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1st QUARTER
2016

Economic Outlook

Brazil

The global economy will continue to grow, but more slowly and with more risks. Uncertainty about China remains and recovery in advanced economies will be fragile. Risks around the baseline scenario were behind increased market volatility in January and February. In addition, commodity prices suffered significant corrections

The prospects for the Brazilian economy continue to worse. The crisis is still far from its end. A solution to Brazil's fiscal problems seem to be far away and economic activity is poised to weaken, further, contributing to maintain political tensions alive. Moreover, the impeachment proceedings and corruption scandals will continue on the spotlight, keeping uncertainty very high, making more difficult a fiscal adjustment and therefore impacting negatively economic activity

Activity will contract sharply again and inflation will remain above the target range in 2016. We expect GDP to fall 3.0% in 2016. Prospects for 2017 are less negative, as uncertainty should decline once the congress takes a decision on the impeachment of President Rousseff, and as terms of trade are expected to increase. Inflation should moderate gradually going forward after, however relatively high indexation, among other factors, will prevent it to converge to within the target range in 2016

Fiscal deterioration will likely persist in 2016 and 2017, as fiscal problems are expected to remain unaddressed. The BCB is expected to keep the Selic unchanged until the end of the year and then start an easing cycle in 2017. Even though maintaining inflation under control and adopting a fiscal adjustment seem to continue to be among the government's main objectives, there is a risk that these goals are not properly prioritized, which would extend the crisis even longer

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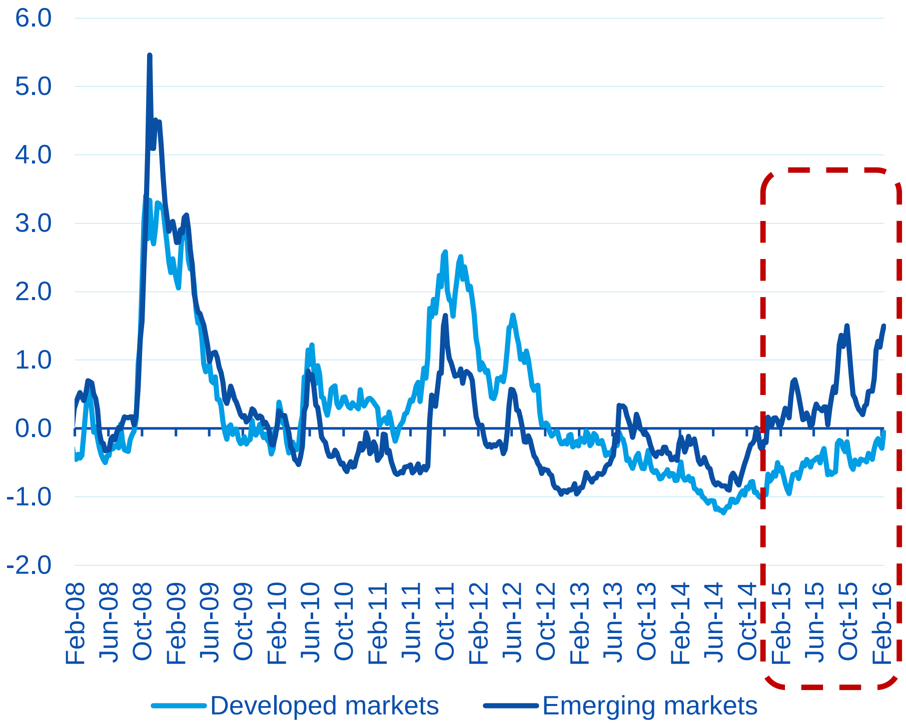
Global

Global economy will continue to grow,
but more slowly and with more risks

Financial stress increased significantly in emerging economies

BBVA Financial stress index



Source: BBVA Research

Financial stress increases again in the last quarter. especially in emerging economies

Capital flows rebalancing towards advanced economies

Market pressure on countries more dependent on external financing and commodity exporters

How to read recent market volatility?

Is it a delayed response to Fed's rate hike

Unlikely: Fed's liftoff was already priced in by markets. If anything. markets now expect a more gradual pace of rate hikes going forward.

Is global growth being revised down?

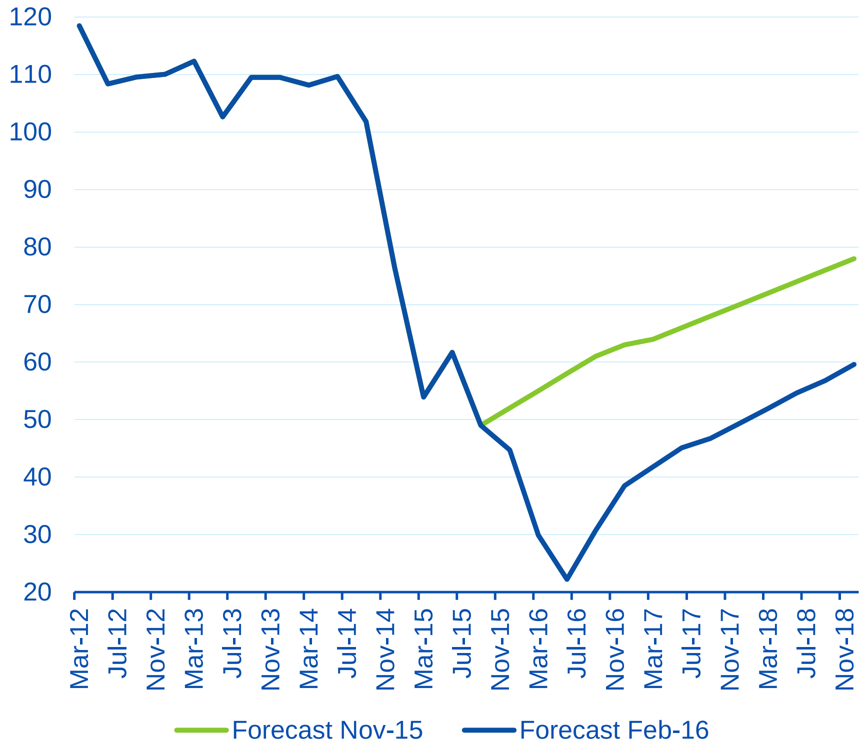
Unlikely: recent hard data do not show significant changes from expected path. except in a few emerging economies.

Is a risk scenario now more likely?

