3rd QUARTER

2016

Economic Outlook

Brazil

Brazil: a cyclical recovery is underway although structural problems remain unaddressed

The worst in terms of activity growth is probably already over, but recovery will be slow as structural factors (such as fiscal deterioration) will continue to weigh negatively. We continue to expect GDP to grow by 0.9% in 2017 after having contracted 3.8% in 2015 and 3.0% in 2016.

The lack of relevant measures to tackle public expenditure should maintain fiscal deficit around 10% of GDP in 2016-17. Thus, public debt will likely continue to move up, converging to 78% in 2018 (and 88% in 2020), from 52% in 2013. Taking that into account, **activity recovery could derail thanks to fiscal problems.**

On the more positive side, the current account deficit is declining sharply and inflation continues to trend down. Anyway, inflation convergence to within the targets will be slow, preventing the new (and more hawkish) BCB to cut the Selic rate soon.

External environment

Central banks offset the fallout from Brexit

Global drivers over the last quarter

Data slightly better

Fed doubts and delay

Brexit

Financial tensions

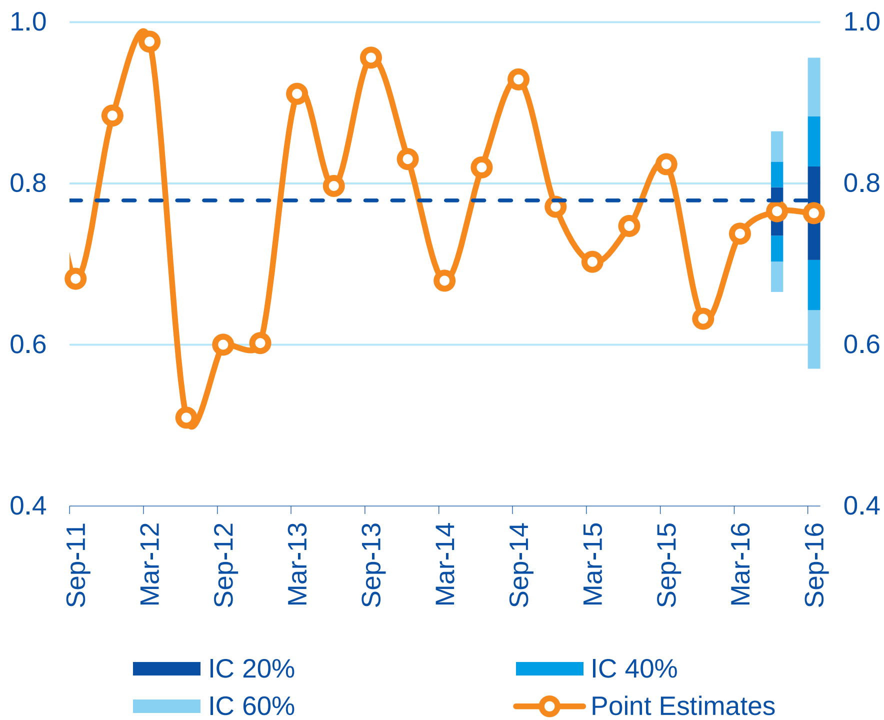
Flight to quality:
Government bonds. yen. gold

High volatility,
especially in equity and Europe

Growth marked down
mostly in advanced economies

Data points to global growth steady at 3.1%

Global growth (% qoq at annual rate)
(Forecasts based on BBVA-GAIN model)



Source: BBVA Research

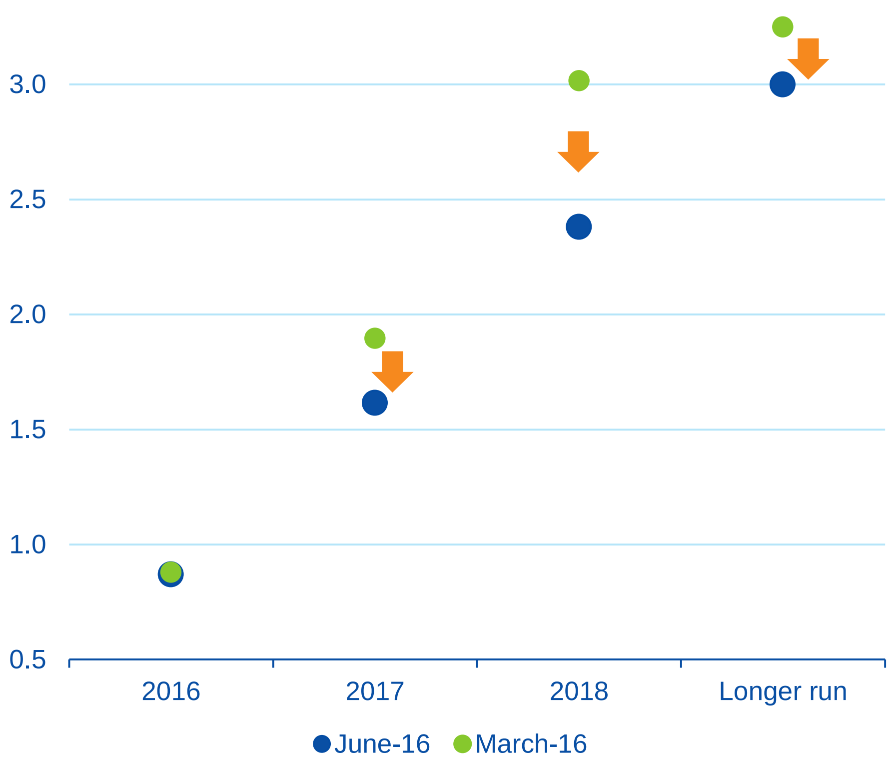
Industrial production recovers slightly in April and May, especially in emerging Asia. Developed economies remain weak

Confidence indicators slightly more optimistic. Global trade recovers in June after many months of subdued activity

Global growth marked down slightly to 3.1% in 2016 and 3.2% in 2017

Fed doubtful about hikes, seems to delay monetary policy normalization

US: Federal Funds rate
(FOMC forecasts)



Source: BBVA Research and Federal Reserve

Fed doubtful about

1. Long-run US growth and productivity
2. How low are real equilibrium interest rates
3. Global shocks and their impact on the US

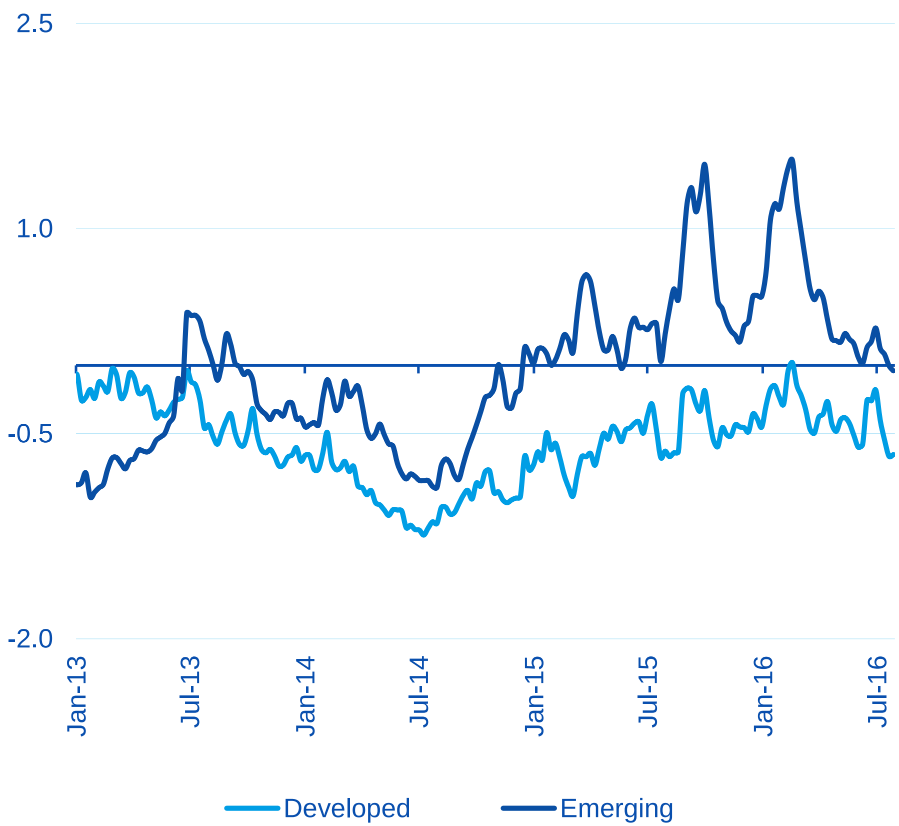
Fed seems more reluctant to raise rates until some uncertainty is lifted

