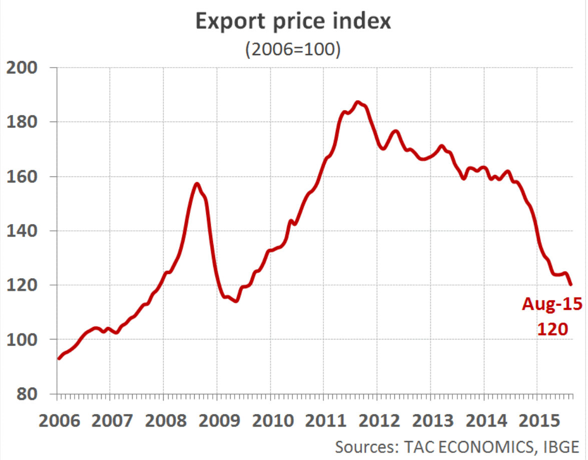
Brazil gets pulled into vicious circles with deepening economic contraction and persistent financial risks

This was one of the worst week for Brazil, when news on a massive -4.5% GDP contraction in 2015Q3 combined with the start of the impeachment procedure against President Rousseff and the arrest of prominent banker Esteves, Chairman of BTG Pactual bank in the background of the Petrobras corruption scandal. Indeed, negative forces are gathering steam and no immediate reversal should be expected, at least in economic growth. In parallel, the currency and domestic financial markets remain sensitive to both the very negative economic performances and the forthcoming monetary tightening in the US. We will have to wait at least another 2 to 3 quarters before seeing initial signs of improvement.

Economic activity entering a vicious circle

The initial blow to Brazil's economic performances came from the external sector: first came the Fed's "tapering announcement" in 2013H1, which led to brutal currency depreciation (although this was long overdue, from a competitiveness perspective - see further below); then, the impact of a slowing Chinese growth and tepid international trade was felt on export volumes and more critically on the prices of most commodities exported by Brazil. As shown in the following chart, Brail's export prices plummeted by 25% over the past 12 months and by more than 35% since the peak in August 2011.



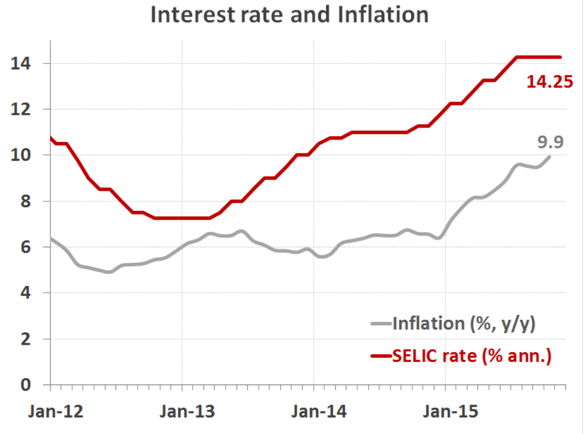
Sources: TAC ECONOMICS, IBGE

The impact was magnified by the subsequent cuts in investment spending by large mining companies, reinforced by the freeze in Petrobras' capital expenditures after the corruption scandal erupted.

Until earlier this year, some resilience was found in consumer demand and a stable labor market.

The situation worsened again when overall risk aversion vis-à-vis Emerging Markets (EMs) increased and the currency depreciated further. The pass-through of the depreciation to import and then domestic prices added to large adjustments in administered prices, pushing headline inflation far above the central bank's target of 4.5% +/-2%.

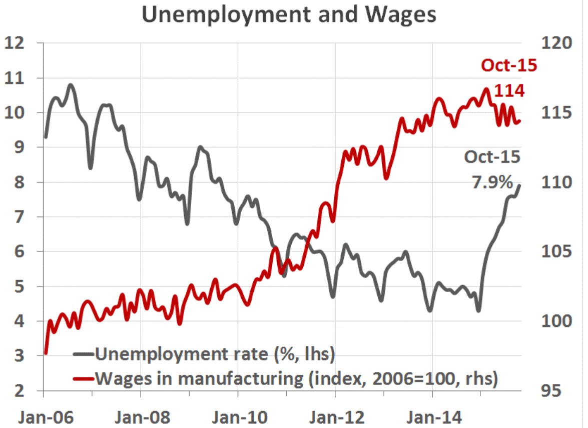
In parallel, the political situation deteriorated rapidly, with the impact of the recession and the deepening of the corruption scandal around Petrobras; to counter the impact on international confidence and to ensure its long-term credibility, the authorities raised rapidly the Selic policy rate, therefore weighing down further on activity.



Sources: TAC ECONOMICS, Datastream

The further economic slowdown in turn had negative consequences on fiscal revenues, and the "policy credibility" imposed another round of fiscal tightening on a rapidly contracting economy. Public accounts continued to deteriorate as the country moved into recession in a context on increasing political uncertainty, and the downgrade of the sovereign rating to speculative by S&P further dampened international investors' confidence.

