Deutsche Bank
Research

Brazil Economic Update

December 2014

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Passion to Perform

Overview: Another Tough Year Ahead

- After posting GDP growth very close to zero in 2014, the Brazilian economy will face another tough year ahead, as it will suffer the consequences of higher interest rates, tighter fiscal policy, lower commodity prices, and perhaps even water and energy rationing. Furthermore, the *Petrobras* bribery scandal poses a threat to the economic recovery due to a possible decline in investment by the gigantic state-owned oil company, as well as potential constraints on some of the country's largest construction companies currently under investigation. We expect GDP to grow only 0.7% in 2015, and believe the risk remains tilted to the downside.
- The silver lining is that the government is signaling important changes in economic policies that could help restore confidence and pave the way for the economy to recover later next year. The strongest signal so far has been the announcement that former Treasury Secretary Joaquim Levy will be the new finance minister. The appointment of a fiscal hawk for this key position suggests that President Dilma Rousseff has decided to interrupt the trend of steady fiscal deterioration that characterized her first mandate, a crucial step to restore economic policy credibility and prevent Brazil from losing the investment grade status.
- Levy has pledged to pursue a primary fiscal surplus target of 1.2% of GDP in 2015 and "at least" 2.0% of GDP in 2016 and 2017, to create conditions to stabilize the gross public debt. We believe the 2015 target is tough but feasible, under the right combination of tax hikes and spending cuts. For the next years, however, we take a more cautious stance. If our growth scenario for 2015 proves correct, Rousseff will suffer enormous pressure to abandon the adjustment and reinstate expansionary policies at a moment when the she could be politically vulnerable due to the repercussions of the *Petrobras* scandal and difficulty in controlling a very fragmented Congress. Rousseff started her first mandate by tightening fiscal and monetary policies in 2011, but quickly reversed course as economic conditions deteriorated.
- The BCB is taking a tougher stance on inflation, which could contribute to restore confidence as well. The COPOM has raised the SELIC overnight rate by 75bps since October, and we expect additional hikes of 50bps in January and 25bps in March (although the risk seems skewed towards lower rates due to weak economic activity). However, due to the needed adjustment in administered prices and expected exchange rate depreciation, we still do not see much relief on the inflation front, and continue to forecast a 6.2% increase in the IPCA consumer price index next year.
- We forecast a current account deficit of 4.2% of GDP for 2014 and 2015, a relatively large deficit considering that economic growth has ground to a halt. The deterioration in terms of trade due to lower commodity prices means that a weaker exchange rate will be needed to prevent a larger current account deficit. Moreover, higher interest rates in the US could aggravate the pressure on the BRL even if domestic fundamentals improve. We expect the BCB to taper its FX intervention program gradually, allowing the BRL to depreciate slowly so as to adjust the balance of payments without putting undue pressure on inflation.

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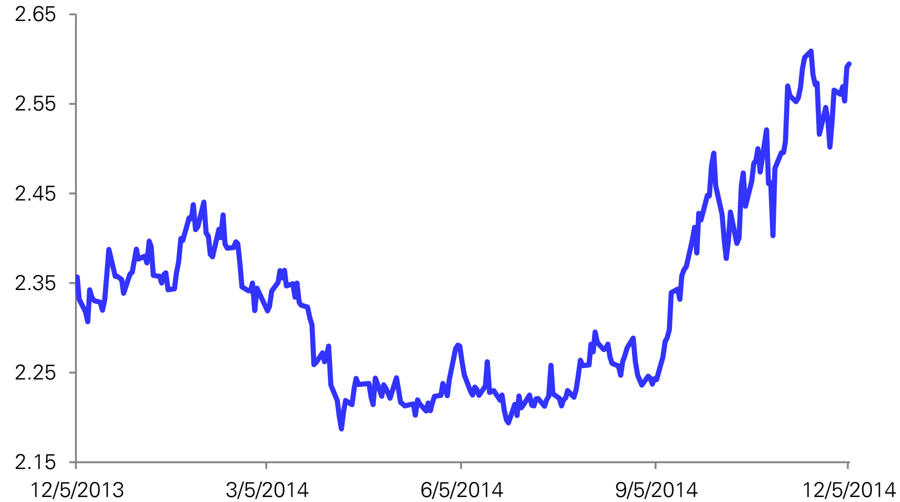
Main forecasts, December 2014

Variable	2014F	2015F
GDP growth	⇩ Lowered slightly to 0.1% from 0.2%, due to the weaker-than-expected 3Q14 GDP data.	⇩ Cut to 0.7% from 0.9%, due to slower 2014 growth, contractionary fiscal and monetary policies, and risk to Petrobras investment.
IPCA consumer price index	⇩ Lowered slightly to 6.4% from 6.5%.	⬄ Stable at 6.2%, as we expect slow growth to offset increases in regulated prices and weaker FX.
SELIC rate (year end)	The SELIC rate will finish 2014 at 11.75% following the 50bp rate hike in December.	⇧ Raised to 12.50% from 12.00%, as the BCB has stepped up the pace of tightening, signaling a tougher stance on inflation.
BRL/USD (year end)	⇧ Raised to BRL2.50/USD from BRL2.45/USD due to recent price action and falling commodity prices.	⇧ Raised to BRL2.75/USD from BRL2.70/USD mainly due to lower commodity prices.
Current account deficit	⇧ Raised to USD92bn (4.2% of GDP) from USD89bn due to the worse-than-expected trade balance.	⇧ Raised to USD87bn (4.2% of GDP) from USD85bn due to lower commodity prices.
Primary fiscal surplus	⇩ Reduced further to 0.2% from 0.5% of GDP due to worse-than-expected results posted until October.	⇩ Lowered further to 1.2% from 1.4% of GDP due to worse-than-expected results in 2014 and new target announced by the government.

Source: Deutsche Bank Research

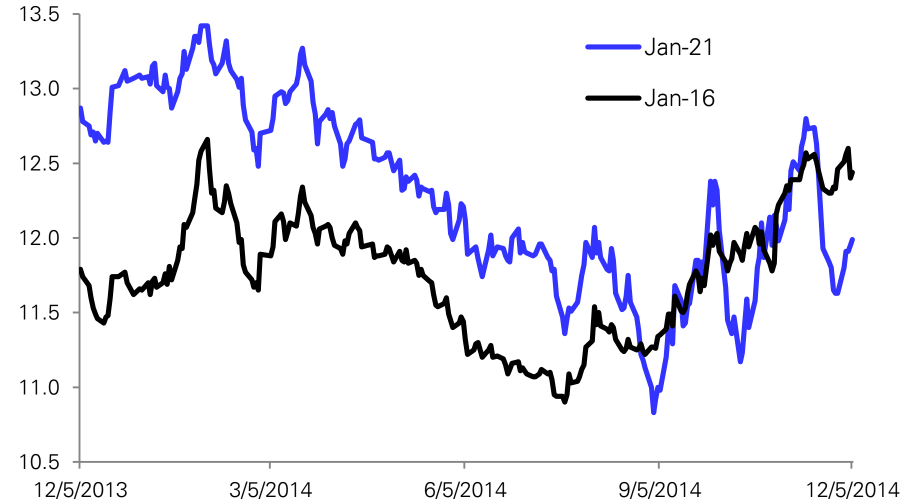
Financial indicators

BRL/USD



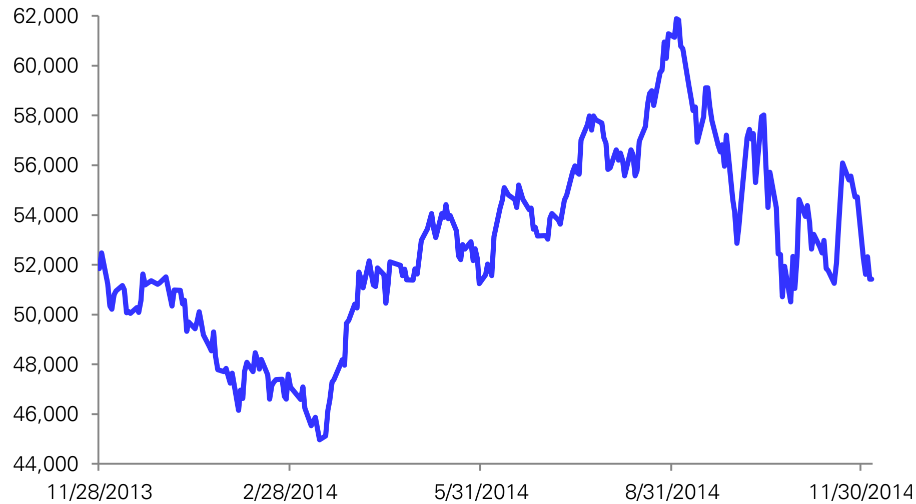
Source: Bloomberg Finance, L.P.

Interest rates (Pré x CDI swaps, %)



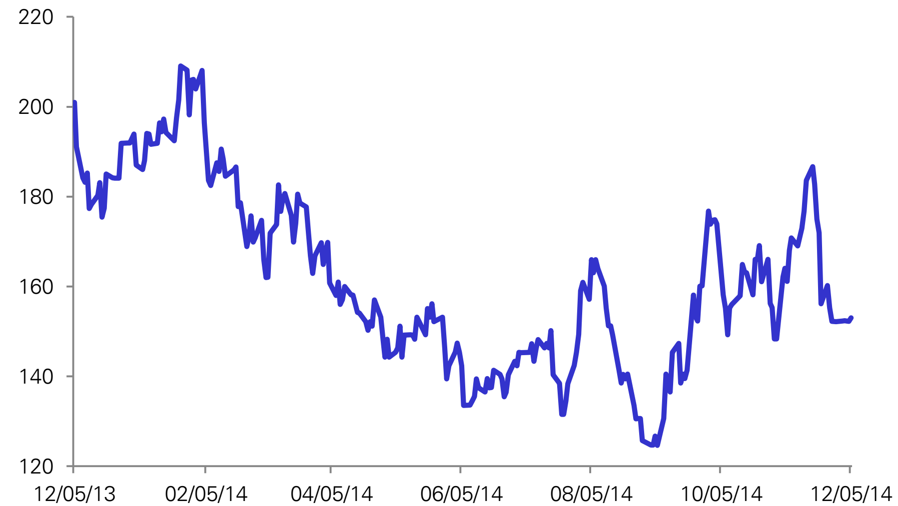
Source: Bloomberg Finance, L.P

Stock market (Ibovespa)



Source: Bloomberg Finance, L.P

CDS spreads (5Y Mid Par Spread, bps)