Elections increase uncertainty even more, with potential effects on consumption and investment

We anticipate an additional interest rate hike at end-2016 and two more during 2017

Financial stress jumped after Brexit, but moderately and temporarily

BBVA Research Financial Stress Index



Source: BBVA Research

Brexit was not priced-in by markets as a systemic shock. Its effect has been short-lived:

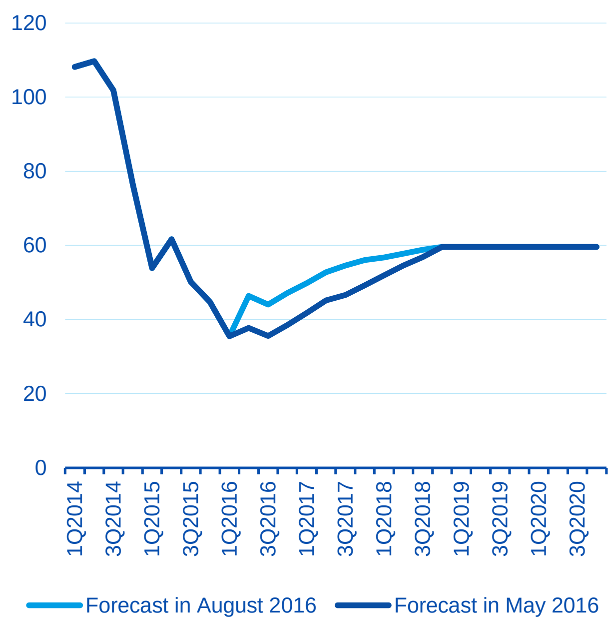
- Limited financial turbulence
- Central banks came to the rescue, postponing monetary policy normalization

All in all, Brexit contributed to extend previous ongoing trends:

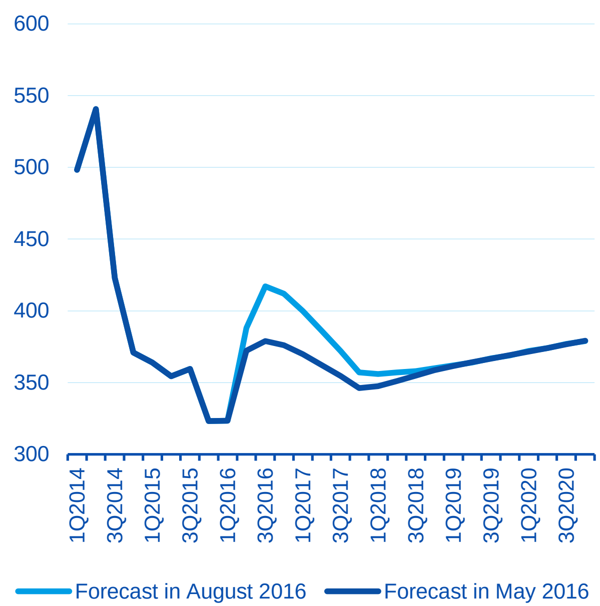
- Downward pressure on long-term interest rates
- Weak equity markets in Europe

Oil and soybean prices benefitted from weak supply

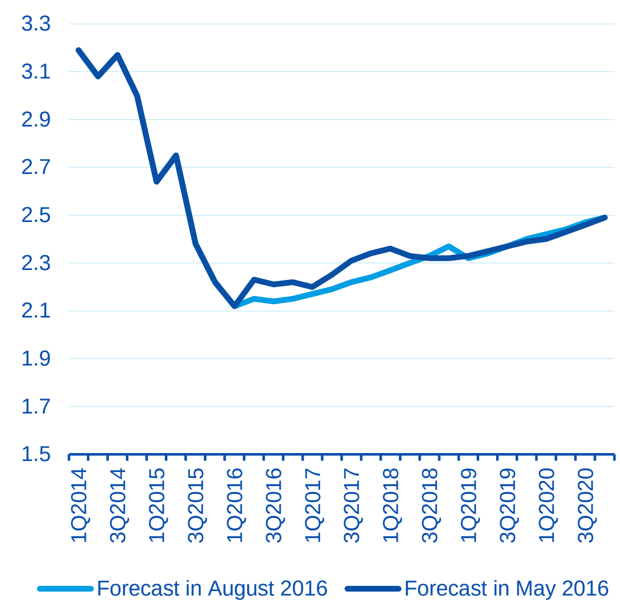
Brent oil: (USD/b)



Soybeans: (USD/mt)



Copper: (USD/lb)



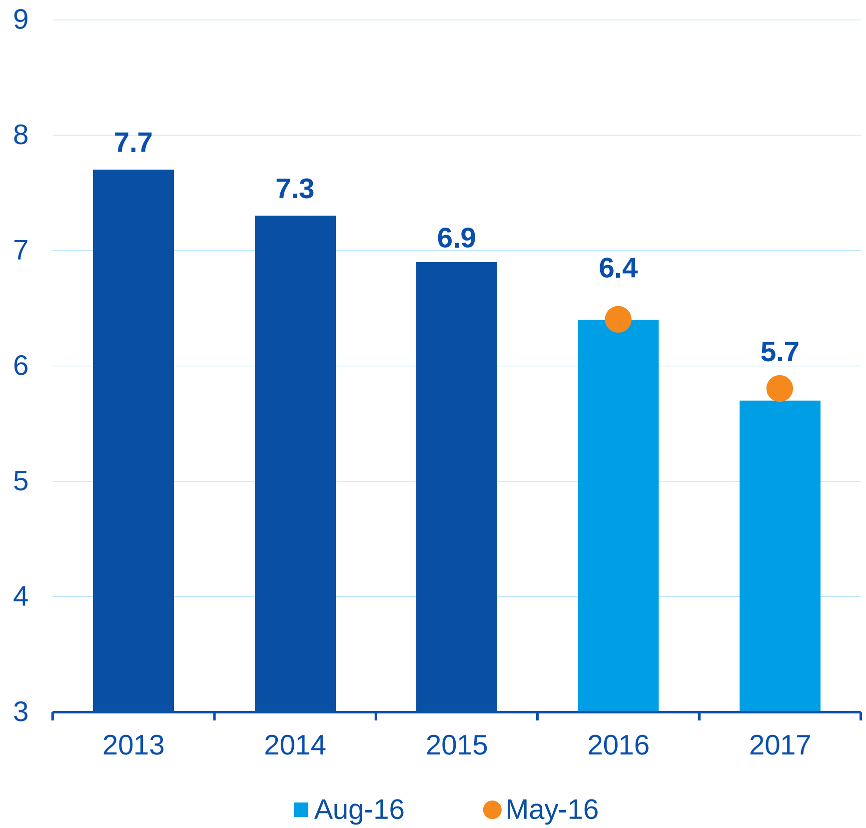
Oil and soybean prices recovered driven in part by weak supply and adverse weather respectively

Copper prices weaken slightly on global uncertainty although production costs will limit further falls

Source: BBVA Research and Bloomberg

China: gradual adjustment to continue

China: GDP growth (%)



Source: BBVA Research

Concerns about a hard landing in China have eased, given recent data, but investment remains weak