As expected, this has now substantially depressed the labor market, with stable nominal wages dented by inflation and a sharp increase in unemployment.



Source: TAC ECONOMICS, Datastream

The international and regional environment will continue to be negative

Brazil is suffering from a particularly negative international environment, with high sensitivities to most of the negative forces currently at work on the international stage:

- Among commodities, iron ore is probably the one suffering most from excess capacities as major new Australian projects came on stream at a time of substantially lower Chinese demand, and our quantitative analysis suggests that this will be the last to benefit from an upward reversal, indeed very unlikely in 2016.
- For agricultural commodities (soybeans, coffee), prices have held up better, but this is partly related to the expected impact of the weather event El Niño on physical supply as the current drought conditions in Asia and heavy rainfalls expected in Latin America later this year and early 2016 are likely to reduce production volumes: the net effect for Latin American producers and exporters like Brazil is therefore likely to be minimal at best.
- The election of President Macri in Argentina is likely to prove negative for Brazil, at least over the short-term: the new administration will have no choice but engineer a sharp devaluation of the Argentine Peso accompanied by a heavy dose of domestic austerity, two developments that will weigh on Brazilian exports (Argentine accounted for 6.5% of total Brazilian exports in 2014, almost 10% over 2005-2013).
- Last but not least, Brazil is highly sensitive to US monetary policy developments: our "reaction functions" that are capturing the traditional central banks' interest rate reaction to economic developments show that (1) the gap between targeted and actual inflation has a major weight in the Banco Central do Brasil (BCB) interest rate setting decisions, and (2) that the transmission of US Fed Funds is almost 1, i.e. a 25 bp increase in Fed Fund rates is usually associated with a similar increase in the Selic rate whatever domestic conditions would suggest.

BCP Reaction Function: coefficient of key variables

Inflation (gap with target)	GDP (output gap)	Fed Fund Rate US
2.55	1.05	0.95

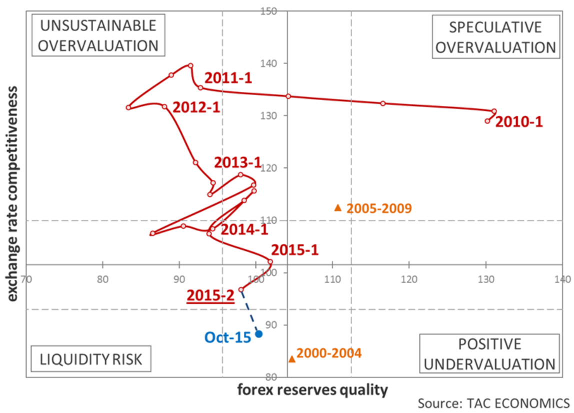
Source: TAC ECONOMICS

Overall, Brazil is now facing a poor international environment, "over-kill" economic policies, near-zero confidence and deteriorating income: until and unless you can highlight a "growth engine" that can counteract such a negative combination, it means a further contraction in economic activity, and by ricochet a highly vulnerable financial situation.

Manufacturing exports and inflation decline are the only factors for a positive economic reversal

In this gloomy perspective, we should not forget that the Brazilian economy is in the middle of its cyclical adjustment, and that all adjustments bear fruits in due time. Brazil has a large industrial base capable of reacting to changing pricing and demand signals. Our Foreign Exchange Balance indicates that the country's exporters are now enjoying a visible (even though not yet massive) competitive advantage, which will push Brazilian manufactured goods in foreign markets and enhance market shares for domestic producers competing against imported goods and services.

Foreign Exchange Balance



Source: TAC ECONOMICS

The current account is therefore likely to improve, gradually over the next few months and more visibly during 2016. This can already been seen in tentative reversals noted in surveys to companies, where expectations have started to pick-up after the lows of the past few months.

The other element that will trigger the positive reversal is related to inflation: not only is the economic contraction and increase in unemployment going to weigh down on inflationary pressures, but we will not have any significant change in administered prices over the next few quarters; as such prices have increased by more than 15% in 2015 and account for almost a quarter of the total inflation index, headline figures should start moving downwards during 2016, enabling monetary policy to start easing… after what will probably be another 25-75 bp increase over the next few months.

The next two quarters are therefore likely to see more bad news on the economic front and occasional bouts of weakness for the Brazilian Real (BRL), which our tools see oscillating in a large range of BRL 3.70 – 4.20 against the USD. Cyclical indicators should then start to improve modestly and the currency would then stabilize.

In such circumstances, risks are moving progressively from the currency to social and political events and likely tensions, themselves able to create bouts of financial volatility.