BBVA Research

Brazil Economic Outlook

FOURTH QUARTER 2017

Brazil: cyclical recovery

1. **We continue to expect the Brazilian economy to grow by 0.6% this year and by 1.5% in the next one.** While recent data suggest that the recovery could be somewhat stronger than expected, the fiscal situation and political noise prevent further optimism about growth

2. **The recovery of the economy is being led by private consumption and exports.** Low inflation, looser monetary policy and the gradual improvement of the labor market will continue to support private consumption. On the other hand, higher terms of trade, a more favorable exchange rate and greater global demand will continue to stimulate exports. Fixed capital investment, which continued to decline in 1H17, should gradually recover from the 2H17 onwards

3. **Lower inflation and interest rates.** Following the recent surprises, we adjusted our inflation forecasts downwards. We now expect it to reach 3.2% in 2017 and 4.3% in 2018. Lower inflation creates room for a more expansive monetary policy than previously anticipated: SELIC rates are expected to converge soon to 7.0%. If the fiscal problem is not solved, inflation and interest rates will hardly remain at historically low levels

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GLOBAL

Robust, stable and more widespread global growth

The positive global environment is consolidated

Robust and stable growth

However with some decoupling between confidence and activity data

Central banks moving towards normalization

High uncertainty and different pace between the US and the Eurozone

More synchronised recovery

Especially in emerging economies

Low financial volatility

Emerging countries have benefited from inflows of capital

Weak core inflation

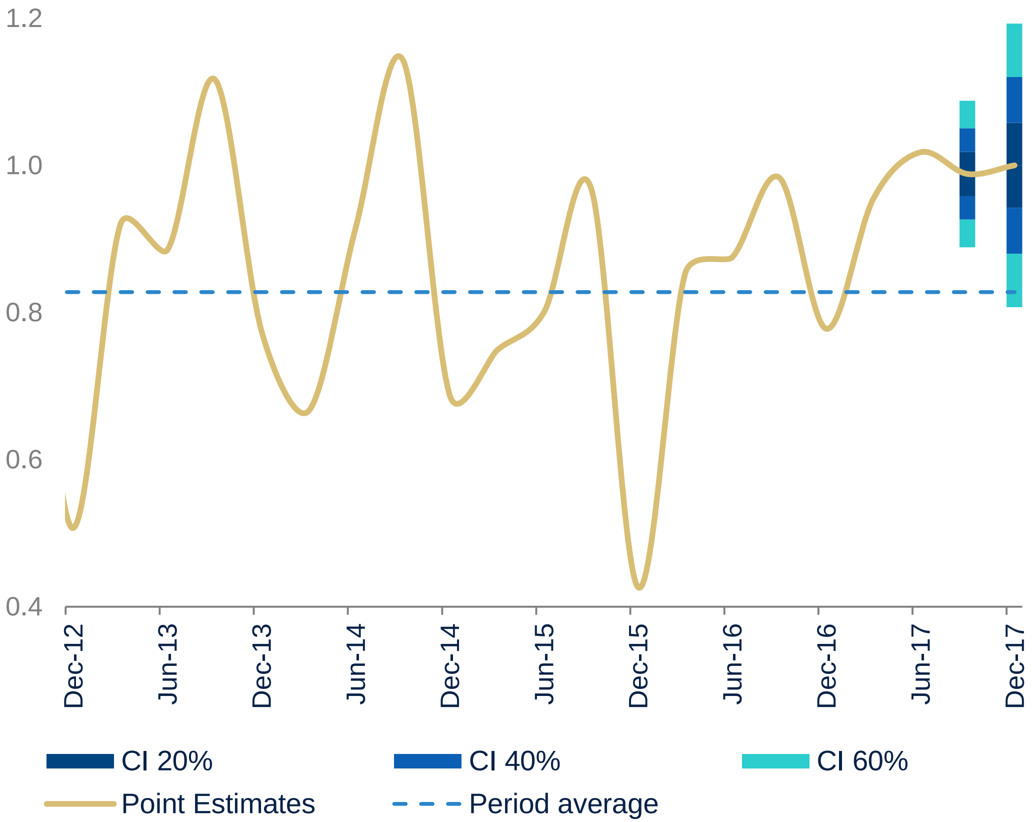
Some signs of recovery in salaries, but still very preliminary

Risk without much change

Certain rebalancing between China and USA in the short term

Global growth: strong and stable in 2H17

Growth of gross world product (GWP)
(Forecasts based on BBVA-GAIN (%, QoQ)

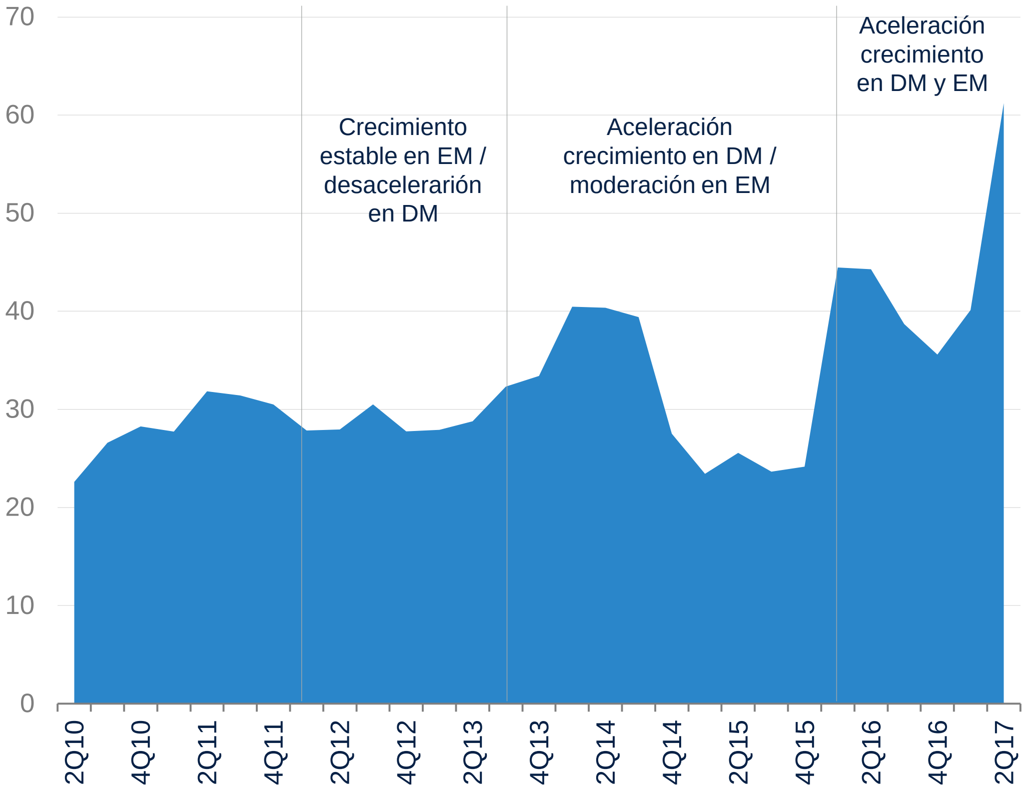


- Trends indicators are improving significantly and suggest a more positive outlook than the activity indicators
- Strong growth in world trade and an ongoing recovery in the industrial sector
- Signs of strength in private consumption despite reduced tailwinds