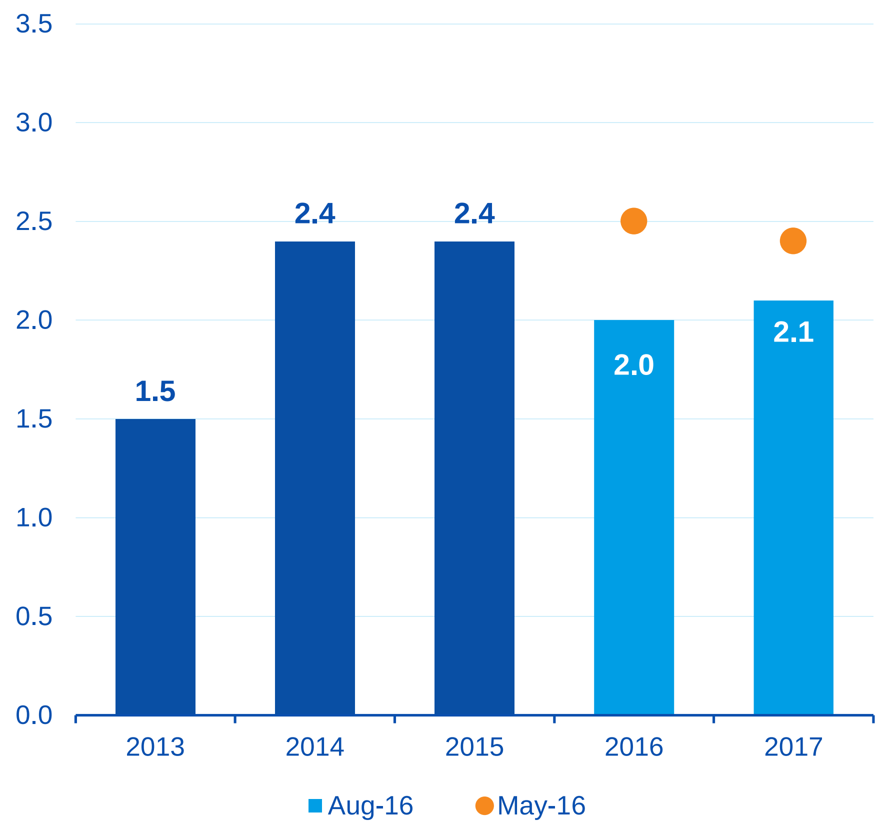
Authorities have slowed the pace on monetary easing over concerns of potential inflation and financial risks

However, tail risks are high:

1. exchange rate depreciation, capital outflows
2. strength of recovery of real estate market
3. corporate sector debt
4. deteriorating global trade environment

US: growth marked down to 2% on disappointing H1 data and weak investment

US: GDP growth (%)

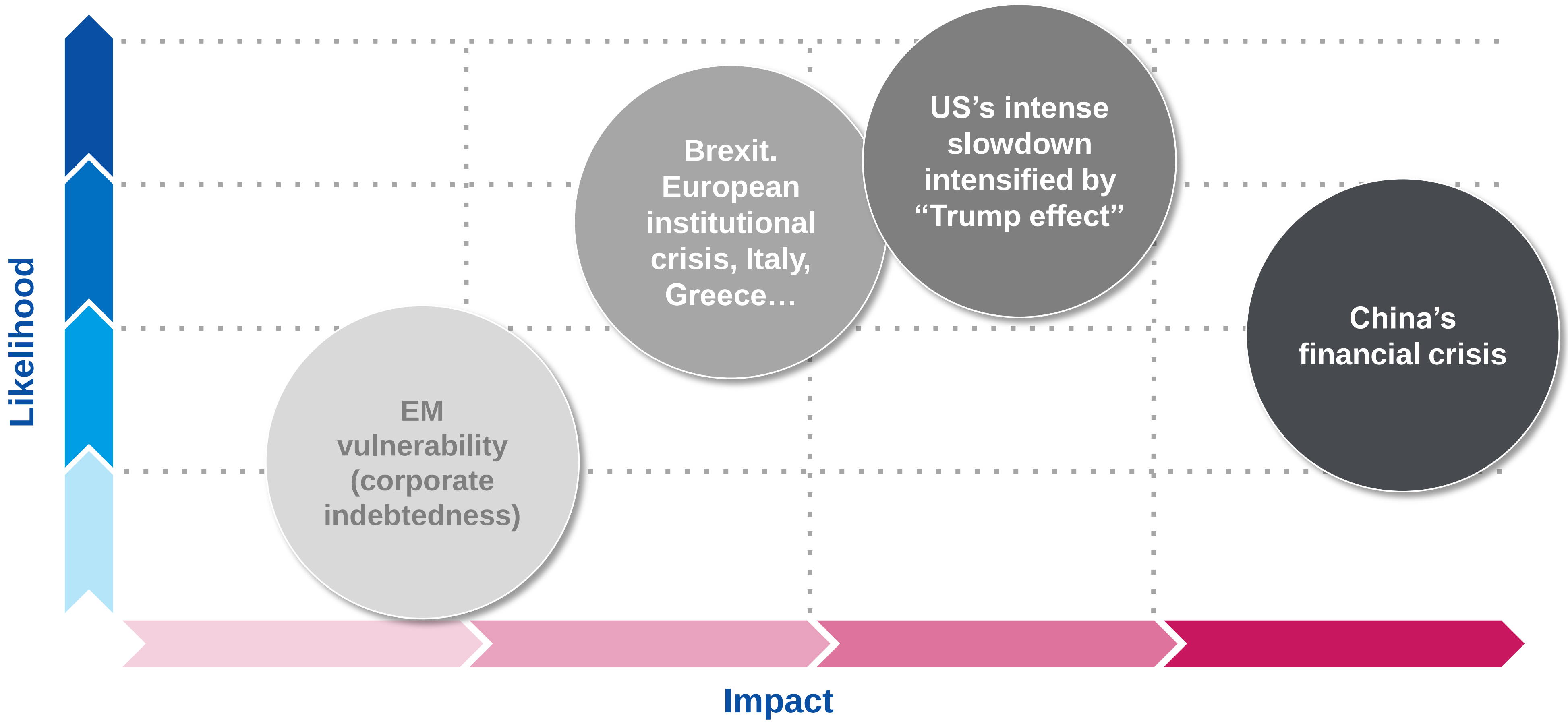


Source: BBVA Research

Disappointing growth data in first semester, with persistently weak investment

High global uncertainty (Brexit, China in the long run) and about prospects for US productivity growth

Risks stemming from China abate somewhat, but those from advanced economies increase



