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Quarterly Macro

The Brazil’s Road Ahead

Brazil is facing a turning point. The country is convincingly emerging from its worst economic recession and investments in infrastructure are vital for a sustainable recovery. From 2017 to 2018, former Temer’s administration auctioned 124 projects in several infrastructure areas, including hydropower, roads, airports, ports and oil & gas and that amounts about BRL 250 billion in expected investments in the coming years. Moreover, the current government inherited a portfolio of projects that represents BRL 110 billion in additional investments.

To support those investments, the country needs to improve business environment, ensuring access to long-term capital at lower costs.

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FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017 #1 FOREX FORECASTER - BRAZIL

FOCUS ECONOMICS ANALYST FORECAST AWARDS 2017 #1 POLICY RATE FORECASTER - BRAZIL

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Reforms:

President Bolsonaro and his team have signalled the intention to set a liberal and reformist agenda built in the following pillars:

a) Decrease bureaucracy, cut of subsides on specific sectors, and enhance labour market flexibility in order to increase productivity;
b) Reduce import taxes and support the entrance of foreign companies/capital into local markets.
c) Reduce dramatically the number of state-owned companies (that represents 418 companies) and stimulate private sector's participation in the infrastructure's investments. Under the current fiscal constraints, federal and subnational governments are pursuing extra revenue.
d) Solve fiscal deficit, by taking control of the public expenditure and stabilising public indebtedness ratio. Pension reform is one of the key measures that should be adopted. Yet trade needs are also extremely relevant.
e) Apply to join the OECD countries. If OECD approves the request, Brazil would become the largest emerging economy to join the OECD members, as well as the first of the BRICS (Brazil, Russia, India, China and South Africa). This approval will benefit the country in order to attract foreign investors and to enhance its institutions.

Our scenario is backed on the following assumptions:

Our base case scenario is backed in two main assumptions: the new administration's commitment towards a more liberal economic policy and the combination of quasi-ideal conditions in the economy (ie: easier financial conditions along with high level of spare capacity).

As a matter of fact, if the scenario assumptions would be performed, we expect the following results:

a) Increase competitiveness in the economy;
b) Higher competitiveness will increase productivity;
c) The high productivity may keep inflation rate under control and will push up economic activity;
d) A strong economic activity will improve perspectives for profits (pushing up investments) and for tax revenue (reducing fiscal crowding out).

Focusing on privatisation, economic growth, trade openness and improving business environment by resuming microeconomic reforms might strengthen the economic rebound. A strong economy will support President's approval rate at high levels, which may be capitalised politically – Congress might not stay against a popular president.

Scenario – Base case

a) Reforms to increase competitiveness and improve business environment

Brazil is ranked at the 109th position (out of 190 economies) according to the latest World Bank´s Easy of Doing Business Ranking. Although performing below when compared to its relevant peers in Latin America and other major developing countries, Brazil performed well, rising from 125^{th} place in the previous report and getting its best position ever in the ranking. The dimensions that supported such performance is starting a business (from 176^{th} to 140^{th}) and trading across borders (from 139^{th} to 106^{th}).