Source: Deutsche Bank - Autobahn

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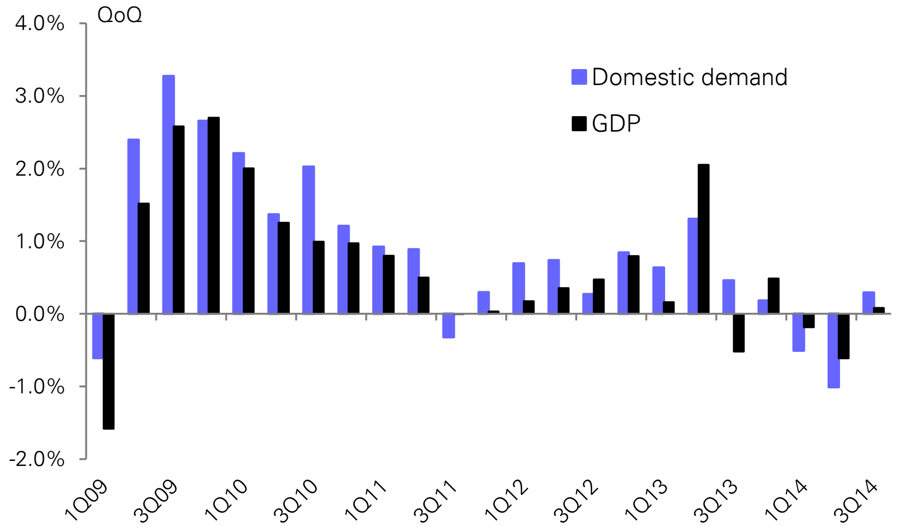
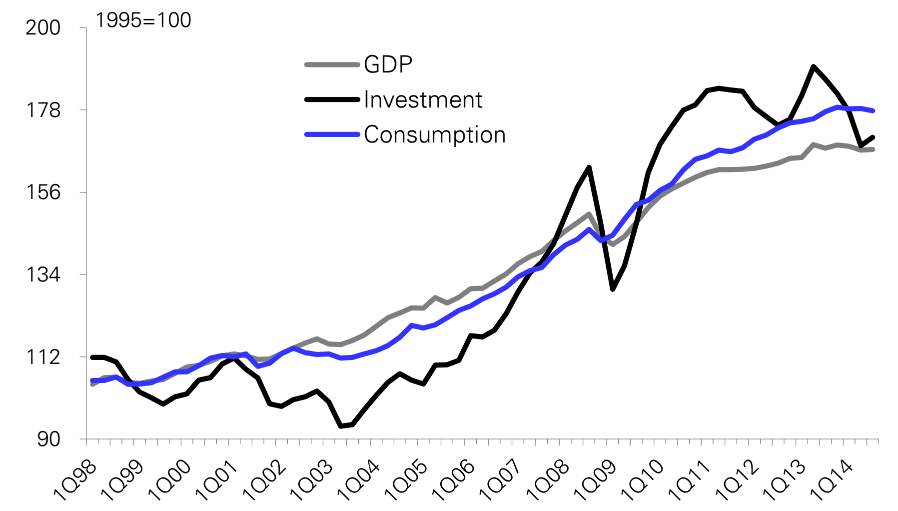
GDP grew only 0.1% QoQ in 3Q14 as consumption declined

Quarterly GDP



Source: IBGE

Quarterly GDP - demand



Source: IBGE

- GDP inched up 0.1% QoQ in 3Q14, slightly less than our forecast of 0.3% QoQ. GDP posted slightly positive growth after declining 0.6% QoQ in 2Q14 and 0.2% QoQ in 1Q14, thus ending the "technical recession." However, economic performance remains dismal, reflecting not only the negative international environment, but also mistakes in the conduction of economic policies.
- The main surprise in 3Q was the 0.3% QoQ decline in household consumption, which remains completely stagnant (it was flat in 2Q14 and fell 0.2% in 1Q14), reflecting the exhaustion of the fast growth in labor income observed amid falling unemployment in previous years, and deceleration in credit.
- Investment climbed 1.3% QoQ, interrupting a sequence of four consecutive quarterly declines, but not enough to offset the hefty 5.2% QoQ decline in 2Q14. A 1.3% QoQ expansion in government consumption prevented even weaker GDP growth. The external sector, which had a positive contribution to overall GDP in the previous quarter, had a negative effect in 3Q14, as exports of goods and services rose 1.0% QoQ but imports climbed 2.4% QoQ.
- On the supply sided, the main drag came from the agricultural sector, which fell by 1.9% QoQ, reflecting the drought. The industrial sector grew 1.7% (led by mining), after falling 2.0% in 2Q14, and the services sector rose 0.5%, exactly offsetting the decline posted in the previous quarter.
- On a year-on-year comparison, GDP fell 0.2%, as household consumption inched up 0.1% YoY, public consumption rose 1.9% YoY, and investment plunged 8.5% YoY. On the supply side, agriculture rose 0.3% YoY, the industrial sector fell 1.5% YoY (led by declines in construction and manufacturing), and services climbed 0.5% YoY.

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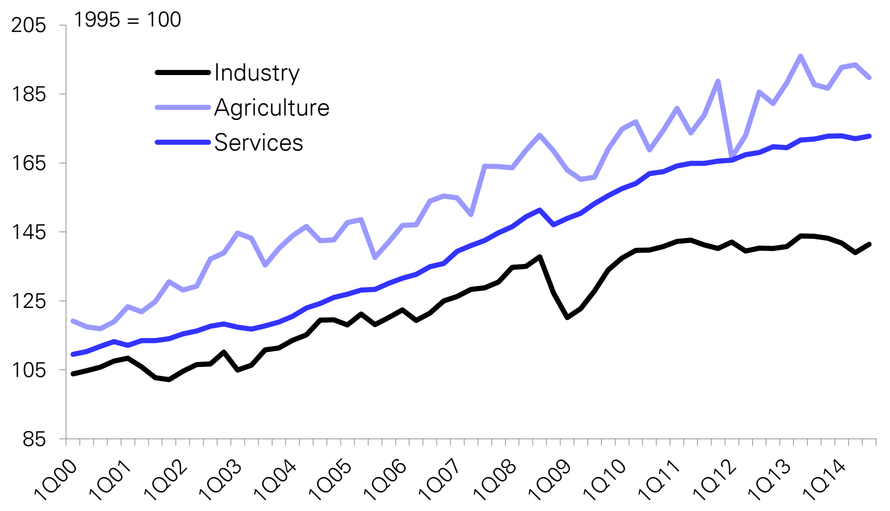
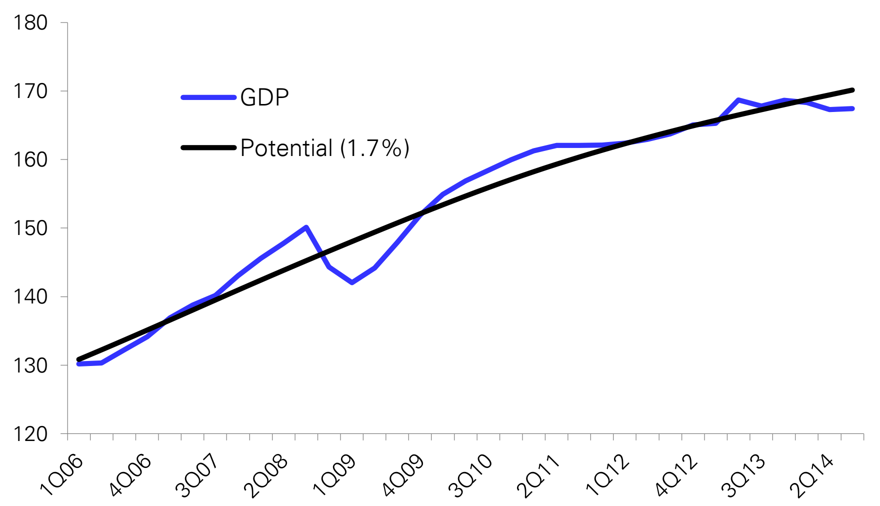
We cut our GDP growth forecasts for 2014 and 2015

Quarterly GDP - supply



Source: FGV

Output gap



Source: IBGE, DB

- In light of the weaker-than-expected 3Q14 data, we cut our 2014 GDP growth forecast slightly to 0.1% from 0.2%. Moreover, the outlook for next year is becoming more challenging and we cut our 2015 GDP growth forecast to 0.7% from 0.9%.
- We note, on the other hand, that IBGE will update its GDP measuring methodology in 1Q15, which could lead to significant revisions to the time series.
- On top of the expected contractionary adjustment in fiscal and monetary policies, the Petrobras bribery scandal poses a threat to economic activity due to a possible decline in investment by the state-owned oil company (which is responsible for roughly 10% of all investments in Brazil), as well as potential constraints on some of the country's largest construction companies currently under investigation.
- Another risk is energy rationing, given that the reservoirs of hydroelectric power plants have declined to dangerous levels and could get even worse should rainfall remain significantly lower than the historic average.
- We estimate that the output gap remains negative, which could mitigate inflationary pressures. However, although we are assuming potential growth of 1.7%, we could be actually overestimating potential growth, given the sharp decline in investment and slow productivity growth.
- Moreover, a decline in current inflation could make it easier for the government to adjust administered prices (which have been repressed) and allow a weaker exchange rate, so the slower-than-expected growth has not significantly altered our inflation projections.

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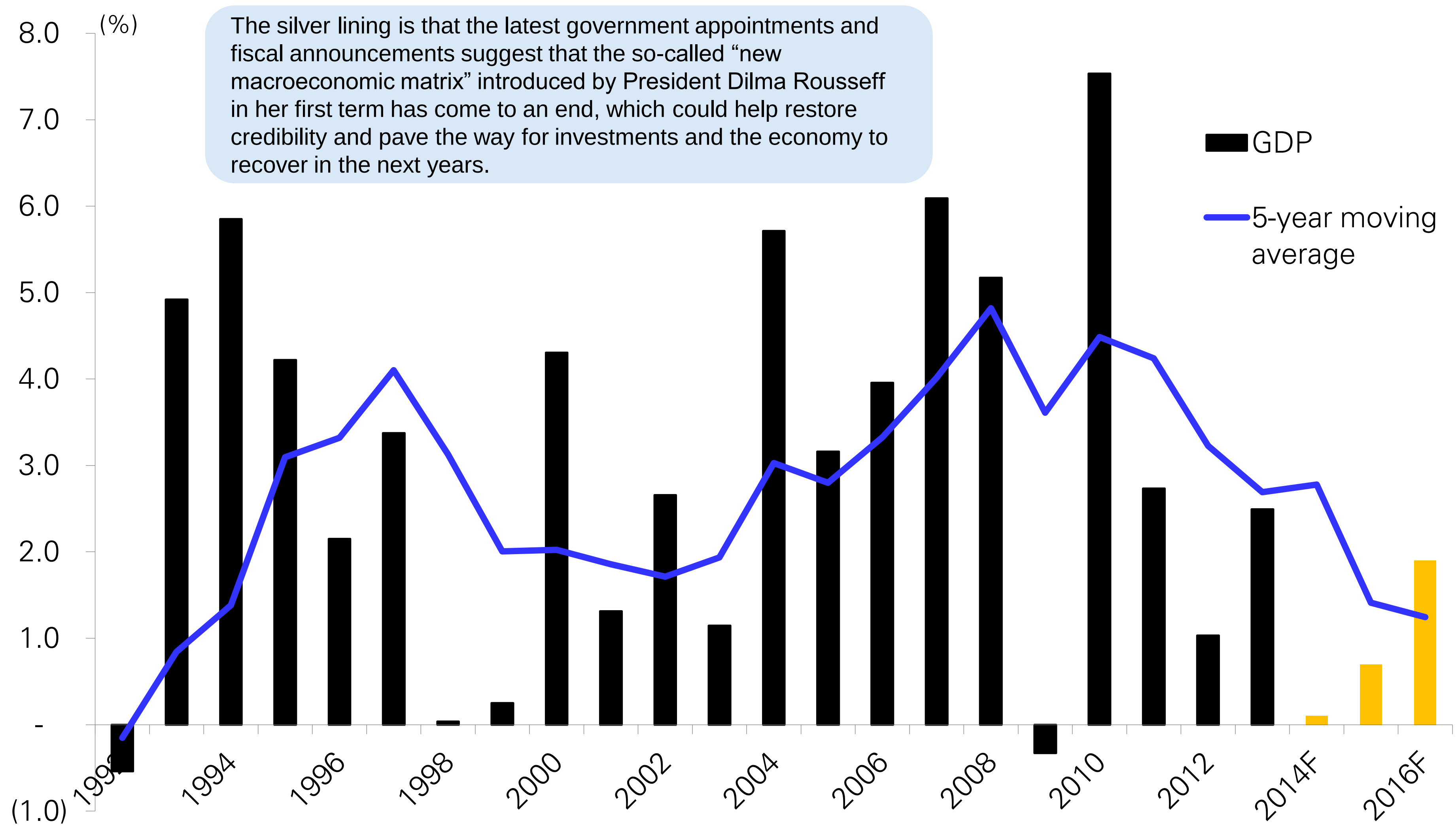
The near-term outlook for economic growth remains dim



