Country Focus: Brazil

March 2016

Brazil close to positive reversal, despite political turbulences

As demonstrations and calls for President Rousseff dismissal amplify in Brazil, unexpected political moves and sudden market reactions are highly likely over the next weeks and months. From our quantitative analysis, we still have a WatchList indication on the exchange rate up to the end of the year (suggesting the potential for a sharp 20% depreciation over a short period of time), but aggregate Ratings have been improving in-between 2013Q3 and 2015Q2: with our usual time-lead, this points to lower risk materialization on both economic activity and the exchange rate in 2016 and early 2017 than 2015.

The risks of a large and sustained devaluation appear much lower now. Persistent financial volatility coupled with stubborn inflation is likely to force the Central Bank to tighten further with an expected hike in the Selic rate of 75-100 bp in 2016. In the very short-run, negative cyclical forces remain dominant, but the expected increase in net external trade contribution is progressively creating the conditions for an upswing, once domestic politics and policies stabilize.

The daily noises from Brazil are undoubtedly disturbing, with increasing prospects of a rapid dismissal of President Rousseff.

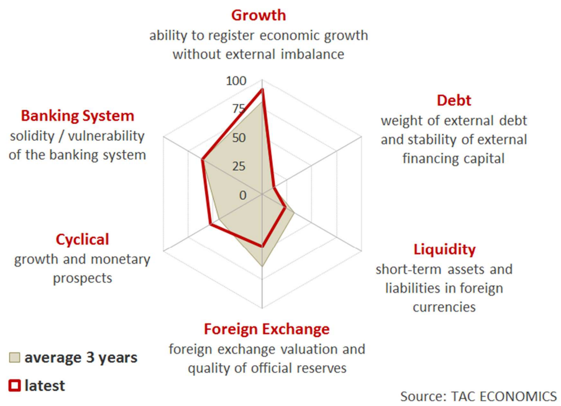
This would create immediate problems for succession as impeachment would imply that the Vice-President takes over, but he is himself under investigation; if the Vice-President cannot assume the Presidency, the leader of Congress is the next in line according to the constitution… but he is also under investigation. A prolonged political standstill and likely policy paralysis would ensue. A “better” solution would be the cancellation of the 2014 presidential elections, if Dilma Rousseff’s campaign funding is found breaching the laws.

Whatever political route is taken, the next few weeks and probably months will remain very turbulent… at the time of the Olympics preparation for next summer!

However, such noises are hiding a painful but on-going economic and financial adjustment. As shown in our polygon of risks, the Foreign exchange Balance as well as the Liquidity Balance have substantially improved; this combine snow with a favorable Debt Balance. As shown in the chart, the most pressing issue relates indeed to the Growth Balance.

Economic & Financial Risk Rating - Brazil 45.1-C

from 0 (lowest risk) to 100 (highest risk)

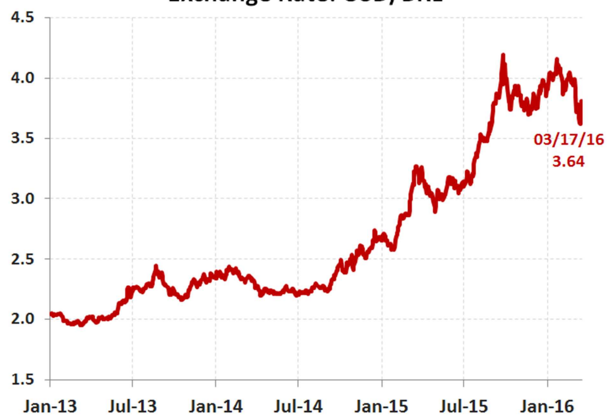


Source: TAC ECONOMICS

Improvement in Brazil’s Foreign Exchange Balance

After 45% depreciation over one year to (a monthly average of) USD/BRL 4.03 in September 2015, the Real has stabilized and re-appreciated to USD/BRL 3.77 on March 17, 2016, despite persistent volatility in between.

