments; but there is still a long way to go. Meanwhile, the steady fall in GFCF will continue to hinder Brazil's potential growth. All in all, we expect the economy to shrink more than 2% this year. The odds for a recovery next year are also very slim.

Figure 5: GDP Growth (private forecasts)



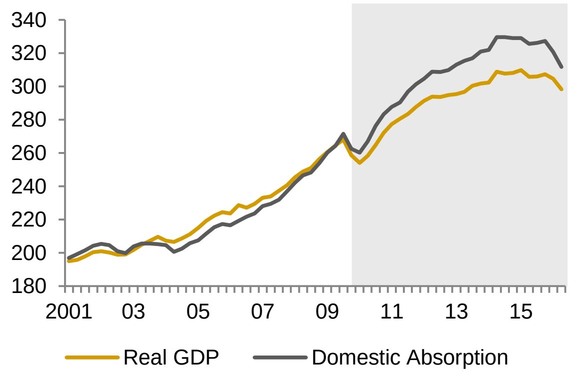
Source: Consensus Economics; BTMU

Figure 6: GDP and CRB Index*



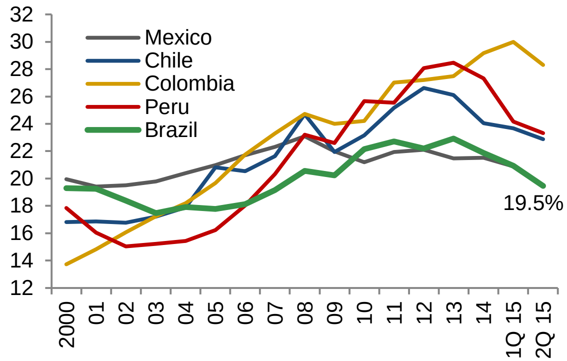
*Commodity Research Bureau Index
Source: IBGE; Commodity Research Bureau (CRB); BTMU

Figure 7: GDP and Domestic Absorption*



*Domestic Absorption = Private and Public Consumption + GFCF
Source: IBGE; BTMU

Figure 8: Investment Rates



Source: IBGE; Central Bank of Chile; DANE; INEGI; INEI; BTMU

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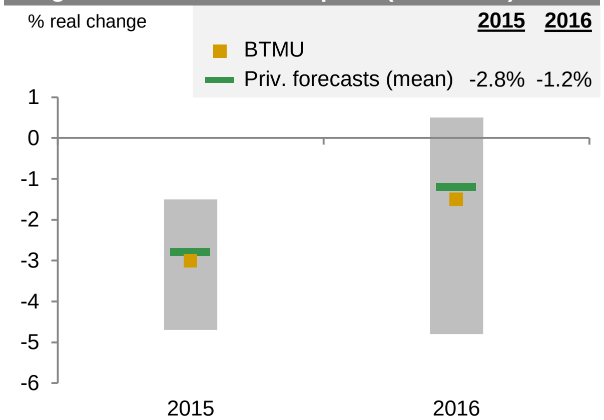
I) Brazil: Growth Momentum (3)

▪ Household consumption will likely stay as a major drag for the economy in the short-to-medium term.

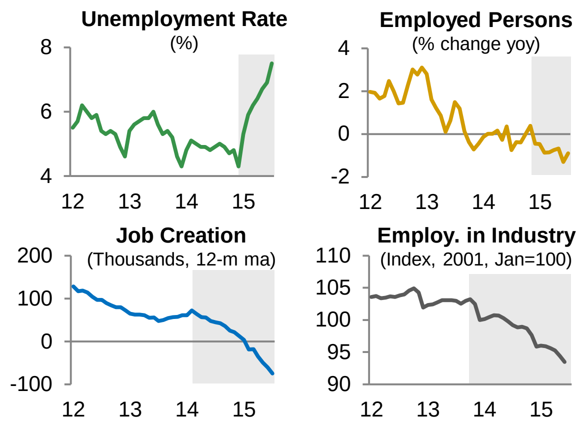
- The fact that Brazil's model of consumption-led growth has run out of gas is self-evident. Consumer spending has recently recorded its steepest quarterly drop in more than a decade. And given that consumer confidence and retail sales continue to fall, chances are household spending will this year post its largest fall since 1996, when new data were first published. This is hardly surprising because high credit growth to speed up household spending is unsustainable without substantial improvements in real wage growth (labor productivity). This is arguably the case of Brazil. After years of excessive credit growth, prompted by the government's policy to boost lending through state-controlled banks and dovish monetary policy, the fallout for Brazilian households is now visible: high inflation, falling real wage, levels of debt that are hard to deal with, and lower consumption. Worse yet, the labor market is still showing signs of worsening, which suggests that household consumption will probably remain as a drag for the economy in the short-to-medium term.