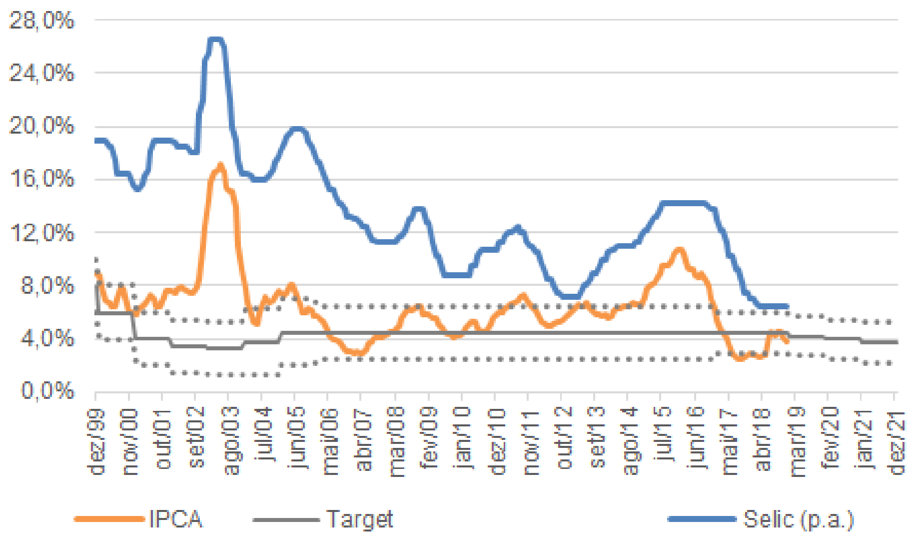
Moreover, Brazil is ranked at 72^{nd} position at the World Economic Forum's Global Competitiveness Index 4.0 2018 edition, falling three places from its 2017 score. On the one hand, Brazil is the largest South America economy and its score for market size is ranked 10^{th}. Brazil has also the leadership in innovation capability drive, yet remains below the potential. On the other hand, Brazil holds a poor trade openness to global markets—reflected in very high import tariffs (12.5% on average, 125th) and high prevalence of NTBs (136th). The lack of policy integration between the public and private sectors is said to be one of the main institutional bottlenecks that hint its performance.

Yet, Bolsonaro's cabinet has made all the right noises towards business environment improvement and public finance stabilisation and if our assumptions might be proved correct, economic activity may recover at strong pace.

b) Better economic fundamentals

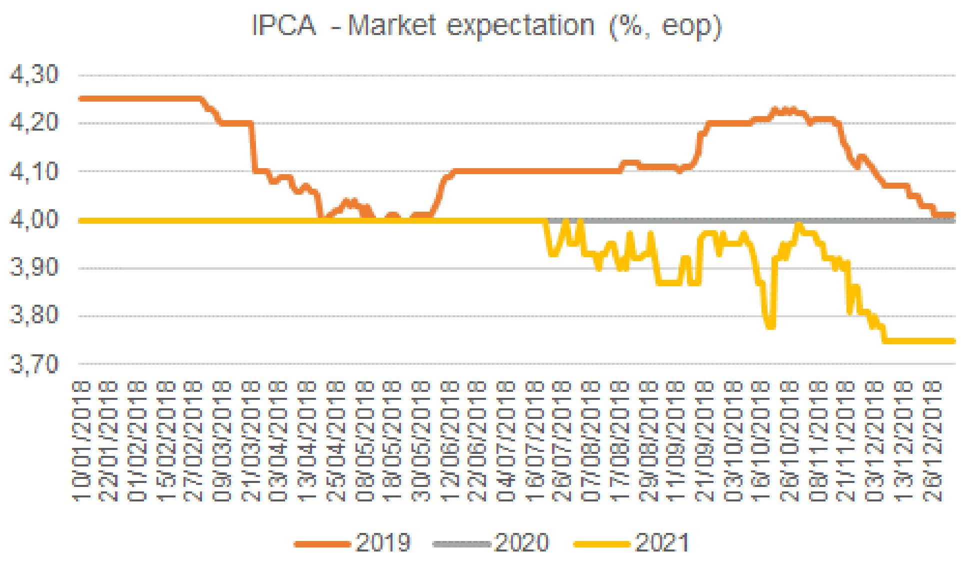
The severe recession Brazil faced in 2015 and 2016 paved the way for a strong decrease in the consumer price index. IPCA has run below the target level over the past 2 years. Moreover, market expectations for IPCA have been well anchored. Given the dovish tone of the Brazilian Central Bank's (BCB's) last statements, the weakness of the latest inflation data shows signs that tightening cycle, if necessary, will be delayed to some moment in 2020. Pinning it down, we argue that the Selic rate expected by market participants seems to be overestimated.