Source: BBVA Research

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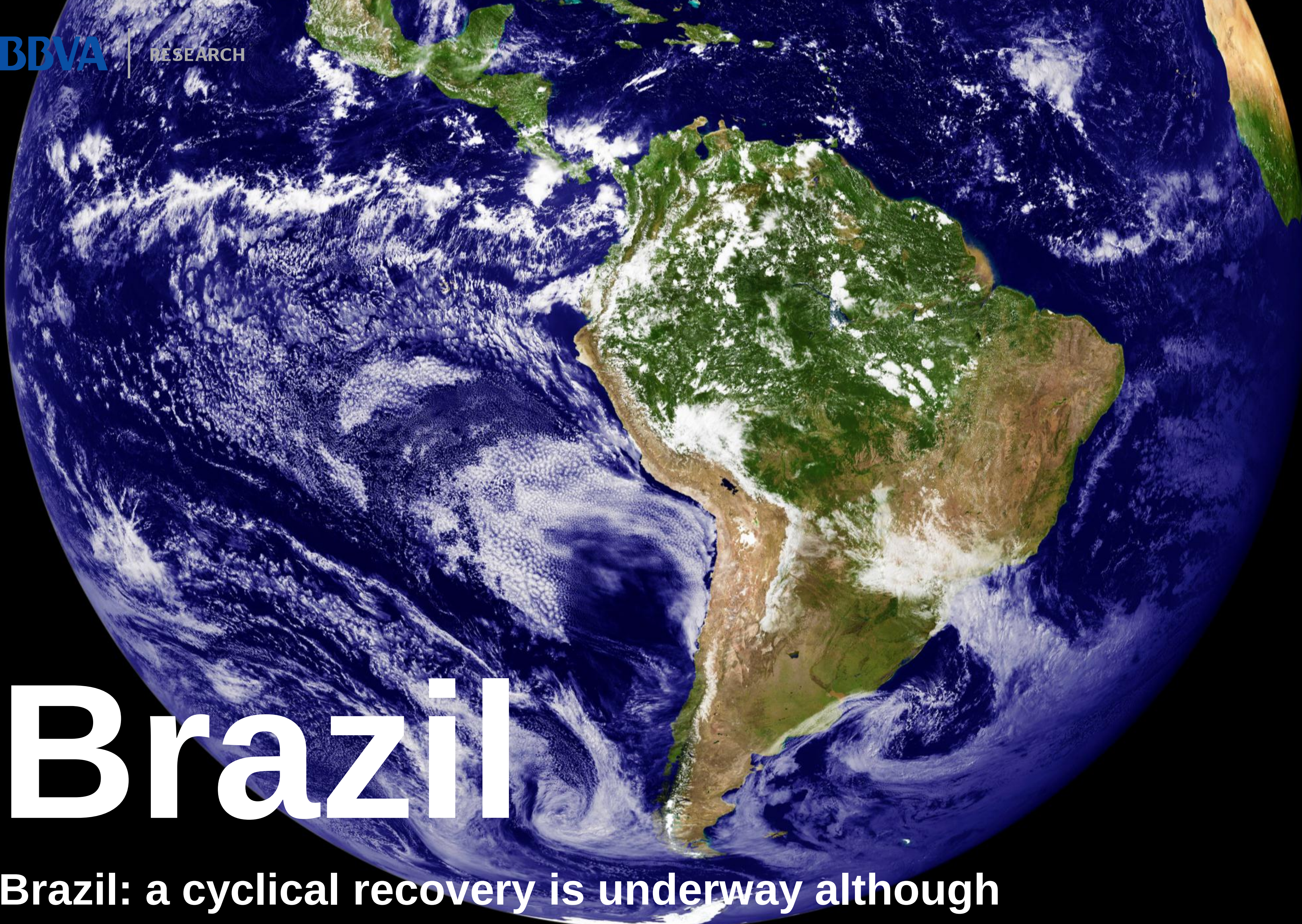
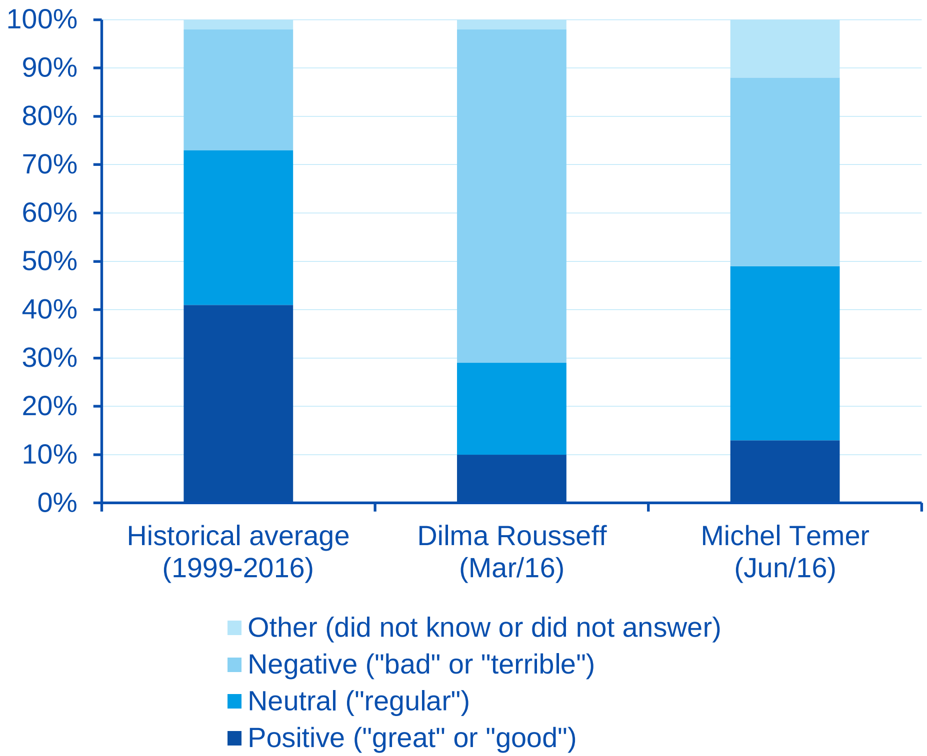


Brazil

Brazil: a cyclical recovery is underway although structural problems remain unaddressed

Michel Temer's government: shift towards more orthodox policies, but still no big news on the needed reforms

Evaluation of the federal government
(%)



Popular support is still very weak: Temer's government is considered "great" or good" by only 13% of the population

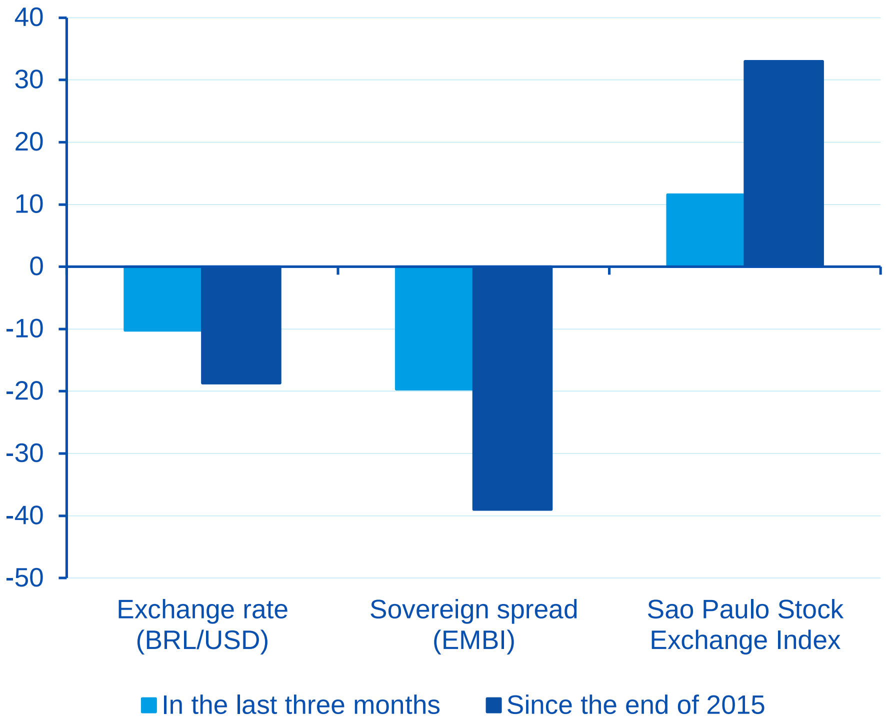
Support by the Congress is still not solid, which helped to prevent relevant advances in terms of economic reforms (including structural changes in fiscal policy)

Temer's administration could be spurred by the expected Senate decision to definitively impeach President Rousseff at the end of August. But we remain skeptical about the implementation of structural reforms. Political turbulence to remain high to some extent due to the ongoing corruption investigations.