Figure 9: Private Consumption (Forecasts)



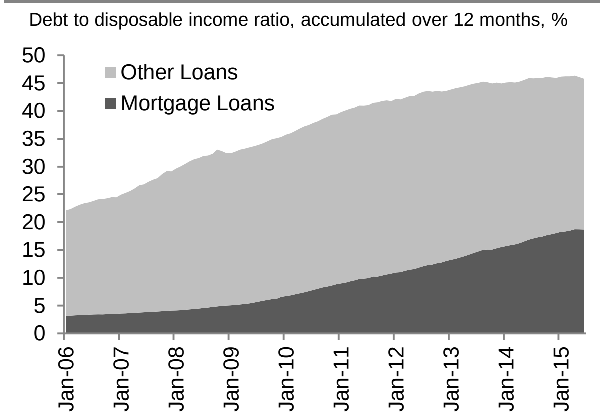
Source: Consensus Economics; BTMU

Figure 10: Labor Market



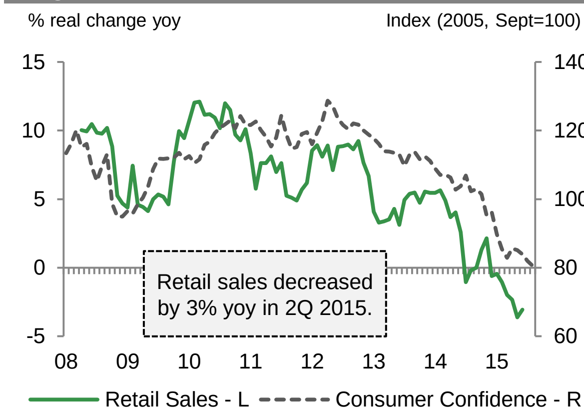
Source: IBGE ; Ministerio do Trabalho e Emprego; BTMU

Figure 11: Household Indebtedness



Source: Banco Central do Brasil; BTMU

Figure 12: Retail Sales and Consumer Confidence

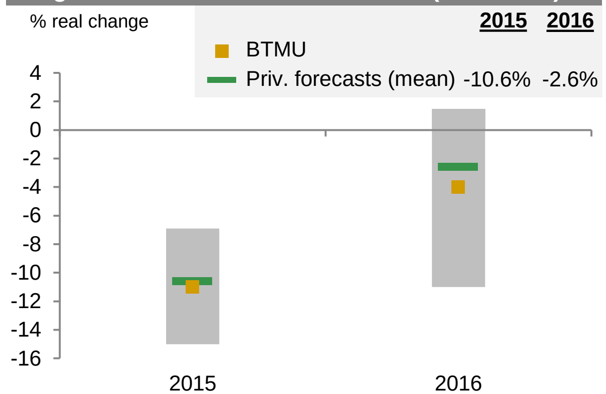


Source: IBGE; Fundacao Getulio Vargas; BTMU

- **Investment is still in free fall. It will probably contract by more than 10% this year.**

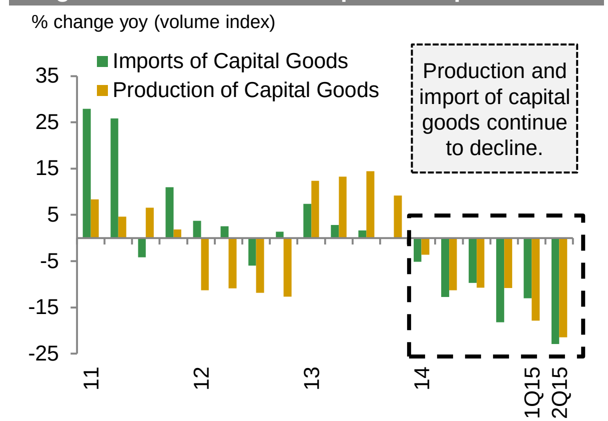
- Last year's GFCF plummeted by 4.4%, and this year's contraction will probably be more than 10% as most indicators appear to signal (e.g., business confidence fell to record-low level) True, GFCF is plunging in most Latin American countries due to increased external headwinds, yet the severity of the fall in Brazil suggests that there are domestic factors to blame as well. One conspicuous culprit is the reduction in public investment as part of government's budget-cutting efforts. Another factor is the scaling back of the Brazilian Development Bank in its lending activities (e.g., subsidized loans to Brazil's corporate sector). The recent downgrade of Brazil's sovereign rating to junk status by S&P will not help either, as it will raise the cost of borrowing for firms and compel the government to take additional fiscal-austerity measures so as to avoid more downgrades in the coming months (Brazilian debt is still rated as investment grade by Moody's and Fitch). Against such as gloomy backdrop, it is likely that GFCF will contract again in 2016.

