Economics&Fixed Income

Monthly Economic Outlook

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Key Takeaways

- *We believe any material fixes to the social security are unlikely to come prior to the next Presidential cycle, should it be either through constitutional amendment or any other alternative.*
- *Our scenario factors in a mild recovery and amid low inflation. Fiscal risks, however, are likely to increase amid political paralysis and the approaching presidential election.*
- *Hopefully, the global background remains benign thus helping the country to navigate these troubled waters until 2019.*

1. Scenario Assessment

The odds of any material pension system fixes have been substantially downgraded, to the extent that we are no longer factoring that in prior to the next presidential cycle. This seems to be the case either if one considers changes through constitutional amendments or through any other alternative.

In a nutshell, we understand Temer's fight to retain his seat should consume the whole opportunity window between now and September, when Congress should then turn to the electoral reform. After that, the election year will get kicked off and only under dramatic circumstances should politician should fell compelled to embark in such costly enterprise.

Similarly, we don't expect the Congress to be particularly sensitive to fiscal issues along the same period, and for the very same reasons. Hence, as investors get ever more wary about the fiscal outlook of the country, it is likely that the economic team may have to resort to measures that should bypass Congressional authorization, in case it needs to boost the Central Government accounts. In this respect, the Cide fuel tax is likely to be raised sooner or later.

In light of the aforementioned political *cum* fiscal background, in addition to the existing deflation forces, the outlook seems to take a twofold pathway. On one hand, in our baseline scenario where deflating forces prevail, inflation should stand ranging about 3.3% in 2017E until reaching 4.1% in 2018. Accordingly, the Selic rate should reach 8.0% by 2017E year-end, where it should stay for most 2018E.

Alternatively, however, a deterioration of the political outlook for 2019 may cast a shadow over the fiscal long-term sustainability, despite the economic team best efforts, thus hindering the economy as the presidential contest heats up. In this case, it is unlikely that Brazil's sovereign credit spreads persists at the current level, which can trigger a different dynamics for the fx rate and the Selic rate. By all means, although this is not our baseline case, this shouldn't be ruled out at this juncture.

Variable	2016	2017E	2018E
GDP (yoy %)	-3.5	0.1	1.5
Selic Rate (%)	13.25	8.50	8.00
Fx Rate (BRL per USD)	3.20	3.40	3.50
CPI (yoy %)	6.3	3.3	4.1
Primary Surplus (% GDP)	-2.1	-2.0	-1.5
Current Account (%GDP)	-1.2	-1.2	-1.8

Amid this local Background, the global outlook persists on a positive mode. Europe - believe it or not, has turned into to being the new darling of the market, as it is growing at a consistent and robust pace. In fact, the market is already eyeing the ECB's unwinding of its QE and some monetary tightening down the line, something unheard of at the turn of the year.

As for the US, the latest numbers have been a bit on the soft side. Despite that, the long-term treasury has gone up in last couple of weeks, while the VIX has persisted stubbornly close to its historical lows. Meanwhile, the Fed has raised its baseline rate by 25pbs, as largely anticipated by the market, while also laying out its plan to shrink its balance sheet effective immediately. The market wasn't bothered too much about it all.

In sum, the major mature economies are growing at consistent pace, so much so that Central Bank's therein are gradually shifting gears. Despite that, the market seems reassured by the idea that monetary tightening ought to be gradual, since lower productivity growth should continue to keep long-term rates at low levels by historical standards. This outlook persisting, it should help the country to navigate these trouble waters.