Probably: uncertainty about China (grwoth rebalancing and exchange rate policy) and fall in oil price could have second-round effects (vulnerability of oil companies and oil-exporting countries)

Oil prices have adjusted driven by supply and demand factors (Box 1)

Brent oil: (USD/b)



Source: BBVA Research and Bloomberg

Prices fell recently on:

1. Lower demand (weather)
2. Resilient supply (US shale. OPEC reluctance to cut production quotas) Uncertainty about future demand (China) and future OPEC behavior

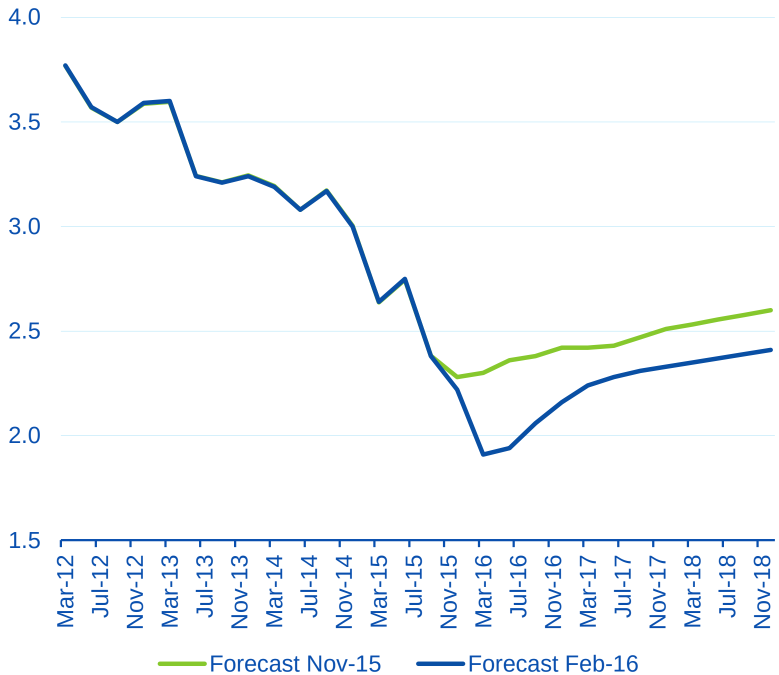
Prices may adjust even further in 1H16 (OPEC. Iran. resilient USshale) and doubts about Chinese growth

Gradual rebound in 2H16 as non-OPEC supply falls (lower investment. lower financing)

Convergence to 60 USD/b as oil oversupply is reduced

Other commodities linked to the cycle have been affected, but not as strongly

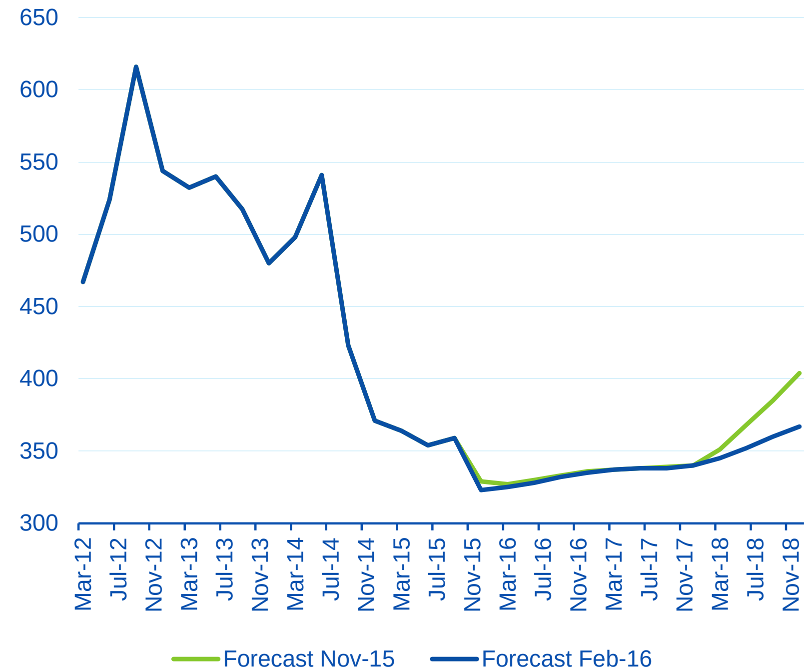
Copper: (USD/lb)



Source: BBVA Research and Bloomberg

Copper prices dragged by concerns about global growth and the derivatives market…

Soybeans: (USD/tm)

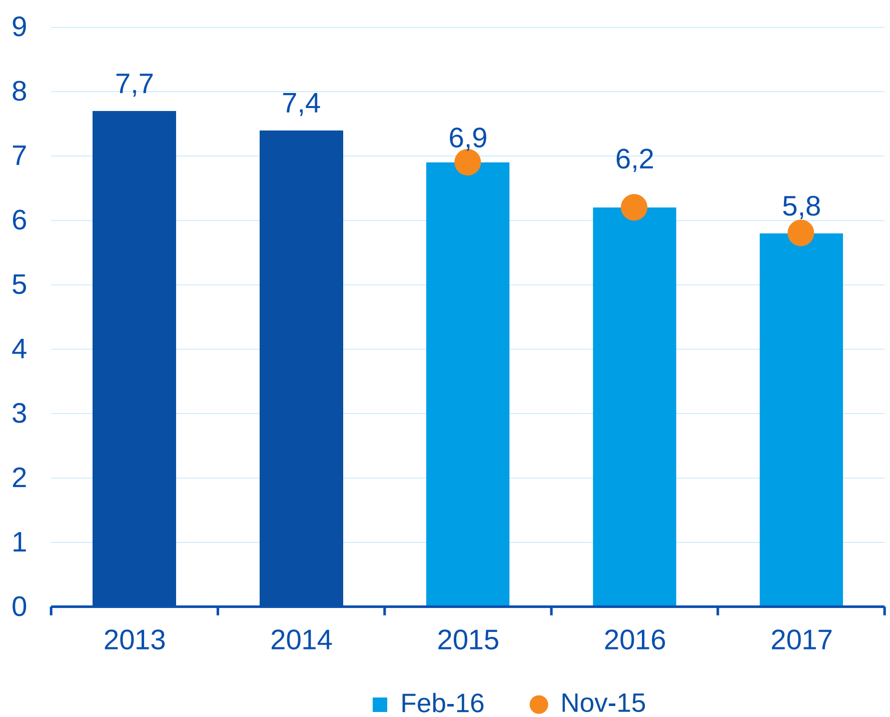


Source: BBVA Research and Bloomberg

… whereas soybean prices. less affected by growth rebalancing in China have evolved as expected

