Brazil Watch

Group Economics
Emerging Markets Research

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Marijke Zewuster
Head of Emerging Markets
Tel. +31 20 383 0518
marijke.zewuster@nl.abnamro.com

Georgette Boele
Senior FX Strategist
Tel. +31 20 629 7789
Georgette.boele@nl.abnamro.com

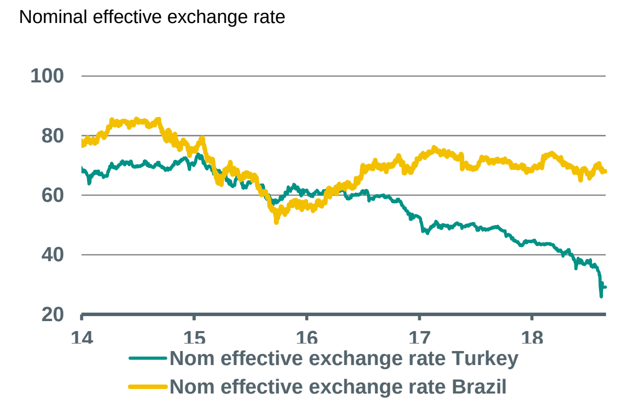
Vulnerable, but not the next Turkey

- **Brazil is facing many external and domestic headwinds**
- **Strong external position will prevent it from following Turkey's fate**
- **May activity figures were impacted by the truck drivers' strike …,**
- **… but June sees acceleration in economic growth**
- **We stick to our growth forecasts for 2018/19 of 1.5% and 2.5%**
- **Higher inflation and currency volatility may force the central bank to raise interest rates soon**

External and domestic headwinds

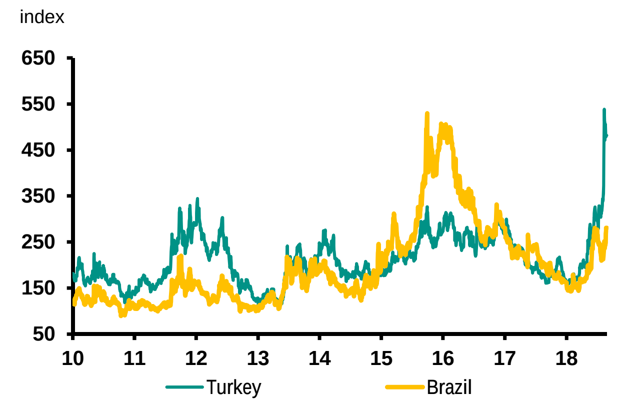
Monetary policy normalisation in the US, fears of rising protectionism and (geo)political tensions have caused significant turbulence in emerging markets in recent months. And the flight to less risky assets also led to a strong depreciation of the Brazilian real. This flight to safety intensified after the recent currency crisis in Turkey and amid rising fears of a business-unfriendly outcome of the October elections. CDS spreads and bond spreads surged further as well. The political situation remains highly uncertain. We are only two months away from the final outcome of the presidential elections, which remains highly unpredictable. Still, we believe that Brazil is less vulnerable than Turkey to a rise in risk aversion caused by either domestic or global headwinds. While Turkey's economy is highly dependent on volatile foreign portfolio inflows to finance an extensive current account deficit, Brazil has a small current account deficit and rather strong foreign direct investment inflows. Inflation is also much lower and real interest rates higher.

Real under pressure but not as much as the lira



Source: BIS, Bloomberg

CDS spreads in Brazil move up, but less than in Turkey



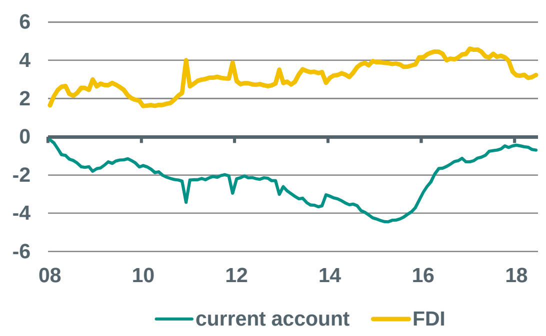
Source: Bloomberg

Brazil's external situation is stronger than that of Turkey

While Turkey has a current account deficit of more than 5% of GDP, Brazil's deficit is less than 1%. With subdued growth continuing and a weaker currency improving Brazil's competitive position, we expect the current account deficit to remain modest next year as well. What is also important is that the current account is more than compensated by the inflow of foreign direct investment. FDI inflows account for over 3% of GDP in Brazil, compared to less than 1% of GDP in Turkey. This makes Brazil far less dependent on volatile capital flows than Turkey. Added to this, FX reserves cover over 15 months of imports in Brazil versus just 3 months of imports in Turkey.

