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Brazil Watch

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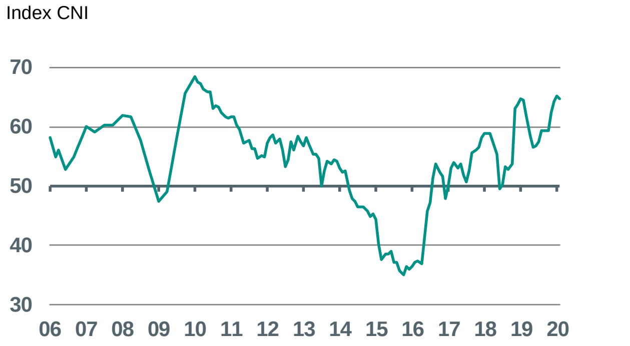
Recovery continues to disappoint

- **Coronavirus will impact Brazil as well**
- **Still, a slight acceleration in growth is expected in 20/21**
- **BRL expected to remain weak**
- **Emergency rate cut could increase downward pressure on BRL**
- **Downward risks remain considerable**

2019 was another disappointing year

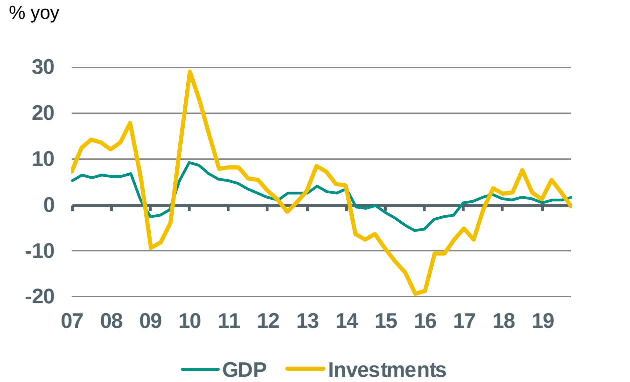
At the beginning of 2019, we thought that after a number of years of recession and, subsequently, a very disappointing recovery, growth in Brazil would finally pick up. However, the recently published definitive figures for the last quarter show that growth for the whole of 2019 was only 1.1%, even marginally lower than the 1.3% growth rates in 2017 and 2018. Three years after the strong contraction in 2015/16, just slightly more than half of the loss has been compensated. Hence, overall total GDP remains below pre-recession levels. External causes like the trade war and the economic collapse in Argentina only offer a partial explanation of this disappointing development. The wait-and-see attitude of investors during far-right president Bolsonaro's first year in office was another clear reason. Added to this are the scandals concerning his sons, tensions between the president and Congress as well as between him and the architect of his liberal economic plan, Paulo Guedes and other allies. The pro-market reform agenda has progressed only slowly, with the final approval of the pension reform last October as the most important milestone. This all have raised doubts about the decisiveness of the government and governability in general. Risk aversion, contrary to expectations, remained high in most of 2019 and confidence low.