Source: BBVA Research

Recovery: more synchronized across different areas

Index of growth synchronization between developed and emerging economies

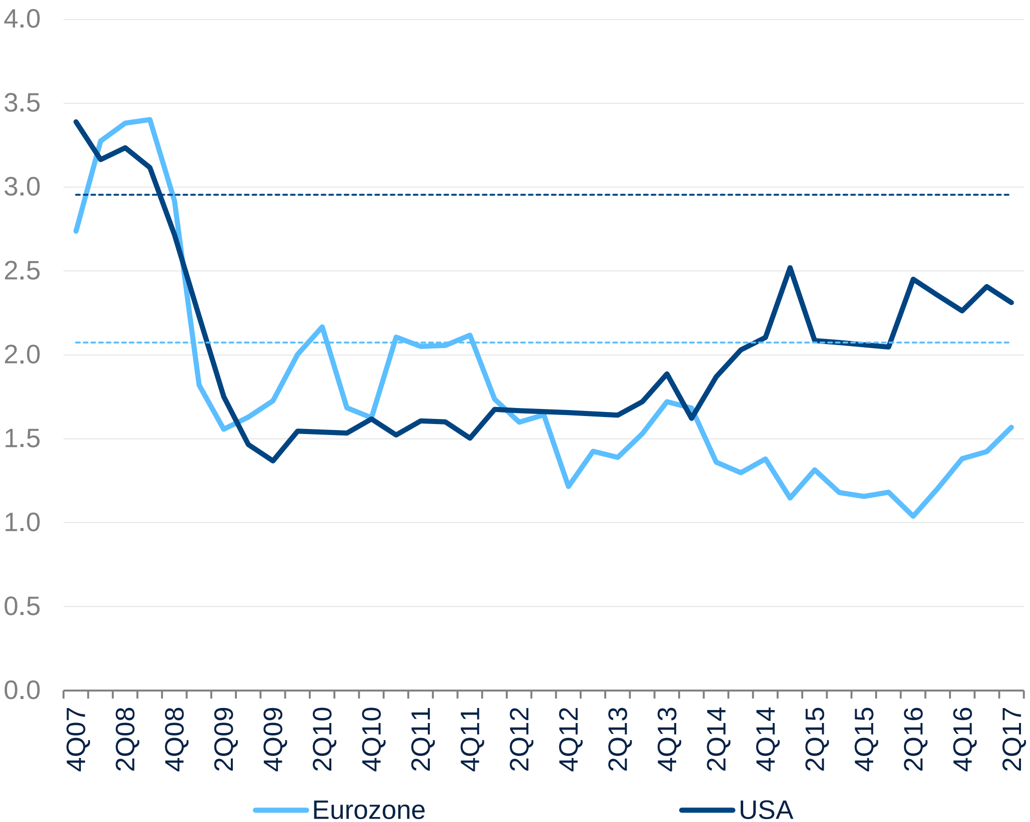


- Developed
  - Significant growth rebound in USA
  - Positive surprise in Europa
- Emerging:
  - Small deceleration in China, although smaller than expected. Still supporting the rest of Asia
  - Recovery in other emerging regions, such as Russia and Latin America
- Growth increasingly supported by economic policy

Index of synchronization: result of inverting the standard deviation of the quarterly growth observed in the countries. In this way, the index associates smaller (greater) volatility in the growth among countries with a greater (less) degree of synchronization at world level.
Sources: BBVA Research, Markit Economics and BBVA Research

Core inflation: no warning signs

USA and Eurozone: wages
(YoY %)



- Despite economic growth and the improvement of the labor market, core inflation remains at low levels
- Doubts about the consolidation of the emerging salary spikes. Contained inflationary pressures
- Uncertainty about the determinants of inflation Temporary or permanent changes?
- Cautious central banks, especially in developed countries. More margin in emerging economies

Source: BBVA Research

Central banks: progress towards very gradual normalization

FED

Normalization of the balance sheet starting in October and the upcoming interest rate hike in December, with two additional increases in 2018

Announcement in October on **reduction of debt purchases for 2018.** Rate increases are expected from mid-2019

BCE

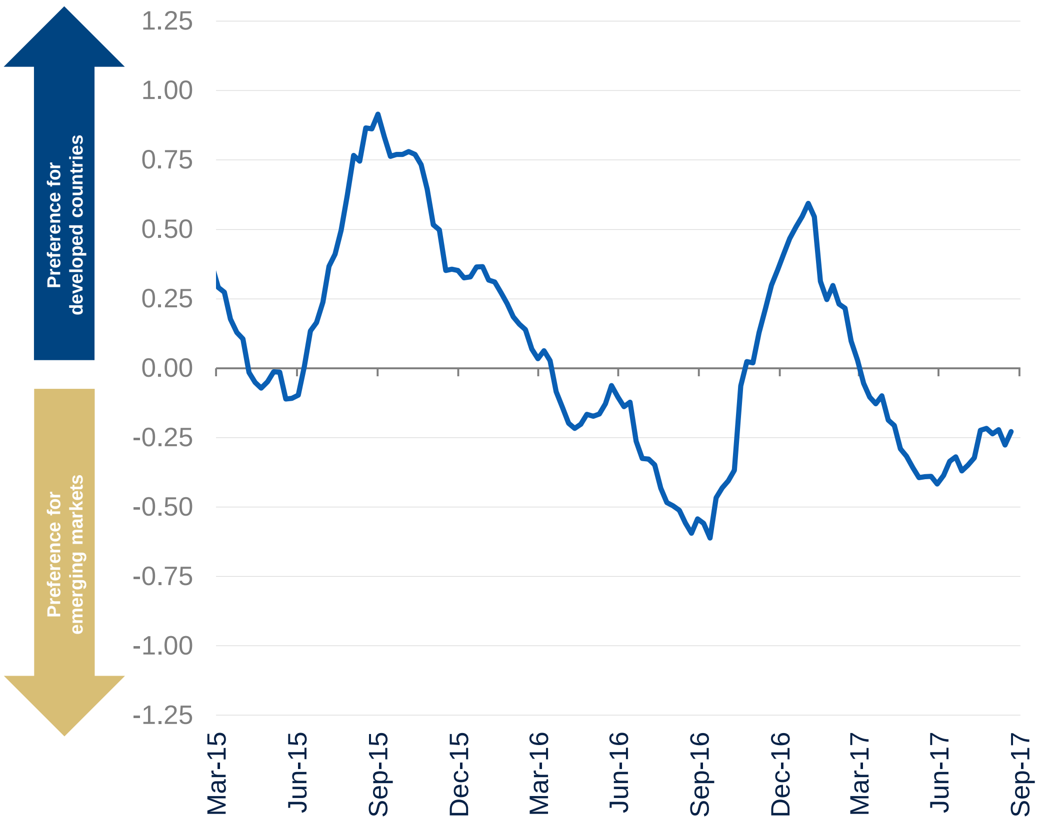
High level of uncertainty:

- In the US, due to the moderation of inflation and the expected change in the FOMC in 2018
- In the **Eurozone**, a bias toward more gradual tapering (strength of the euro) and a lag in the cycle of rate hikes (low inflation)