Exchange Rate: USD/BRL



Source: Banco Central do Brasil

The latest position of Brazil in the Foreign Exchange Balance shows an exchange rate that has now completely erased the previous competitive handicap (the quarterly average exchange rate corresponding to Brazil’s position is BRL 3.5: at current levels and notwithstanding inflationary pressures, the position would therefore be slightly more undervalued than shown in the Balance).

This clearly suggests that the risks of further large and sustained devaluation appear much lower now.

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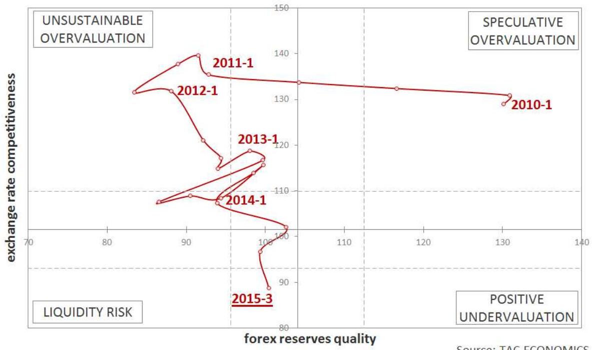
Foreign Exchange Balance



Source: TAC ECONOMICS

However, the still low forex reserve quality index highlights that further volatility is likely.

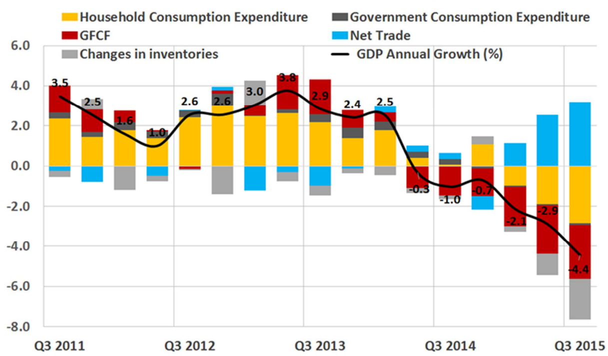
Following the depreciation of the currency and the collapse in domestic demand, external accounts are now improving faster than previously expected: the current account deficit was -2.9% of GDP over the last 12 months, against -4.4% in 2014. In absolute amounts, this deficit (USD 52 bn) is over-funded by FDI inflows (USD 75 bn).

Still negative outlook for activity in the short run

The domestic adjustment is in full swing, with all its negatives. GDP shrunk by 3.7% in 2015 and is expected continue contracting by around -3.0% on average in 2016: the continuous weakening of labor market (job destruction of 1.54 million in the year, falling wages, increasing unemployment by 0.7 bp to 7.6% in January) leads to contracting retail sales in 2015 (-8.6%), while both the poor demand and the fall-out of the Petrobras scandal continues to weigh on capital investments.

However first positive signs appear through volumes of trade: strongly rising exports and declining imports create a large and positive contribution to domestic activity ahead.

Brazil Contributions to year-on-year GDP growth (%)



Source: TAC ECONOMICS, Datastream

The bottom line is that Brazil is likely reach a trough in its cycle during the next few quarters and a more solid recovery should unfold in 2017… in a more supportive environment (higher commodity prices, lesser political uncertainties, and better terms of trade).

Persistent inflationary pressures indicating further ST monetary tightening

Inflation has markedly risen from a low point of 6.4% in December 2014 to 10.8% in February 2016. Prices continue to rise due to food, transport and education prices. However, the outlook is more sanguine as the recession and deteriorating labor market put high pressures on wages (real wages are declining); the exchange rate stabilization since end-September is now limiting the exchange rate pass-through to prices Moreover, service and regulated prices are now on a clear downtrend path.

Over the very short-term, credibility issues and loose fiscal stance, while inflation remains largely above the target range in 2016 (4.5% +/- 2), are going to create intense pressures on the central bank. It left the Selic rate unchanged since July 2015 to 14.25%. Despite more dovish comments during the last Copom meeting (March 2, 2016) (“*considering the domestic and, mainly, external uncertainties*”), a new tightening appears difficult to avoid. Our policy reaction function suggest a further 100 bp required hike to 15.25% over the next few quarters, but this could be slightly excessive if the currency remains strong.