Figure 13: Gross Fixed Investment (Forecasts)



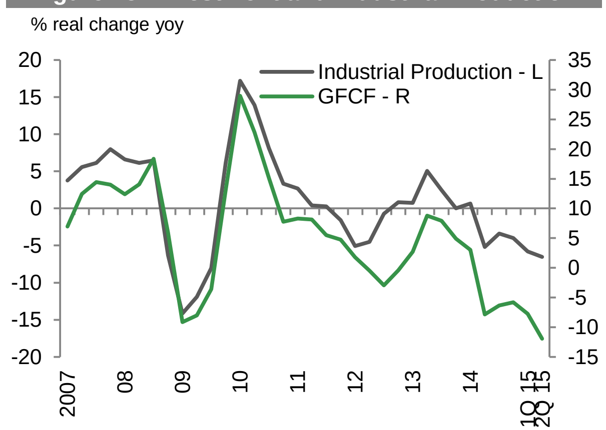
Source: Consensus Economics; BTMU

Figure 14: Production & Import of Capital Goods



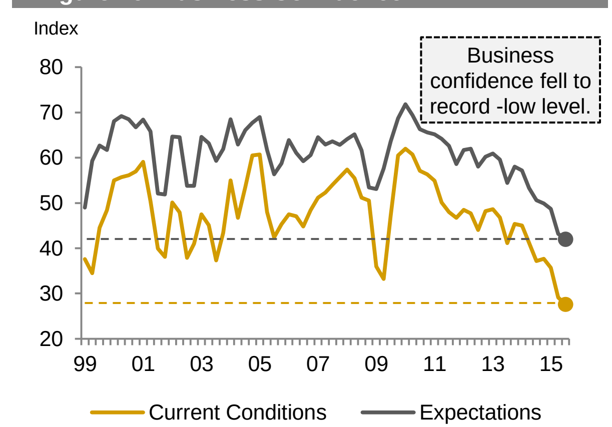
Source: IBGE; FUNCEX; BTMU

Figure 15: Investment and Industrial Production



Source: IBGE; BTMU

Figure 16: Business Confidence



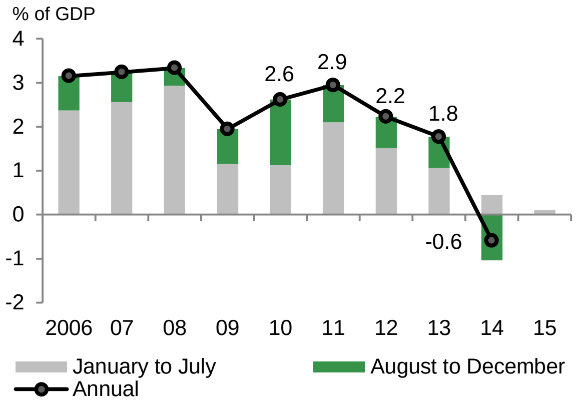
Source: Banco Central do Brasil; BTMU

II) Brazil: Public Finance

▪ S&P downgraded Brazil's rating to junk status; and another rating downgrades are looming.