Financial markets: still favoring emerging economies

Indicator of regional relocation of assets

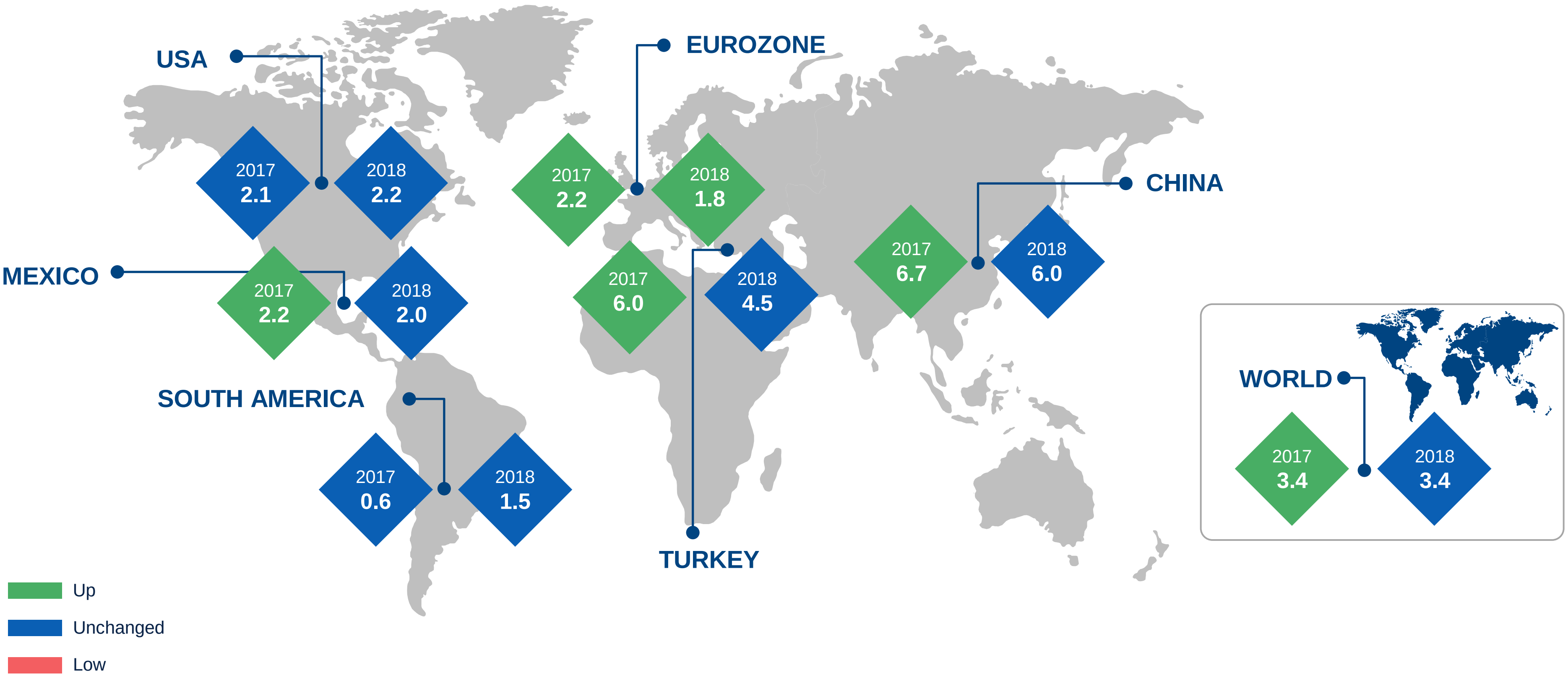
(standard deviation from the historical average)



- Weakness of the dollar and poor US bond yields boost the quest for profitability and bolster assets in emerging markets
- Global liquidity will remain high, given the gradual process of normalisation by the Fed and the ECB, although these tailwinds will disappear

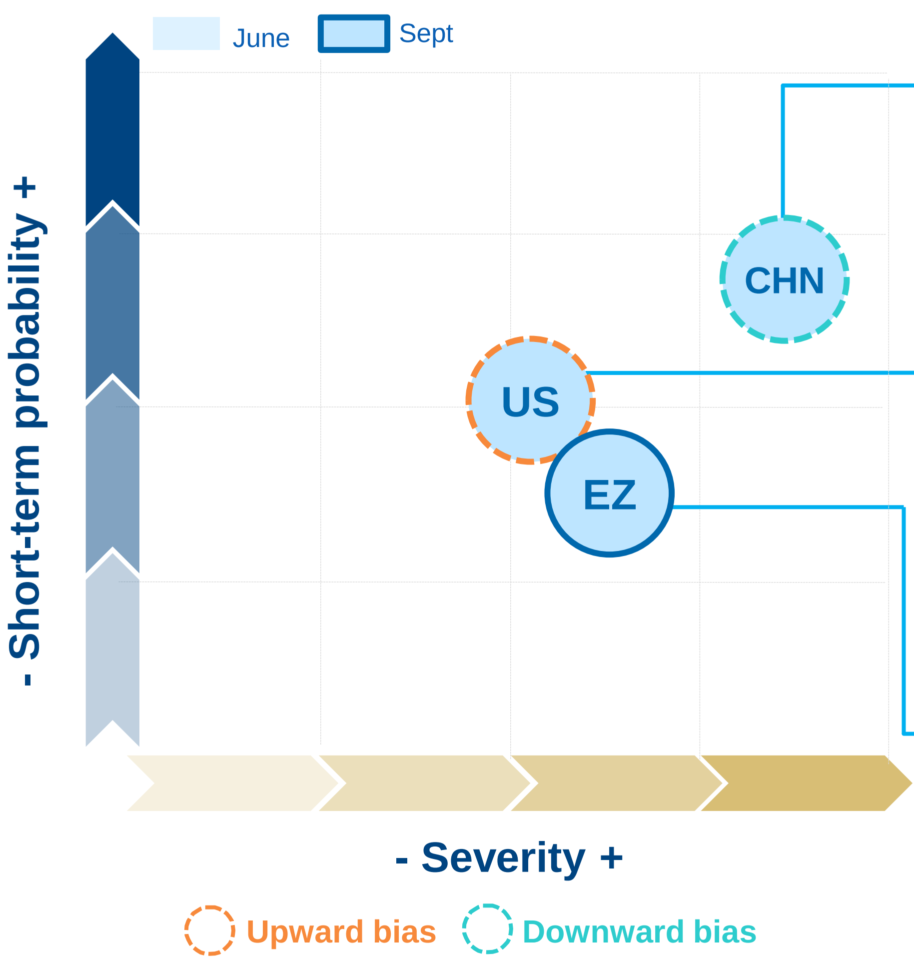
Source: BBVA Research and Bloomberg

Upward revision for Europe and China Positive bias in South America



Source: BBVA Research

Risk: short-term rebalancing from China to US



- Deleveraging risk: very high but more contained in the short run (more gradual economic slowdown & authorities strategy)
- Need to reform state-owned companies
- Management of the soft landing

- Political controversy & cyclical slowdown risk
- Financial instability risk: signs of overvaluation in some assets (potential spillovers on private sector)
- Fed's exit risk: low but high uncertainty on hikes path

- Political and banking concerns: more contained except in Spain
- German elections: the FDP role in a three-way coalition and the surge of AfD may restrict the margin for pro-EU policies.
  - Italian elections (before May18): risk of a coalition (led by Berlusconi's party) contrarian to European project
  - Brexit: lower risk. Towards a soft position: "transition period around two years based on the existing structure of EU rules"
- ECB's exit risk: low; very gradual starting with tapering in 2018