Current account deficit more than covered by FDI

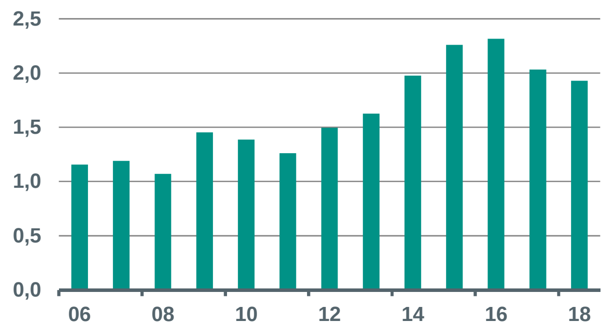
% GDP



Source: Bloomberg

Foreign debt levels are high

Foreign debt/current account receipts



Source: EIU

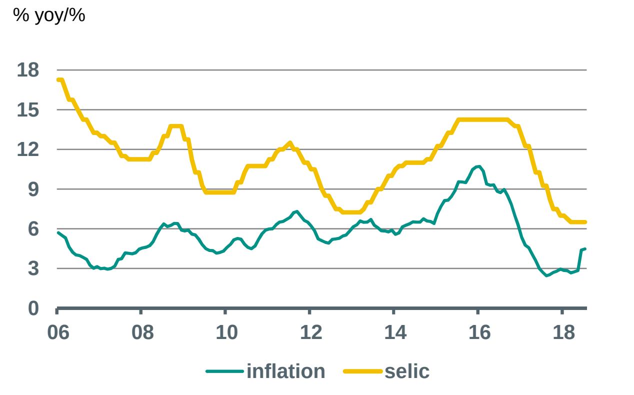
Nevertheless, there are some weaknesses as well. Overall foreign debt-to-export levels are high and comparable to debt levels in Turkey. The foreign debt-to-export ratio stood at 2 end 2017 and at 2.1 in Turkey. A positive factor is that the ratio has been on a downward trajectory since it reached a peak of 2.3 in 2016. An increasing debt-to-export ratio (defined as the ratio of total outstanding foreign debt to the economy's exports of goods and services) over time implies that total debt is growing faster than the economy's basic source of external income. Similar to Turkey, around half of the foreign debt is in the hands of the corporate sector. This relatively high debt service ratio is also comparable to that of Turkey. However, given the declining trend of the debt-export ratio, the much lower current account deficit and the much higher FX reserve position, Brazil's external position remains rather strong overall and an important cushion against external shocks.

Fiscal situation remains a weak spot

While the overall external position is Brazil's biggest asset, the fiscal situation is definitely its weakest spot. The fiscal deficit has been running above 5% of GDP since 2015 and even if the reform process goes full speed ahead after the elections, the deficit will remain elevated in the coming years. Government debt levels have been rising since 2013 and might soon surpass 80% of GDP. This compares to Turkey's more modest sovereign debt level of less than 30% of GDP. Muddling through with the reform process will most likely remain the name of the game after the elections. While this is not the most desirable situation, it is better than a reversal of the reforms. Widening polarisation will make it difficult to achieve the required two-thirds majority to approve the highly unpopular pension reform programme. But it also makes it difficult to find enough support for a reversal of the already approved reforms, like the spending gap.

We therefore think that the fear of radical change after the elections is exaggerated. Our best guess is that if one of the centrist candidates fails to win the elections, we still will see some gradual improvement in the fiscal deficit based on the reforms already in place. With a reform-minded government the nominal public deficit (8% of GDP in 2017) will also decrease only gradually in the short term while the public debt-to-GDP ratio will rise further. This is because it takes several years for savings from a pension reform to become visible. Still, the longer-term debt trajectory would look more favourable should a reform-minded government win. And this is important for the future creditworthiness of Brazil. While the debt-to-GDP ratio will remain too high for comfort in the coming years, the structure of the debt remains solid. Debt maturities are rather long and most of the debt is domestic. Foreign currency-denominated government debt accounts for less than 10% of GDP. Furthermore, interest rates have come down significantly and this has clearly reduced the debt service costs.