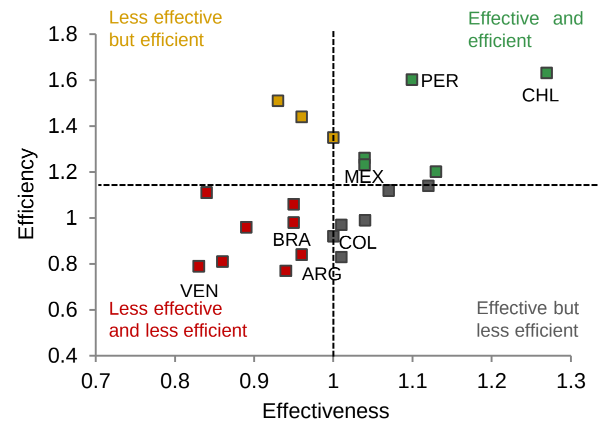
- If there is a common complaint among economists about President Rousseff's first four years in power, that would be her handling of public finances. The primary balance, an indicator of how well the government is managing public finances, dropped from a surplus of 2.6% of GDP in 2010 to a deficit of 0.6% in 2014, pushing public debt up sharply. So when Ms. Rousseff was re-elected last year, there was already a growing sense of urgency to fix Brazil's flagging public finances. Aware of that grueling task, she picked Joaquim Levy, a well-known fiscal hawk, as her new finance minister. But almost nine months into the job, he is still jockeying to make headway. In fact, after failing to meet the initial targets and backtracking on new ones, S&P downgraded Brazil's debt to junk status. To be fair, Mr. Levy is hardly the one to blame given the economic and political constraints, and the country's inefficient public sector. Yet given how market currently perceives Brazil's debt, another downgrades by rating agencies are looming. And the odds are against him.

Figure 17: Government Primary Balance*



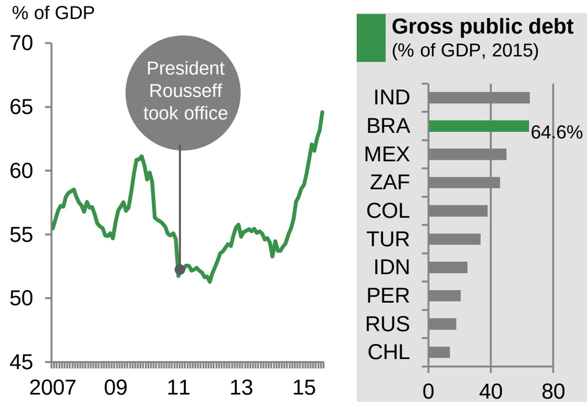
*Consolidated Public Sector
Source: Banco Central do Brasil; CRB; BTMU

Figure 18: Pub. Sector Efficiency in Latin America



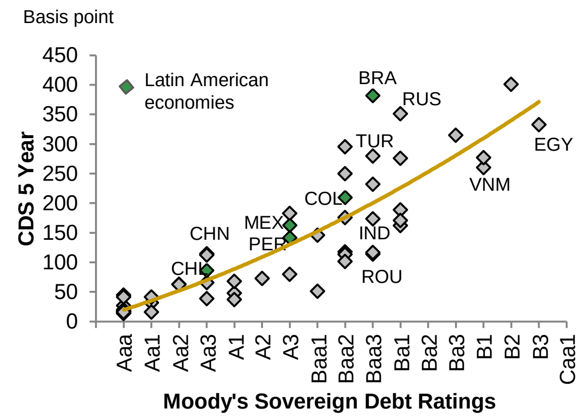
Source: Alfonso, Romero and Monsalve (2013), IDB; BTMU

Figure 19: Gross Public Debt



Source: GlobalSource Partners; Banco Central do Brasil; BTMU

Figure 20: Sovereign Debt Ratings and CDS



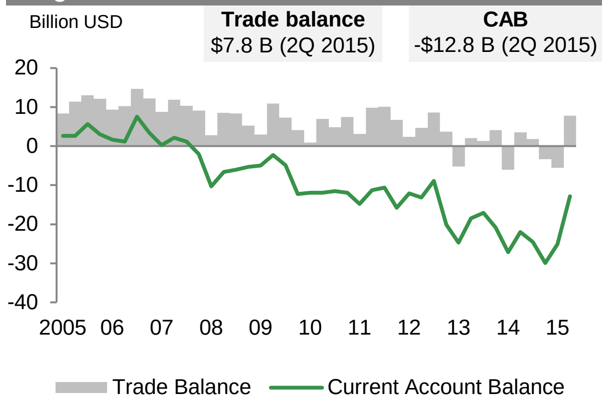
Sample: Developed, emerging, frontier markets. MSCI definition.
Source: Bloomberg, as of 09/15/2015; BTMU

III) Brazil: External Sector

▪ A weaker real has not yet provided the expected impulse for the real economy.