**Other risks: Geopolitical (North Korea); Protectionism (China-US)

BRAZIL

Cyclical recovery

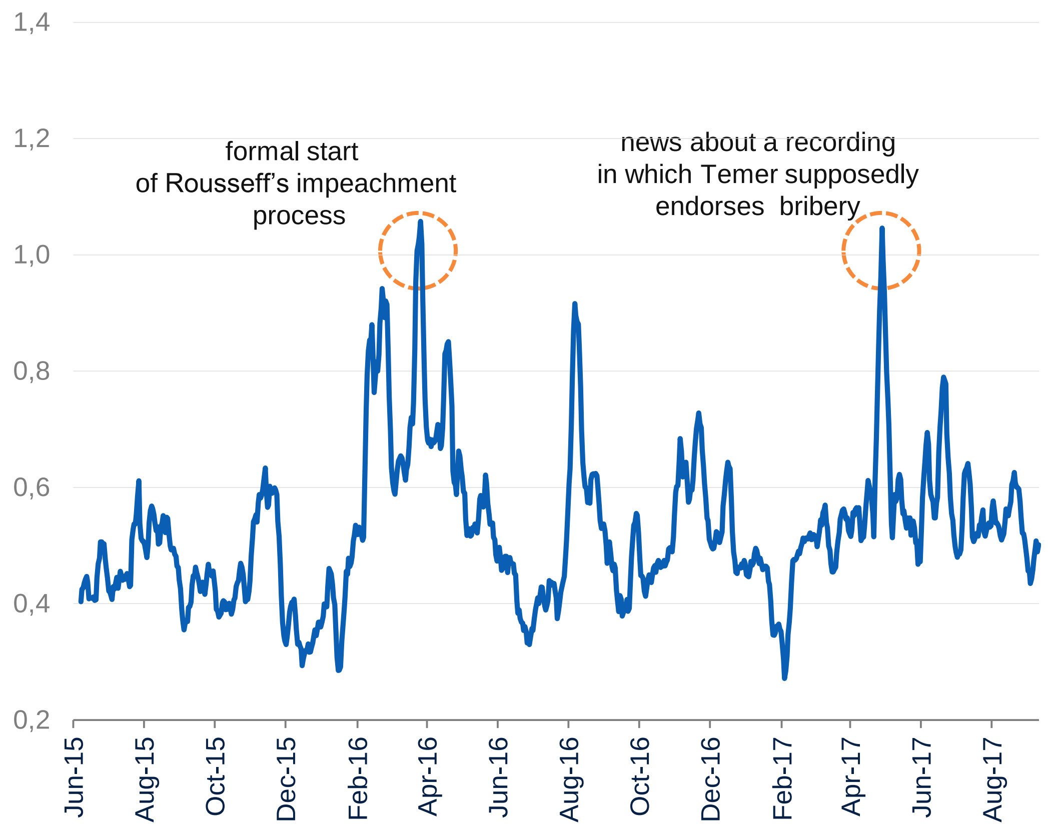
Political tensions will remain at high levels

- Recent signs showing Congress backs President Temer increase the likelihood that he will be able to govern until the end of his mandate (end of 2018). On the other hand, only 3% of the population approves the current government

- The Supreme Court's request for Congress to examine a new complaint against Temer (a previous one was rejected in August) and multiple ongoing corruption investigations have the potential to increase political tensions

- One year ahead of next presidential elections, there is still significant uncertainty about the profile of the next government. Recent polls suggest that the risk of heterodox policies is not negligible

BBVA Research's index of political tensions in Brazil*
(7-days moving average)



Source: BBVA Research and GDELT. * Index of political tensions = share of news about politics * (1- average tone of news about politics)

The recent evolution of local financial markets reflects more the favorable global environment than the internal situation

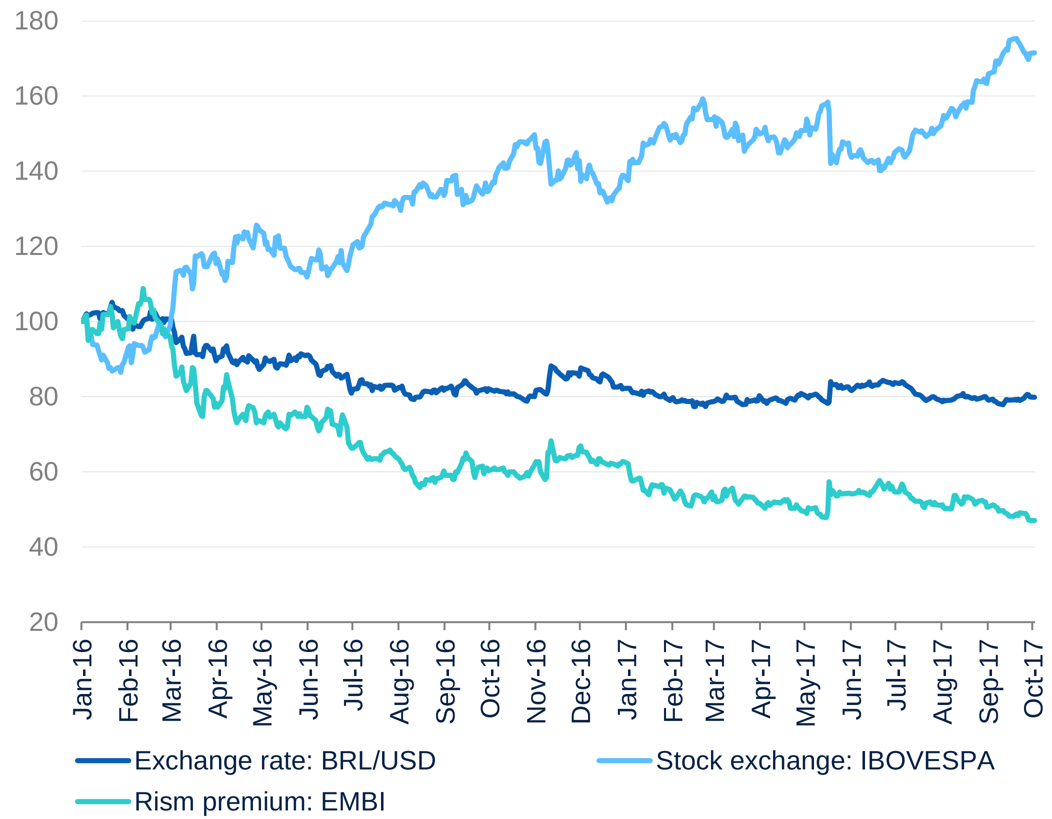
- During the last three months the Brazilian real (BRL) appreciated 4%, the Sao Paulo Stock Exchange appreciated 17% and the country's risk premium fell 14% to around 250 bp

- Even though both current government's recent stabilization and the prospects of economic recovery contribute to the positive evolution of local assets, financial markets' current optimism reflects more the favorable global environment than the internal situation

- The tone of local markets could change abruptly, whether due to external factors (lower global liquidity, stronger dollar) or internal factors (political turbulence)

Exchange rate, risk premium and stock exchange

(indices with figures of January 1, 2016 equal to 100)