Source: IBGE, DB Research forecasts

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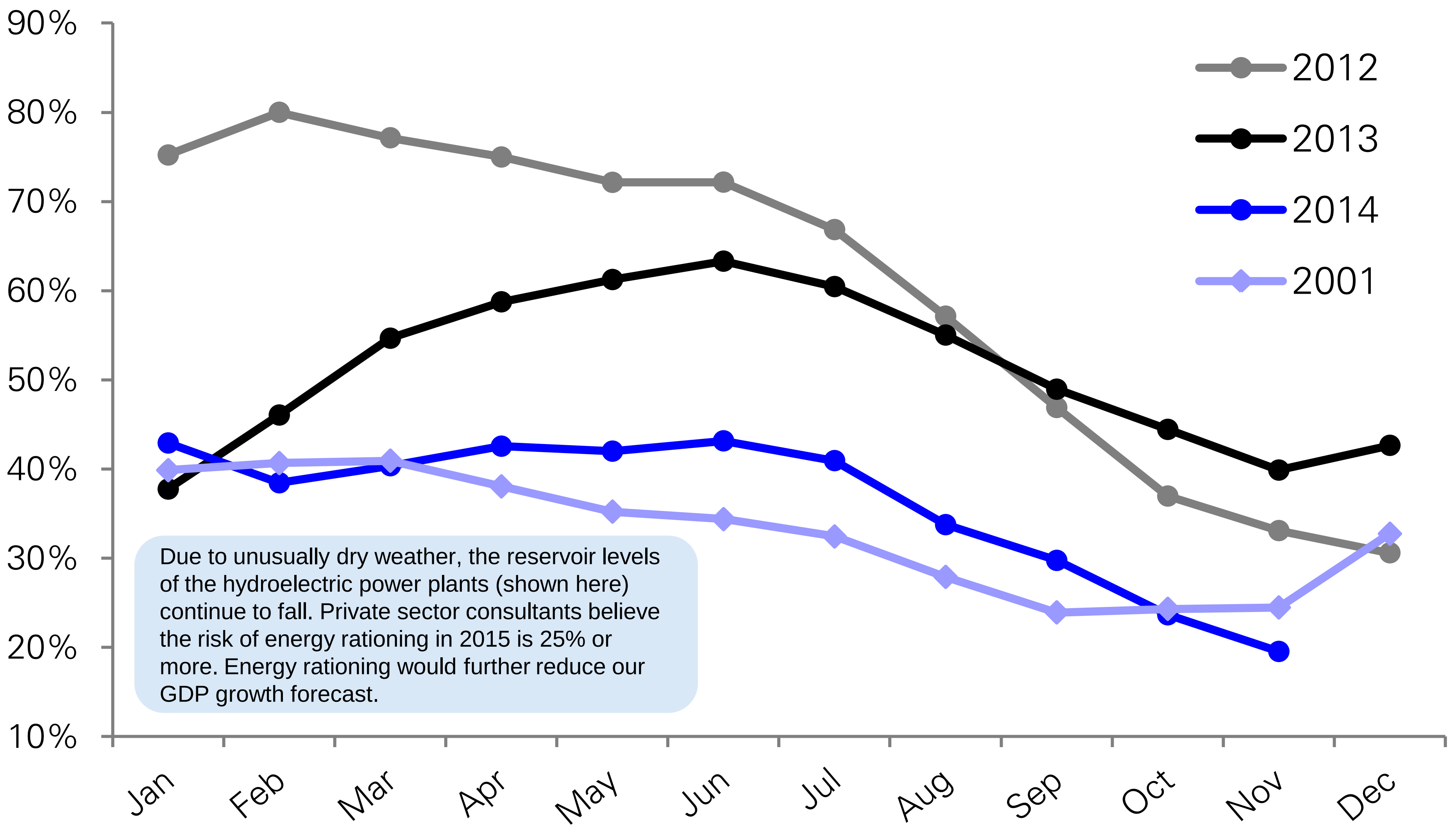
Our forecasts assume no energy rationing



Source: ONS

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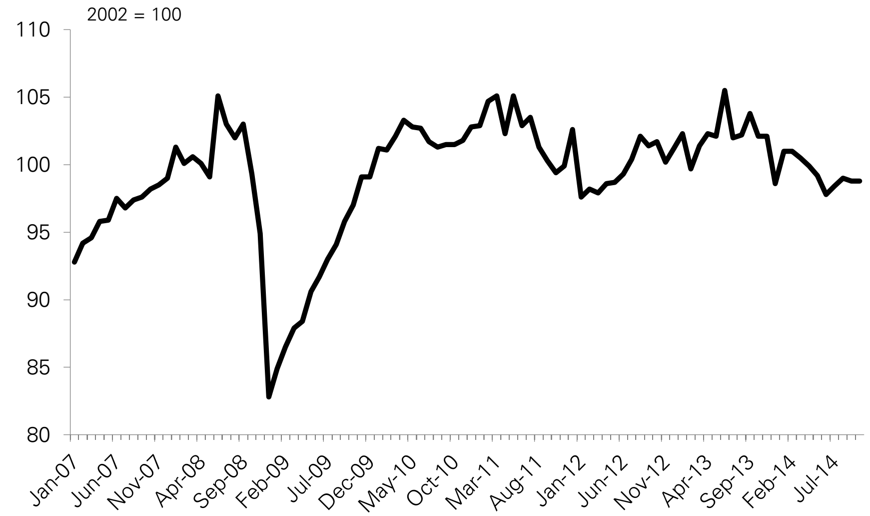
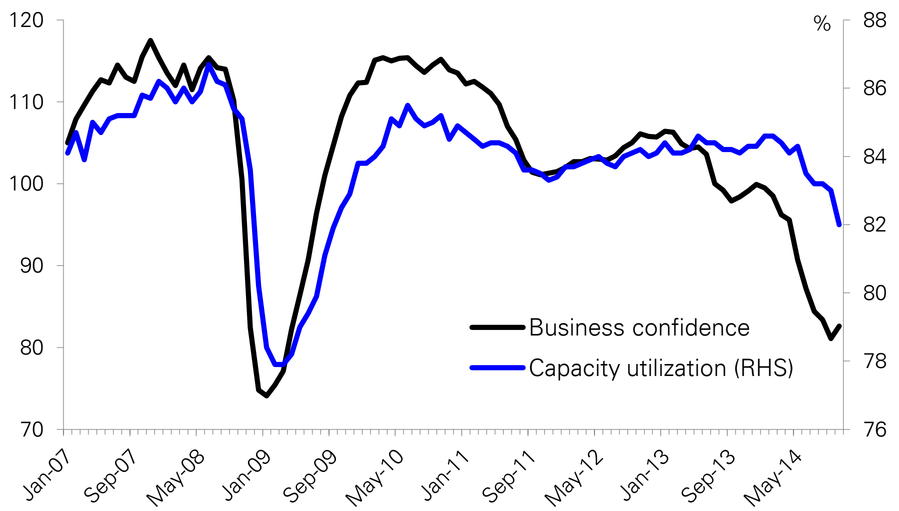
Industrial production remains stagnant

Industrial production



Source: IBGE

Business confidence



Source: FGV

- Industrial production remained unchanged in October. We expected a small increase of 0.2% MoM and the market consensus was 0.3% MoM. The 0.2% MoM decline previously reported for September was unchanged. Durable goods posted the worst performance in October, falling 0.8% MoM, mainly due to a 2.2% MoM decline in automobile production. Intermediate goods and capital goods remained unchanged.
- Industrial production fell 3.6% YoY, as capital goods plunged 11.4% (reflecting the decline in investment), durable consumer goods fell 9.4% YoY, intermediate goods declined 2.8% YoY, and non-durable goods inched down 0.1% YoY.
- The industrial sector remains stagnant due to lack of competitiveness, sluggish domestic and external demand, and low confidence. Although the exchange rate depreciation could help the sector, the near-term outlook remains negative due to high inventories and rising interest rates.
- According to FGV, its business confidence index for the industrial sector rose 3.6% MoM to 85.6 in November after climbing 1.8% MoM in October. The index rose to the highest level since June 2013. Although the expectations index fell 0.6% the current conditions index jumped 8.3%. According to FGV, “the index shows an improvement in the business environment in 4Q14 after three consecutive quarters of deterioration, but the stagnation of the expectations index casts doubts on the continuation of this recovery.”
- Capacity utilization rose to 82.7% in November from 82.0% in October, in line with the improvement in the current conditions index. However, inventory levels remain high and the outlook for economic growth remains challenging, so we do not expect a meaningful recovery in industrial production in the near term.

