Brazil Macro Update

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EXECUTIVE SUMMARY:

- **Domestic drivers of the Brazilian economy face still-stretched balance sheets, which represent headwinds to a potential economic rebound. However, very low output levels in industrial production (sitting at 2004 levels) mean there is some potential for a base effect improvement.**
- **On the reform front, pensions remain the key reform, and the outlook is still highly uncertain. The long-term interest rate (TJLP) reform appears more likely to be approved, and could allow interest rates to compress, providing some relief to a widely over-levered economy.**
- **The 2018 elections remain highly uncertain.**

GROWTH

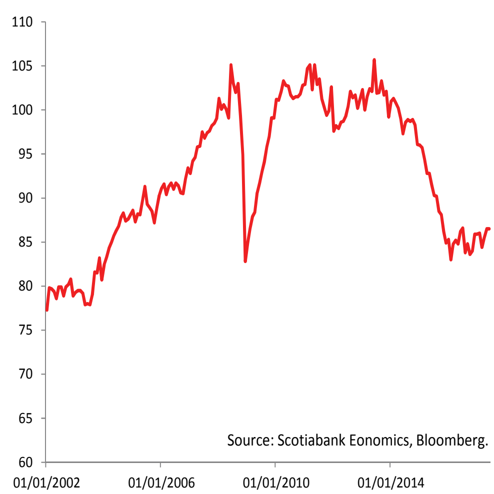
The outlook for Brazil over the next year is extremely binary. If reforms are approved, and a market-friendly candidate is elected we could see additional relief for Brazilian markets, and FDI flows gain further traction. Few places in LATAM need strong foreign investment as much as Brazil does at the moment, given the sluggishness of its uncompetitive manufacturing sector, highly levered households, and a stretched public sector balance sheet, which have led to the country's worst recession on record.

On the household front, the share of after-tax income that Brazilian households devote to debt service remains near its historic high (see chart 1)—and around (or higher than) the levels reached in the US or Spain before their respective debt crises. There is potential for some relief for households as interest rates fall—particularly if the TJLP and pension reforms are passed (as we explain later on), but our sense is that consumption will remain relatively weak until households' balance sheets improve. At the government level, the balance sheet is constrained by rating pressures, which prevent it from going on a spending spree to boost the economy (the fiscal deficit is expected to again come in around 8% of GDP, and gross public debt is nearing 90% of GDP).

The manufacturing sector could experience improvements from base effects, as industrial production remains near 2004 levels in real terms, but two factors act as constraints: 1) whatever competitiveness it got from the Brazilian real's initial depreciation was eaten away by very high inflation, which has meant the gross depreciation of the real was essentially eaten up by rising costs, and 2) a large share of corporates themselves are highly levered. The weakness in domestic economic drivers due to stretched balance sheets makes foreign investment appetite very important for any potential Brazilian rebound.

Chart 1: Household balance sheets remain highly levered—dampening growth prospects.

Chart 2: Brazil's industrial production currently sits near 2004 levels in real terms, offering some potential relief—if for nothing else, due to base effects.



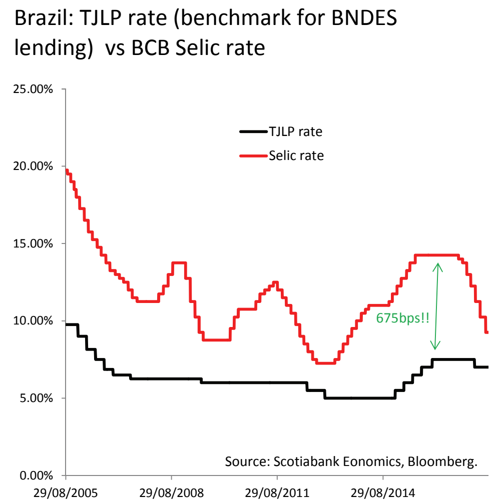
REFORMS

Although we are likely to get some good news on the reform front, most likely on the TJLP rate changes, it is far from clear if the pension reform—arguably the most important one—can pass without being materially watered down. The TJLP reform can help the economy to the degree it can allow interest rates to fall, but pensions is arguably the make-or-break reform.