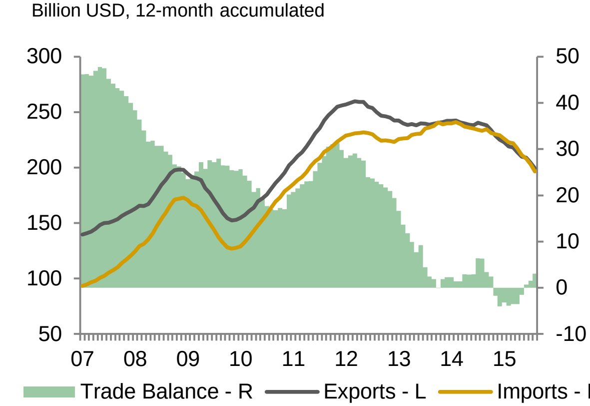
- Mr. Levy believes the economic recovery in Brazil will likely stem from the supply side rather than from the demand side. In theory, he is right: with domestic demand in free fall, a weakening currency could rekindle economic growth by making domestic industries more competitive, boosting manufactured exports, and galvanizing a process of import substitution. But as the economy continues to weaken, it would be comforting to see some evidence of that taking place. Certainly Brazil's external sector improved greatly in 1H 2015. Its current account deficit in 2Q 2015 was 42% smaller compared to a year earlier, and was largely driven by an improving trade balance. But the picture is not as rosy as it looks like. First, that improvement was explained by a steep drop in imports rather than a rise in exports. Second, although exports rose sharply in real terms, it was mainly fueled by higher production of primary products (e.g., oil and metals) rather than by a weaker real. Third, there is no clear evidence that a process of import substitution is underway.

Figure 21: Current Account Balance



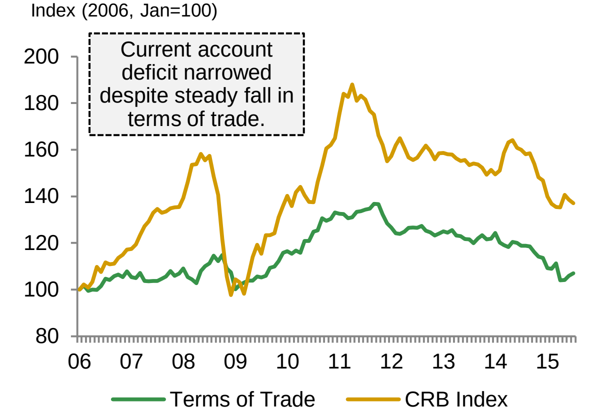
Source: Banco Central do Brasil; BTMU

Figure 22: Trade Balance, Exports and Imports



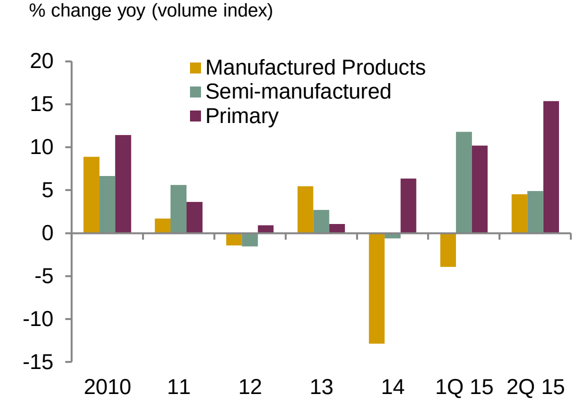
Source: Ministry of Development, Industry and Foreign Trade; BTMU

Figure 23: Terms of Trade and CRB Index



Source: FUNCEX; Commodity Research Bureau; BTMU

Figure 24: Exports



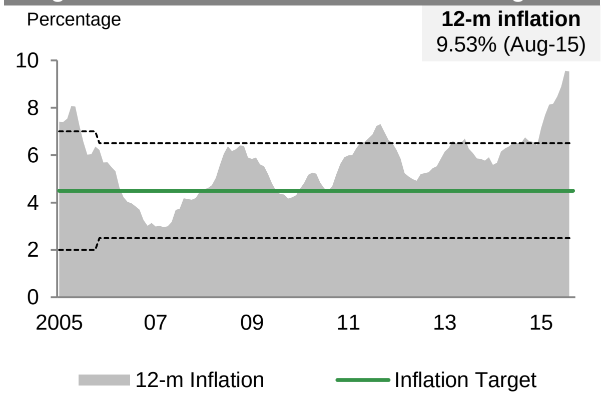
Source: FUNCEX; BTMU

IV) Brazil: Prices and Monetary Policy (1)

▪ Currency depreciation and ongoing fiscal-austerity measures continue to drive inflation up.

