

Market Discipline or a Fallout

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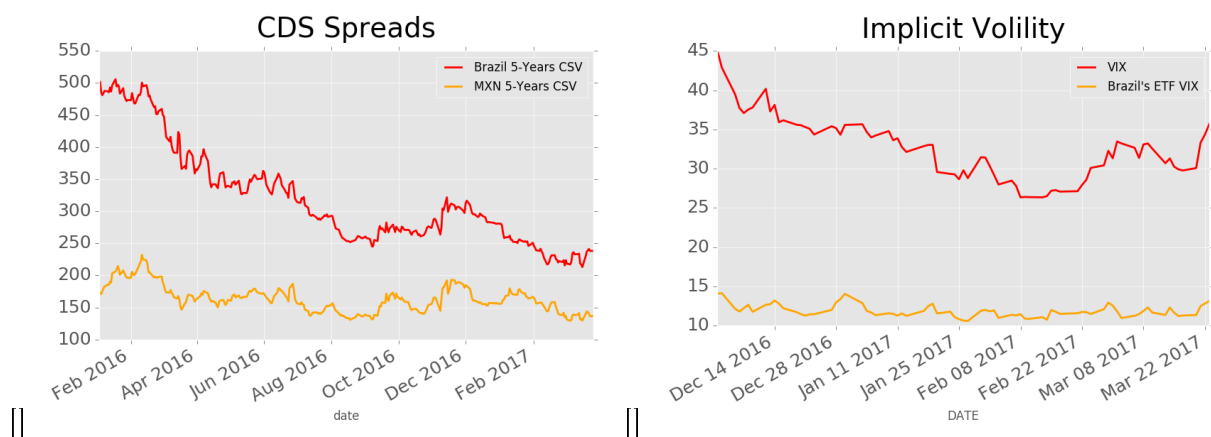
Market Discipline or a Fallout?

- *We understand the balance of risks have tilted to the downside as odds of a muddling through type of social security reform have increased.*
- *This implies a two-fold path going forward: a) market discipline forces the political class to embrace a meaningful reform, or b) political forbearance reign in entailing a negative re-pricing for the longer term. The odds of a volatility free path towards a significant reform seems very low.*

1. The Two-fold paths

- ◇ **Balance of risks have tilted.** 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 to leave State civil servants out of the reform has opened a Pandora box, making difficult to predict what is going to come out of it.
- ◇ **The Genie out of the box.** Simply put, once one makes a compromising to a specific class 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 leaving off social benefits, who are held pretty close to the heart of politicians in Brasilia. Hence, once we sum all this up, the budget of acceptable concessions may well fall short of all mounting pressures arising either within politicians class or from specific sectors of the society.
- ◇ **Any counteracting pressure?** In light of the fore mentioned, the easy path towards a reform that comprises a) an increase the minimum retirement age to 65 for both genders; b) the end 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 nutshell, all these theme seems far too much to fit in the budget of the demands which currently floating around. In fact, if we are to witness any satisfactory compromising, counteracting forces against these pressure are of paramount importance, and in this respect the market looks like the main candidate that may step up and take up this role.
- **A two-fold path.** As in ??, 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 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 not 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 think latter of the most likely candidate,

1. THE TWO-FOLD PATHS



but with 2018 general elections take over their agenda, one should not dismiss the former altogether.

- **A new Round of Reforms.** Be all that as it may, what is become clear is that Mr. Temer's reform won't be any silver bullet to fix social security structural under-funding, as just like the reforms of his predecessors. In fact, with State and municipalities left out and plus other concessions that we are yet to see, the budget of changes for 2019 and beyond is growing, and if history is repeat itself, they should only be ticked off with pressure coming market.

2. FORECASTS

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

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