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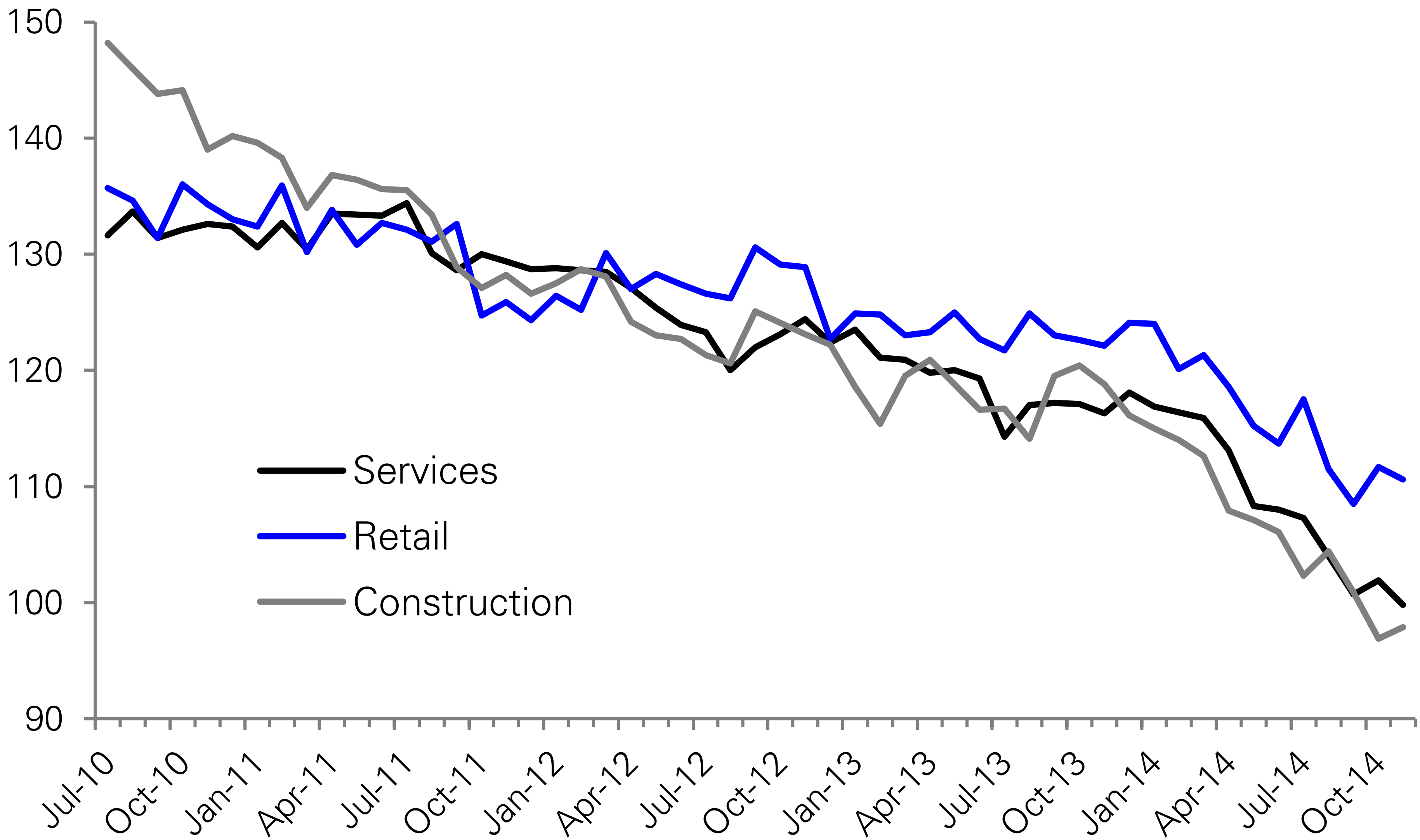
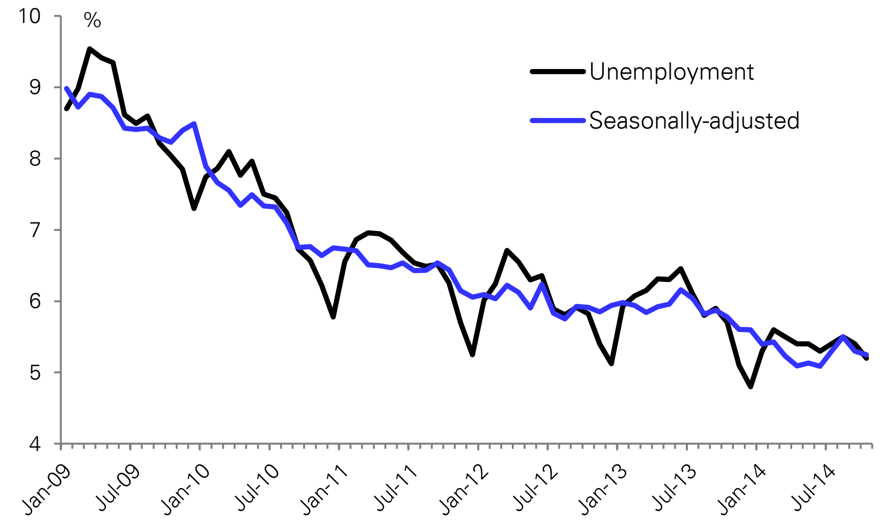
Business confidence remains depressed in other sectors too



Source: FGV

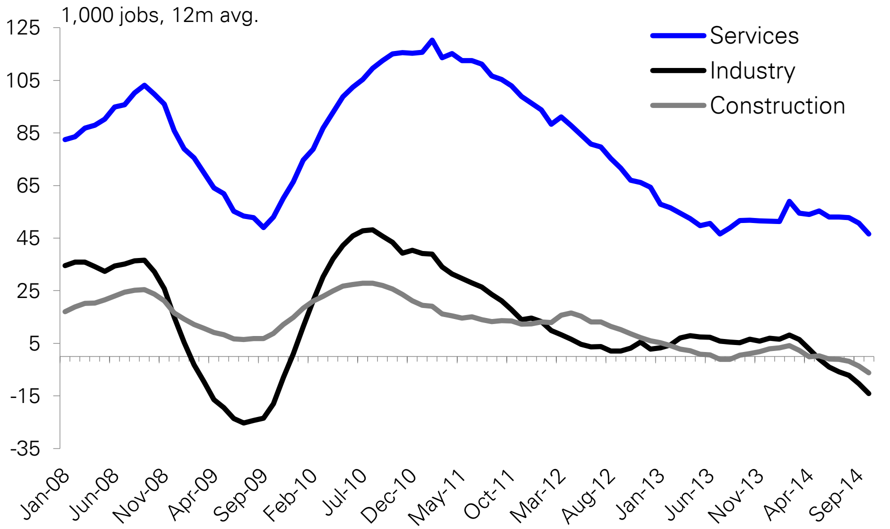
We still believe unemployment is poised to rise

Unemployment



Source: IBGE, DB seasonal adjustment

Job creation (CAGED survey)



Source: Labor Ministry

- Brazil's unemployment rate fell to 4.7% in October from 4.9% in September, falling below our forecast of 4.8% and the market consensus of 4.9%. Although the seasonally-adjusted unemployment rate remained unchanged at 4.8% (according to our own calculations), it was a surprising result in light of the much weaker-than-expected CAGED survey data (although the two surveys have completely different methodologies, especially because the CAGED only comprises the formal labor market).
- According to CAGED, the labor market lost 30K jobs in October (the first negative number for October since the survey was introduced in 1999), compared to +95K in October 2013. There was weakness across the board, with particularly negative results in the construction and industrial sectors. Job creation totaled 700K in 10M14, compared with 1,132K in 10M13 (the industry lost 67K jobs in 10M14).
- According to IBGE, although the labor force grew 0.6% MoM in October (leading to another slight increase in the participation rate, which bottomed in April), the number of jobs increased by 0.8% MoM. The increase in job creation was concentrated in self-employed workers (3.0% MoM), as the number of documented workers fell by 0.3% MoM, another sign of latent labor market weakness.
- The unemployment rate fell from 5.2% in October 2013, as the number of jobs remained unchanged but the labor force contracted by 0.5% YoY. Still reflecting the low unemployment rate, average real earnings rose a hefty 2.3% MoM and 4.0% YoY – the highest YoY increase since November 2012. Total real wages grew 3.1% MoM and 3.8% YoY.
- All in all, the labor market remains very tight, but we still believe that an increase in joblessness next year will not be avoided given expected anemic economic growth.

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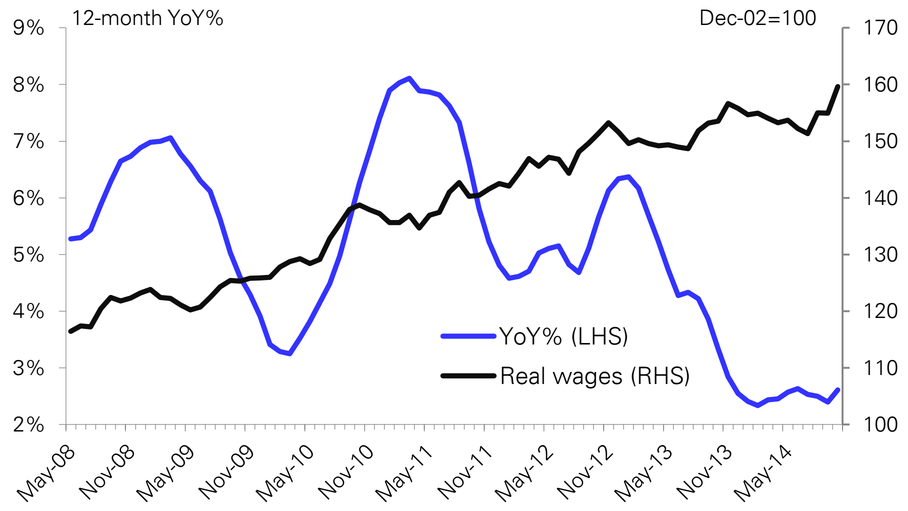
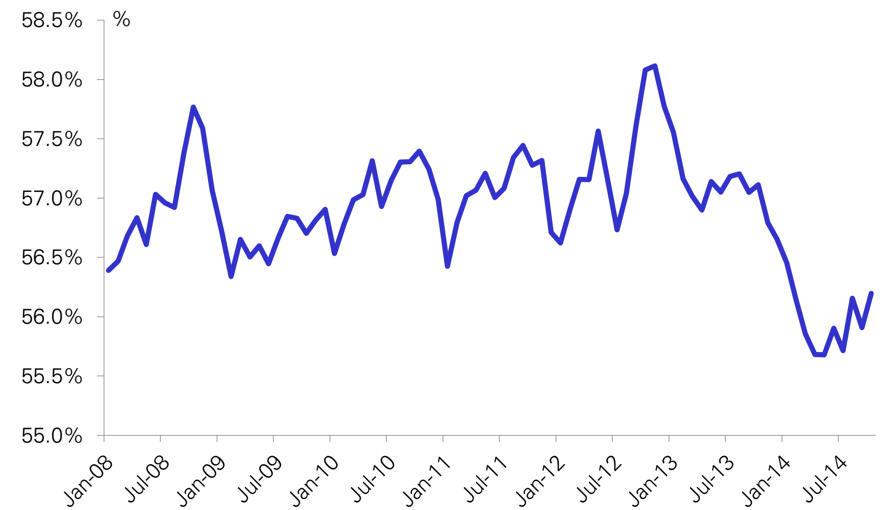
Labor market data

