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BBVA Brazil Perspectives: Stuck at a bad macro equilibrium

Macro Drivers and Perspectives

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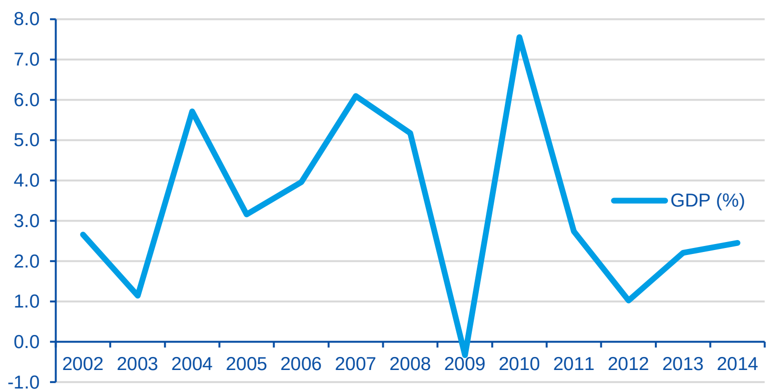
Growth unable to pick-up materially

- A challenging environment for growth over the next two years remains.
- Key headwind is the deterioration of the outlook for domestic consumption, as credit and labor markets slow down and macro uncertainties increase.
- External environment and fears of a disorderly exit by the Fed have also weighed on growth expectations.
- Political willingness to re-activate reform agenda to increase productivity is non-existent at the moment.
- The scope for officials to use the BRL to promote competitiveness has declined significantly. Infrastructure bottle necks and high costs will continue to dampen external competitiveness.
- On the positive side, we expect higher investment in part from private participation in infrastructure projects, and for exports to rebound slightly following the recent FX depreciation.
- BBVA Economic Research forecasts growth to pick-up to a still soft 2.5% YoY in 2014, with risks to the downside.

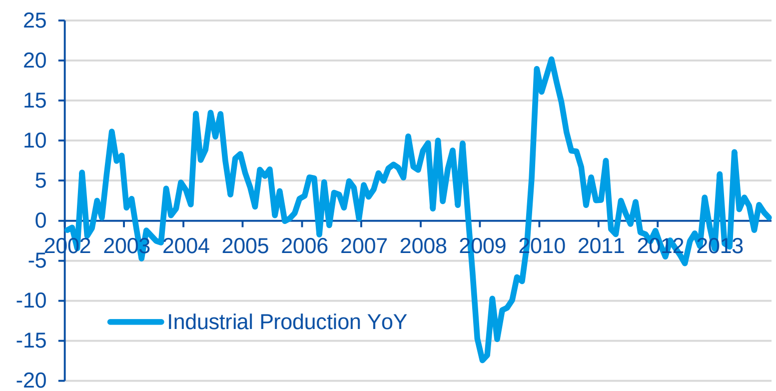
GDP growth is making only a modest recovery

Source: Bloomberg and BBVA Research



Industrial production remains weak

Source: Bloomberg and BBVA Research



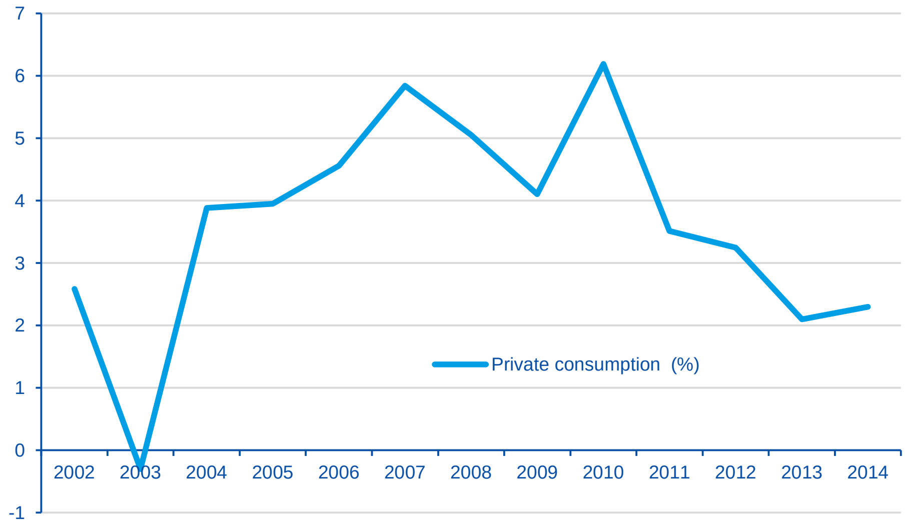
Expect modest economic recovery, but with structural constraints