Chart 1 a. Consumer prices and Expected Selic rate



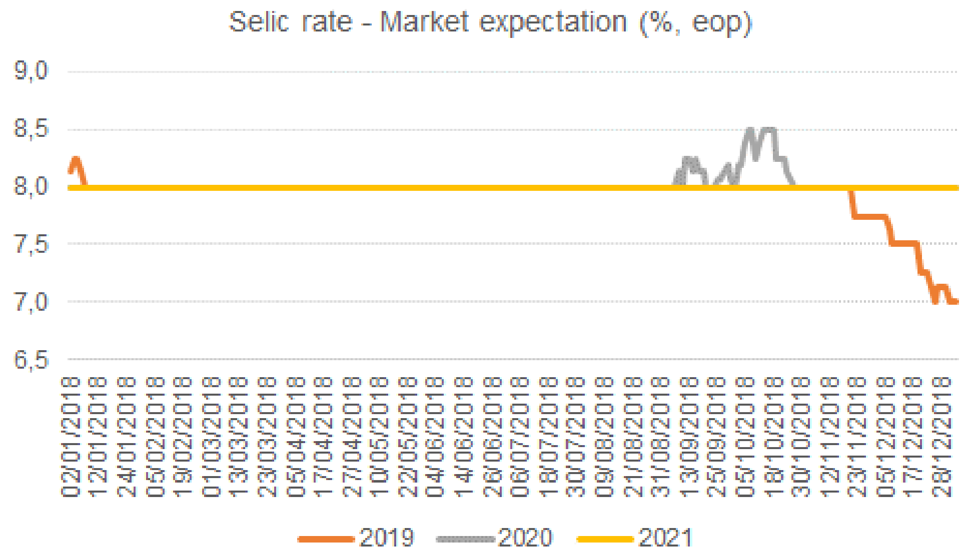
Source: IBGE and BCB

Chart 1 b. IPCA – Market Expectation



Source: IBGE

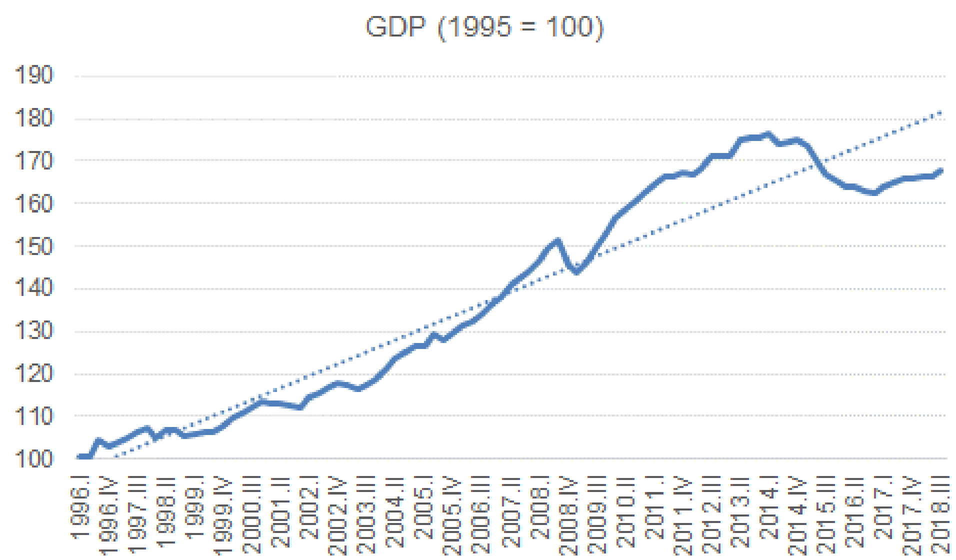
Chart 1c. Selic Rate – Market Expectation



Source: BCB

In terms of the economic activity, GDP has been recovering gradually from its worst recession. Yet the recovery has not been balanced.