China: deceleration as expected. but increased uncertainty

China: GDP growth (%)



Source: BBVA Research

Central scenario: gradual. controlled deceleration to 6% in 2016-2017. driven by lax economic policies. including the exchange rate

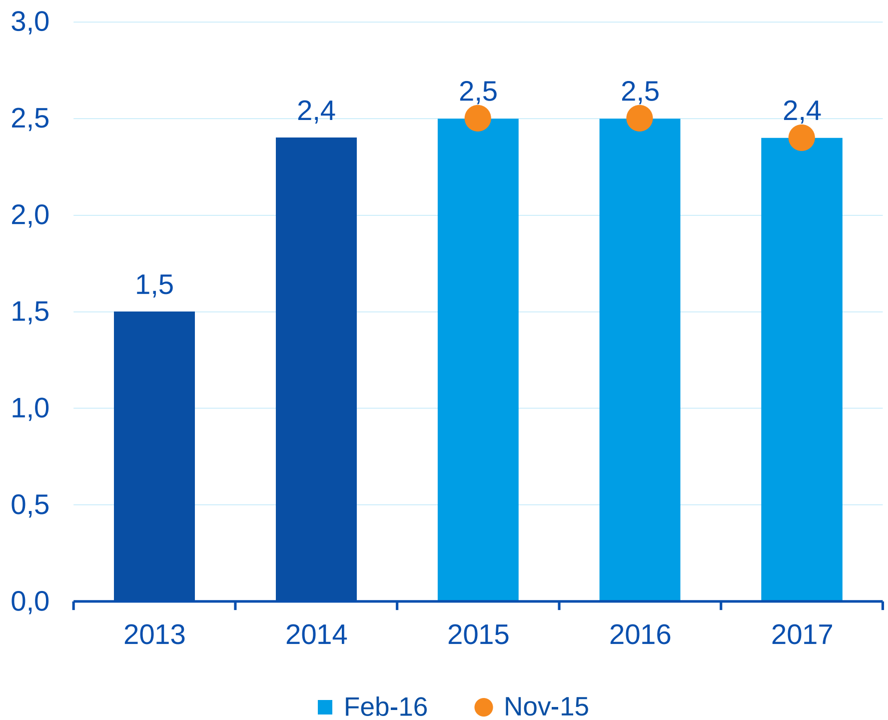
… but there is significant uncertainty on:

1. Ability to successfully manage the transition to lower and more balanced growth
2. Exchange-rate policy and incentives to capital outflows

More likely that doubts about exchange-rate policy will vanish sooner than doubts about authorities' ability to engineer a successful transition to lower growth

US: growth around 2.5%. supported by consumption.

US GDP growth (%)



Source: BBVA Research. BEA

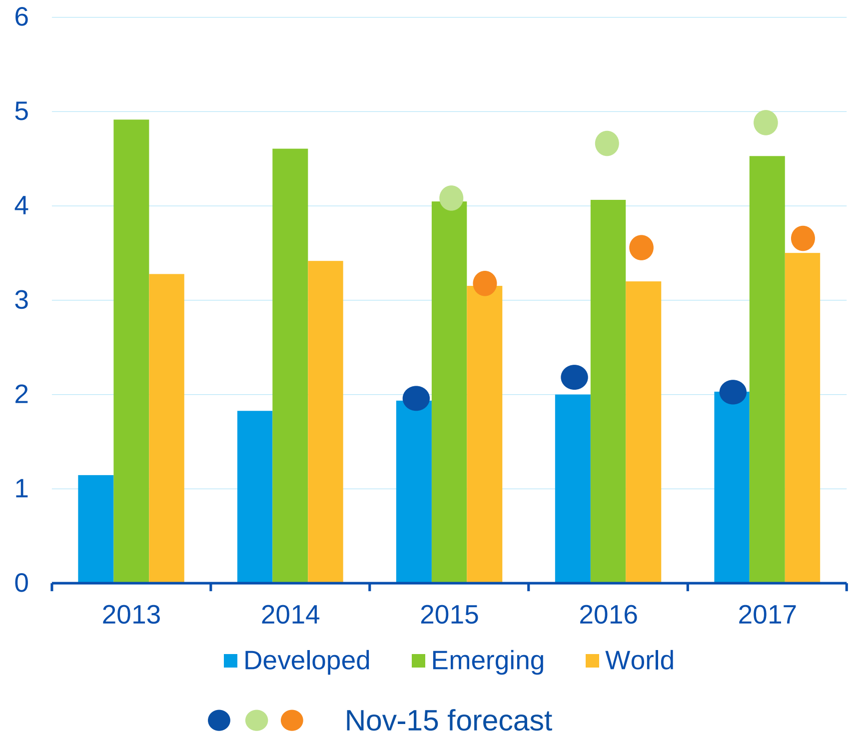
The positive effect on consumption from lower oil prices offsets its negative effect on investment and the drag from dollar appreciation

Growth momentum seems to have abated in the last weeks

Fed will implement gradual rate hikes. conditional on incoming data on economic activity and inflation. We expect two 25bp interest rate hikes during 2016

Global GDP will grow 3.2% in 2016. postponing recovery to 2017

Global GDP growth (%)



Source: BBVA Research

Confidence indicators and the increase in financial tensions point to moderate growth at the beginning of 2016

Subdued growth in 2016 (similar to 2015) is driven by weak demand in emerging economies

Recovery in developed economies continues to be fragile

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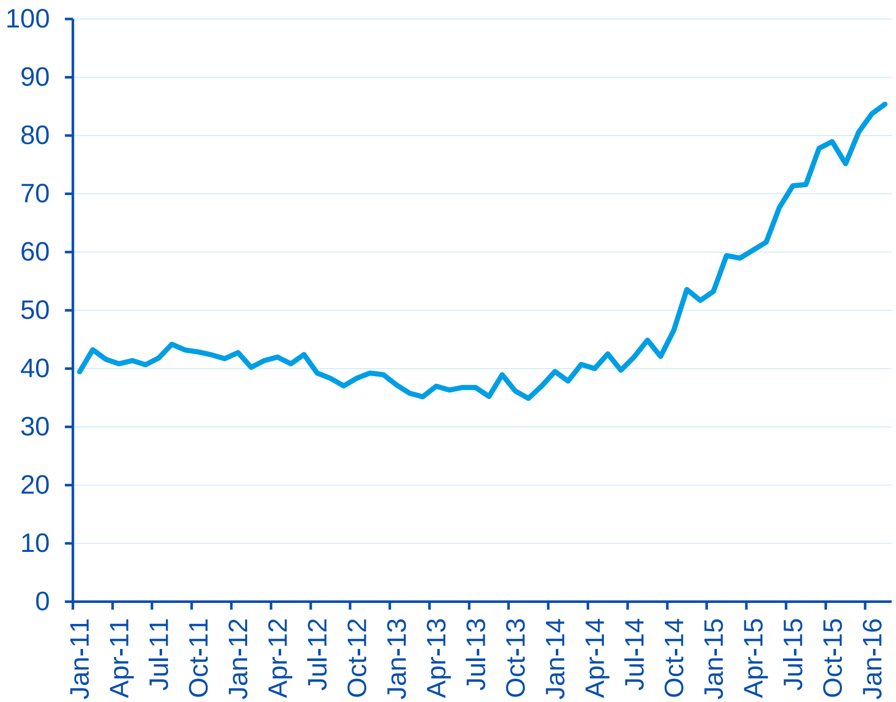
Brazil