Total labor income, inflation-adjusted



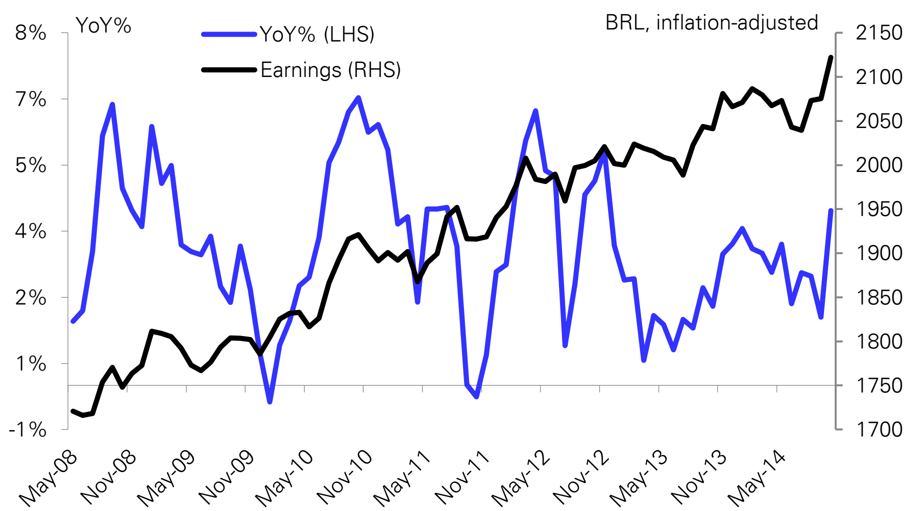
Source: IBGE

Labor participation



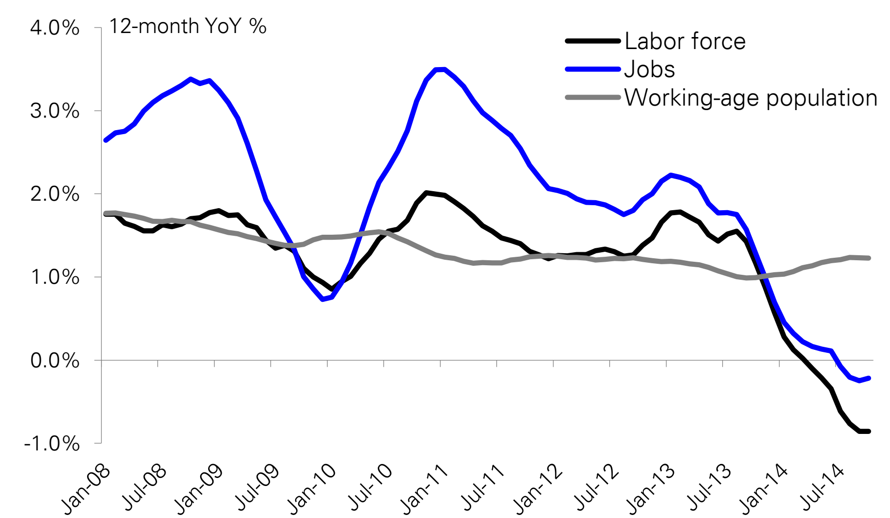
Source: IBGE

Average real earnings



Source: IBGE

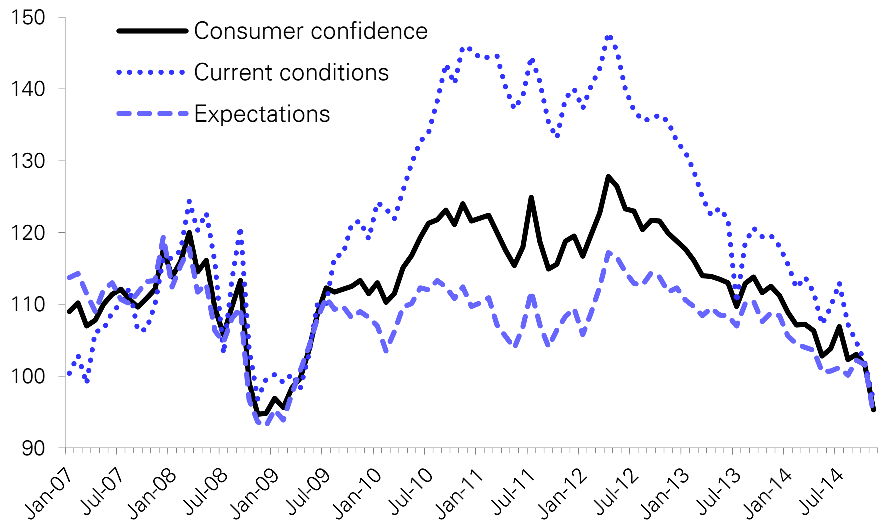
Labor force and job creation



Source: IBGE

Consumer confidence has declined sharply

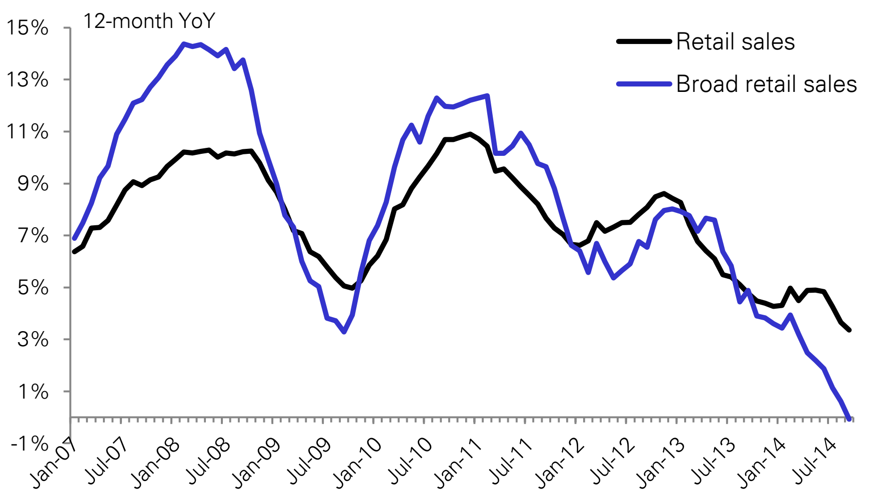
Consumer confidence



Source: FGV

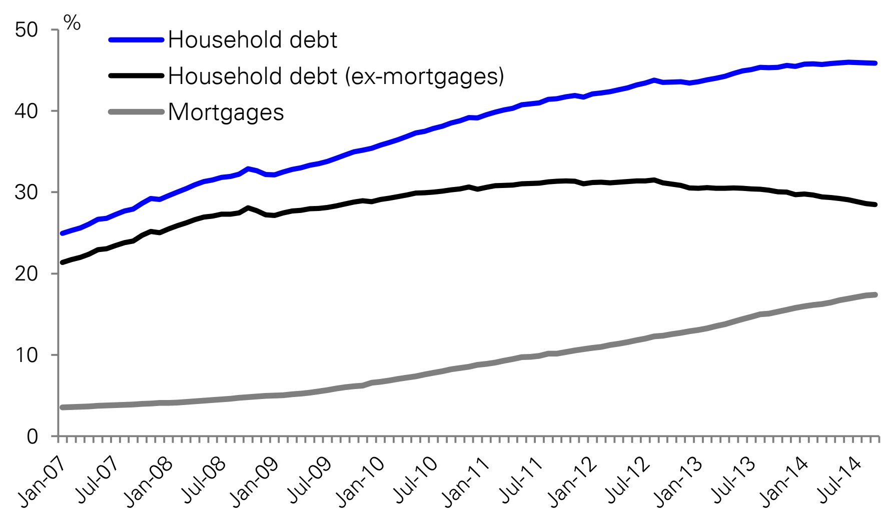
- The FGV index of consumer confidence plunged 6.1% MoM to 95.3 in November after falling 1.5% MoM in October, and reached the lowest level since December 2008. The current conditions index fell 5.1% to 96.6 (the lowest level on record), and the expectations index declined 6.8% to 94.7 (the lowest level since February 2009).
- According to FGV, the decline in confidence reflected concerns with inflation, labor market and the increase in interest rates announced by the central bank at the end of October.
- Given the slow economic recovery, high consumer indebtedness and probable increase in unemployment, we expect consumer confidence to remain relatively low in the next months.

Retail sales



Source: IBGE

Consumer indebtedness (% of income)



Source: BCB

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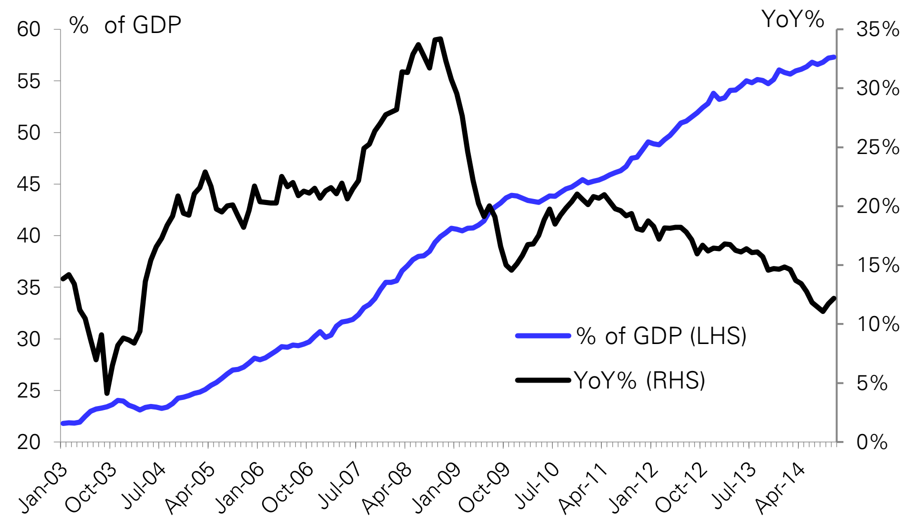
Credit expansion remains concentrated in public banks

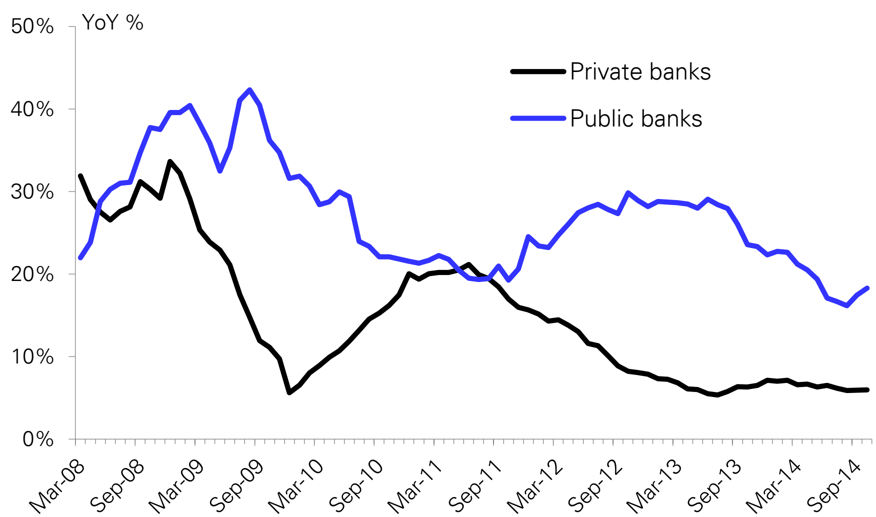
Total bank loans



Source: BCB

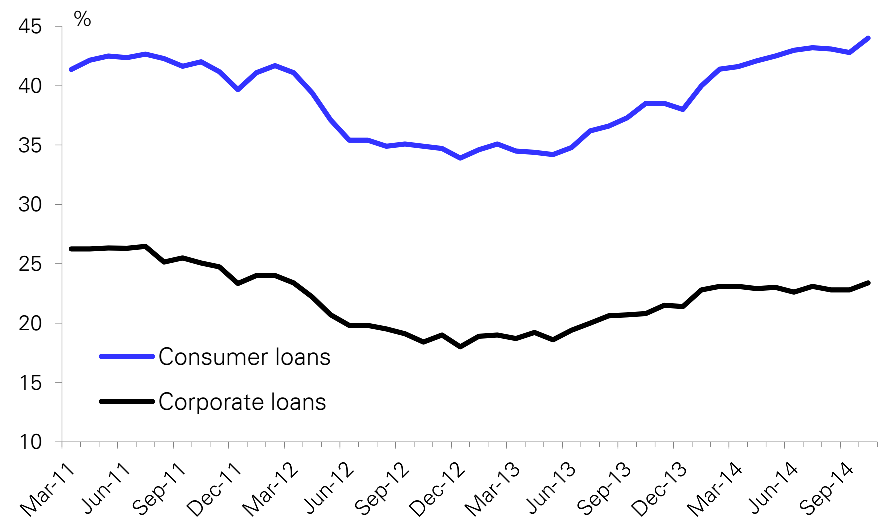
- Total bank loans rose 0.8% MoM to BRL2,926bn in October, growing 12.2% YoY, and climbing to 57.3% of GDP. Credit in the "free market" continued to grow much more slowly than directed loans (which are heavily concentrated in public banks), and rose only 4.9% YoY in October. Directed loans climbed 21.9% YoY, led by BNDES loans and mortgages.
- The good news was that non-performing loans fell to 6.4% from 6.6% in the consumer sector, reflecting cautious behavior by corporate and consumers, and slow credit expansion. Given the new tightening cycle initiated by the BCB and the deterioration that we expect in labor market conditions, we do not expect a recovery in consumer credit in the near term. Moreover, since credit origination has been heavily concentrated in public banks, restraining official lending, as the government is allegedly planning to do, could contribute to further deceleration in overall credit growth.