Domestic consumption facing headwinds

- Business and consumer confidence have deteriorated over the short-term, as uncertainty remains high.
- The ability for labor market and credit channels to promote domestic consumption has declined on a structural basis. Higher policy rates and household debt burdens have reduced domestic credit growth.
- The constraints on the fiscal situation leave very little room for counter-cyclical fiscal policies. Monetary policy is increasingly less supportive.
- Difficult to anticipate a quick rebound of domestic demand conditions.

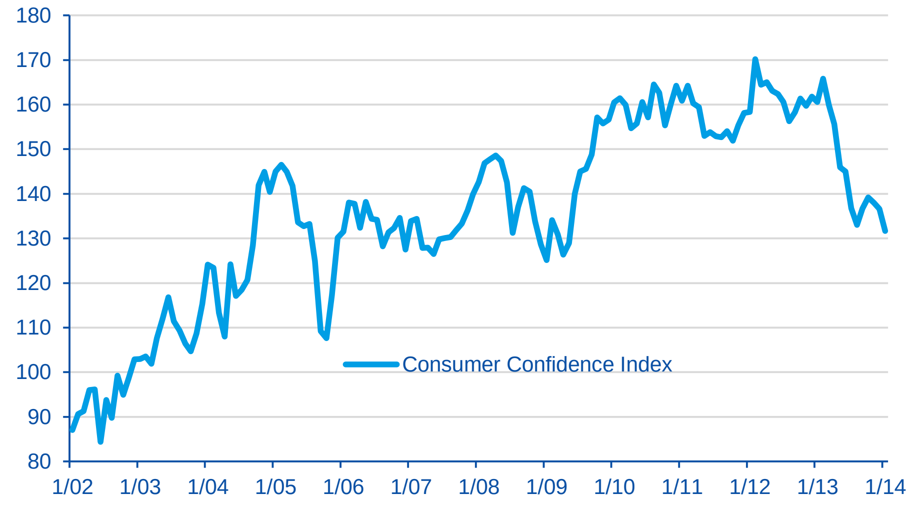
Private consumption growing at a slow pace

Source: Bloomberg and BBVA Research



Consumer confidence declining

Source: Bloomberg and BBVA Research



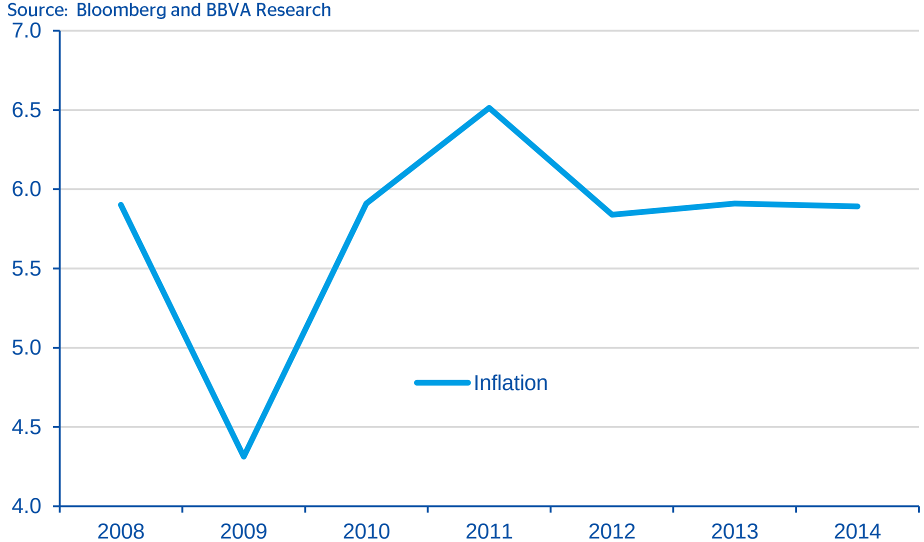
Room for fiscal, external and domestic stimulus in 2014 is very tight

A strong floor for inflation

- The recent decline in inflation has been modest and is likely temporary.
- The decline in inflation towards the end of last year was concentrated in a few sectors. Domestic food prices have been particularly helpful as global prices and domestic taxes decline.
- The government's intervention in administrative prices has masked real demand pressures. The room to continue this policy is much more limited.
- Services and core components demonstrate underlying pressures, which should keep the floor for inflation high.
- The on-going BRL sell-off should further push inflation higher, despite relatively low pass-through coefficients.
- The actions taken by the Copom thus far have failed to shift the negative dynamics for CPI expectations.

