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Recovery killed before being born

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- **Economic growth in Q1 fairly positive, but risks of slowdown have risen**
- **We cut our 2017 growth forecast to 0.5%, risks still tilted to downside**
- **Policy rate cuts expected to continue**
- **Corruption scandals continue to spread**
- **President Temer expected to stay on until next elections in 2018**

From Lava Jato to Carne Fraca

The impeachment of President Rousseff in August 2016 for violating budget laws has by no means put an end to political uncertainty in Brazil. Quite the contrary: the political turmoil has reached new highs in recent months and President Temer's approval rate has fallen further from 20% in March to below 10% – similar to that of Dilma Rousseff in the last months before her impeachment. The new scandal known as Carne Fraca (weak meat), which involves JBS, the country's largest meat-packing firm, has sparked fresh accusations against politicians including President Temer. Mr Temer allegedly spoke to Joesley Batista – one of the two brothers who own JBS – about cash payments to Eduardo Cunha. Cunha is the former Speaker of the Lower House, who has been imprisoned for his role in the Petrobras corruption case known as Lava Jato. The plea bargains agreed by the two Batista brothers were said to contain talks that incriminate several other leading politicians as well. These include former presidential candidate Aecio Neves (PSDB) and former Finance Minister Guido Mantega.

President Temer expected to stay on until October 2018 elections

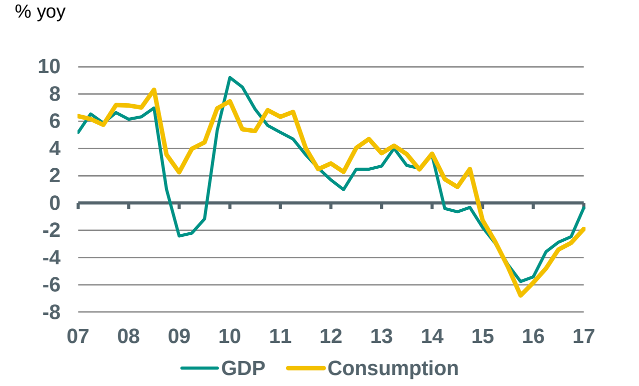
Although his popularity has fallen dramatically, we still believe it to be most likely that Mr Temer will remain in power until October 2018. The Supreme Electoral Tribunal (TSE) voted 4-3 on 10 June not to annul the 2014 elections. TSE has investigated whether illegal campaign funds were used in the 2014 election campaign of President Rousseff and then Vice-President Temer. If the tribunal had voted otherwise, Mr Temer would have had to resign.

There are now three options left for an early end to his presidency. First, President Temer might decide – or be forced by his coalition partners – to resign. Second, he could be impeached. Third, he could be officially investigated by the Supreme Court. The second and third options require a two-thirds majority in Congress to initiate and the coalition partners have sufficient seats to block this avenue. In addition, both procedures are lengthy and costly, and may still be in progress in October 2018, when the next elections are scheduled to be held. Whatever the option, it seems that the centre-right coalition of PSDB and PMDB has more to lose than to win if Mr Temer steps down. But, never say never in Brazilian politics. Yet, even if Mr Temer steps down - be it voluntarily, as a result of an impeachment process or because he is being prosecuted – the current coalition would probably remain in place and a caretaker president would be appointed by the coalition partners. Therefore, it seems valid to assume that fiscal consolidation would continue, although the reform process would slow. This probably also explains why markets overall have remained rather resilient so far.

Meanwhile, on the economic front, Q1 GDP figures were promising

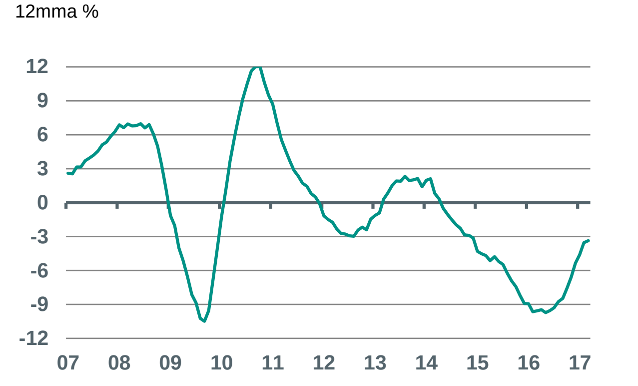
First-quarter GDP growth looked strong (1% qoq and -0.4% yoy) driven by good results for the agricultural sector. The performance in other sectors remained weak. At the demand side, the external sector was the only growth engine, while consumption and investments continued to contract, albeit at a slower pace. Export strength was broad-based, with both agriculture (soybeans) and mining (iron ore) growing sharply, while the export of cars was strong as well. The first data available for the second quarter are also rather positive. Retail sales rose by 1.9% yoy in April, the first positive reading since March 2015. The high rate of unemployment fell marginally from 13.7% in March to 13.6% in April. The April manufacturing PMI rose above the 50 benchmark for the first time since January 2015, followed by a further rise to 52 in May. That said, overall industrial production remains weak, although the speed of decline has steadily fallen. In April, industrial production fell by 4.5% yoy. Still, looking at the 12- month moving average, the decline was -3.4% yoy in April, compared to a fall by 6.6% for the full year 2016.