Chart 2a. GDP and GDP potential

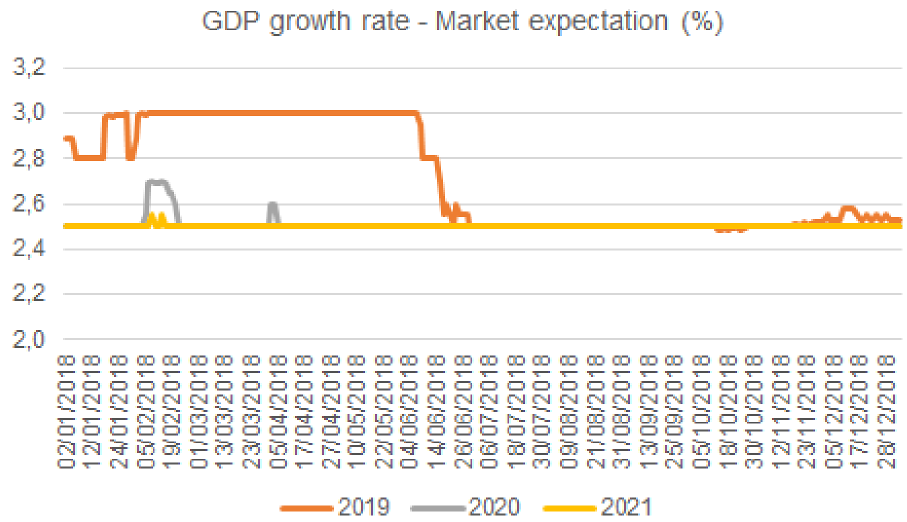


Source: IBGE

The Brazilian GDP is running below its potential, what means that there is an idle capacity. The Brazilian GDP grew 0.8% in 3Q18 in the seasonally-adjusted qoq, slighting under our expectations. Yet, in the year over year comparison, GDP expanded 1.3%, pushed by the industrial growth at 0.8%, services at 1.2% and agriculture at 2.5%.

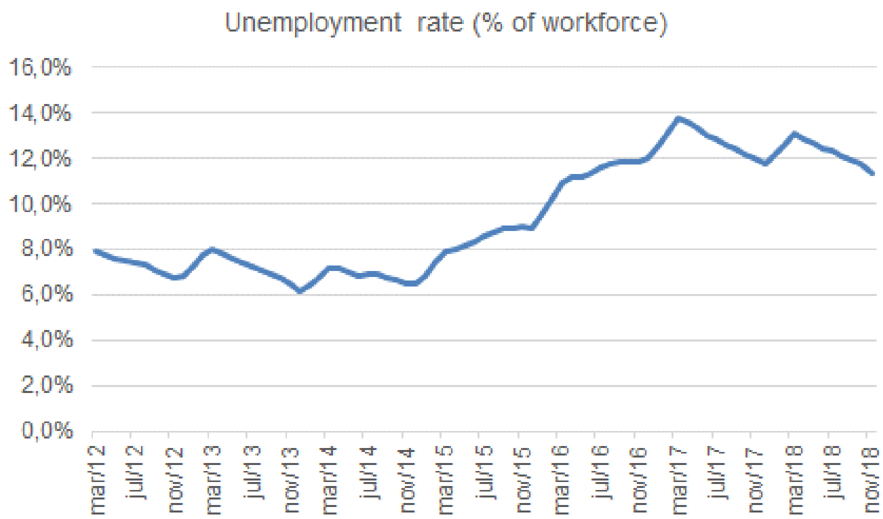
At the pace expected by market consensus, the output gap will narrow only in 2021. We expect the GDP to grow about 3 per cent, per year, in the coming 3 years. Moreover, unemployment rate may bottom in 2022, as follows:

Chart 2b. GDP growth rate



Source: IBGE

Chart 2c. Unemployment rate

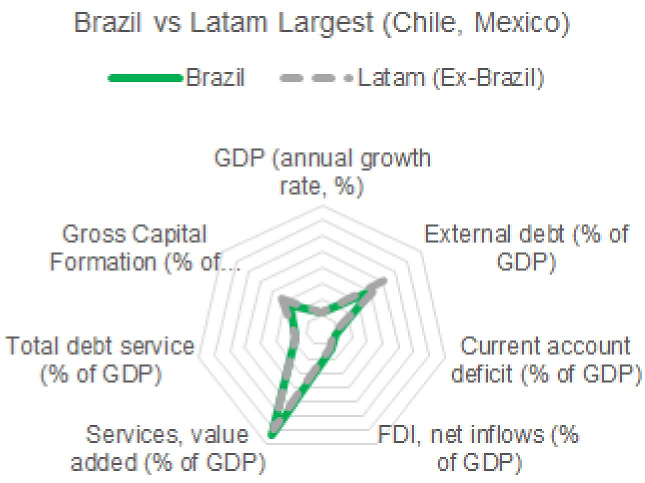


Source: IBGE

Brazil vs Latam vs 'RICS'

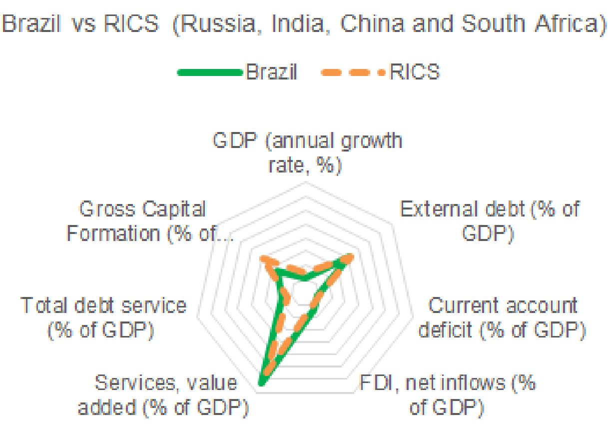
In terms of fundamentals, the Brazil's economic fundamentals have been quite similar when it is compared to its relevant peers (Chile, Mexico, Russia, India, China and South Africa), that hold better sovereign credit rating as well, as follows:

Chart 3a. Brazil vs Latam



Source: Pezco and Valor Pro

Chart 3b. Brazil vs RICS

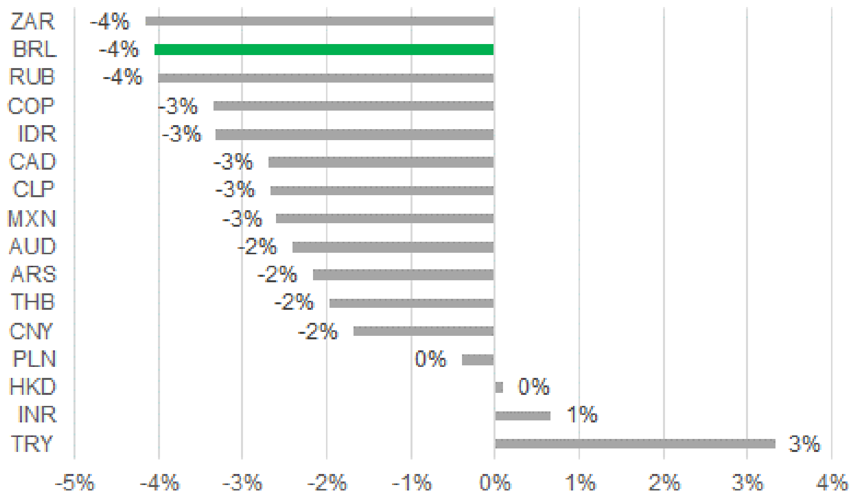


Source: Pezco and Valor Pro

In terms of fundamentals, the BRL has been one of the world´s best-performing currencies in early 2019. BRL has bounced back from a historic low against the US dollar that it reached in September. However, this strengthening movement is more associated to a USD weakening, as observed in other emerging currencies appreciation.