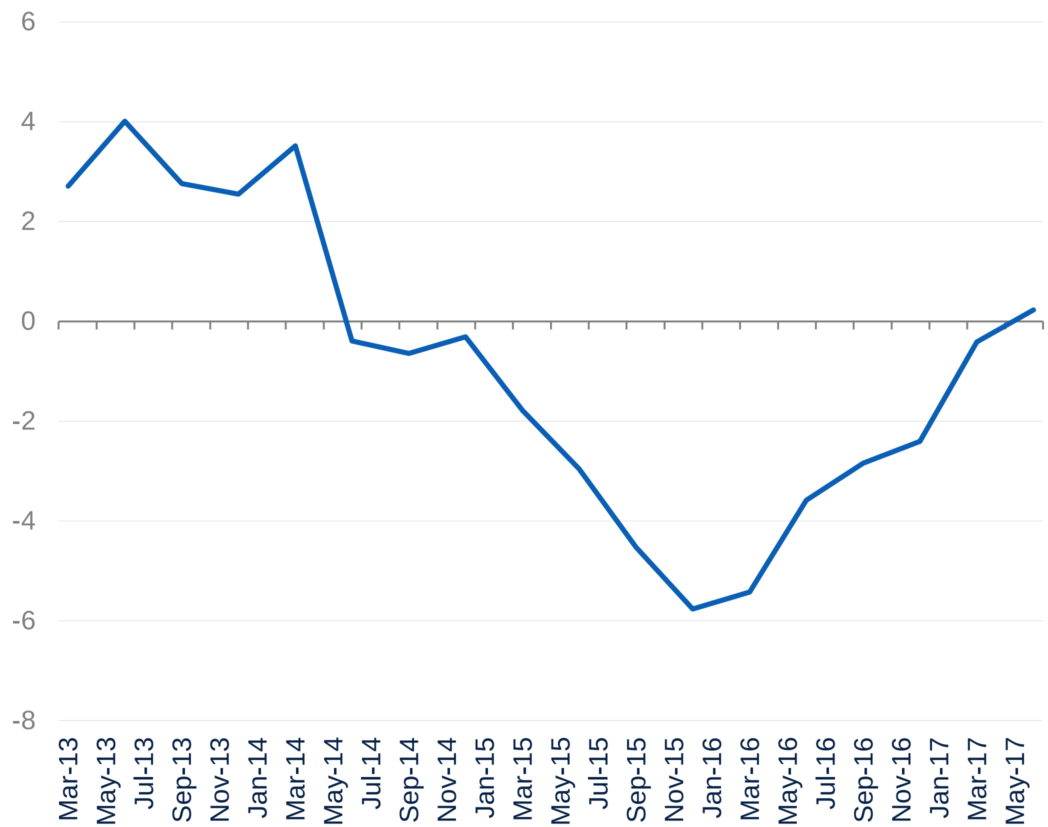


Source: DataStream and BCB

Economic activity is growing again at positive rates

- GDP grew by 0.2% YoY in 2Q17. This was the first positive growth rate since the beginning of 2014
- In quarterly terms, GDP expanded by 0.2% QoQ in 2Q17 after having grown by 1.0% QoQ in 1T17
- GDP figures surprised to the upside in both 1Q17 and 2Q17

GDP growth
(YoY %)



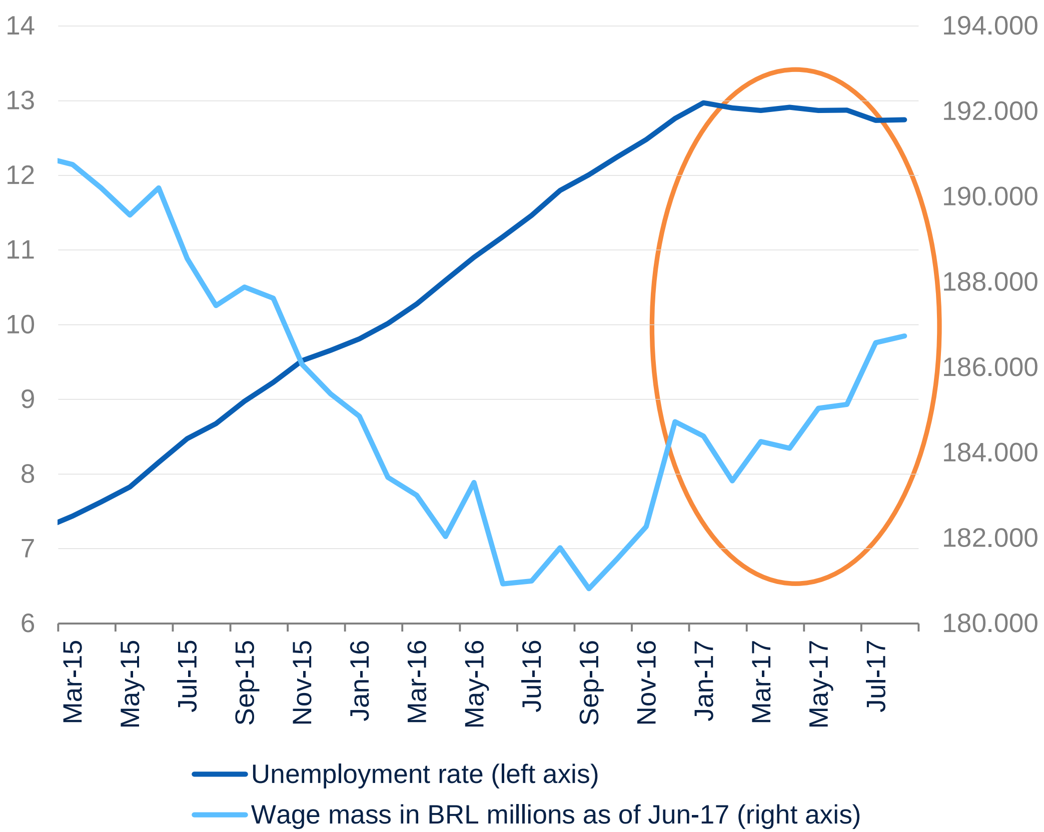
Source: BBVA Research and IBGE

Private consumption and exports are the engines of economic recovery

- After having fallen 10% since 2014, private consumption stabilized in Q1 and grew 1.4% t / t in Q2
- The recovery in private consumption is due to the fall in both inflation and interest rates and to the recent improvement in the labor market. It occurs despite the weakness of both credit markets and consumer confidence
- Exports increased again in 1H17, thanks to better terms of trade, a more favorable exchange change, a record harvest and higher global demand, while imports continued to decline
- Investment continued to fall in 1H17; it now accumulates a 30% drop since 2013