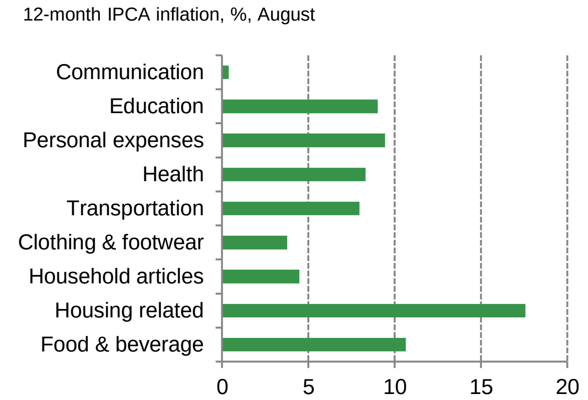
- 12-month inflation inched up to 9.53% in August, the highest rate in more than a decade. One major underlying force behind Brazil's galloping inflation is the ongoing fiscal adjustments spearheaded by Brazil's hawkish finance minister, Joaquim Levy, who has been trying to unwind much of the energy subsidies and tax breaks to industry implemented during President Rousseff's first term, in an attempt to keep the country's public debt sustainable. But those measures came with significant side effects on inflation: government-regulated prices (e.g., transportation fares, fuel and electricity) in August, which make up about 23% of a typical consumer's basket, were about 16% higher compared to a year earlier, largely explaining this year's spiraling inflation. Another key factor driving prices up is the real, which has depreciated about 50% against the US dollar this year (i.e., higher import costs). True, the current deep recession should have somewhat offset the pass-through effect on inflation by restraining wage growth and damping domestic demand (continued on next slide).

Figure 25: IPCA* Inflation and Inflation Target



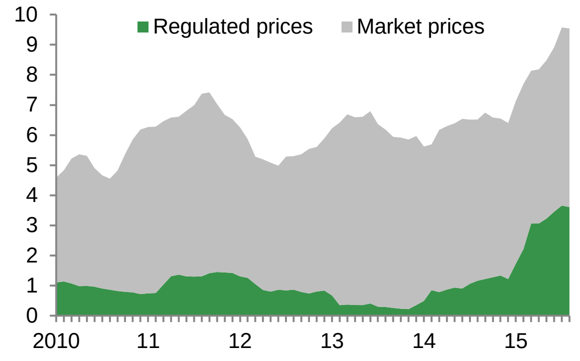
*Extended National Consumer Price Index
Source: IBGE; BTMU

Figure 26: Inflation by Components



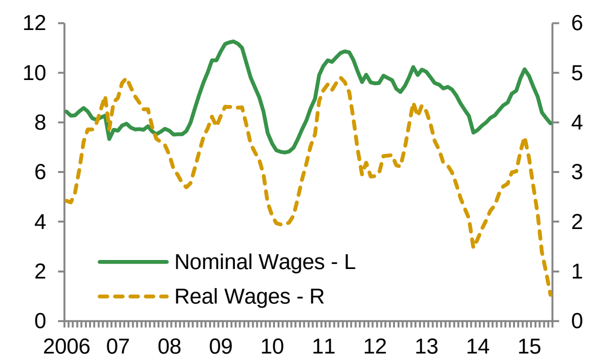
Source: IBGE; BTMU

Figure 27: IPCA Inflation



Source: IBGE; BTMU

Figure 28: Wages



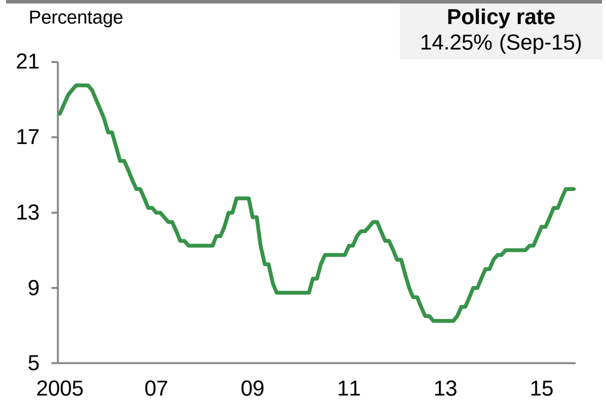
Source: IBGE; BTMU

IV) Brazil: Prices and Monetary Policy (2)

▪ Inflation will probably converge to the target of 4.5% in the medium term.