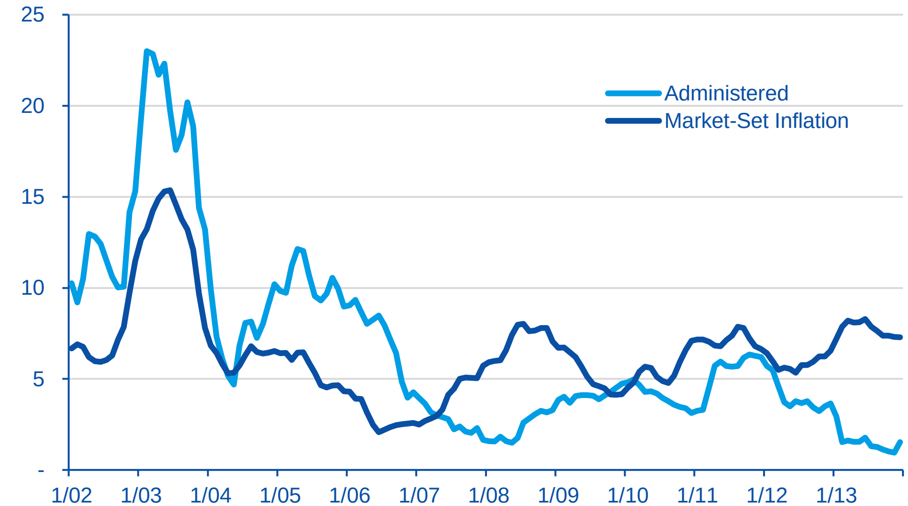
End of period Inflation still hovering close to 6%

Source: Bloomberg and BBVA Research



Large divergence between administered and market pressures

Source: Bloomberg and BBVA Research



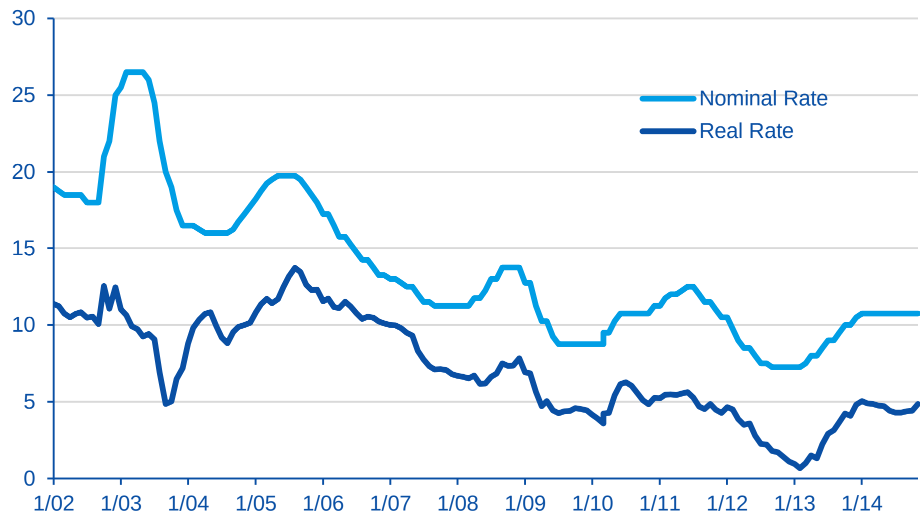
The recent drop in inflation masks several sources of additional pressures.

Monetary tightening close to the end

- The Copom has shown willingness to extend the hiking cycle; but this is likely to end at the next meeting.
- Committee has responded to market pressure and deteriorating macro dynamics (especially high inflation expectations).
- This has pushed the Selic higher as the Copom reverses the previous easing cycle.
- We expect the committee to deliver a 25bps hike at the next meeting, less than the rate markets are pricing in.
- However, a weaker-than-expected BRL could force an extra adjustment of monetary conditions.
- We maintain our defensive stance of local rates as policy uncertainty is high and fundamentals weak.