Slowly moving out of recession …



Source: Bloomberg

Contraction in industrial production is abating



Source: Bloomberg

Fiscal austerity remains essential

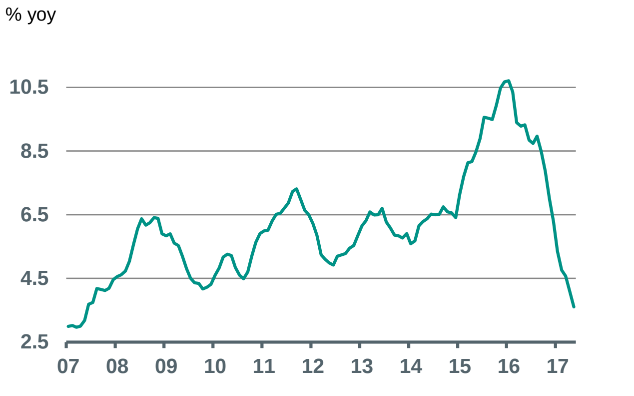
While a strong external position remains an important shock absorber, fiscal austerity remains essential, giving a nominal fiscal deficit, which closed around 10% of GDP last year, and a government debt of around 70% of GDP. A deterioration of the fiscal situation would put the credit rating (currently at Ba2/BB) at risk. This in turn could lead to a stronger fall in the currency and reverse the current decline in inflation, leaving less room for monetary relaxation. Assuming that President Temer will stay in power, or at least that the current coalition will remain in place, overall austerity most likely will continue, but the pace of reforms will slow down. Measures that have already been approved, such as the spending cap, will help to limit the budget deficit as well.

The fact that the coming months will be difficult for the coalition was reflected, however, in the recent rejection of the labour bill by a Brazilian Senate committee. The government nevertheless remains confident that this bill will be approved in the plenary session at a later stage. The labour reform is not a constitutional reform and hence a simple majority will suffice. This is not the case for the social security reform, which requires a two-thirds majority and this seems very unlikely at this point. For this reason, this process is expected to be postponed until after the elections.

Continuing fall in inflation leaves room for further rate cuts

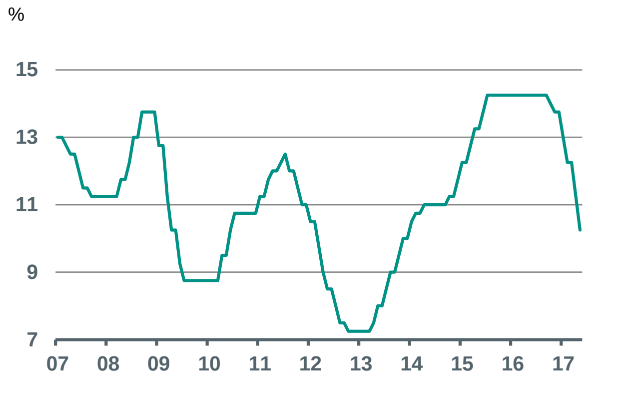
In April, inflation fell to 4.1% yoy, which was below the central target (4.5% +/- 2pps) for the first time since the end of 2009. In May, inflation dropped further to 3.6%. Inflation could even fall further in the coming months, but we expect it to land at slightly below 4% at year end. In this scenario, the central bank will be able to go full speed ahead with monetary relaxation. Overall, this leaves room to lower the Selic rate from its current level of 10.25% to probably 8.5 or 9%. In this base case scenario, the currency will weaken only gradually to around 3.40 in Q3 (with possible spikes to 3.50) and fall back to 3.30 at year end. Rising US Treasury yields are unfavourable to the real. On the other hand, modestly rising commodity prices and the strong external position provide support to the real, (please read also our FX Watch: Near term risks for BRL).

Inflation falls below central target rate



Source: Bloomberg

More rate cuts expected



Source: Bloomberg

However, we have cut our growth outlook for 2017 and 2018

Looking at data for the first half of 2017, the economy seemed to be on track for a growth rate of around 1%. So far, economic data for this year have pointed to a recovery and expected lower rates are a positive for growth as well. We have nevertheless lowered our growth forecast for 2017 to 0.5% given that the political turmoil will most likely postpone a revival in investment, while consumption growth will continue to be hampered by high unemployment levels and the deleveraging process. We have lowered our forecast for 2018 as well, reducing it from 3% to 2.5%. Next year, we expect uncertainty to remain and volatility to flare up now and then in the run-up to the elections. Still, a competitive currency, lower interest rates, rising commodity prices and eventually reviving confidence, will underpin the recovery. That said, looking at all the attendant uncertainties, the risks affecting our growth forecasts remain tilted to the downside.

Key forecasts for the economy of Brazil

	2014	2015	2016e	2017e	2018e
GDP (% yoy)	0.5	-3.8	-3.6	0.5	2.5
CPI inflation (% yoy)	6.3	9.0	8.7	4.0	4.0
CPI Inflation (% eoy)	6.4	10.7	6.3	3.8	4.2
Budget balance (% GDP)	-6.0	-10.0	-9.0	-8.0	-6.5
Government debt (% GDP)	56	65	70	77	82
Current account (% GDP)	-4.2	-3.3	-1.5	-1.5	-2.0
Gross fixed investment (% GDP)	20	18	16	17	18
Gross national savings (% GDP)	16	14	14	16	15
USD/BRL (eop)	2.66	3.90	3.26	3.3	3.0
EUR/BRL (eop)	3.21	4.24	3.44	3.8	3.6

Economic growth, budget balance, current account balance for 2017 and 2018 are rounded figures
Source: EIU, ABN AMRO Group Economics

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