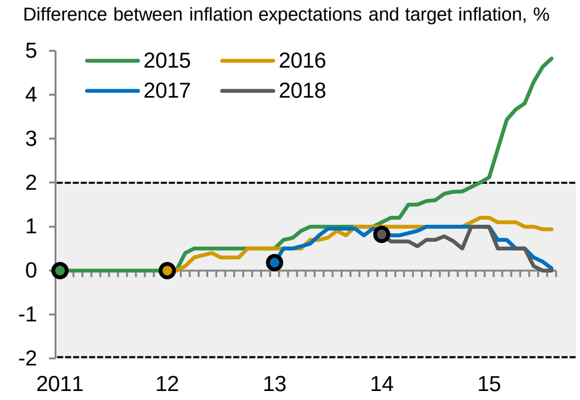
- Yet the upcoming normalization of US monetary policy, amid growing concern over Brazil's fragile fiscal position and dicey political landscape, could spell additional depreciation pressures on the real. Of course, the central bank's intervention in the sport and future markets will help smooth currency volatility, but it may not stop the real from depreciating further. The monetary authorities, aware that inflation could slip out of their hands, aggressively raised the benchmark Selic rate from 11% in September 2014 to 14.25%. Now the central bank intends to hold its policy rate at that high level so as to guarantee that inflation will converge to the target of 4.5% by the end of 2016. That might be too optimistic as the inflationary pressures stemming from a weaker real may not wane in the short term. Still, inflation should fall in 2016 because pressures from regulated prices will fade away. Moreover, judging by how quickly medium-term inflation expectations have went down since the tightening cycle, headline inflation should return to the target in 2017.

Figure 29: Policy Rate



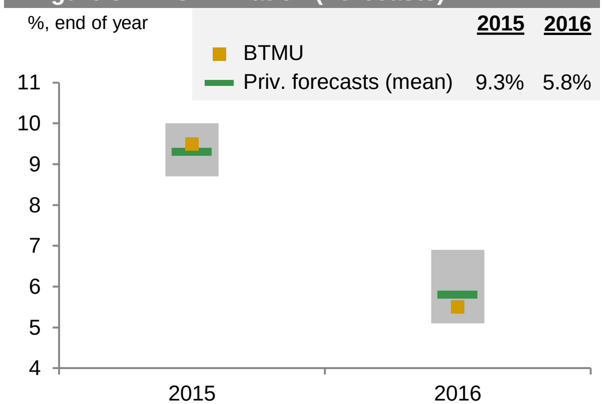
Source: Banco Central do Brasil; BTMU

Figure 30: Inflation Expectations



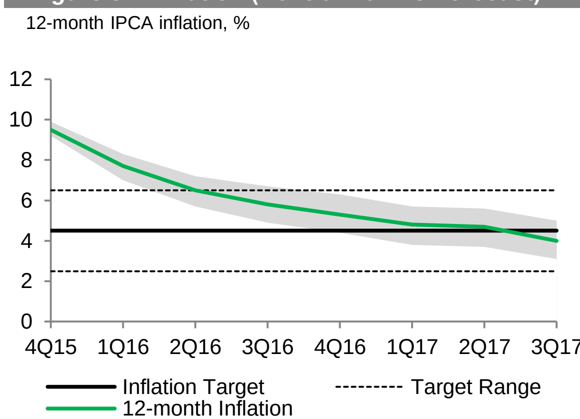
Note: target inflation is 4.5%, and tolerance range is +/- 2%
Source: Banco Central do Brasil; BTMU

Figure 31: IPCA Inflation (Forecasts)



Source: Consensus Economics; BTMU

Figure 32: Inflation (Central Bank's Forecast)



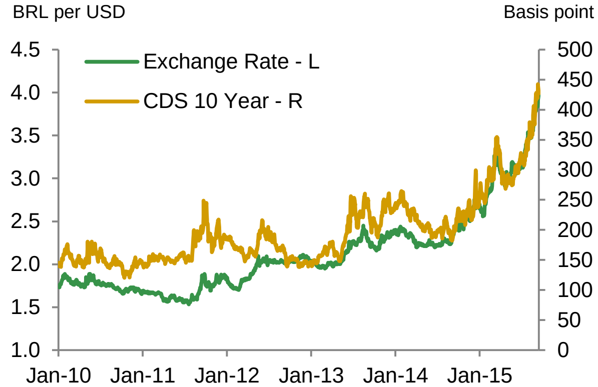
Source: Banco Central do Brasil, Inflation Report, Sep 15; BTMU

V) Brazil: Exchange Rate and Asset Prices

▪ The real is one of the worst performing emerging-market currencies so far this year.