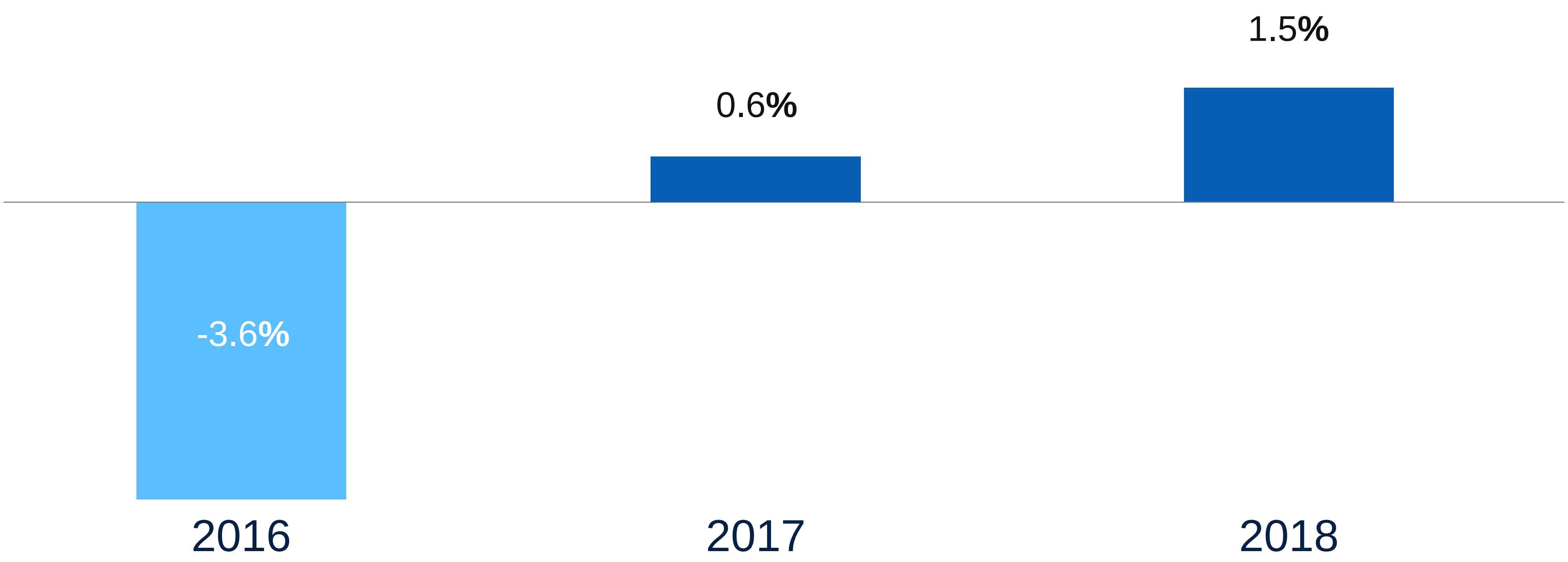
Real wage mass and unemployment rate

(seasonally-adjusted series)



Source: BBVA Research and IBGE.

The economy will continue to grow going forward, but the recovery will be more cyclical than structural



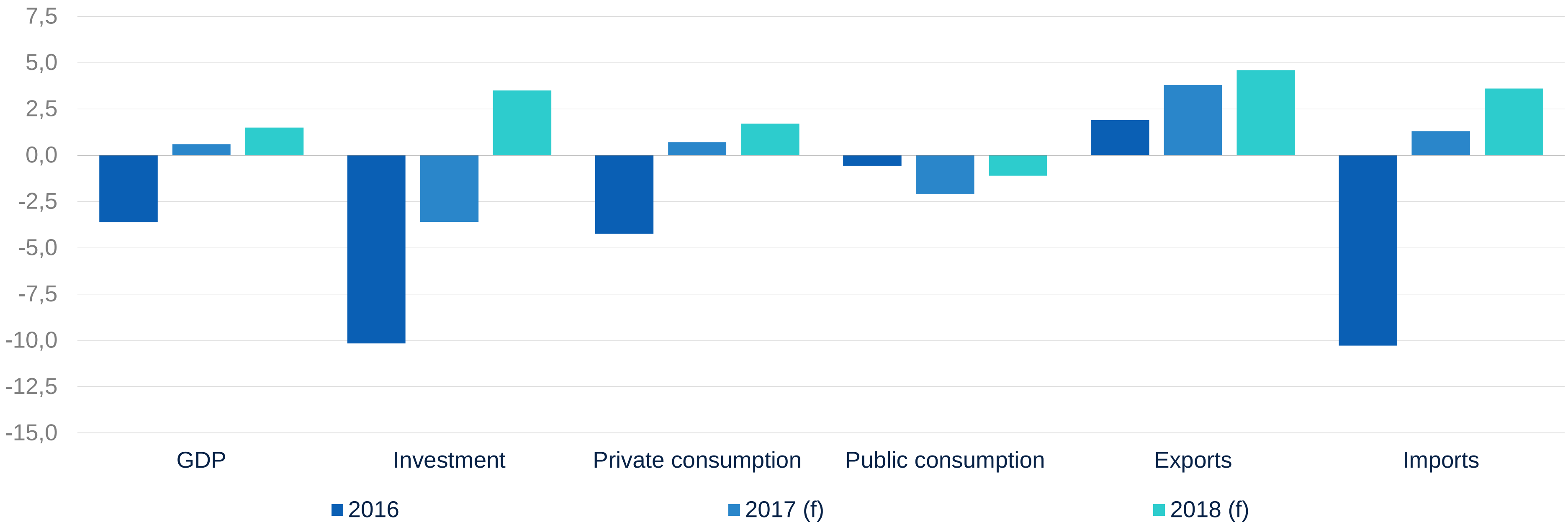
We keep our growth forecasts unchanged. The economy will continue to recover cyclically, stimulated by falling inflation, loose monetary policy, the dynamism of the agricultural sector and the favorable external environment

Political noise and fiscal problems will prevent a faster recovery. Despite some positive measures (the new reference rate for long-term financing, the new privatization program) the local environment makes the adoption of ambitious structural reforms unlikely

In forthcoming quarters investment will start to contribute positively to growth, as private consumption is already doing

GDP growth, by demand components

(%)



* (f) = forecasts. Source: BBVA Research and IBGE

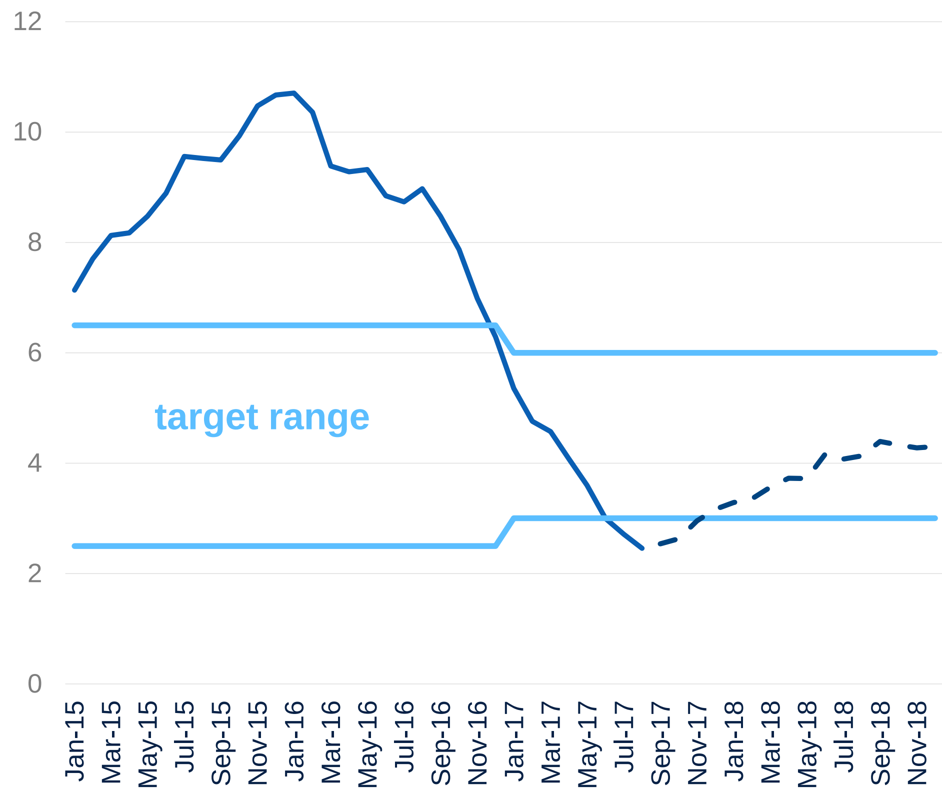
The performance of private consumption in 1H17 was more positive than anticipated, while investment surprised to the downside in the period. Thus, recent data suggest that this time the recovery will be led by private consumption rather than by investment

As domestic demand recovers, imports will increase. Thus, although exports will continue to grow, the contribution of net external demand to growth will decline

