Economics&Fixed Income

Time for Market Discipline

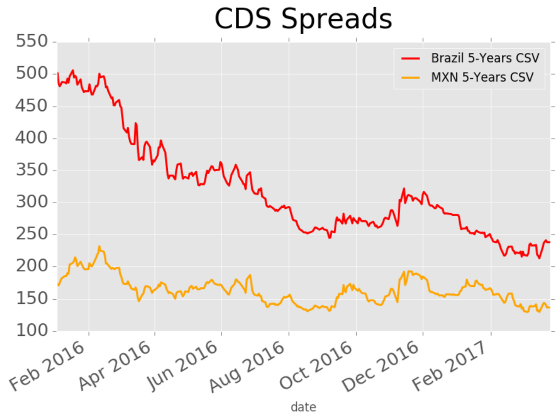
Joao Mauricio Rosal, *Chief Economist, PhD*
joao.rosal@bgcpartners.com
March 28, 2017

Time for Market Discipline

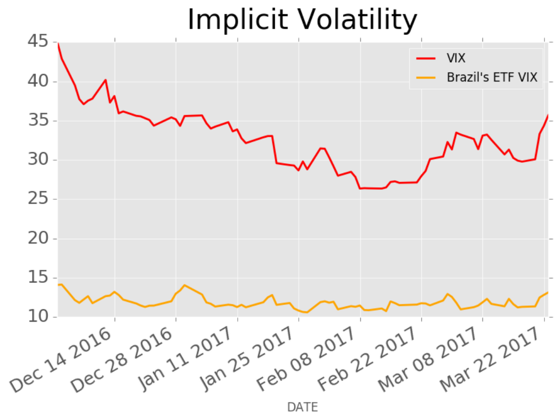
- *We understand the balance of risks have somewhat tilted to the downside as the odds of a muddling through type of social security reform have increased.*
- *This implies a two-fold path going forward: either a) market discipline forces the political class to embrace a meaningful reform (our base-case), or b) political forbearance leads to a soft version, with negative impact on local assets.*
- *The odds of a volatility free path towards a significant reform seems very low at moment.*

1. Market Discipline

- **Balance of risks have tilted down**. The latest flow of news have confirmed the difficulties of Mr. Temer to approve his social security reform as is. While some type of compromising has been expected from the outset, we believe the latest announcement that Mr.Temer may leave State civil servants out of the reform has opened a Pandora box, making more difficult to predict what is going to come out of it. As matter of fact, the government itself has understood the complexity of the move, and is - reportedly - attempting to take a u-turn on the issue.
- **The Genie is out**. Simply put, once one makes a compromising to a specific class of entrenched interests, the incentives are such that other organized classes should soon start to lobby for the same type of favoritism. In addition, there is also the interest of less organized citizens, such as those living off social benefits, who are held pretty close to the heart of politicians in Brasilia. Therefore, if one sums all that up, the budget of acceptable concessions may run the risk of falling short of the mounting pressures, a question mark we will need get accustomed to in the next few months.
- **Any counteracting pressure?** In light of the aforementioned, the easy path towards a reform that comprises a) an increases the minimum retirement age to 65 for both genders; b) the end of the retirement linked to the number of years contributing to the system; and c) encompasses rural, urban, private and public workers alike, looks very slim. In fact, if we are to witness any satisfactory compromising, counteracting forces against the softening pressures are of paramount importance, and in this respect, the market looks like the only candidate that may take up this role. In other words, reform without volatility looks close to a contraction at moment.
- **The Room for Discipline**. In fact, as in the exhibit 1a, Brazilian sovereign spreads have 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 Brazil's fiscal 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 not been shrugged off by the market, and the volatility of Brazilian assets have clearly take off from the US' benchmark (1b).



(a)



(b)

- **Forecasts unchanged for now**. Risk balances aside, we stick to the vision that the Selic rate should reach 8.00% by year-end, including a couple 100bps cuts in the next two COPOM meetings. Our thesis relies on inflation drivers as opposed to any hypothesis concerning structural rate debate, and provided no major dislocation of the market occurs, this story should remain intact.

João Mauricio Rosal, *PhD*
joao.rosal@bgcpartners.com
+55 11 3077-2351

2. Forecasts

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

João Mauricio Rosal, *PhD*
joao.rosal@bgcpartners.com
+55 11 3077-2351

3. Disclaimer

http://www.bgcpartners.com

CONFIDENTIAL: This document has been sent to you by one of the BGC entities (collectively BGC) Please see important legal information and disclaimer relating to this mail at the following links: http://www.bgcpartners.com/disclaimers/

Please see for BGC Disclosures. The link contains company and FCA registration numbers. This e-mail, including its contents and attachments, if any, are confidential. If you are not the named recipient please notify the sender and immediately delete it. You may not disseminate, distribute, or forward this e-mail message or disclose its contents to anybody else. Copyright and any other intellectual property rights in its contents are the sole property of BGC and its affiliates. E-mail transmission cannot be guaranteed to be secure or error-free. The sender therefore does not accept liability for any errors or omissions in the contents of this message which arise as a result of e-mail transmission. If verification is required please request a hard-copy version. Although we routinely screen for viruses, addressees should check this e-mail and any attachments for viruses. We make no representation or warranty as to the absence of viruses in this e-mail or any attachments. Please note that to ensure regulatory compliance and for the protection of our customers and business, we may monitor and read e-mails sent to and from our server(s). The registered offices of the BGC entities are at 1 Churchill Place, London, E14 5RD. For any issues arising from this email please reply to the sender. The FCA register appears at http://www.FCA.org.uk/register/. The FCA regulates the financial services industry in the United Kingdom and is located at 25 The North Colonnade, Canary Wharf, London, E14 5HS. BGC Financial LP CFTC Rule 1.55(K) Firm Specific Disclosure Statement

João Mauricio Rosal, *PhD*
joao.rosal@bgcpartners.com
+55 11 3077-2351