Growth in loans of public and private banks



Source: BCB

Interest rates



Source: BCB

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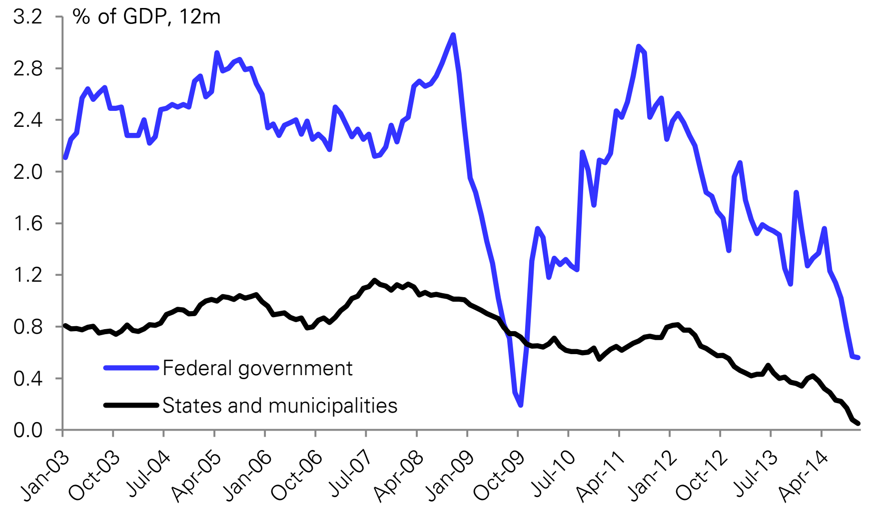
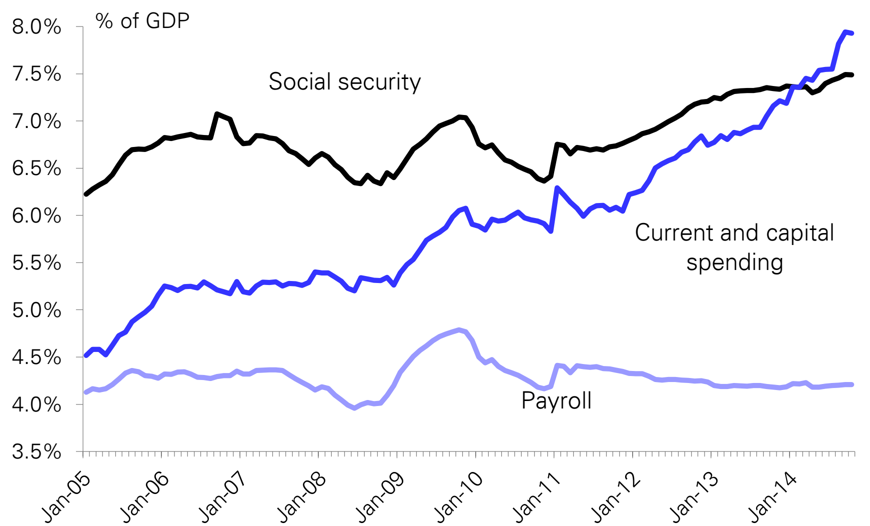
The government faces a complex fiscal adjustment

Primary fiscal balance



Source: BCB

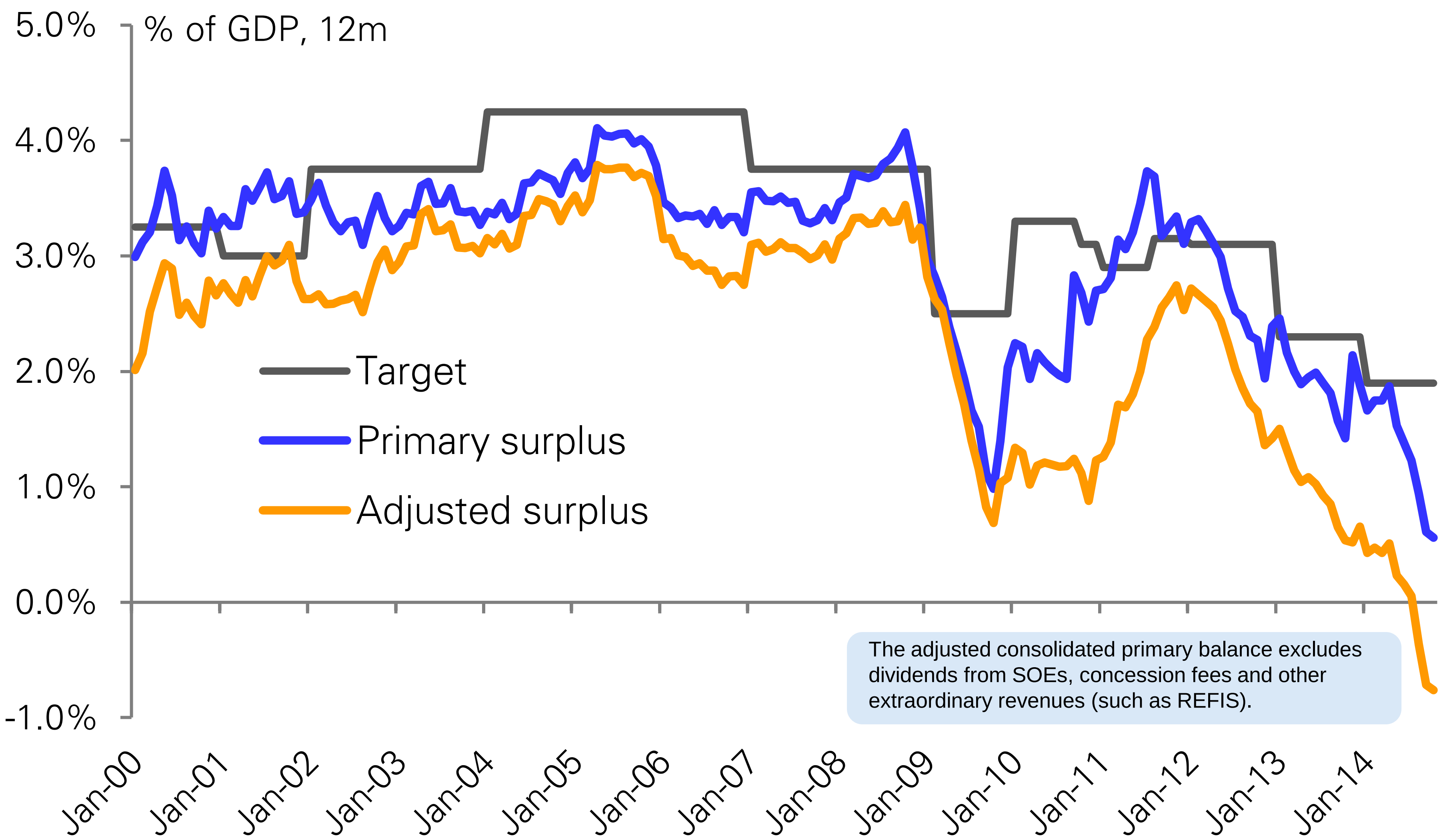
Federal spending



Source: STN

- The public sector posted a consolidated primary deficit of BRL11.6bn in 10M14, compared with a surplus of BRL51.1bn in 10M13. The fiscal deterioration has been widespread, but the federal government has been the main culprit.
- While nominal federal revenues rose 7.0% YoY (led by a 22.2% surge in dividends, as slow economic growth and a large amount of tax breaks have taken a toll on tax collection), spending surged 12.6% YoY (led by a 20.5% increase in discretionary spending, including a 17.9% expansion in current spending and 28.0% in investments).
- In 12 months, the consolidated primary surplus fell to 0.56% of GDP. Excluding non-recurring revenues (such as concession fees, dividends from SOEs and REFIS), we estimate that the public sector posted a primary deficit of 0.8% of GDP in the year to October, which shows how expansionary fiscal policy has become.
- Even resorting to the BRL67bn (1.3% of GDP) in “deductions” allowed by the 2014 Budget Guideline Law (LDO), the government would not be able to meet this year’s primary surplus target of 1.9% of GDP, which has prompted the authorities to pass legislation in Congress altering the LDO and practically eliminating this year’s fiscal target. We now expect a reported primary fiscal surplus close to 0.2% of GDP in 2014, mainly from the federal government.
- Future Finance Minister Joaquim Levy has announced a primary surplus target of 1.2% of GDP for 2015, and “at least” 2.0% of GDP for 2016 and 2017. Since we project a primary fiscal surplus close to 0.2% of GDP in 2014, Levy’s target will require an adjustment of roughly 1% of GDP. We believe the 2015 will be difficult, but doable. The targets for the next years will be more challenging, and it is not clear whether they will be politically feasible.

The primary fiscal balance is very far from the target



Source: BCB, DB Research

How a primary surplus target of 3.2% of GDP has become zero

Central government primary balance

BRLbn	10M13	10M14	change	% ch.
Total revenues	834.8	894.5	59.7	7.2%
Personal income tax	78.3	86.0	7.7	9.9%
Corporate income tax	131.0	140.2	9.1	7.0%
IPI tax	34.3	36.8	2.5	7.3%
IOF tax	21.8	21.7	-0.1	-0.3%
Import tax	27.0	27.3	0.3	1.0%
PIS/COFINS/CSLL	224.5	231.7	7.2	3.2%
Royalties	26.8	29.7	3.0	11.0%
Concessions	7.0	2.8	-4.2	-60.3%
Dividends	14.5	17.7	3.1	21.5%
Social security	214.3	237.4	23.1	10.8%
Total spending	806.8	910.2	103.4	12.8%
Transfers	139.8	155.0	15.2	10.8%
Personnel	147.5	158.2	10.7	7.3%
FAT *	34.8	39.9	5.2	14.8%
Subsidies	7.8	6.9	-0.9	-11.4%
LOAS	25.3	28.2	2.9	11.5%
CDE (energy)	4.0	8.0	4.0	99.1%
Administrative	134.4	162.2	27.9	20.7%
Payroll tax rebate	8.1	14.2	6.2	76.3%
Investments	46.5	62.4	15.9	34.1%
Social security	261.9	285.0	23.1	8.8%
Primary balance	28.0	-15.7	-43.7	-156.1%
Memo: nominal GDP				6.6%

Source: STN (*) Includes unemployment benefits.