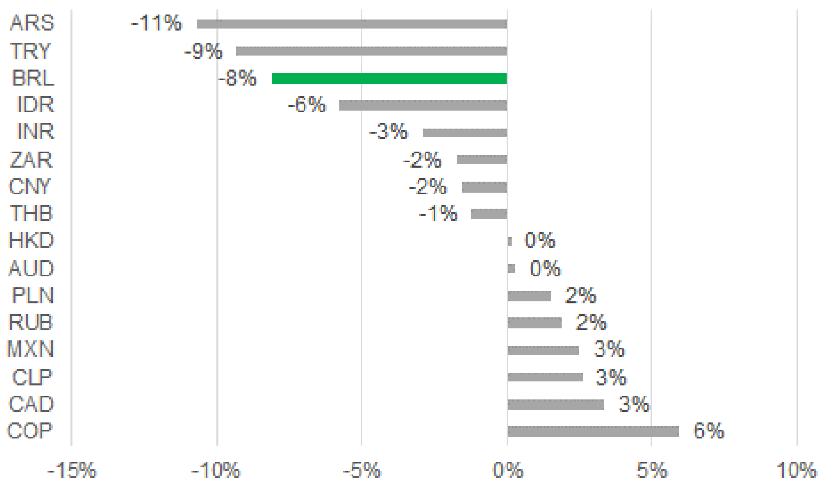
Yet, BRL is still around 60 per cent below its dollar value of mid-2011. If Brazil succeeds in approving Pension reform or other measures that might improve the business environment - such as trade openness and less bureaucracy - BRL might strengthen further against the USD. We forecast the BRL/USD at 3.22, given that scenario.

Chart 4a. Currencies against USD (2019 YtD)



Source: Pezco and Valor Pro

Chart 4b. Currencies against USD (since Sep 30, 2018)



Source: Pezco and Valor Pro

From the demand standpoint, in the 3Q18 the investment in fixed capital grew at 7.8% yoy, or 6.6% qoq/sa, while household consumption increased at 1.4%. Moreover, according to the IBGE, the investment rate reached 16.9% of GDP, while savings stood at 14.9%.

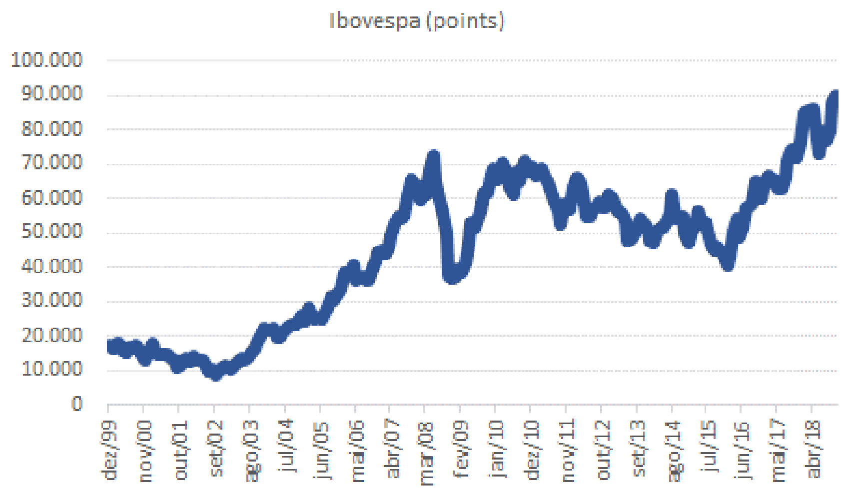
Brazil shows a better picture regarding balance of payments (higher FDI and lower external debt and current account deficit). Yet, the GDP growth rate and Gross Capital Formation has been meager.

What may support the economic growth from now onwards?

We foresee that there have been foundations to foster economic growth over the coming months. This argument has strengthened, given the increase in confidence of the agents, who show a more benign dynamic according to the data released by the National Confederation of Industries (CNI) and the Fundacao Getulio Vargas (FGV).