Source: CNI, IPEADATA

The change of government and external factors boosted local financial markets in the last few months

Brazilian financial assets
(% changes)*



* Data until August 5 2016. Positive variations represent exchange rate depreciation.
Source: BCB and Haver Analytics

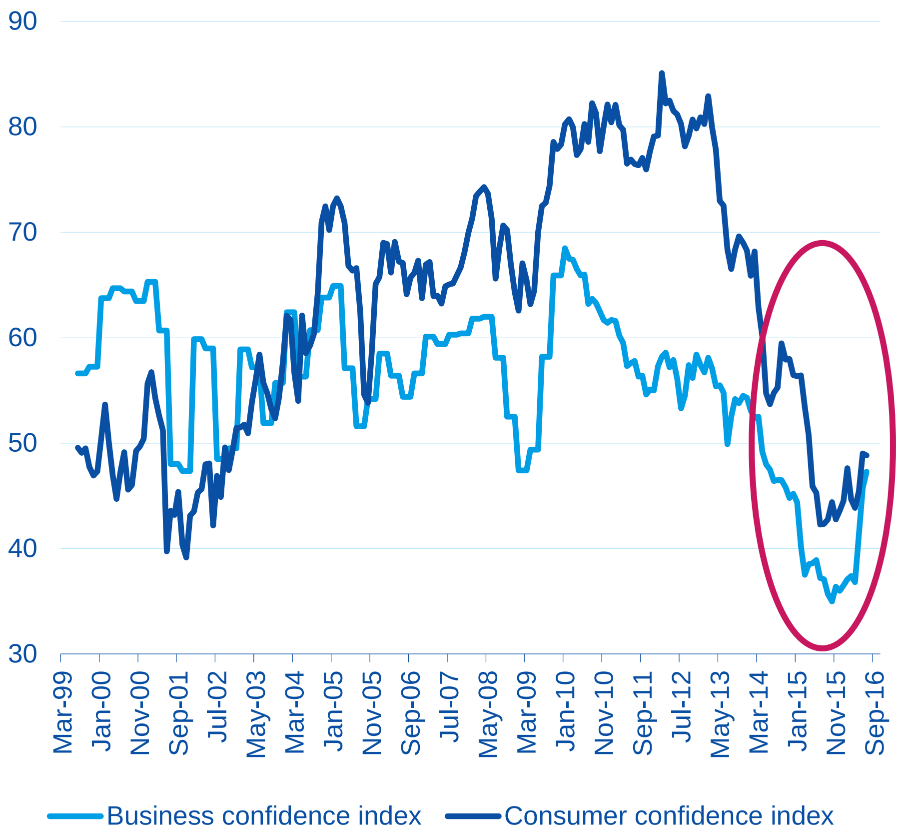
The announcement of more orthodox economic policies helped to boost market's confidence (although the lack of structural advances represents a risk for local financial markets)

More importantly, the positive dynamics of Brazil's financial markets is related to the lower concerns about the Chinese economy and the perception that the monetary tightening in the US will be gradual

The negative impact of the Brexit was relatively small and short-lived

As we expected, confidence is improving as political uncertainty falls

Confidence indices



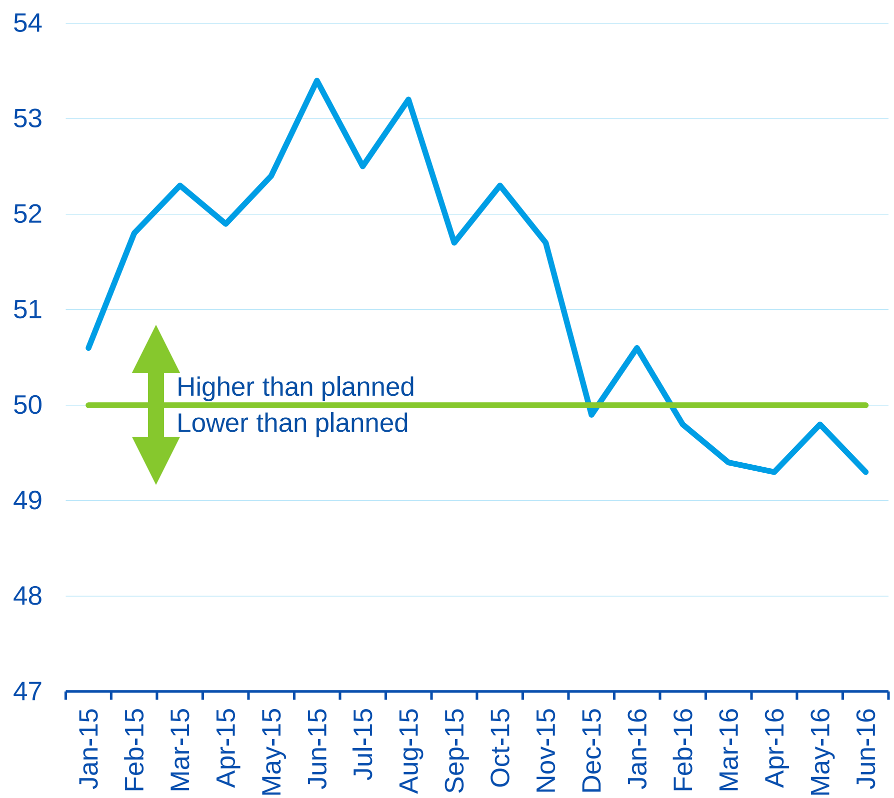
Source: CNI, Fecomercio and BBVA Research

Confidence improved somewhat once the doubts about who will govern the country have been mostly cleared up

Anyway, confidence levels remain very low, which is not surprising given the fact that the political environment remains turbulent in spite of the recent improvement

After a sharp adjustment, manufacturing inventories are now at low levels, allowing an expansion in the production

Manufacturing inventories : actual/planned index



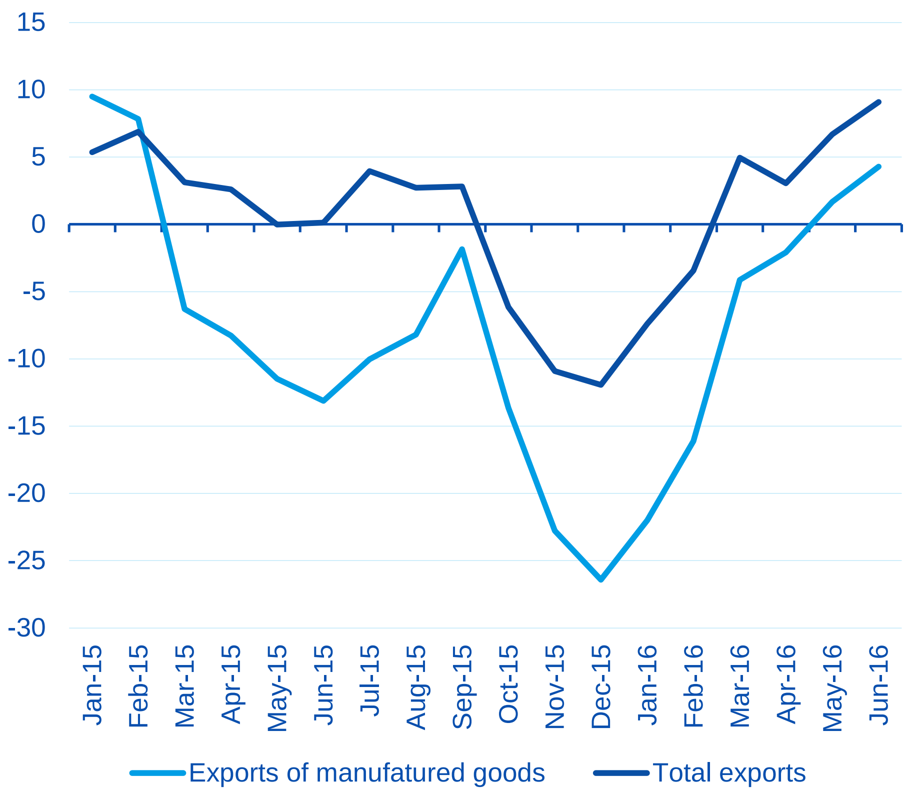
Manufacturing inventories are now below planned levels, encouraging increases in the supply

In fact, among other signs of supply recovery, industrial production grew positively in MoM terms in the last four months, accumulating a 3.5% expansion

Source: CNI and BBVA Research

Exports are recovering, favored by a more depreciated exchange rate than in the past

Quantum of exports
(YoY% change of exports' three-months moving average)