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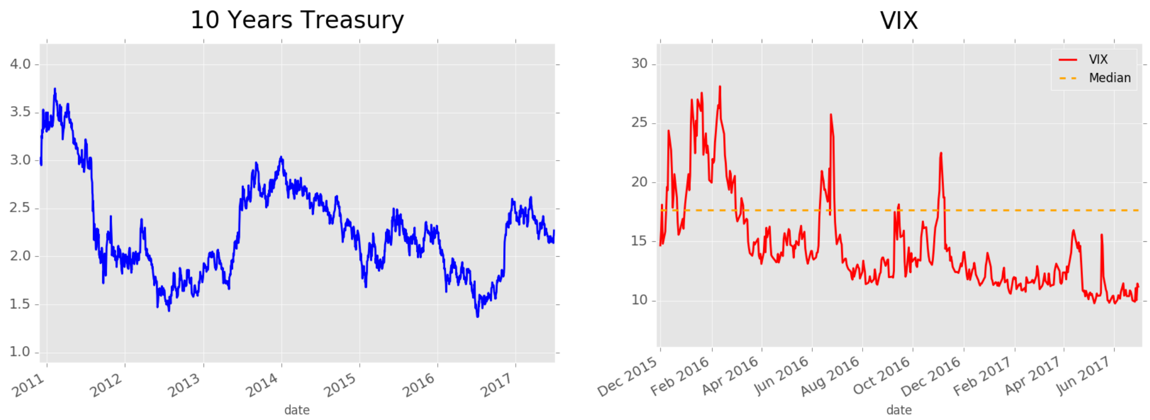
2. Global Economy

US and EU are facing similar challenges: economic expansion at full potential and stubbornly low inflation. Monetary policy is certainly in order, but pace should remain mild.

The US activity figures came in a bit on the soft side as of late. However, the view that it is operating at full potential remain intact. In fact, despite the weak batch of data, the yield of ten years Treasury has gone up and is back gain above the 2.30%. Meanwhile, volatility has remained at close to historical lows.



(a) (b)

Figure 1: source: Federal Reserve

On the momentary policy, the Fed decided to raise the Fed Funds by 25bps to xx, as largely anticipated by the market. More importantly perhaps, it has disclosed its plan to unwind its balance. In a nutshell, should market conditions allows, it will gradually increase its amortization payment it receives, net of rollovers, from Treasuries and mortgage-backed securities up to a monthly of USR50bn in 12 months time. Following this policy, it expects to lower the excess reserves liability its holding, albeit at levels about crisis one.

Across the Atlantic, the EU continues to show signs of growth resilience, by and large as product of the ECB QE. As matter of fact, growth has been widespread,. . .

Similar to the Fed, the ECB is facing the puzzle of facing an economy expanding at its full potential, and, at the observing inflation stubbornly. Hypotheses abound, however, none of these Central Banks seem to have a clear answer as of when this divergence is like to disappear.

In face of this benign global backdrop, the main fear on our radar screen is the political risk in US combined with extremely low risk aversion. Taken together, they raise worries of possible tail events, should the market decide to turn sour because of the any meaningful political setbacks in the US.

3. Brazil

In short-term, the crisis is likely to have augmented deflating drivers. However, amid political paralysis and and waning reform hopes, this should provide little extra leeway to monetary policy.