The crisis is still far from its end

The prospects for the Brazilian economy continue to worse. The ongoing crisis is still far from its end.

Brazil's crisis index *
(based on web searches)



The effects of a less supportive external environment are being exacerbated within Brazil especially by the impact of the fiscal deterioration

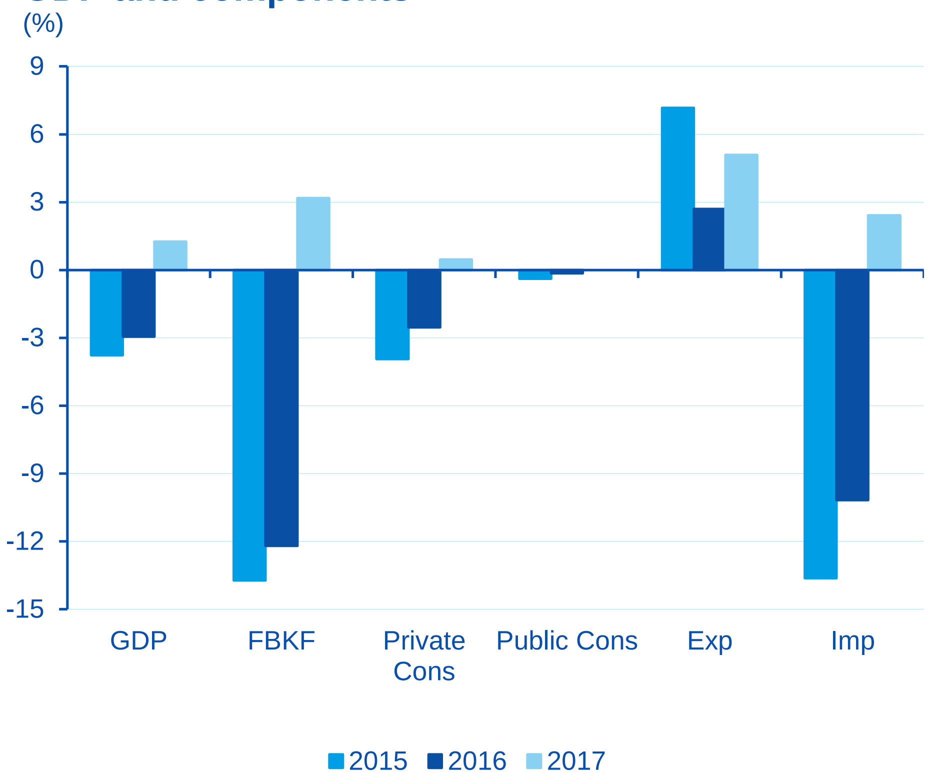
As a consequence, Brazil is now going through an economic crisis, which has been fueling - and being fueled by- a political crisis

As a solution to Brazil's fiscal problems seem to be far away, economic activity is set to further weaken. Impeachment proceedings and corruption scandals will keep political tensions alive

* Seasonally-adjusted index built on the interest about the term "crise" (crisis in Portuguese) in Brazil.
Source: Google Trends and BBVA Research

GDP to contract 3.0% in 2016 after having contracted around 3.8% in 2015. Prospects for 2017 are less negative

GDP and components



Source: IBGE and BBVA Research

A contraction of both private consumption and fixed capital investment will be the main factors behind the GDP decline this year, as in 2015

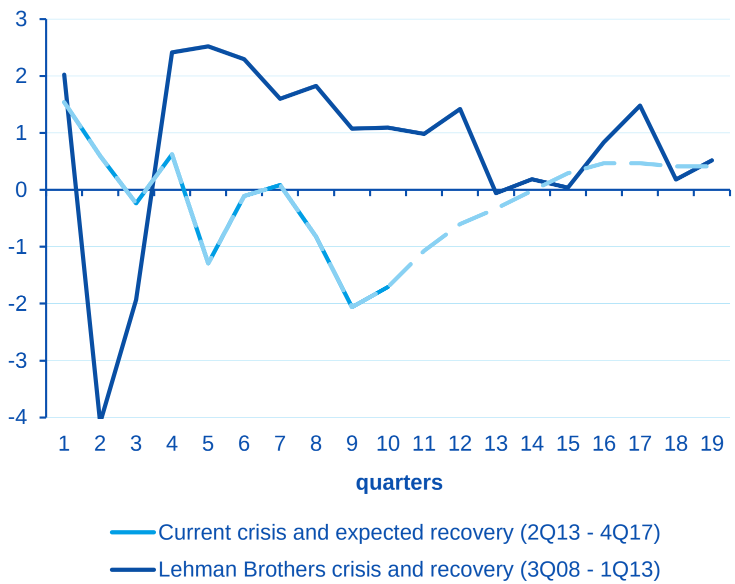
On the other hand, net external demand should continue to contribute positively to activity growth in 2016

Prospects for 2017 are less negative as uncertainty should decline once the congress takes a decision (whatever it is) about the impeachment

Quarterly growth to remain in negative territory until 3Q16. Statistical carryover effects will play a negative role in 2016