The volume of exports has been trending up since the beginning of the year

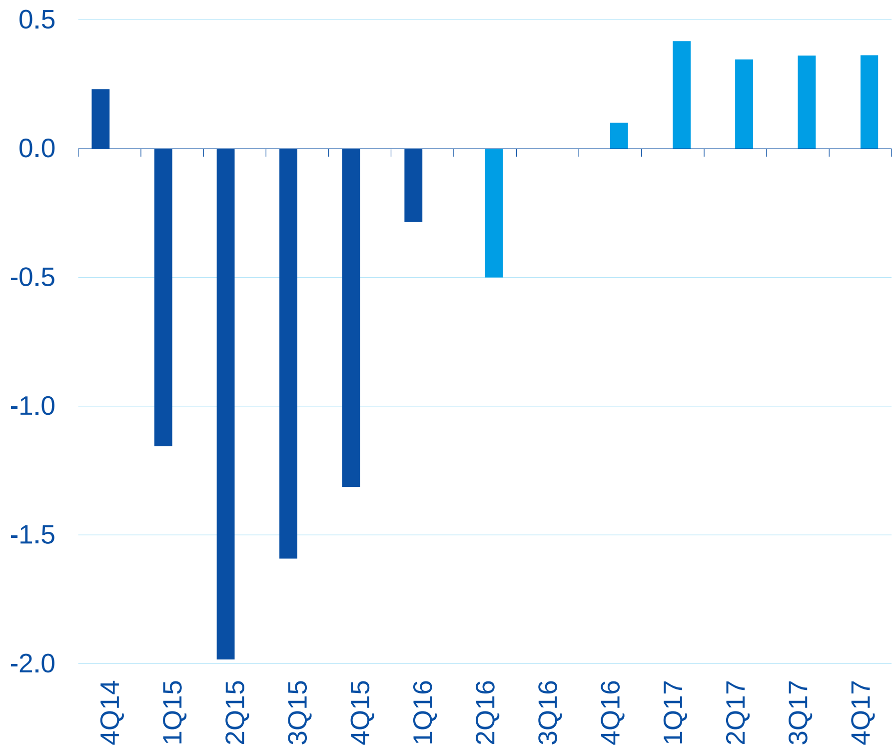
The Brazilian real is now at a much weaker level than in the recent past (around 45% weaker than two years ago)

Anyway, the appreciation of the exchange rate represents a risk for the recovery of exports (and therefore of economic activity)

Source: MDIC, IPEADATA and BBVA Research

A cyclical recovery underway: GDP to fall again in 2Q16, stabilize in 2H16 and grow positively in 2017

GDP growth
(QoQ %; forecasts from 2Q16 onwards)



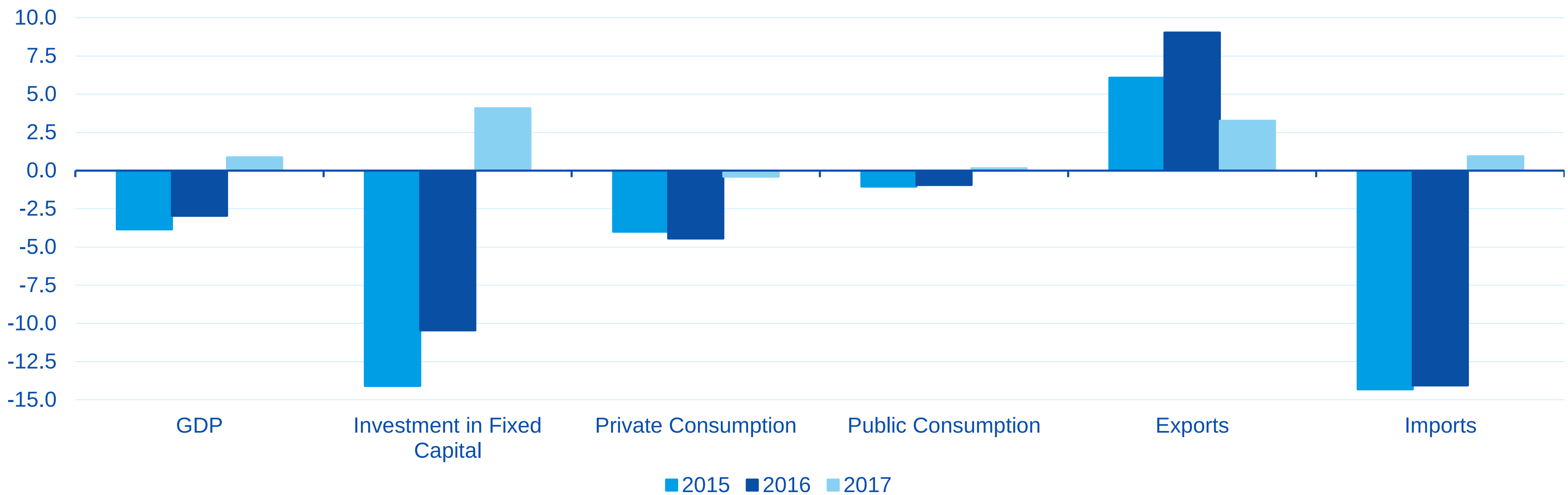
All in all, the aforementioned factors (improvement in local financial markets, higher confidence, lower manufacturing inventories, exports, etc.) are creating the conditions for a cyclical (not structural) recovery of economic activity

We expect 2Q16 GDP to fall less than it did over 2015 (as happened in 1Q16), and then stabilize in 2H16, before starting to grow positively in 2017

Source: IBGE and BBVA Research

We continue to expect GDP to fall 3.0% in 2016 and then grow by 0.9% in 2017

GDP and components
(% growth)



External demand will contribute positively to GDP growth in 2016-17

Investment will be back into positive territory in 2017

Consumption will be a drag in 2016-17, mostly due to weakening labor markets

Source: IBGE and BBVA Research

In spite of the expected recovery, growth will remain low

GDP will grow 0.9% in 2017 and then around 1%-2% in the the next few years, close to potential growth rates

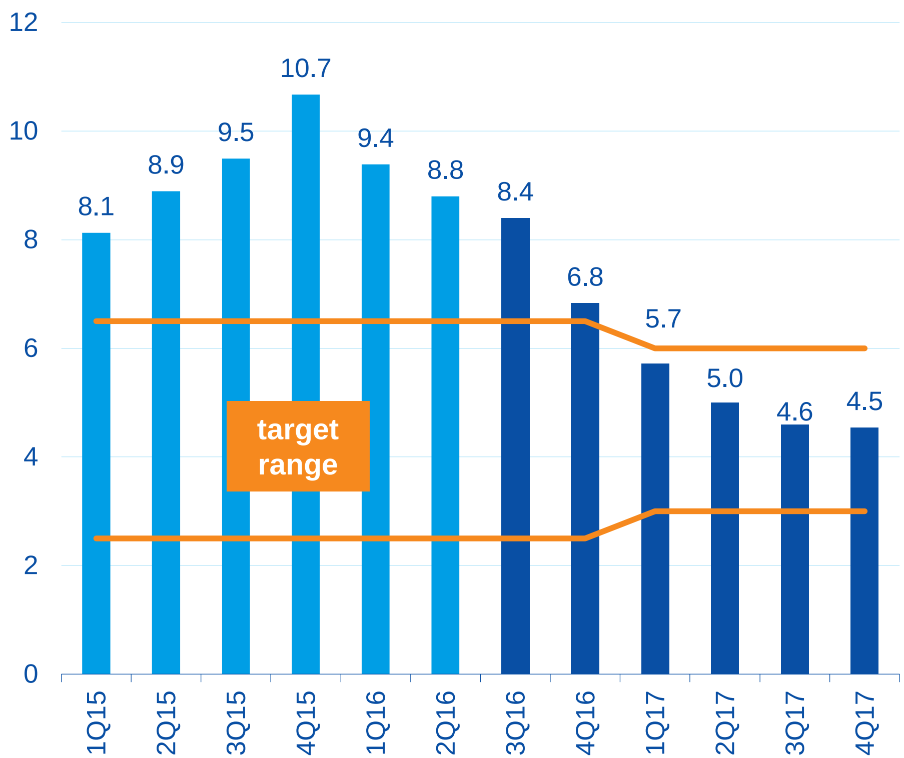
In the short-term, a deterioration of labor markets will continue to prevent a recovery of private consumption. We forecast it to continue to fall in 2H16 and in 2017.