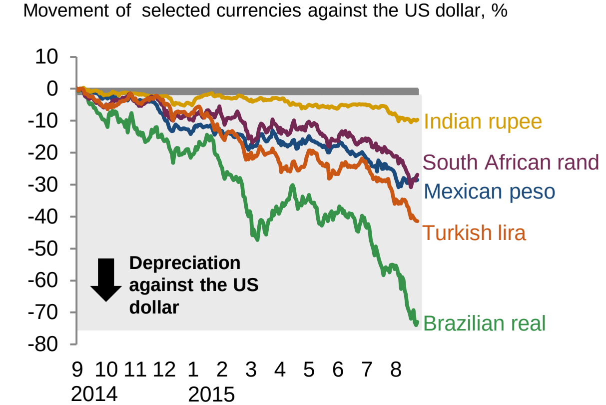
- The real was briefly trading above 4 to the dollar last week, down 67% from a year ago, making it one of the worst performing emerging-market currencies so far this year. Alas, not only has the ongoing economic and fiscal turmoil in Brazil, amid a swelling political crisis, dragged the real to its lowest level since its launch in July 1994, but it has affected asset prices as well. Government bond spreads have been soaring steadily since July; credit default swaps have been trading at levels that essentially consider Brazil's bonds as junk rated even before the downgrade by S&P; and more intriguingly, the entire yield curve has shifted markedly up, particularly its longer end. One explanation for these sharp movements in the yield curve is that investors are probably reducing their exposure to Brazilian assets as they become increasingly wary of the country's prospects. Another reason could be that investors expect the central bank to keep interest rates high for a protracted period so as to offset the pass-through effect on inflation from a weakening real.

Figure 33: Exchange Rate and CDS



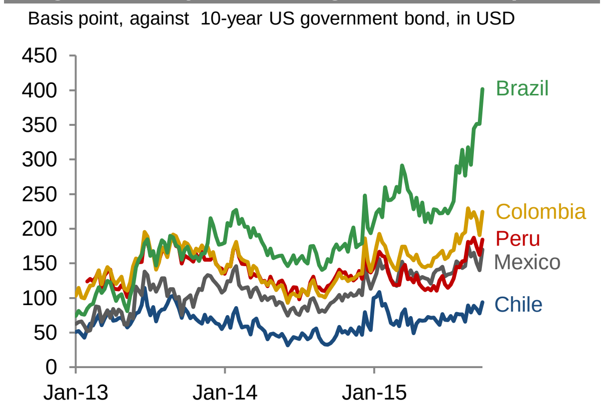
Source: Thomson Reuters Datastream; BTMU

Figure 34: Exchange Rates



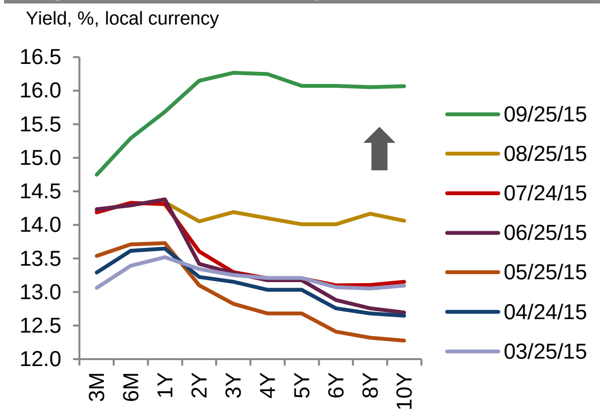
Source: Thomson Reuters Datastream; BTMU

Figure 35: 10-year Sovereign-bond Yield Spreads



Source: Bloomberg; BTMU

Figure 36: Brazil Sovereign Yield Curves



Source: Bloomberg; BTMU

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