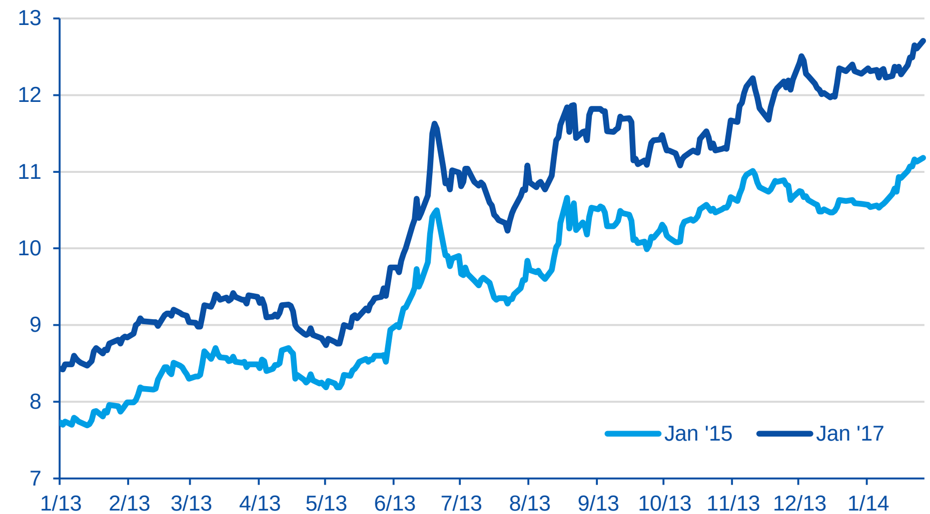
Nominal rates back towards recent ranges...

Source: Bloomberg and BBVA Research



...but the pressure on rates has been strong; we remain defensive

Source: Bloomberg and BBVA Research



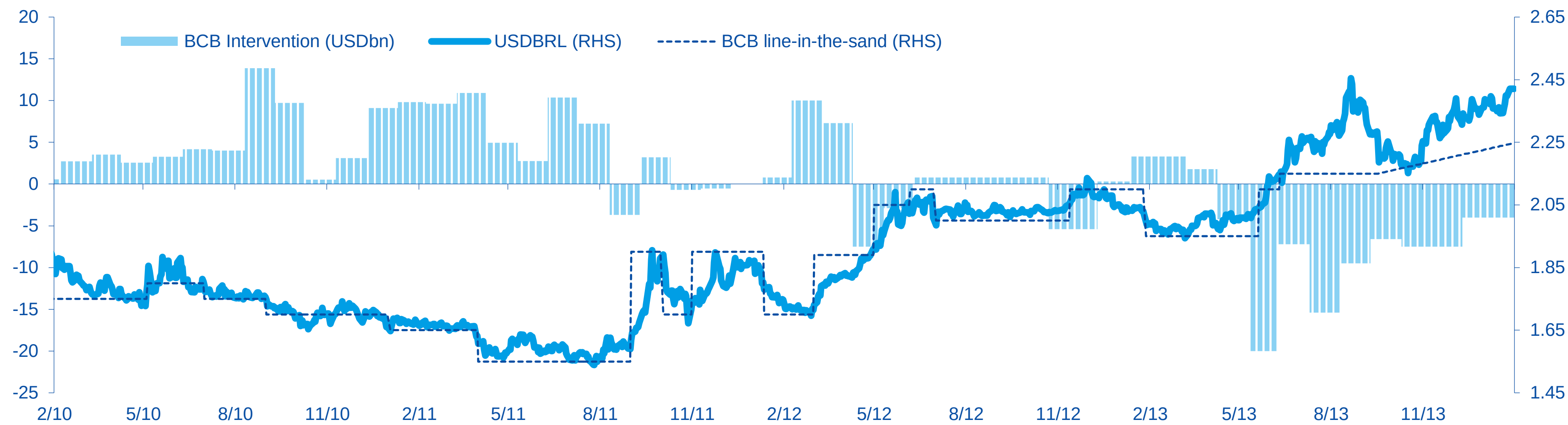
We are close to the end of the tightening cycle. We expect a last hike of 25bps at the next meeting.

BRL: Testing the power of intervention

- Official actions have eased extreme BRL pressure, but overall negative dynamics remain firmly in place.
- Authorities have shown sensitivity to FX pass-through to higher inflation, but long-term commitment for a stronger BRL could falter.
- FX intervention program has been a key driver, but effectiveness of previous actions is becoming questionable.
- Overall negative external drivers for EMFX are likely to exert pressure on the BRL.
- Terms of trade offers little immediate support, as commodity prices should remain subdued.
- We remain defensive over the medium-term, even as carry has become more attractive.