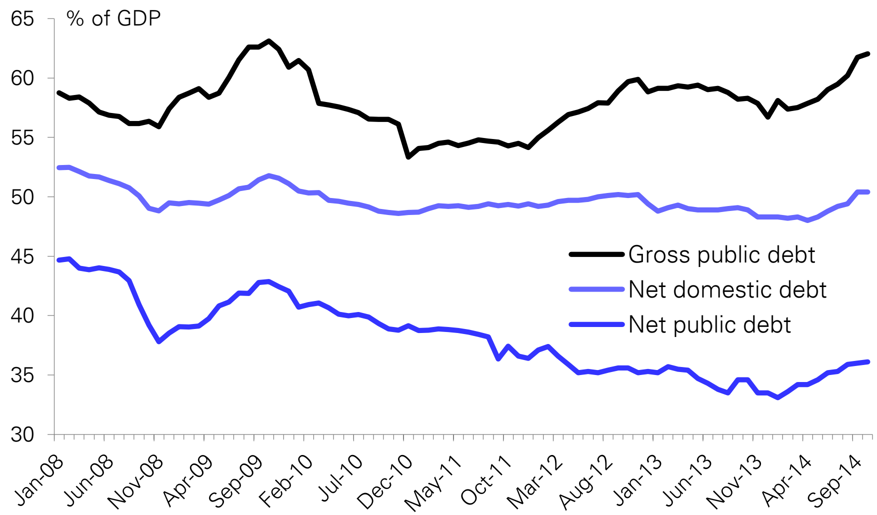
- The 2014 Budget Guideline Law (LDO) originally established a primary surplus target of BRL116.1bn (2.2% of GDP) for the central government and BRL51.3bn (1.0% of GDP) for the local governments (hence a consolidated surplus target of 3.2% of GDP).
- However, the LDO did not require the central government to compensate for the local government's shortfall, thus effectively reducing the consolidated target to BRL116.1bn (2.2% of GDP).
- Furthermore, the LDO allowed the federal government to reduce the BRL116.1bn surplus target by up to BRL67bn (1.3% of GDP) spent on PAC investments and tax breaks, setting a primary surplus floor of BRL49bn (1.0% of GDP).
- Although the government arbitrarily set a target of BRL99bn (1.9% of GDP), the public sector posted a consolidated primary deficit in 10M14, making it clear that it would not be able to reach the BRL49bn floor. The authorities have decided to fix the problem by simply eliminating the BRL67bn limit on the deductions, further lowering the floor.
- It is not clear what would have happened if the government had missed the official target. It has never happened before, and the Fiscal Responsibility Law (FRL) does not set a punishment for government officials who do not meet the fiscal target set by the LDO. There is a caveat though, as the FRL establishes that officials must cut spending when they realize, in their bi-monthly fiscal assessments, that the targets will not be met. The penalty, in this case, is a fee equivalent to 30% of their annual remuneration. However, there are controversial technical issues involved, and the fiscal watchdog *Tribunal de Contas da União* would probably have the last word on that.

A primary surplus target of 1.2% of GDP has been set for 2015

Nominal fiscal deficit

Source: BCB

Net and gross public debt

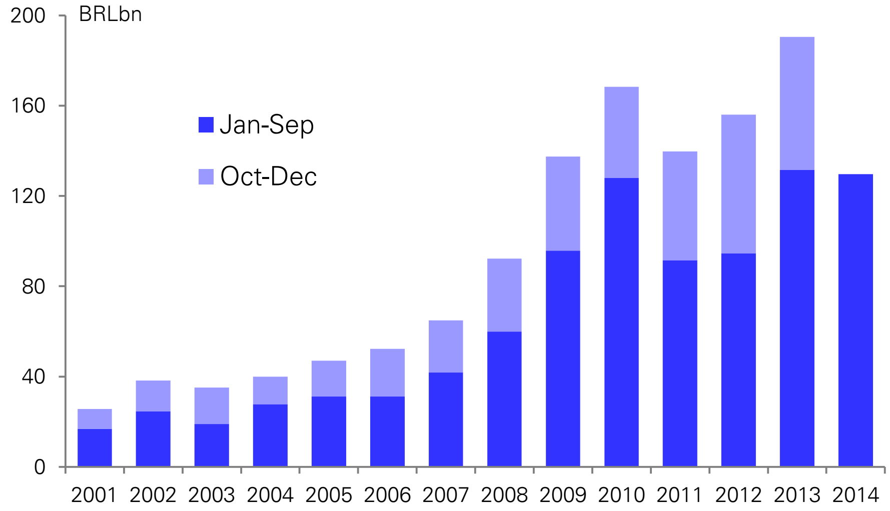


Source: BCB

- Although a primary surplus of 1.2% of GDP is still not enough to stabilize public debt-to-GDP ratio (we estimate that at least 2.5% of GDP would be necessary), the adjustment needs to be implemented gradually due to the federal budget's rigidity and slow economic growth.
- The government is assuming GDP growth of 0.8% for 2015, which is much more realistic than previous budgets based on overestimated growth forecasts and inflated revenues.
- The federal government will have to produce a surplus of 1% of GDP, while states and municipalities will have to deliver 0.2%. Although local governments will probably post a zero surplus in 2014, we believe they can achieve 0.2% in 2015.
- Since we estimate a federal surplus of 0.2% of GDP this year, the federal government will need an extra 0.8% of GDP in 2015. We expect mandatory spending to rise by roughly 0.2% of GDP, while extraordinary revenues will probably fall by the same amount. Thus, the federal government will need an extra 1.2% of GDP.
- On the revenue side, we expect the return of the CIDE tax on fuel sales (roughly 0.2% of GDP in 2015) and of the IPI tax on cars and other goods (another 0.2% of GDP). We also think that federal discretionary spending could be cut by as much as 0.3% of GDP.
- In this scenario, we would have a gap of approximately 0.5% of GDP that would most likely have to be closed by additional tax hikes. The likely candidates would be the personal income tax, mining royalties, and especially the CPMF tax on financial transactions. The CPMF, abolished n 2008, used to generate 1.4% of GDP in revenues (at a tax rate of 0.38%). The government would face strong resistance in Congress to reinstate the tax, so its rate would probably have to be much lower than 0.38% now.

Focus on the gross debt puts the public banks in the spotlight

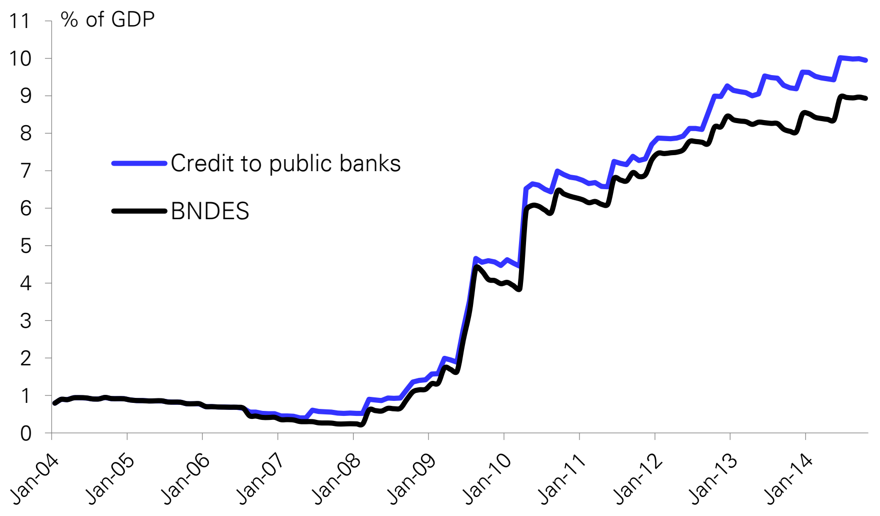
BNDES lending



Source: BNDES

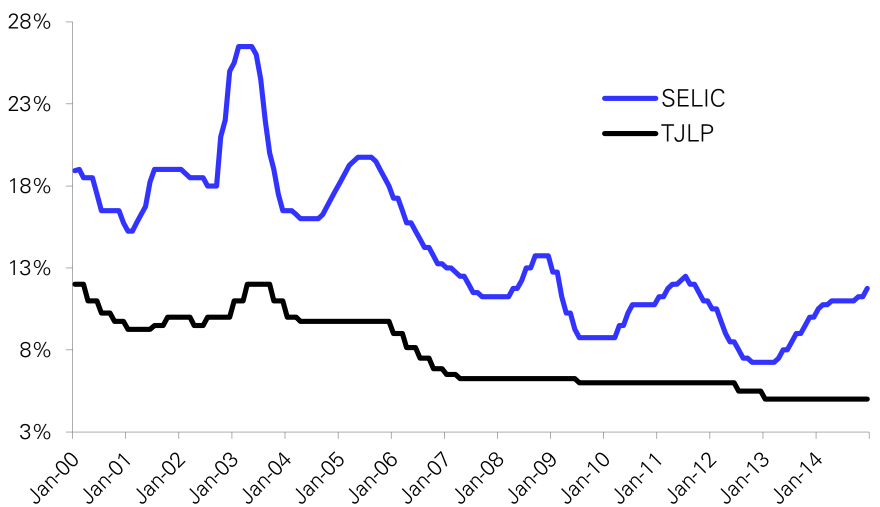
- The new economic team will have to work on the government's "quasi-fiscal" policies, mainly by moderating public bank lending.
- The government has just allowed the National Treasury to lend another BRL 30bn to the National Development Bank, (BNDES). The government estimates that the BNDES subsidies will cost BRL30.6bn (0.6% of GDP) in 2015.
- Future Planning Minister Nelson Barbosa has publicly advocated an increase in the TJLP interest rate charged by BNDES, currently at 5% (compared to the 11.75% SELIC overnight rate). In our opinion, it would be paramount for the National Treasury to stop financing the BNDES as well.
- Nevertheless, it is far from clear to us by how much the government would raise the TJLP, or the magnitude of a possible deceleration in BNDES lending.