Business confidence rises



Source: Bloomberg

Investments and overall growth remain subdued

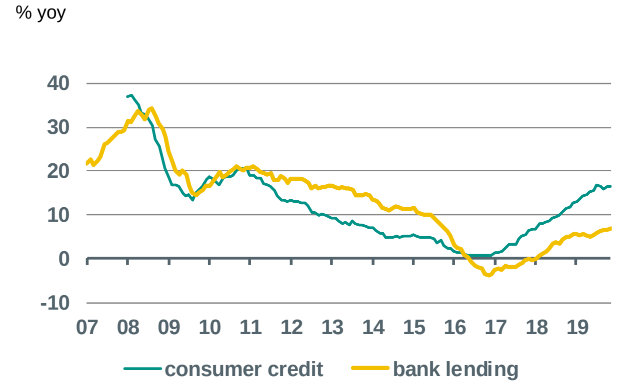


Source: Bloomberg

Coronavirus will impact Brazil as well

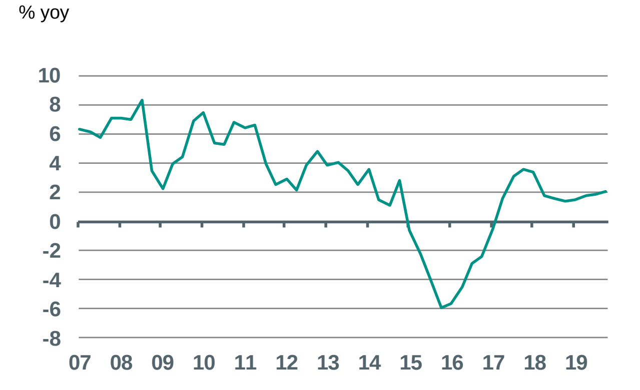
The starting position for 2020 looked fairly decent. The long-anticipated pension reform was approved, interest rates stood at historic lows and the prospects of a truce in the trade war between the US and China were good. On top of that, the rating agency Standard and Poor's raised its outlook for Brazil's BB sovereign rating from neutral to positive at the end of 2019. This all led to a marked improvement in business confidence and a further improvement in consumer confidence. The ingredients appeared to be in place for a final take-off after three years of sluggish recovery, until the coronavirus outbreak started to impact global markets. Global financial conditions tightened again, commodity prices weakened and global demand began falling. The real has plummeted, the stock market tumbled and CDS spreads have once again risen above 100 bp.

Consumer credit is up again...



Source: Bloomberg

…underpinning private consumption growth



Source: Bloomberg

In light of the coronavirus outbreak, we have adjusted our growth forecasts for China, the US, eurozone and several emerging markets down and as the outbreak continues to unfold, risks to our scenario are definitively still tilted to the downside. For changes in our global forecast see our report: Global Monthly – Corona shock deeper and longer for weakened global economy. All this weighs on the Brazilian economy as well. China is an important market for Brazilian commodities, such as iron ore, oil and soybeans, with nearly 30% of total exports going to China. Less demand and, as a consequence, temporarily lower prices for export products, not only affect growth but can also cause the current account balance to deteriorate further. In addition, almost 20% of Brazilian imports come from China. This also concerns many semi-finished products. A temporary cessation of deliveries can therefore have an adverse effect on the manufacturing sector, which is important for Brazil. Aside from China, the US and Europe are also important trading partners. On the other hand, Brazil is a relatively closed economy, with exports and imports together accounting for around 35% of GDP. This compares to a much higher share of 65% for a commodity exporter like Chile, for which China is also more dominant as an export destination.

We remain cautiously optimistic for 2020 and 2021…

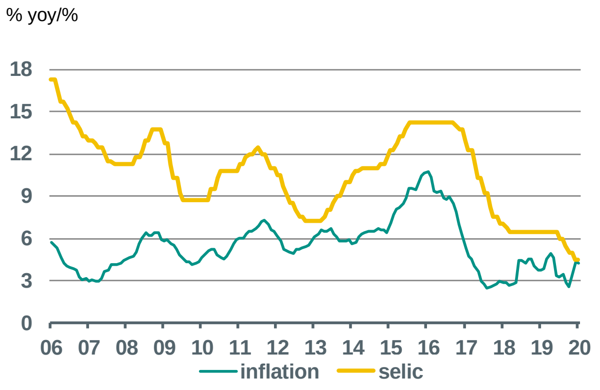
Despite the disruptive impact of the coronavirus, some of the reasons behind the positive starting position for this year still hold. Low inflation and interest rates will continue to boost credit growth, which will support consumer demand. Consumer credit rose from less than 3% in 2017 to almost 15% in 2019. Private consumption has been the main driver of growth in recent years, even though unemployment remains uncomfortably high. Last year, private consumption grew 1.8% and - given an even more accommodative monetary policy this year - we expect growth to accelerate slightly in 2020. Government expenditure will continue to be restrictive, but we expect progress on the reform front to be limited. Municipal elections in October 2020 are not only a test case for Bolsonaro's popularity but will also make most members of Congress reluctant to agree with measures that are not highly popular.