Following the recent slowdown, inflation should rise gradually from now on

- Inflation will continue at relatively low levels, which will contribute to the recovery of the economy
- After downward surprises in the last few months, largely due to lower food prices, we cut our inflation forecast in 2017 by 0.5 pp. down to 3.2%. We maintain our 4.3% forecast for 2018
- Three factors will continue to sustain an environment of low inflation (although less and less):
  - weak domestic demand
  - relative stability of the exchange rate
  - food prices (favorable supply shock)

Inflation
(IPCA; YoY %; forecasts from October 2017 onwards)

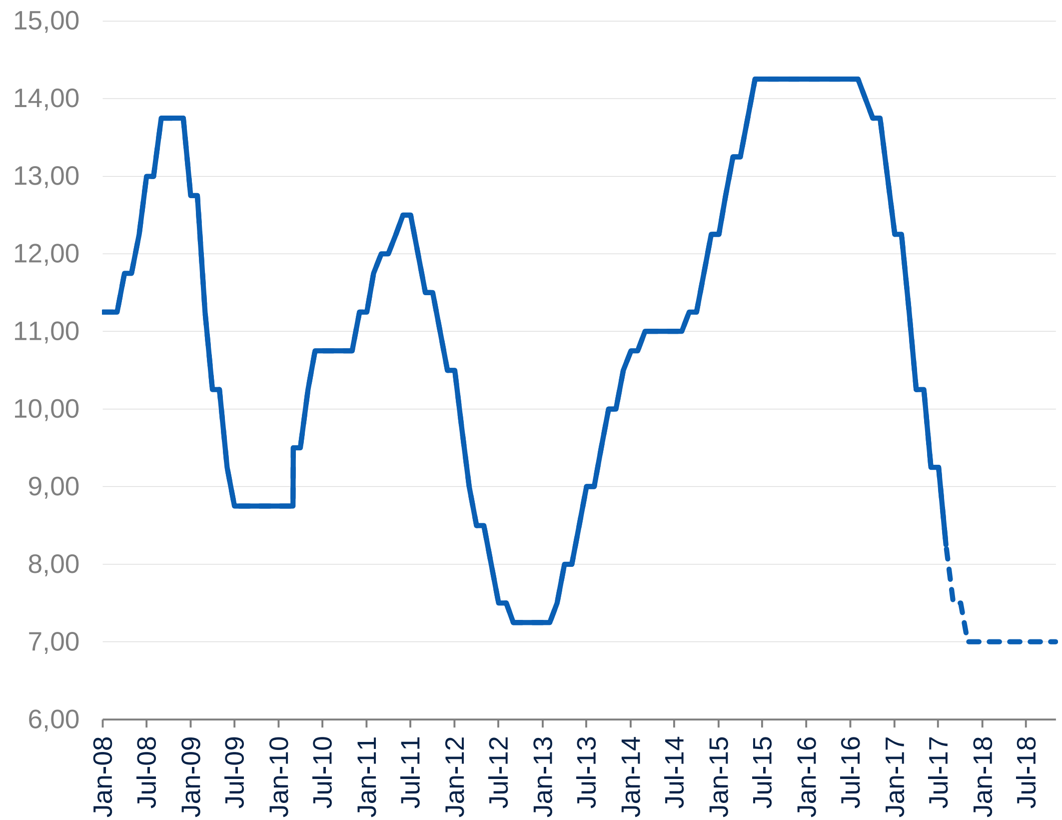


Source: BBVA Research and IBGE

Downward surprises in inflation have created additional room for a looser monetary policy

- The sharper deceleration of inflation will allow the BCB to continue to cut rates aggressively, even though fiscal problems remain unresolved
- Most likely now is that, after previous cuts of 100bp, the BCB announces a cut of 75bp in October and another of 50bp in December
- The SELIC rate should thus reach 7.0% and remain at this historically low level for a long period of time.

Interest rates: SELIC
(%; forecasts from October 2017 onwards)

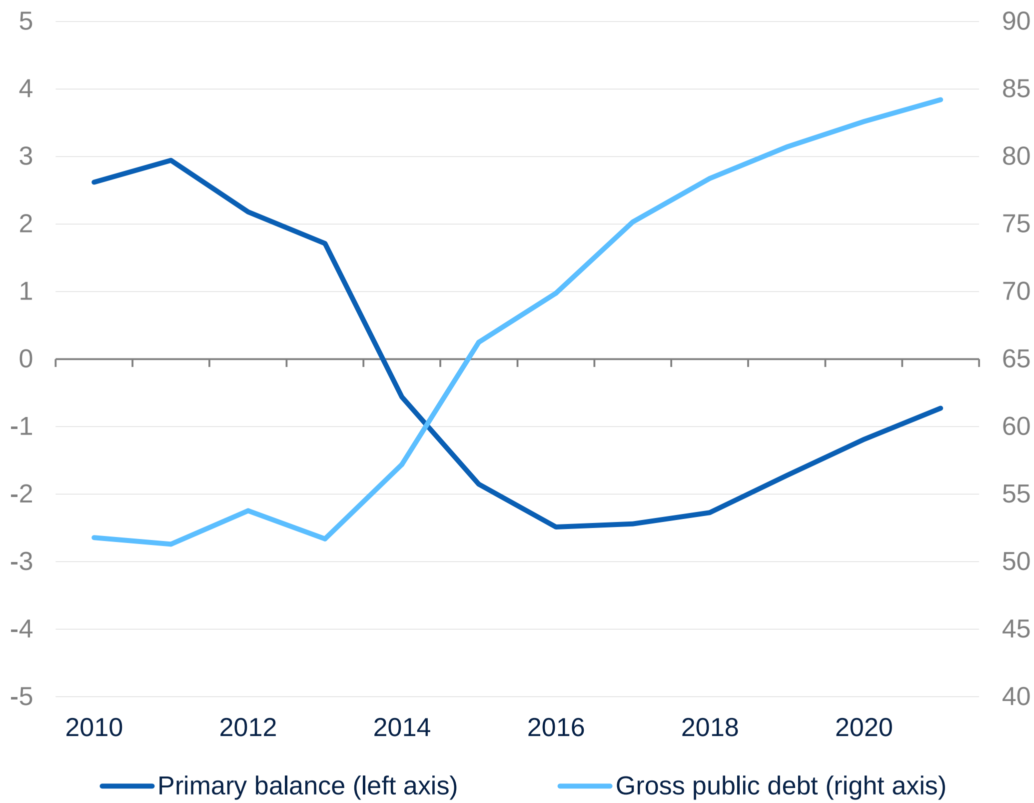


Source: BBVA Research and BCB.

The fiscal situation continues to deteriorate

- Low revenues and the difficulty of making additional fiscal adjustments have forced the government to lower its fiscal targets: the new target is now to deliver a primary deficit no higher than R$ 159bn in both 2017 and 2018 (before: R$ 139bn in 2017 and R$ 129bn in 2018)
- The impact of a larger primary deficit on public debt will be likely offset by lower interest payments(in line with expectations of a lower SELIC rate from now on)
- The current government will hardly be able to pass an ambitious social security reform and it is still not clear that the next one, to be elected in Oct-18, will succeed in doing so. Without this reform, the law of stability (in real terms) of public expenditures could be unfulfilled and then an alternative scenario with lower growth and higher inflation could emerge.