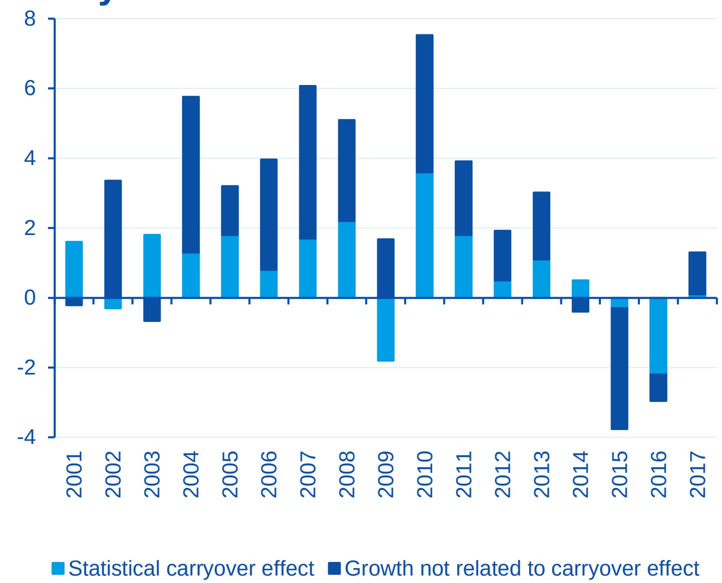
Economic activity cycles: recession and recovery now and after the Lehman Brothers crisis *

(GDP QoQ)



* BBVA forecasts from 4Q15 to 4Q17.
Source: CNI, IPEADATA and BBVA Research

GDP growth and contribution to it of statistical carryover effect *



* BBVA forecasts for GDP from 4Q15 to 4Q16 were used to calculate contribution of carryover effects in 2016 and 2017.
Source: BBVA Research

Longer and sharper recession

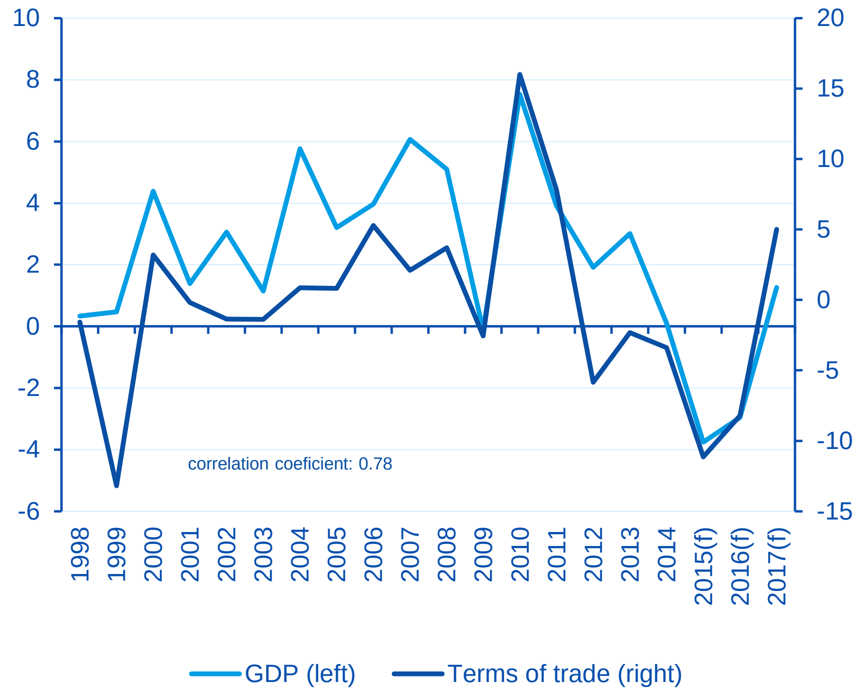
Quarterly GDP's downward trend in 2015 means that if it stays unchanged during the four quarters in 2016, then GDP would decline 2.2%

Prospects for global economy support the view that GDP will contract again in 2016 and recover mildly in 2017

World GDP and Brazil's trade partners GDP *
(% growth)

Brazil's trade partners GDP is the GDP of Brazil's trade partners weighted according to their share as a destination of Brazil's total exports as of 2015. Growth data comes from the IMF's WEO.
Source: IMF and BBVA Research

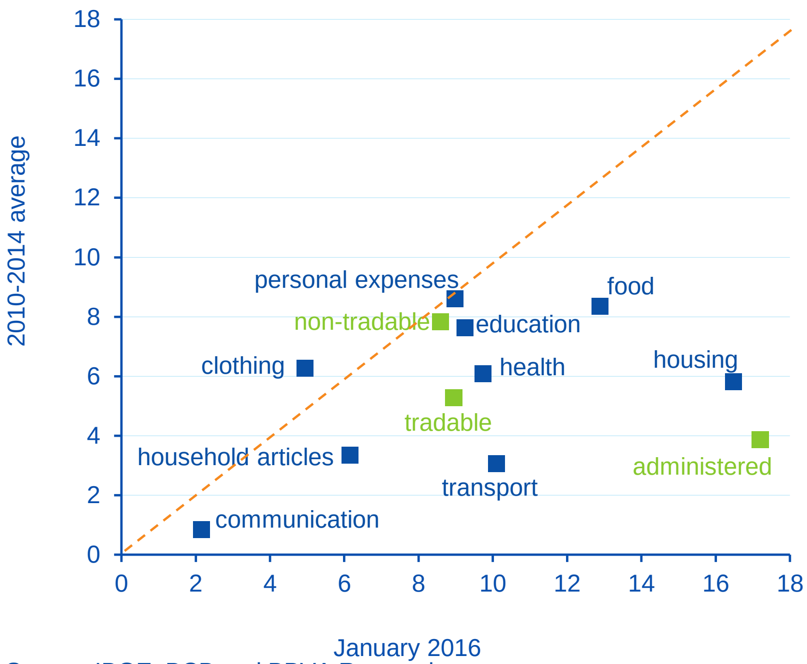
Brazil's GDP and terms of trade *
(% growth)



Source: IBGE, Funcex and BBVA Research

Inflation will remain above the 6.5% target ceiling over 2016

Inflation: January 2016 vs. 2010-2014 average
(YoY)



Source: IBGE, BCB and BBVA Research

Inflation pressures are widespread.