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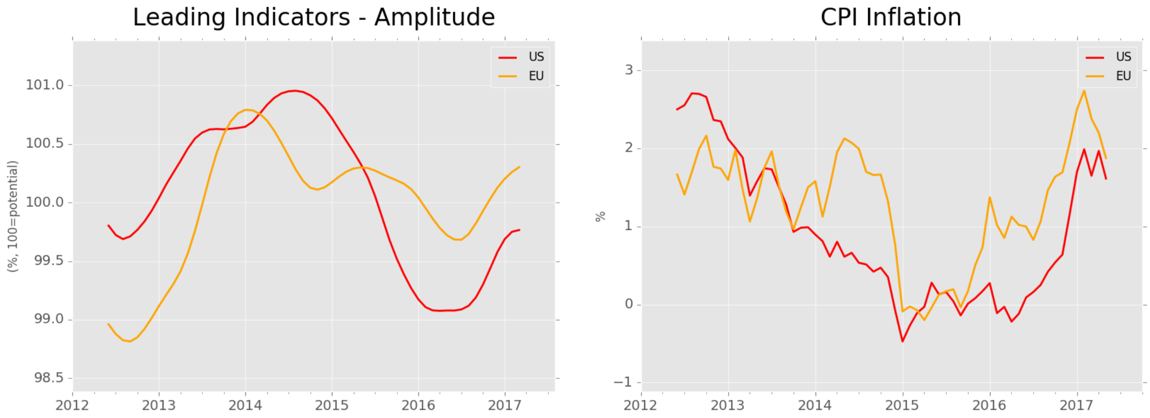
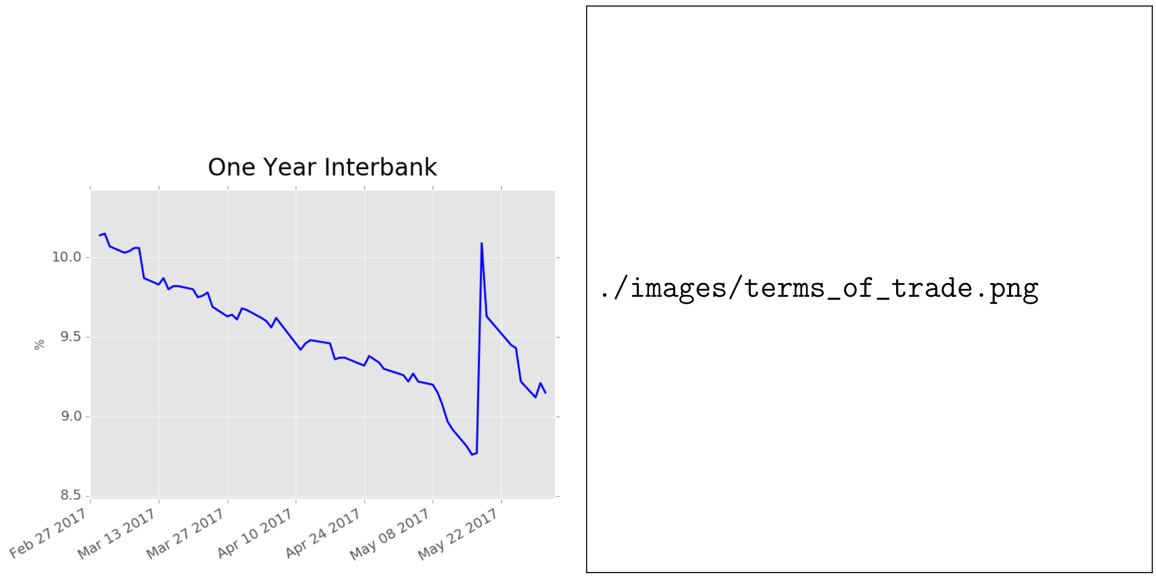


(a) (b)

Figure 2: source: Federal Reserve

The latest patch of data wasn't bad. By and large activity numbers' of April were pointing northward and, as underscored by the Central Bank's Ibc-br, overall activity expanded in the month. Moreover, industrial production of May has inaugurated the month expanding yxy%.

In the meantime, inflation in May yet again came in quite low by historical measures, regardless of energy related one-timers. However, the main question persists: How much is the economic crisis likely to nhave deffer the economic recovery?



(a) (b)

Figure 3: source: Federal Reserve

Based on confidence gauges, the crisis is already abating activity, something that should become more clear as June's data start to come out. Importantly, once this weakness is confirmed, it is undoubted that deflating forces will persist longer, provided everything else is the same.

As matter of fact, the Central Bank itself has acknowledged that the ongoing crisis may have a deflationary impact, although warning the risks over the neutral interest rate. Therefore, the

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net impact on interest rates is left to be since.

Ourselves, we believe that everything else the same, the Selic rate should reach 8.00% by year-end, where it should stand for the whole 2018E. Cutting a long story short, the crisis has hindered the neutral rate, as thus entailing large rates by the end of the cycle. However, the fiscal risks implies that upside risk to this call should not be dismissed.

Fiscal policy and Politics: risks to fiscal consolidation

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