Public sector's primary result and gross debt
(% of GDP; forecasts from 2017 onwards)



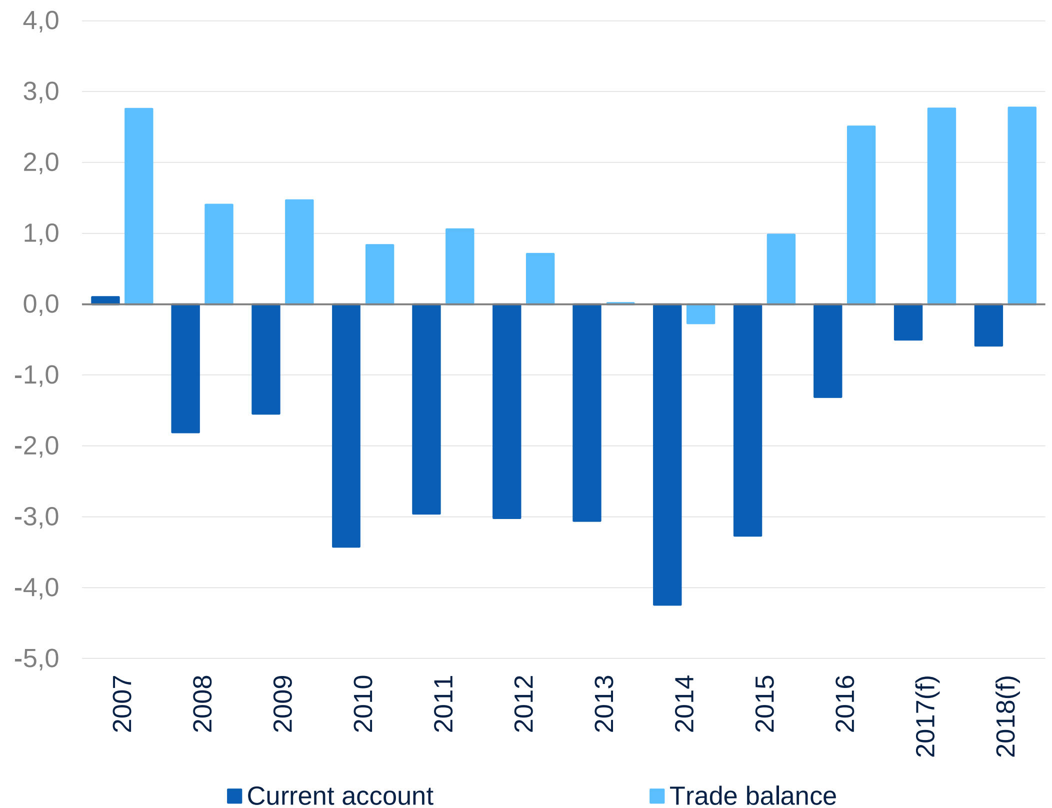
Source: BBVA Research and BCB.

A rising trade surplus drives the current account deficit close to zero

- The robustness of exports (due to higher terms of trade, record agricultural harvest, more favorable exchange change, higher global demand) coupled with weak imports (due to timid domestic demand) are generating particularly high trade surpluses and, consequently, reducing the deficit in current account.

- After some particularly positive data during the last few months, we have somewhat improved our forecasts for Brazil's current account deficit to around 0.5% of GDP in both 2017 and 2018.

Trade balance and current account
(% of GDP; forecasts from October 2017 onwards)



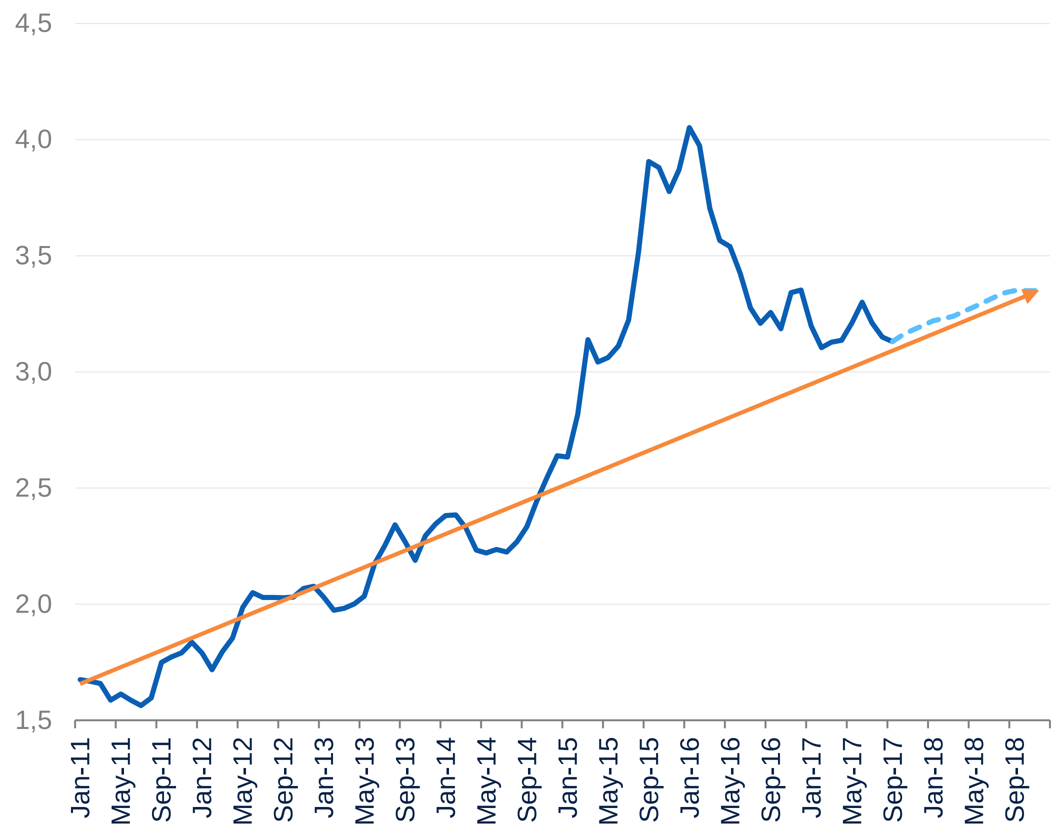
* (f) = forecasts. Source: BBVA Research and BCB

The Brazilian real exhibits strength, but we continue to expect it to weaken going forward

- The Brazilian real (BRL) stands at around 3.15 per dollar, posting an appreciation of about 5% compared to its equilibrium level.
- Political noise, fiscal risk, the prospect of commodity price stability, the gradual reduction of the differential between local and external interest rates support the view that the BRL will depreciate in the coming months.
- We forecast the BRL to reach 3.20 at the end of this year and 3.35 at the end of 2018.

Nominal exchange rate

(BRL / USD; forecasts from October 2017 onwards)



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FORECASTS

Brazil's forecasts

	2015	2016	2017f	2018f
GDP (%)	-3.8	-3.6	0.6	1.5
Private consumption(%)	*-3.9*	*-4.2*	*0.7*	*1.7*
Public consumption (%)	*-1.1*	*-0.6*	*-2.1*	*-1.1*
Gross fixed investment (%)	*-13.9*	*-10.2*	*-3.6*	*3.5*
Exports (%)	*6.3*	*1.9*	*3.8*	*4.6*
Imports (%)	*-14.1*	*-10.3*	*1.3*	*3.6*
Unemployment rate (average)	8.3	11.3	12.8	12.1
Inflation (end of period. YoY %)	10.7	6.3	3.2	4.3
Selic rate (end of period. YoY %)	14.25	13.75	7.00	7.00
Exchange rate (end of period)	3.87	3.35	3.20	3.35
Current account (% of GDP)	-3.3	-1.3	-0.5	-0.6
Public sector's total fiscal result (% of GDP)	-10.2	-9.0	-8.1	-6.8
Gross public debt (% of GDP)	66.2	69.9	75.2	78.4

f = forecast

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