Contribution from market and administered prices to annual inflation (pp)*

Source: IBGE and BBVA Research

Inflation is expected to decline due lower adjustments in regulated prices and weaker demand

Concerns on activity play a more important role on the definition of economic policies

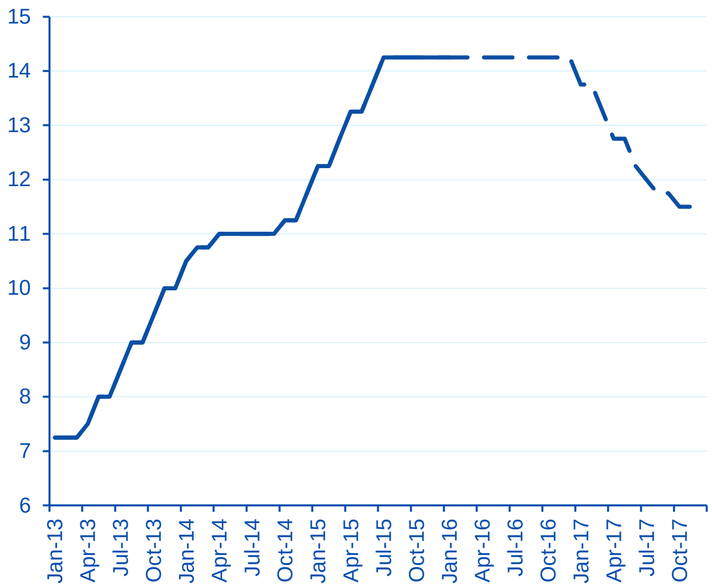
Recent decisions by local economic authorities show that increasing concerns about the sharp contraction of economic activity, and also political pressure, are starting to have a more important role on the setting of monetary, fiscal and quasi-fiscal policies

Maintaining inflation under control and adopting a fiscal adjustment seem to continue to be among the government's main objectives…

…but there is a risk that, as other moments in the recent years, these goals are not properly prioritized, which in our view would increase macroeconomic distortions and extend the crisis even longer

Monetary policy: stable rather than increasing interest rates

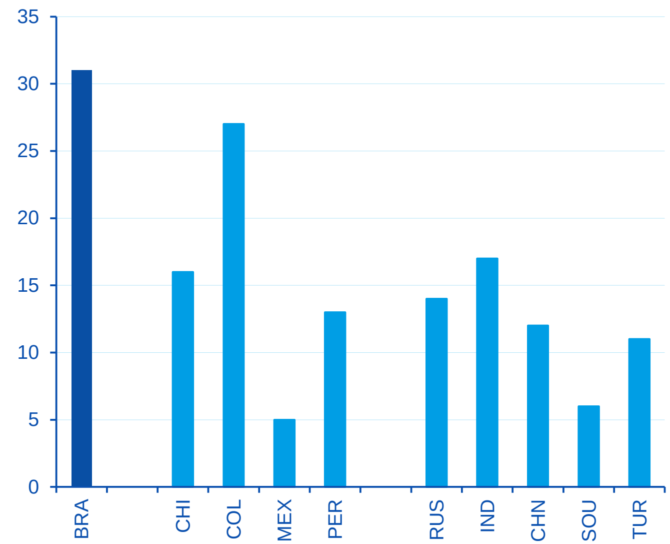
Reference interest rate: Selic rate
(%)



Source: BCB and BBVA Research

Stability in 2016 and easing cycle in 2017

Number of changes in the reference interest rate since January 2011*

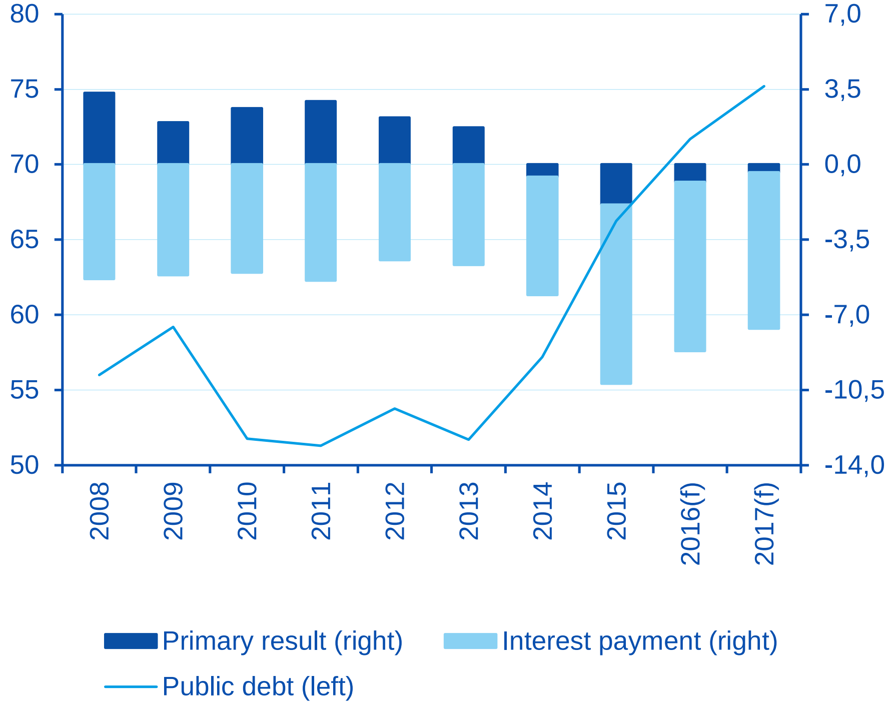


* BRA=Brazil. LATAM: CHI=Chile, COL=Colombia, MEX=Mexico, PER=Peru. Other emerging economies: RUS=Russia, IND=India, CHN=China, SOU=South Africa, TUR=Turkey. Source: Bloomberg and BBVA Research

But BCB is a very “active” central bank, meaning that we should not rule our earlier than expected adjustments

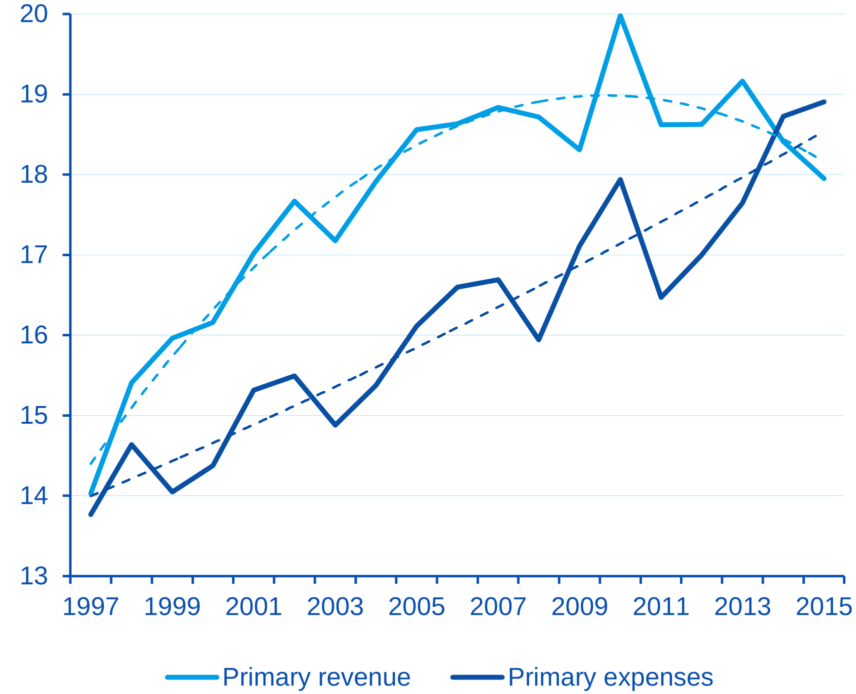
Fiscal policy: deterioration continues as problems remain mostly unaddressed