However, the biggest question remains whether investments will finally also pick up. So far, investments have continued to disappoint and even contracted by 3.3% in the last quarter of 2019 compared to the previous quarter. During the last three years, only 6% of the almost 30% decline in capital investment in 2015/16 has been recovered. This is also reflected in an investment-to-GDP ratio which has remained below 20% since 2014. Although not rocket science, it seems that a level of at least 20% is a prerequisite for a sustainably stronger growth trajectory. While industrial confidence as measured by the CNI remains clearly above the 50 threshold, this has not yet translated into a rise in investment. Given that uncertainty is rising, there is a clear risk that, despite low interest rates, investments will remain subdued. While credit to consumers has risen strongly, credit to corporates stayed flat. Another uncertain factor is the external sector. Last year, exports declined by 2.5%, but in the last quarter exports picked up slightly compared to the previous quarter. A weaker currency is positive for exports, but the timing of when this will translate into a stronger rise is very dependent on how long demand for export products will be subdued due to the coronavirus. All in all, we still expect growth to improve slightly from 1.1% in 2019 to around 2% in 2020 and 2021.

…but risks of lower growth have risen

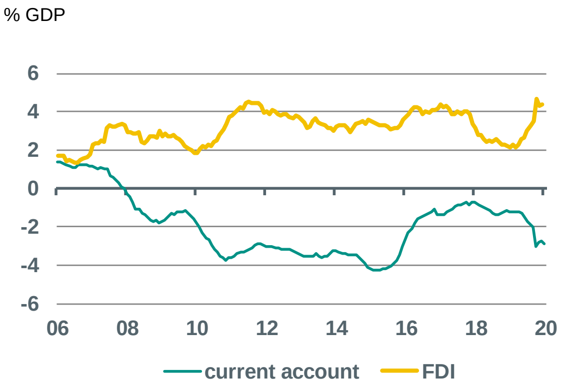
The risks to our base scenario are high. In a slightly less benign scenario it is easy to see growth staying around current levels. For starters, a lot of structural problems, such as the poor state of the infrastructure, low savings and investment ratios and low labour productivity will continue to temper growth prospects. Second, if the demand fallout for Brazilian export products worsens and commodity prices stay low for longer, this will also have a more serious impact on domestic demand. While last year's wave of social unrest in most of the Spanish-speaking part of Latin America did not have much impact on Brazil, social discontent is still an issue. Widespread income inequality and poor government provisions play a role in Brazil as well and austerity measures will not help to improve this. Meanwhile, there is the possibility of a scenario in which the virus spreads more rapidly in Brazil. On the other hand, there are signs that activity is Chine is already picking up. A strong acceleration of exports to China could give a boost to confidence and ultimately lead to a stronger pick-up in investments. This is more likely if accompanied by some fresh successes on the reform front, like the approval of the tax reform.

Real interest rates at all-time low



Source: Bloomberg

Current account has weakened, FDI remains strong



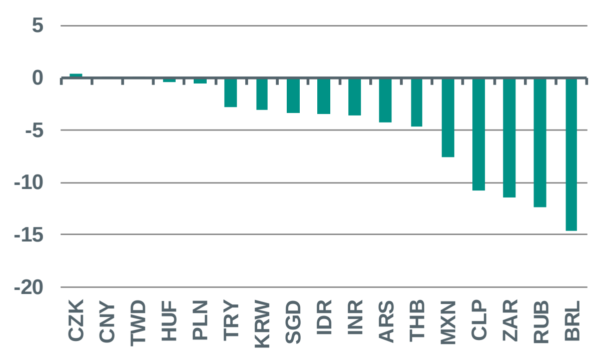
Source: Bloomberg

A further rate cut could be a risky move

Brazil's very slow recovery has kept inflation subdued in recent years and below the central inflation target for most of the second half of 2019. This, together with a strong external position, has created scope to push ahead with further interest rate cuts. The key rate was lowered from 14.25% in October 2016 to a historic low of 4.25% in February. With more easing on the cards in the developed economies due to the corona outbreak, most analysts now expect another 25 bp so-called "emergency" rate cut in Brazil as well. We think this might be a risky move. The impact of a further rate cut on economic growth is probably limited, while there is a clear risk that this will lead to a further weakening of the currency, which is already under pressure due to increased risk aversion. If this happens, Brazil could be forced sooner rather than later to reverse the rate cut and raise rates further.