Selic might soon need to rise again



Source: Bloomberg

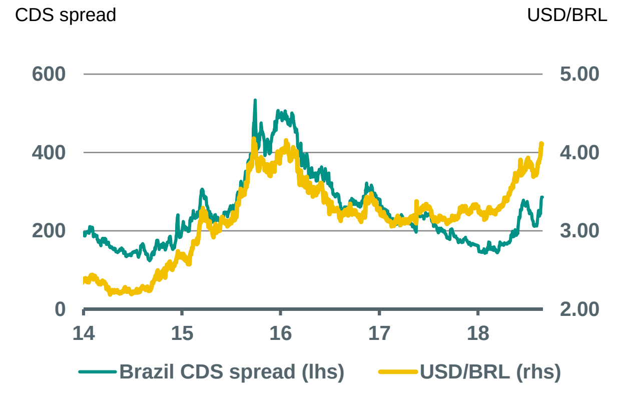
Will interest rates stay at current levels?

While lower interest rates are favourable for the government debt situation, it will be difficult to maintain real interest rates at current low levels without a strong improvement of the fiscal situation. Inflation rose to 4.5% yoy in July, just at the central inflation target. Meanwhile, the SELIC rate has been on hold at 6.5% since the latest rate cut in March. This means that the real policy rate has fallen to only 2%. This is the rate’s lowest level since mid-2013 when the taper tantrum caused a depreciation of the real and the monetary authorities were forced to reverse their monetary loosening cycle and had to hike interest rates instead. While scarcity caused by a truck drivers’ strike in May partly explains the recent rise in inflation, the weaker currency also played a role. In our base scenario we expect inflation to remain subdued. The central bank will remain on hold for the rest of the year and resume a tightening cycle at some point in 2019. However, if – due to a combination of internal uncertainty and global tensions – the currency comes under more and longer lasting pressure than we currently expect, the central bank may intervene by already raising interest rates in the coming months.

FX weakness not justified by fundamentals

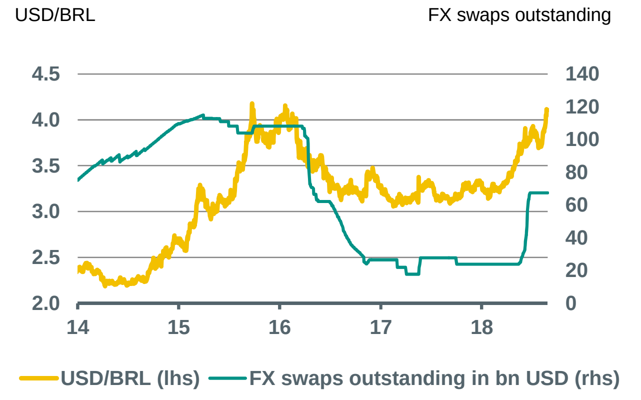
So far this year, the Brazilian real has lost close to 20% versus the USD and is among the weakest emerging market currencies. Only the Argentine peso and the Turkish lira have done worse. Weakness in the real has gone hand in hand with higher CDS spreads; this is partly a reflection of heightened EM risks and partly due to risks surrounding the elections in October. Last week, USD/BRL broke above 4.0 and is challenging the high set in September 2015 (just below 4.25), when there was a crisis in Brazil (2014-2016). The weakness in the real is understandable and largely due to external factors but it is not justified by Brazil's current fundamentals. Indeed, the situation in 2014-2016 was far worse. We think that once the elections are behind us and there is clarity about who will be the new president, currency markets will calm down. This will come at a time when the US dollar will lose some attractiveness and the path of Fed rate hikes for the remainder of 2018 and for 2019 is priced in. In addition, some stabilisation in Turkey, higher commodity prices (which we expect) and a recovery of the Chinese yuan will also help. According to the latest data, the central bank has not recently increased the outstanding FX swaps but we think it will step this up if the real is under pressure in isolation. It is likely that the central bank would like to avoid a break in USD/BRL of above 4.25, because this could trigger more investor selling of the BRL. In short, the real is currently under pressure but the central bank will counterbalance this move by increasing FX swaps and, ultimately, by raising interest rates. Later in the year (after the elections) we expect a recovery of the real thanks to decreased political uncertainty and a less negative external environment. We therefore maintain our forecast for the BRL/USD of 3.70 end-2018 and 3.20 end-2019.

