Economics&Fixed Income

Market Discipline or a Fallout

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Market Discipline or a Fallout?

- *We understand the balance of risks have changed, unfortunatley, not for the better.*
- *A muddling through type of social security reform is becoming more likely as opposed to a material one.*
- *This implies a two-fold path going foward: a) market discipline forces a meaningful reform, or b) political forebearnace leads to negative re-pricing for the longer term.*

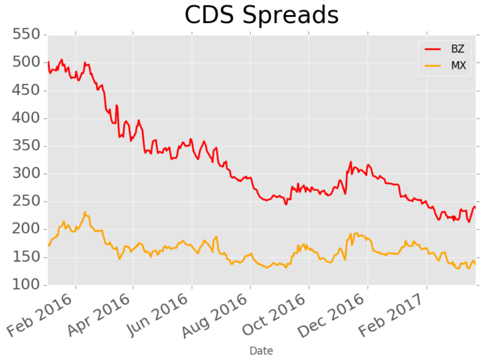
1. The Two-fold paths

◇ **Balance of risks have changed**. The latest flow of news have confirmed the difficulties of Mr. Temer to approve the social secutiry reform as is. While some type of compromising have been expected from the outset, we believe the latest announcement to leave State civil servants out of the reform has opened a pandora box, making it is difficult to predict what is going to come out of it.
More specifically, once one makes such a type of compromising involving specific classes of workers, the incentives in place are such that other classes should soon start to lobby for favoritism. In addition, there is also the interest of less organized citizens, such as those leaving off social benefits in many corners of the country, who hold great voting relevance. Thence, once sums all that up, the budget of acceptable concessions from the fiscal adjustment standpoint may start to fall short of the mounting pressures.

- **A two-fold path**. In light of the fore mentioned, the easy path towards a reform that comprises a) increases the minimum retirement age to 65 for both genders; b) ends with retirement of period of contribution of the system; and c) encompasses rural, urban, private and public workers alike is no longer possible. In fact, in order to reach a compromise that contemplates parts of either of these topics, there ought to be pressure in the opposite direction, and the only possible candidate to looks in the positions to do so is the market.

  In fact, Brazilian credit spreads as in **??**, it's been standing about 90bps above Mexico's year-to-date, a country holding a sovereign credit rating about 4 notches above Brazil's. No doubt, it entails a rather benign vision towards the country's outlook, in particular, with respect to the country social security system. Hence, should this perception changes significantly, there is plenty of room for things to turn sour. In fact, the recent moves concerning the social security reform have been shrugged off by the market, and the volatility of Brazilian assets have clearly take off way from the US's benchmark.

  Hence, the question: will the political class remain oblivious to that and follow their own agenda, or will the kneel to market pressures? We thinks latter of the most likely candidate, but with 2018 general elections take over their agenda, one should not dismiss the former altogether.



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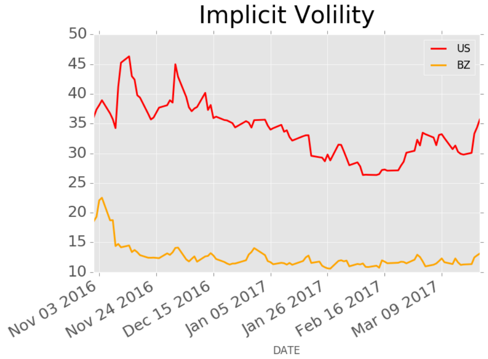

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2. Forecastsn

Variable	**2016**	**2017E**	**2018E**
GDP (yoy %)	-3.5	0.3	2.5
Selic Rate (%)	13.25	8.00	7.5
Fx Rate (BRL per USD)	3.20	3.25	3.30
CPI (yoy %)	6.3	4.0	4.4
Gross Debt to GDP (%)	73.0	77.2	83.2
Primary Surplus (% GDP)	-2.1	-2.0	-1.0
Trade Balance (% GDP)	2.0	1.5	1.5
Current Account (%GDP)	-1.2	-1.5	-2.0
Foreign Reserves (xUSD Gross Liabilities)	1.1	1.1	1.1

3. Disclaimer