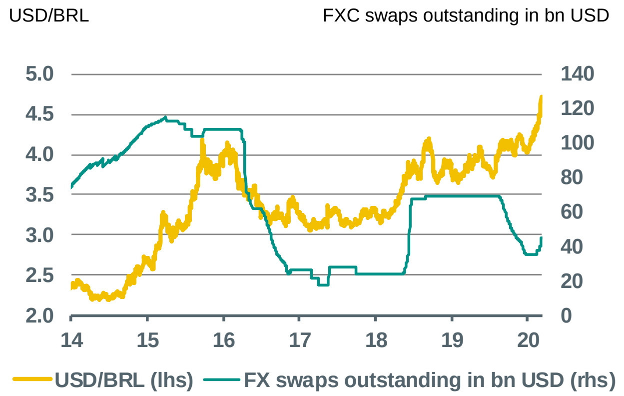
In addition, while inflation remains low in Brazil, it did jump from 3.3% yoy in December 2019 to 4.3% in January 2020 and 4.2% in February. While this is still around the central inflation target for 2019 of 4.25%, it means that real interest rates are now close to zero. The country only approached this level in 2013. Back then the central bank quickly needed to reverse course to counter rising inflationary pressures. While the current low growth levels should mean inflation pressures remain subdued, there is a risk that a persistently weak currency would lead, at minimum, to some further upward pressure. This is even more likely if it occurs in combination with scarcity due to the coronavirus. The current account has also deteriorated in recent years, with the deficit rising from -0.7% of GDP in 2017 to close to -3% in 2019. This makes the country more vulnerable to a reversal in capital flows, even though FDI inflows currently remain strong and are still more than sufficient to cover the deficit.

Real is worst performing currency



Source: Bloomberg

FX interventions dampen sell-off



Source: Bloomberg

FX will remain weak

Since the start of this year, the Brazilian real has weakened by more than 14%, making it the weakest currency in the EM FX sphere. Initially, the real was out of favour due to more country-specific factors, but since the coronavirus outbreak starting unnerving investors, emerging market currencies have been hit hard. USD/BRL has rallied to a new all-time high of just below 4.80. Financial markets have roughly priced in our scenario of rate reductions by the Fed and the ECB. We expect markets to remain risk-off in Q1 and Q2. Emerging market currencies, including the real, will probably decline given that weaker global growth and the risk-off environment are negative for these currencies. The Brazilian FX authorities have been reluctant to intervene in FX markets to support the real via FX swaps. But when the real weakened to a new all-time low, they appear to have once again supported the currency via FX swaps. The graph above shows that FX swaps have recently picked up from a low level. The authorities have ammunition to support the real, but they will likely be more willing to intervene if it is weakening more than other emerging market currencies or if the sell-off is extremely brutal. We therefore expect the real to remain weak in Q1 and Q2, while FX interventions will likely dampen the weakness. As a result, we have lowered our forecasts for the real. Our new USD/BRL forecasts are 4.75 for Q1 and Q2, 4.6 for Q3 and 4.5 for Q4.

Key forecasts for the economy of Brazil

	2017	2018	2019e	2020e	2021e
GDP (% yoy)	1.3	1.3	1.0	2.0	2.0
CPI inflation (% yoy)	3.4	3.7	3.7	4.3	3.5
CPI Inflation (% eoy)	2.9	3.7	4.3	3.9	3.7
Budget balance (% GDP)	-8.9	-6.9	-5.7	-4.5	-4.5
Government debt (% GDP)	74	77	78	79	78
Current account (% GDP)	-0.7	-2.2	-2.7	-3.0	-3.0
Gross fixed investment (% GDP)	15	15	16	16	17
Gross national savings (% GDP)	14	13	14	14	14
USD/BRL (eop)	3.31	3.87	4.03	4.5	4.0
EUR/BRL (eop)	3.97	4.44	4.53	5.2	4.8

Economic growth, budget balance, current account balance for 2019, 2020 and 2021 are rounded figures
Source: EIU, ABN AMRO Group Economics