What is the TJLP rate, and why is it relevant? It's the benchmark interest rate at which the BNDES lends to the corporate sector in Brazil, and at times over recent years, this interest rate has been set over 600bps "tight" to the BCB's policy rate (the Selic rate—see chart 3). The reform seeks to move this benchmark (the TJLP) closer to being determined by market forces. This is relevant for two reasons. As the IMF argues, the reasons why Brazil's market clearing interest rates are higher than most of Latin America, include:

- Fiscal considerations: high levels of public debt, as well as a history of defaults could be part of the reason why Brazil's market clearing rates are high. More recently on the fiscal risk front, one of the reasons why the country's credit ratings came under pressure over recent years (and Brazil lost its investment grade) is that the government was very aggressive in providing the private sector with financing through state-owned banks, such as BNDES. If the subsidy on the TJLP rate is cut, and the development bank's lending rates converge to market ones, we could see fiscal concerns decline—as both the subsidy declines, and the dependence of the corporate sector on BNDES drops. This could help lower market clearing rates.

Chart 3: The subsidy implied by the spread between the TJLP and the SELIC rate got to nearly 700bps. Reducing that spread could help reduce Brazil's market clearing rates.

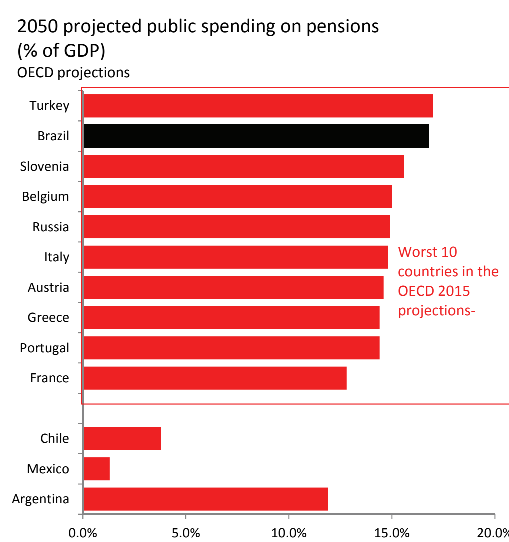


- The second way in which we see the TJLP reform helping lower market clearing rates is by improving the pool of borrowers who rely on market financing. Even though the development bank's role is supposed to be covering segments of the economy that don't have access to market financing, we would argue that for much of the Partido dos Trabalhadores' (PT) administration, the BNDES was aimed at supporting "national champions" (i.e., the top corporates in Brazil—or the prime borrowers). By taking top borrowers out of the market pool, the government was leaving a lower quality pool of borrowers for market players—thus pushing up the market clearing rate. If the reform succeeds in lessening this market segmentation, we could see market rates drop in Brazil.

Hence, our take is that the TJLP reform could allow market clearing rates to fall, and consequently allow the BCB to cut rates to a lower sustainable level… giving the highly levered economy some relief.

Why is pension reform the "make or break" reform? Brazil's fiscal position is currently under a lot of pressure, with the country having lost its investment grade from all three major rating agencies. One of the weak spots of Brazil's public finances is the size of its unfunded pensions deficit. According to the OECD, if the pension issue is not addressed, the country will be facing annual payments of around 15% of GDP by 2050 (see chart 4)—making it one of the countries facing the worst pension situations of all those measured. The current proposal does not fully address the issue, but it is estimated to save a potential US$190bn over the next decade, which could improve the country's fiscal position, and also drive yield compression. The problem is that approval of the reform remains highly uncertain.

Chart 4: Brazil faces one of the worst pension deficits of any country measured by the OECD, if left un-addressed. If the current reform proposal is approved, it could alleviate fiscal pressures, and help lower the country's interest rates—a boon for the government, households, and corporates.



LULA AND THE 2018 ELECTIONS

Although President Lula presided over Brazil's golden moment at the start of the 2000s, our sense from client talks is that, as the fiscal deterioration that took place under PT governments became apparent once the commodity price environment became less benign, market players have taken a much more cautious stance regarding prospects of a return to PT rule. However, next year's election remains a question mark, with not only uncertainty over whether Lula would win a presidential election in 2018, but also over whether he will be able to run given ongoing trials the former president faces. If he is not barred from competing, Lula may still be the candidate to beat given his relatively strong backing, while the latest poll released by Ipsos (August 28th), shows his popularity is once again rising.