Real moves in tandem with CDS spreads



Source: Bloomberg

FX swaps have not yet been increased

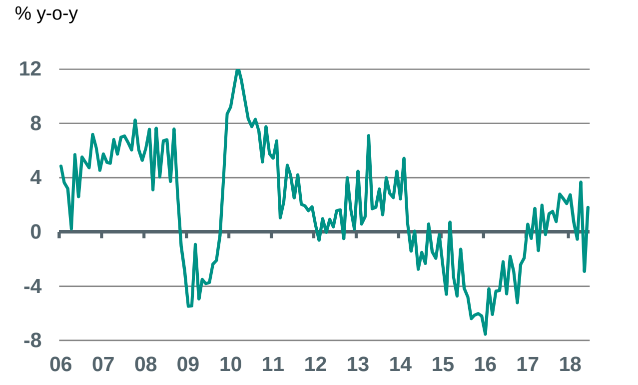


Source: Bloom

Some positive economic figures

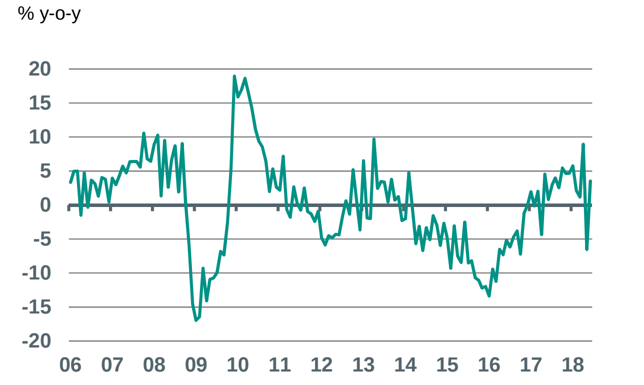
So far, our fear that the truck drivers' strike in May has further undermined confidence seems unfounded. Industrial confidence dropped below 50 in June (the threshold between growth and contraction) but rose to 53.3 in July. Moreover, the manufacturing purchasing managers' index (PMI), which dipped just below 50 in June, moved back to 50.5 in July. The services PMI, which slid to 47 in June, bounced back to 50.4. A strong fall in economic activity was also partly corrected in June. The economic activity index rose 1.8% yoy in June, after a contraction of 2.9% yoy in May. Industrial production, which was hit hardest by the strike, grew 3.5% yoy in June after a contraction of 6.7% in May. Retail sales show a less rosy picture: compared to a year earlier, growth slowed from 2.7% in May to 1.5% in June.

Monthly GDP figure returns to positive territory



Source: Bloomberg

Industrial output moves up again



Source: Bloomberg

The second quarter GDP figures will be published on 31 August. Given the monthly economic activity indicator figures, we expect growth to be around the same level as in Q1, namely 1.2% yoy. In the second half of the year we expect only a minor acceleration of economic growth. Low interest rates and relatively low inflation will be positive for consumer demand, but investments are still held back due to uncertainty about the election outcome and future economic policy. Next year, some of that uncertainty will at least have faded, and we expect the economy to accelerate. But with a tight fiscal policy and a monetary policy that is becoming less accommodative, economic growth of 1.5% in 2018 and 2.5% in 2019 will remain below potential, and not strong enough to make up for the 7% decline in GDP in 2015/16.

Key forecasts for the economy of Brazil

	2015	2016	2017e	2018e	2019e
GDP (% yoy)	-3.5	-3.5	1.0	1.5	2.5
CPI inflation (% yoy)	9.0	8.7	3.4	3.8	4.2
CPI Inflation (% eoy)	10.7	6.3	2.9	4.5	4.0
Budget balance (% GDP)	-8.2	-6.5	-8.0	-7.0	-5.5
Government debt (% GDP)	66	70	74	79	83
Current account (% GDP)	-3.3	-1.3	-0.5	-0.5	-1.5
Gross fixed investment (% GDP)	18	16	16	16	17
Gross national savings (% GDP)	14	14	15	15	15
USD/BRL (eop)	3.90	3.26	3.31	3.7	3.2
EUR/BRL (eop)	4.24	3.44	3.97	4.3	4.0

Economic growth, budget balance, current account balance for 2018 and 19 are rounded figures
Source: EIU, ABN AMRO Group Economics

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