BRL still under pressure despite policy intervention

Source: Bloomberg and BBVA Research



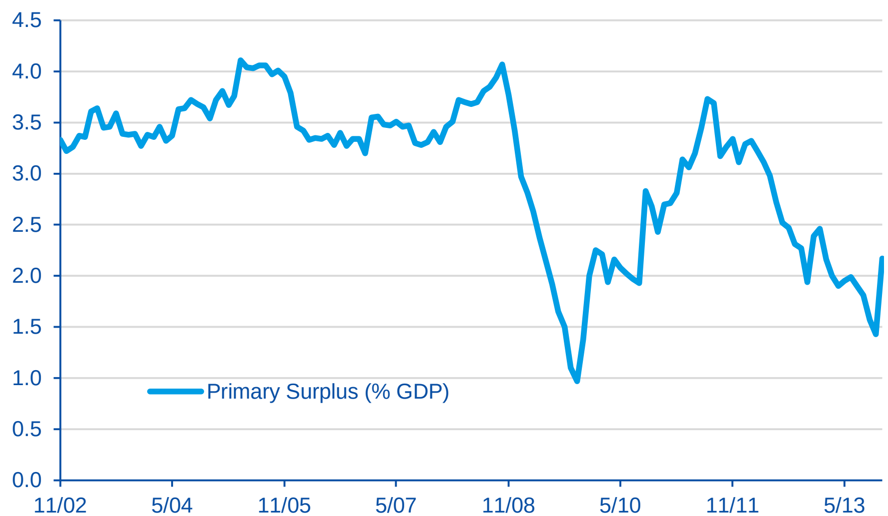
We target the BRL at 2.49 by year-end amid high vol and upside risks

Strong risks to fiscal position

- The fiscal position of the Brazilian economy has deteriorated materially over the past couple of years
- Gross-net to GDP has increased, remaining above the levels of similar EM economies
- The government has reduced the primary deficit to around 1.6%, significantly worse than in previous years in spite of very significant one-off revenues
- The recent monetary policy tightening will increase the burden of interest payments (around 5% of GDP)
- General elections in October 2014 reduce the incentives for the government to adjust fiscal expenditure
- We expect the rating agencies to downgrade the Brazilian sovereign rating in 2014.