In the medium and long term, the likely inability of the government to implement economic reforms and to address the fiscal problems will keep growth constrained

Main upside risk for domestic growth: faster than expected addressing of fiscal problems. Main downside risks: building up of a public sector solvency crisis, corporate sector crisis, political instability, financial crisis in China and growth deceleration in the US

Inflation continues to trend downwards. It should converge to the target range in 1Q17 and to 4.5% in 4Q17

Headline inflation: observed and forecasts
(YoY %, end of quarter)



Source: BCB and BBVA Research

Factors behind inflation deceleration:

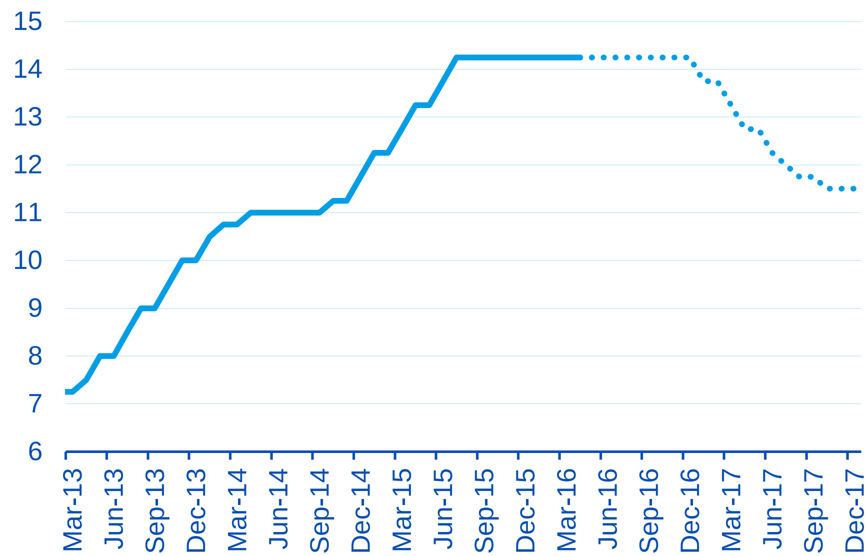
1. smaller adjustments in regulated prices
2. weakening of domestic demand
3. recent exchange rate appreciation

Factors preventing faster inflation slowdown:

1. high inertia
2. fiscal problems
3. food inflation (13% YoY in June) due to supply shocks

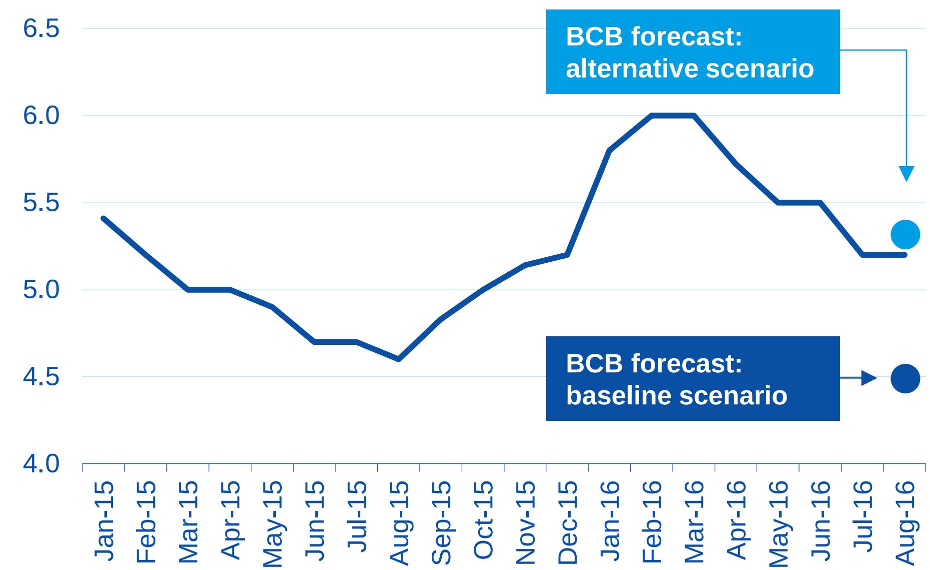
The new BCB board exhibits a hawkish tone and sees no room for a monetary easing yet

Selic interest rate (%)



The BCB board, reshuffled after Michel Temer took office, has maintained the Selic rate unchanged and exhibited a hawkish tone (as we expected, but somehow in contrast with market expectations)

Inflation expectations (market consensus) and BCB forecasts for the end of 2017 (YoY %)

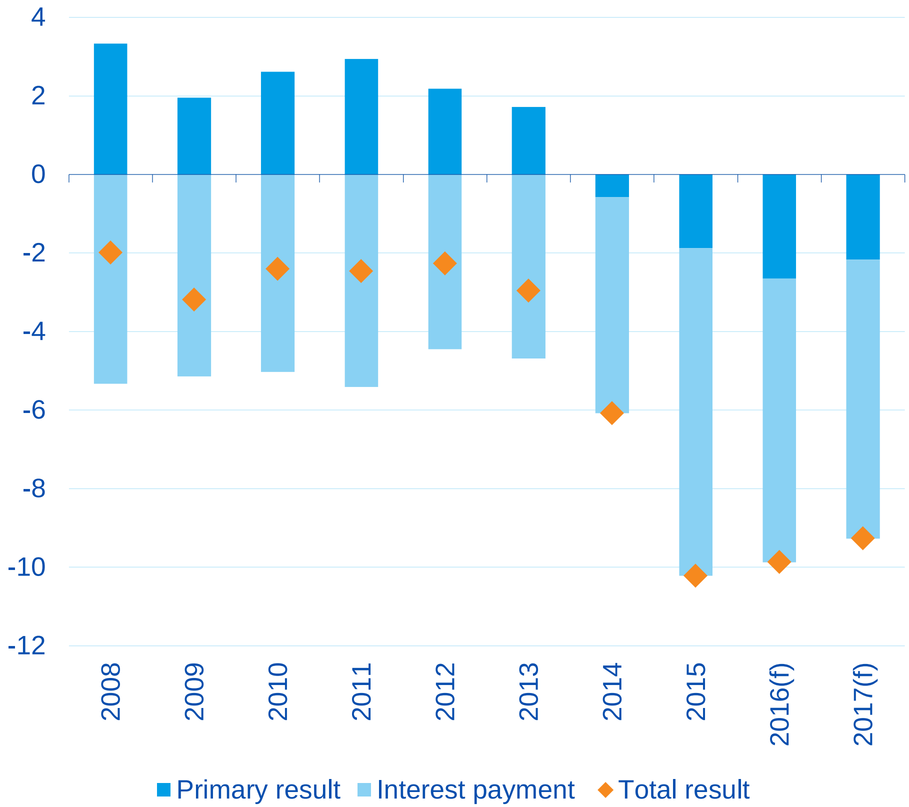


The BCB has signaled that a monetary easing will start once both inflation expectations and BCB forecasts for 2017 converge to 4.5%. We expect that to happen at the beginning of 2017. Anyway, positive fiscal surprises could trigger an earlier Selic cut, in the end of 2016

Source: BCB and BBVA Research

Fiscal deficit remains high due to problems to cut expenditure and the impact of the recession on revenues

Fiscal results (% of GDP)