Fiscal indicators: primary result, interest payment and gross public debt (% of GDP)



Source: BCB and BBVA Research

Federal government's primary accounts: observed and trend* (% of GDP)

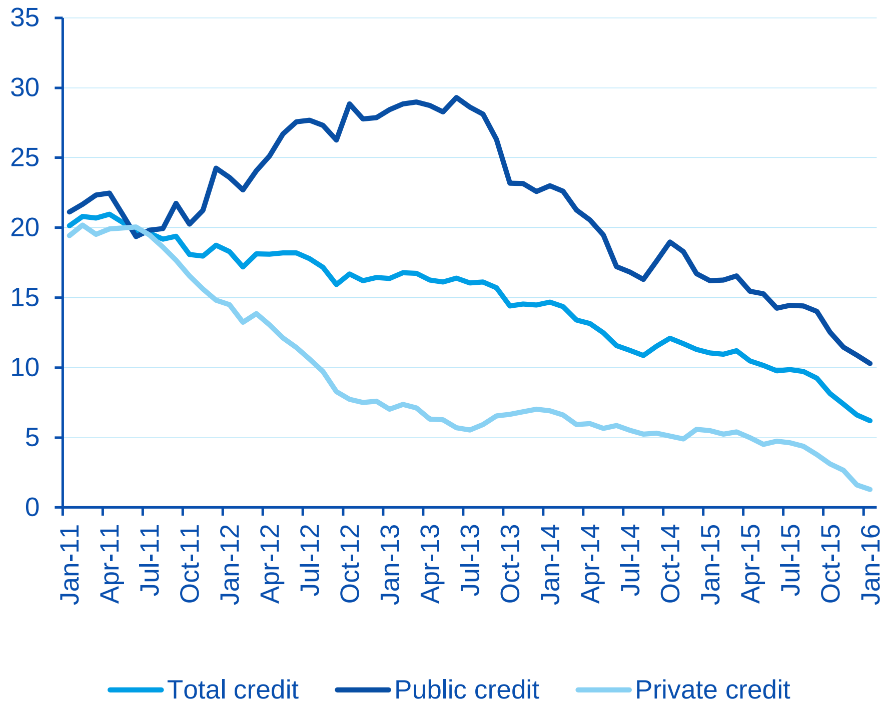


* Observed figures: solid lines. Trend: dashed lines. Primary revenues exclude transfers to regional governments.

Source: BCB and BBVA Research

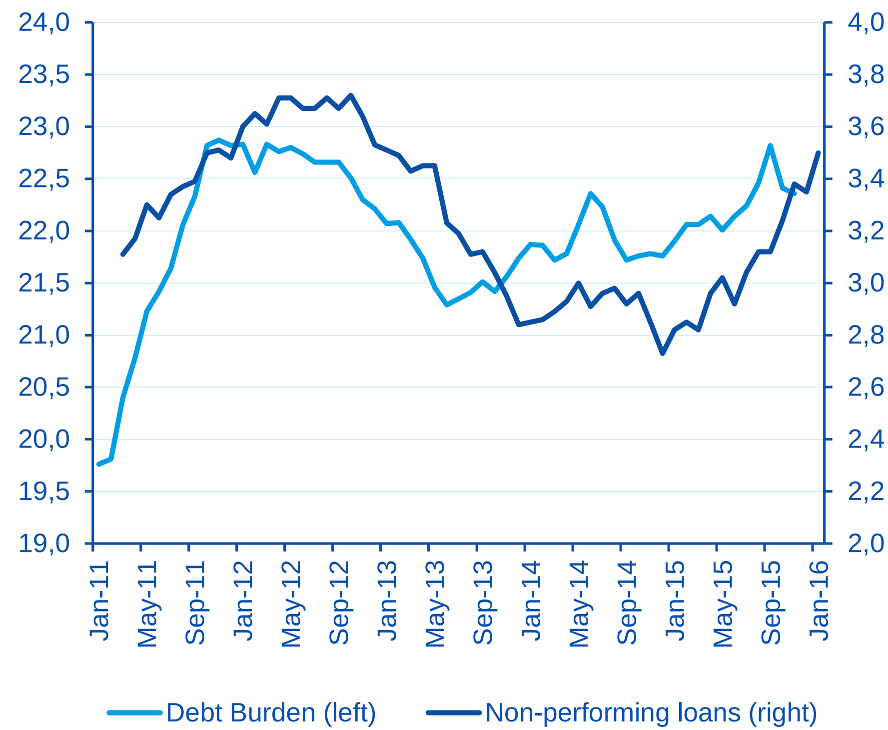
The suggested higher supply of public credit should have a limited impact on activity and could bring along some risks

Credit stock: from public and private banks
(YoY % nominal growth)