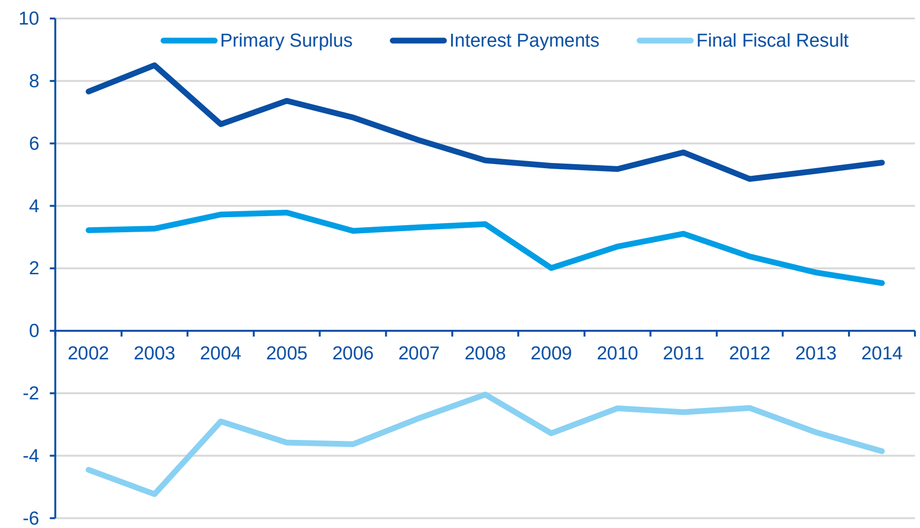
Primary surplus falling

Source: Bloomberg and BBVA Research



Weaker fiscal result despite lower interest payments

Source: Bloomberg and BBVA Research



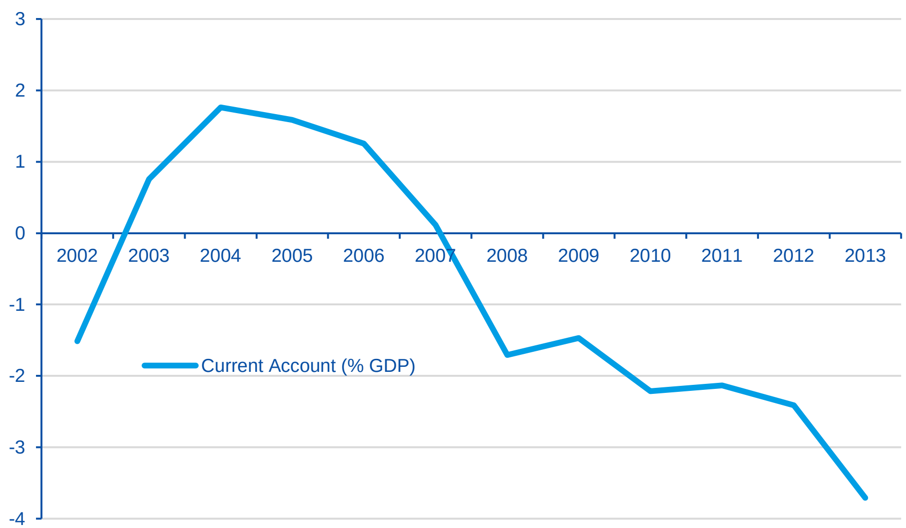
The fiscal balance sheets have deteriorated, increasing the chances of sovereign credit downgrade

Watching the external accounts

- Deterioration across current account categories
- Trade balance has worsened, and manufacturing exports have declined as well
- High FX reserves cushion against systemic concerns, but current account deficits add to Brazil's macro vulnerabilities
- BBVA Economics expects the CA deficit to ease somewhat in 2014 (to around 3.4% of GDP from 3.7% in 2013)

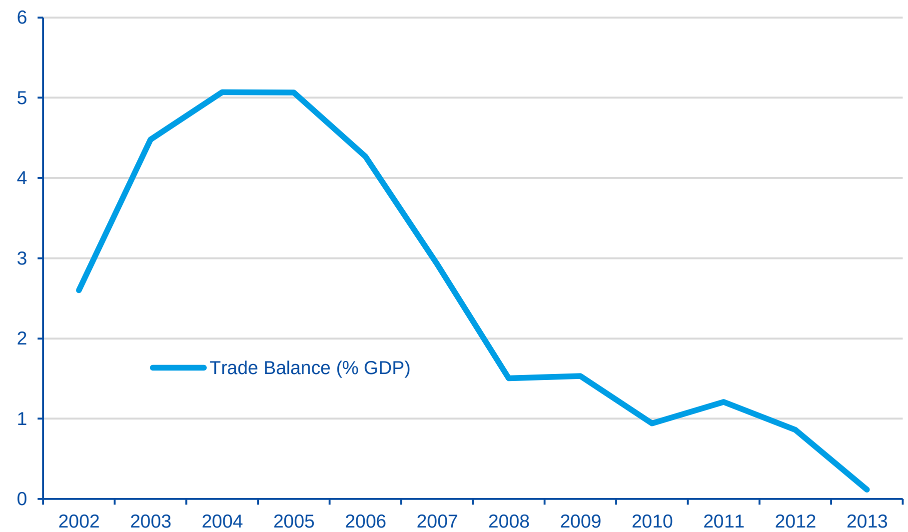
Current account deteriorates materially...

Source: Bloomberg and BBVA Research



... as trade surplus evaporates

Source: Bloomberg and BBVA Research



Elevated current account deficit adds to Brazil's macro vulnerabilities

What will it take to gain back confidence?

Weak Macro Equilibria

- GDP growth unlikely to rebound strongly
- Domestic consumer demand faces structural challenges (credit, labor markets)
- Copom delivers hikes, but we only expect one more 25bps move
- BRL increasingly subject to external environment
- Weaker external and fiscal stance pose downside risks, including potential for sovereign downgrade

Negative External Environment

- Less potential for Fed surprises, but negative balance of risks
- Appetite for weaker (high CA deficit) EM economies remains very tactical
- Lack of sustained demand for Brazilian rates and BRL

Unconvincing Policy Response

- Copom finishing reluctant hiking cycle
- Lack of appetite for structural reforms
- Weak market credibility to remain until appetite for EM improves

Macro downside risks remain; maintain bearish stance on local Brazilian assets

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