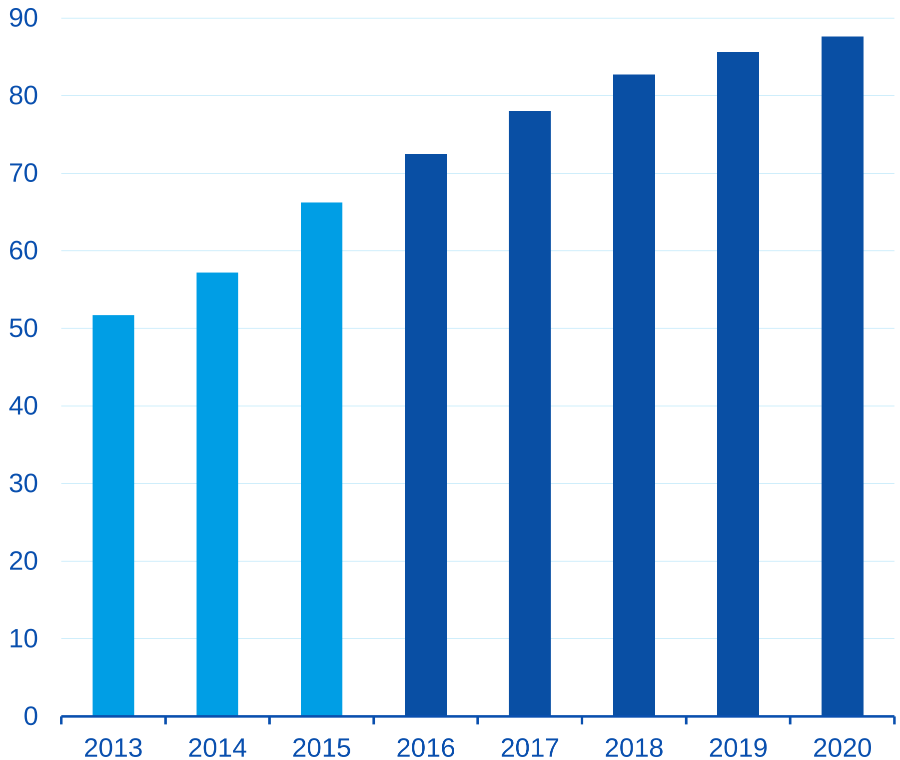
Source: BCB and BBVA Research

Primary deficit to reach 2.7% of GDP in 2016 and 2.2% of GDP in 2017 as the government faces problems (mainly on the political side) to cut expenditure and as the contraction of domestic demand hits revenues

As a consequence of that, and of higher interest rate payments (higher interest rates, higher spreads, etc.), the total fiscal deficit will remain worryingly around 10% of GDP

No clear prospects of public debt stabilization

Public gross debt , prospects with stable expenditure in real terms and no tax increases (% of GDP)



Source: BCB and BBVA Research

The new administration has proposed to maintain public expenditure unchanged in real terms for the next 20 years

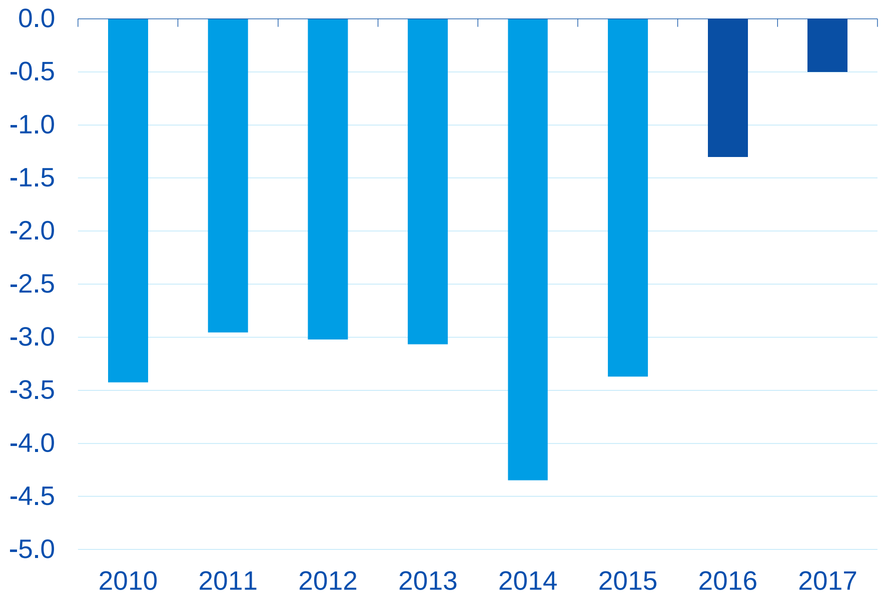
It is still not clear whether Temer's government will be able to get the Congress to approve it. Even if it does, its implementation will require a social security reform and/or a reduction in the degree of rigidity of expenditure, which are not straightfprward

Anyway, an approval of the expenditure ceiling would not guarantee the debt stabilization in the short and medium terms. That would require further measures such as tax hikes

All in all, the increase in public debt represents a risk to our baseline scenario for the Brazilian economy

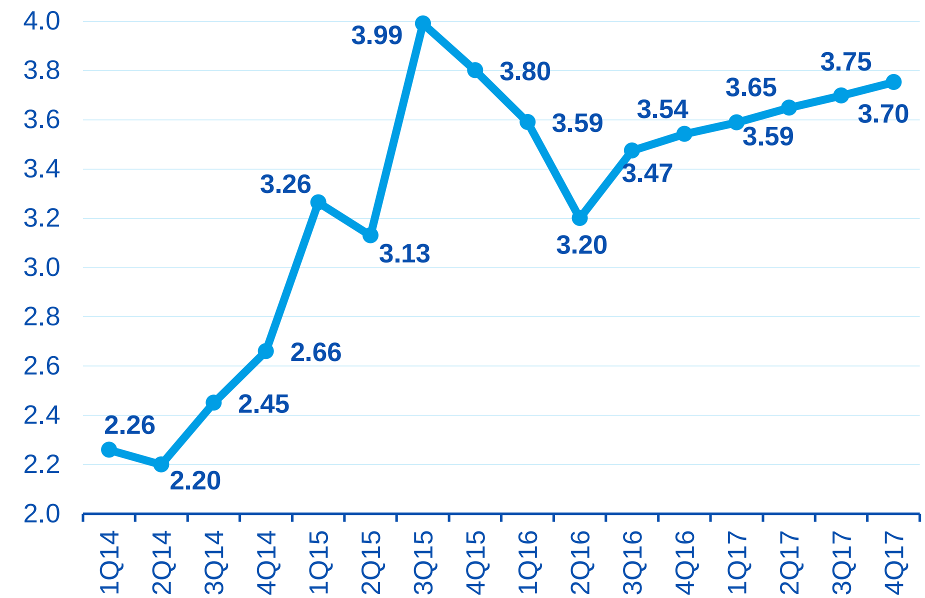
Current account is adjusting sharply, due to a weaker exchange rate and the contraction in domestic demand

Current account
(% of GDP)



One of the positive trends regarding the Brazilian economy is the sharp downward adjustment of the current account deficit

Exchange rate: Brazilian real per USD dollar
(end of period)



In spite of the recent appreciation, we continue to expect the exchange rate to weaken as the Fed increases US interest rates and as local fiscal problems persist

Source: BCB and BBVA Research

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On the more positive side, the current account deficit is declining sharply and inflation continues to trend down. Anyway, inflation convergence to within the targets will be slow, preventing the new (and more hawkish) BCB to cut the Selic rate soon.

Annex

Forecasts

	2013	2014	2015	2016f	2017f
GDP (%)	3.0	0.1	-3.8	-3.0	0.9
Private consumption (%)	3.5	1.3	-4.0	-4.4	-0.4
Public consumption (%)	1.5	1.2	-1.0	-0.9	0.2
Fixed capital investment (%)	5.8	-4.5	-14.1	-10.4	4.1
Exports (%)	2.4	-1.1	6.1	9.0	3.3
Imports (%)	7.2	-1.0	-14.3	-14.1	0.9
Inflation (eop, YoY %)	5.9	6.4	10.7	6.8	4.5
Selic interest rate (eop, %)	10.0	11.75	14.25	14.25	11.50
Exchange rate (eop)	2.34	2.66	3.80	3.54	3.75
Fiscal result (% of GDP)	-3.0	-6.1	-10.2	-9.9	-9.3
Current account (% of GDP)	-3,1	-4.3	-3.3	-1.3	-0.5