Source: BCB and BBVA Research

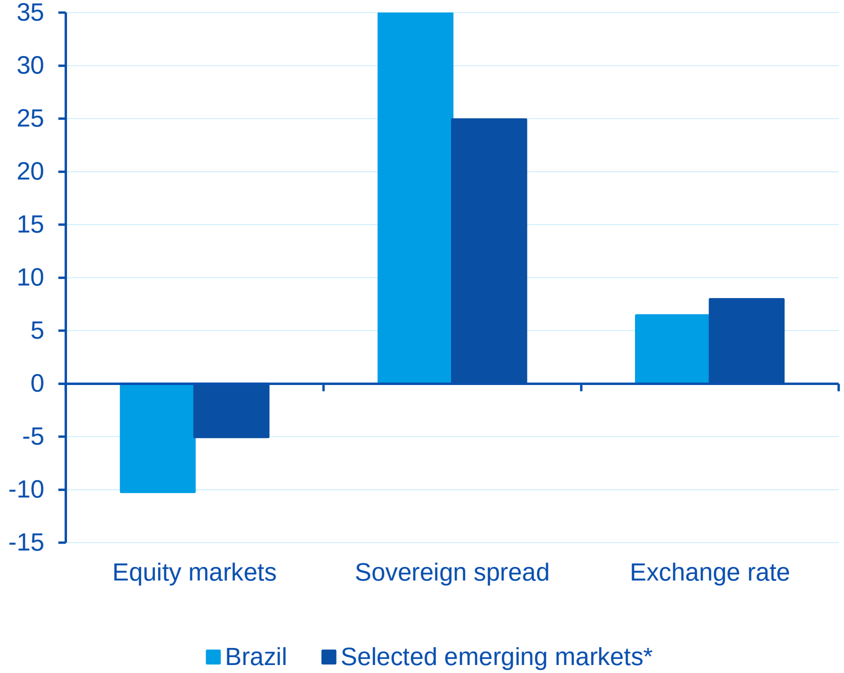
Credit markets indicators: households' debt burden (% of their income) and non-performing loans (% of total loans)



Source: BCB and BBVA Research

Prices of domestic financial assets declined sharply in the last few months

Equity markets (BOVESPA), sovereign spreads (EMBI +) and exchange rate (USD/BRL). Changes in the last three months (%)



* Selected emerging economies: Colombia, Mexico, China, Russia, Turkey and South Africa. Variations calculated between February 26, 2016 and November 26, 2015.
Source: Datastream and BBVA Research

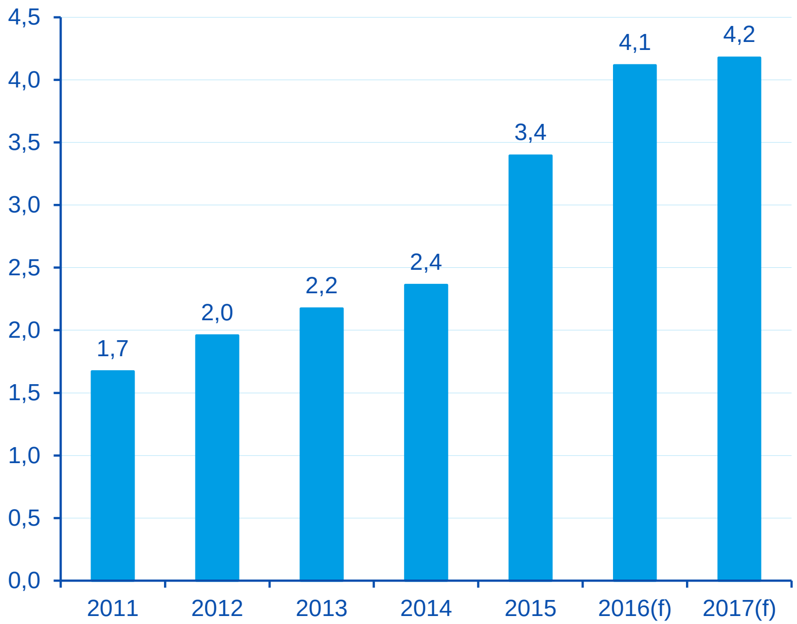
The recent corrections in local equity markets and sovereign spreads were on average higher than the losses recorded in other emerging markets…

…they were even sharper than the corrections observed in oil producer countries, such as Mexico, Colombia and Russia, which are more exposed to the ongoing decline in the prices of the commodity

However, the BRL depreciation in the last three months was on average milder…

A weaker currency (and a contraction of activity) will continue to determine a (cyclical) reduction of the CA deficit

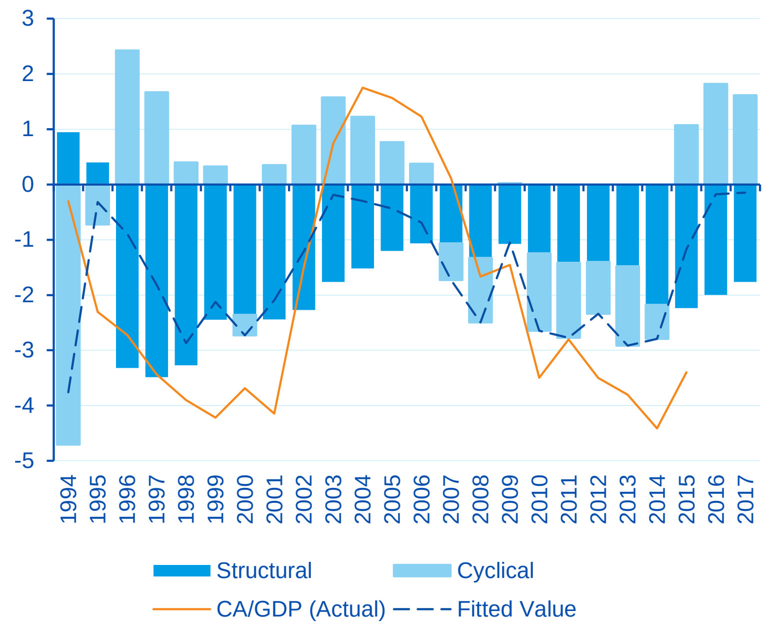
Exchange rate
(annual average, Brazilian real per USD dollar)



Source: BCB and BBVA Research

The expected deepening of both the economic and the political crisis, especially in 2016, will work as a trigger for an additional weakening of the BRL

Current account deficit and importance of cyclical and structural on its dynamics (% of GDP)



Source: BCB and BBVA Research

After a sharp, but cyclical rather than structural, adjustment, the CA deficit is already fully covered by FDI

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Annex

Forecasts

	2014	2015	2016	2017
GDP (% growth)	0.1	-3.8	-3.0	1.3
Inflation (% YoY, end of period)	6.4	10.7	6.8	4.5
Exchange rate (BRL/ USD,end of period)	2.66	3.96	4.15	4.20
Interest rate, SELIC (%, end of period)	11.75	14.25	14.25	11.50
Private consumption (% growth)	1.3	-3.9	-2.5	0.5
Public consumption (% growth)	1.2	-0.4	-0.1	0.0
Fixed capital investment (% growth)	-4.5	-13.7	-12.2	3.2
Exports (% growth)	-1.1	7.2	2.7	5.1
Imports (% growth)	-1.0	-13.6	-10.2	2.4
Fiscal result (% GDP)	-6.1	-10.2	-8.7	-7.6
Current account (% GDP)	-4.3	-3.4	-2.7	-1.1

Source: BBVA Research