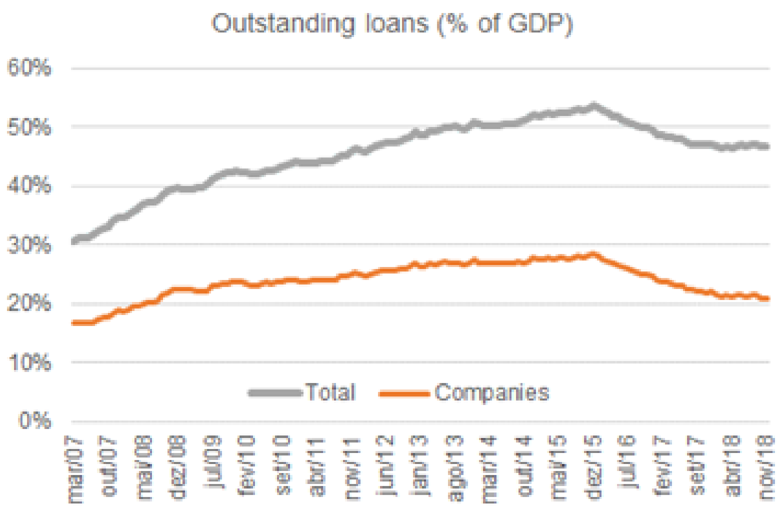
Moreover, the Brazilian stock market index, IBOVESPA has hit a string of record highs over the past fortnight. IBOVESPA reached a new nominal record at 96,000 points.

Chart 5a. Ibovespa



Source: Pezco and Valor Pro

Chart 5b. Liquidity



Source: Pezco and Valor Pro

The severe recession led companies and households to adjust their balance sheets. Corporate outstanding amount of loans shrank back to 10 years ago. The lower leverage and lower cost of capital may encourage companies to resume debt issuance in the coming years, in the context of declining forward interest rates. It is a striking sign to the infrastructure sector.

What may go wrong?

There might have some risks to the base case scenario:

a) Domestic market risks:

The new administration might fail to implement the liberal economic agenda, frustrating the market expectations.

b) Global risks:

In terms of the international scenario, the trade ceasefire agreed by Presidents Donald Trump and Xi Jinping has been challenged by the US trade war and Chinese internal policies. That hit the Chinese consumer sentiment and capital expenditure. Growth in 2018 was 6.6% per cent down from 6.8 per cent in 2017, the lowest level since the country faced international sanctions after the Tiananmen Square massacre. GDP growth rate fell to 6.4 percent in 4Q2018, the lowest level since the Global Financial Crises. Flagging that, growth in China has slowed for 3 consecutive quarters, prompting concern among investors regarding a global drag down in economy. Specialists argue that US tariffs on Chinese exports have not directly imposed enormous harm on the country´s GDP. Yet, the trade battle put a heavy toll on sentiment in consumer spending and capital expenditure.

A US shutdown of the major part of the federal government began on December, 2nd as result of a divergence between Trump and US Congress over funding a wall along the US border with Mexico. This partial shutdown is causing in important agenda plans such as deregulation and other pro-business measures, raising concerns on long-term impacts for business, especially the energy sector. The shutdown may lead the Fed to postpone the tightening monetary policy approach in 2019, and interest rates may be cut in 2020.

There has been a slowdown in the euro-zone. French riots may pose new difficulties to president Macron in order to implement his liberal reforms. In Italy, the fiscal stimulus measures seem to be offset by the higher borrowing costs. In terms of UK, we still foresee that the Brexit uncertainty may endure and it seems it will not be finished soon. The EU tensions over the Brexit deal have emerged again. EU diplomats expect Mrs May to persuade the Labour Party by moving towards a deeper customs union with the EU, rather than asking more concessions on the backstop. The backstop plan keeps Britain in a customs union with the EU and Northern Ireland in even stronger regulatory relationship until any other arrangement between EU and UK might be reached.

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