Federal loans to government banks



Source: BCB

SELIC and TJLP Interest rates



Source: BCB, BNDES

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The net and gross public debts in detail

Public debt (% of GDP)

	Dec-11	Dec-12	Dec-13	Oct-14
A. Domestic government debt	**51.5%**	**55.8%**	**53.6%**	**58.7%**
Bonds in the market	42.2%	42.5%	41.1%	39.3%
Repurchase agreements	8.3%	11.9%	10.9%	17.4%
Other government debt	1.1%	1.4%	1.3%	1.3%
B. External government debt	**2.6%**	**2.9%**	**3.1%**	**3.4%**
C. Gross government debt (A + B)	**54.2%**	**58.7%**	**56.7%**	**62.0%**
D. Government assets	**-27.2%**	**-31.7%**	**-31.2%**	**-28.0%**
Funds, financial programs	-2.4%	-2.6%	-2.4%	-2.6%
Unemployment benefit fund (FAT)	-3.8%	-3.9%	-3.8%	-3.9%
Treasury reserves	-11.5%	-14.1%	-13.5%	-9.3%
Credits against oficial financial institutions	-7.7%	-9.2%	-9.6%	-10.0%
Tax collection	0.0%	-0.1%	-0.1%	-0.5%
Bank deposits	-0.2%	-0.2%	-0.2%	-0.2%
Other state credits	-1.6%	-1.6%	-1.6%	-1.6%
E. Treasury bonds at the BCB (ex. repos)	**9.9%**	**8.7%**	**8.9%**	**2.2%**
F. Exchange rate equalization	**0.3%**	**0.2%**	**-0.1%**	**0.5%**
G. Net government debt (C + D + E +F)	**37.1%**	**35.9%**	**34.3%**	**36.8%**
H. Central Bank debt	**-1.3%**	**-1.4%**	**-1.3%**	**-1.4%**
Treasury bonds at the Central Bank	-18.1%	-20.6%	-19.8%	-19.6%
Treasury reserves	11.5%	14.1%	13.5%	9.3%
Exchange rate equalization	-0.3%	-0.2%	0.1%	-0.5%
Repurchase agreements	8.3%	11.9%	10.9%	17.4%
Money base	5.2%	5.3%	5.2%	4.5%
Deposits at the Central Bank	9.0%	6.2%	6.4%	5.8%
Credit to banks	-0.9%	-0.9%	-0.5%	-0.5%
International reserves	-15.7%	-17.1%	-17.9%	-17.8%
Other	-0.1%	-0.1%	0.8%	0.0%
I. State-owned enterprises	**0.6%**	**0.6%**	**0.6%**	**0.7%**
J. Net public sector debt (G + H + I)	**36.4%**	**35.2%**	**33.6%**	**36.1%**

Source: BCB

Whereas the Treasury has reduced debt issuance to avoid paying high interest rates, the BCB has raised its open market repo operations, increasing short-term debt

A significant decline in Treasury cash reserves at the BCB this year also explains the increase in the net public debt

The Treasury loans to the BNDES and other public banks have reached 10% of GDP – here, they are assets that are discounted from the net debt

International reserves at the BCB are assets that reduce the net public debt, and fluctuate according to the exchange rate – a weaker BRL reduces the net public debt

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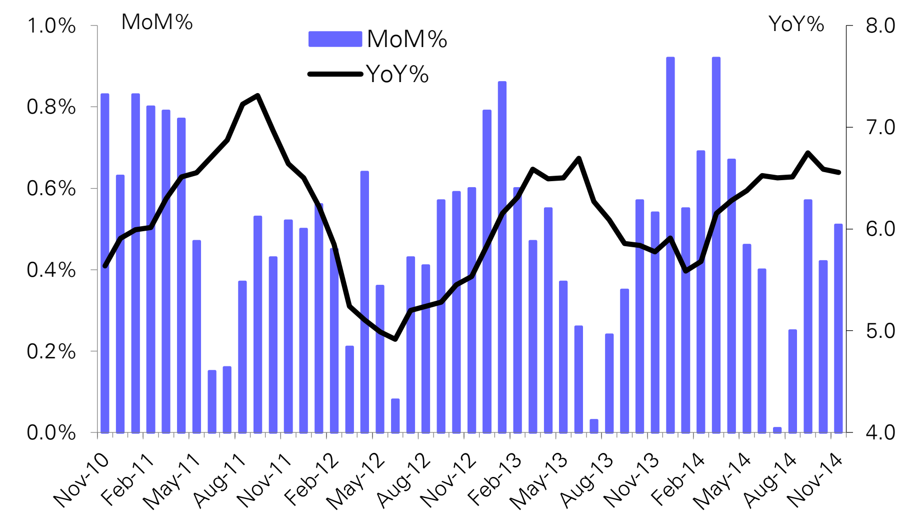
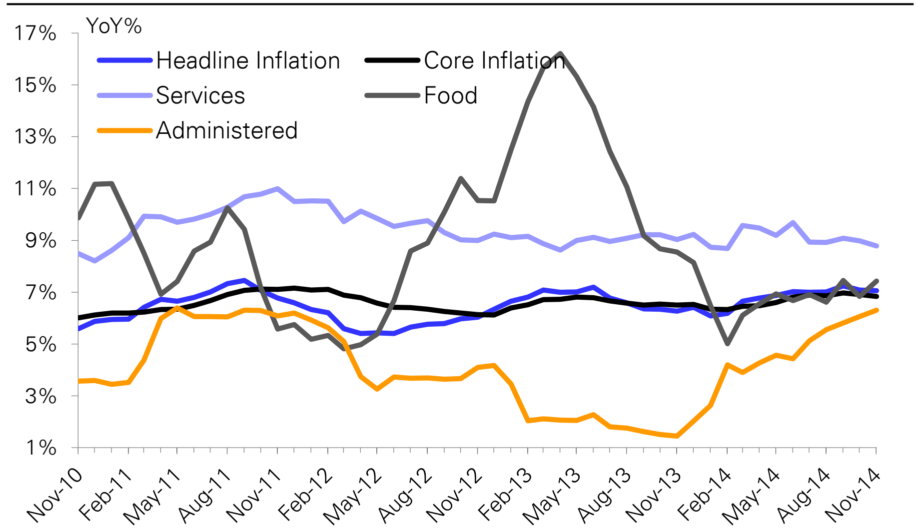
We expect inflation to remain slightly above 6% in 2015

IPCA



Source: IBGE

IPCA: headline, core, services and food



Source: IBGE

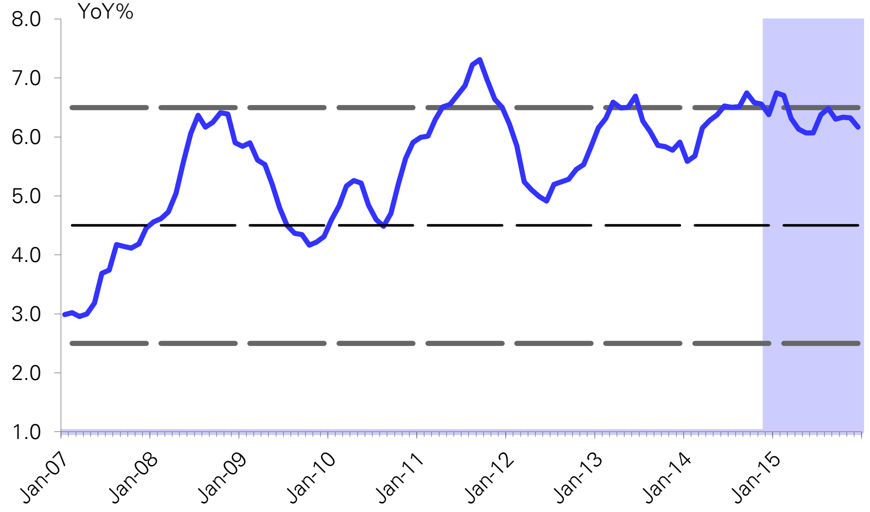
- The IPCA consumer price index rose 0.51% in November, up from 0.42% in October, and roughly in line with our forecast of 0.53%. In 12 months, the IPCA decelerated slightly to 6.56% from 6.59% in October, remaining above the 6.50% ceiling of the inflation target's tolerance band.
- Inflation accelerated in November mainly due to food prices (0.77% vs. 0.46% in October, led by meat prices), transportation costs (0.43% vs. 0.39% led by gasoline), and personal expenses (0.48% vs. 0.36%, mainly seasonal).
- We expect the IPCA to accelerate further to 0.75% MoM in December due to seasonal factors (more pressure on food prices and transportation costs). However, we expect the 12-month IPCA to decelerate to 6.38% in December.
- Core inflation decelerated in November as well. The trimmed core with smoothing of regulated prices slowed to 0.38% from 0.51% in October, and the diffusion index fell to 61.4% from 64.9%.
- However, services accelerated to 0.46% from 0.43%, or to 0.53% from 0.46% if we exclude restaurant meals and air travel. While services seem to be decelerating gradually due to sluggish economic growth, they still rose 8.3% YoY.
- Although slow economic growth will contribute to lower inflation by restraining wage growth, we continue to forecast inflation of 6.2% in 2015 due to heavy adjustments in administered prices and pass-through of FX depreciation.

IPCA	2012	2013	2014F	2015F
Food	10.0%	7.6%	7.0%	5.8%
Tradables *	2.7%	5.4%	5.6%	5.5%
Non-tradables *	7.6%	8.2%	7.3%	6.7%
Monitored	3.7%	1.5%	5.4%	6.5%
IPCA	**5.8%**	**5.9%**	**6.4%**	**6.2%**

Source: IBGE, DB (*) Ex-food

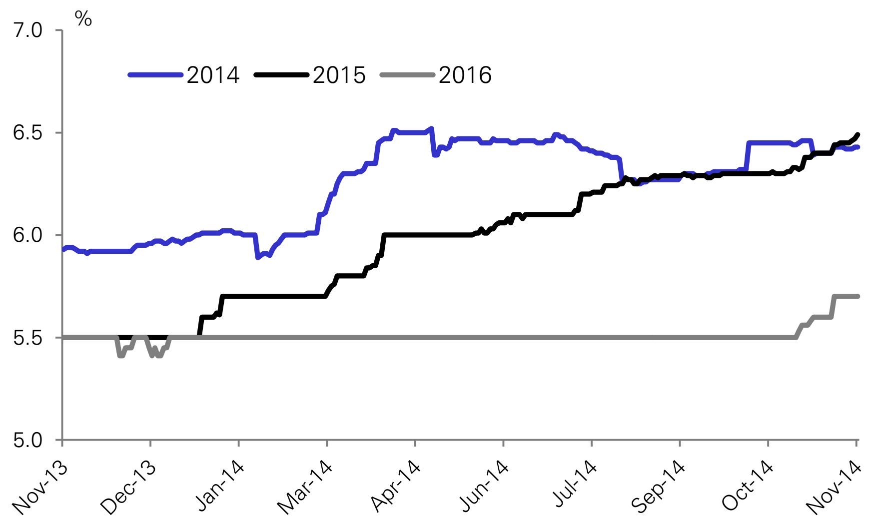
We expect the SELIC rate to climb to 12.50%

12-month IPCA and inflation targets



Source: BCB, IBGE, DB forecasts

Expected IPCA



Source: BCB, Focus survey

- The BCB surprisingly raised the SELIC overnight rate by 25bps to 11.25% in October and then stepped up the pace of tightening with a 50bp rate hike in December.
- The resolute increase in interest rates in an environment of very slow economic growth indicates that the BCB is willing to make a strong effort to restore the credibility of its inflation targeting regime, anchor expectations, and bring inflation closer to the 4.5% target. The last time inflation was close to the center target was in 2009, which explains why inflation expectations remain unanchored.
- We expect inflation to remain above 6% in 2015 despite weak economic activity due to adjustments in administered prices and the effect of exchange rate depreciation. We expect inflation to be particularly high in 1Q15, with the 12-month IPCA topping 6.7% in the first two months of the year.
- Under these conditions, it will be difficult for the BCB to interrupt its tightening cycle before 2Q15. Therefore, we expect the BCB to raise the SELIC by 50bps again in January and conclude the cycle with a 25bp hike in March. The SELIC rate would remain unchanged at 12.50% until the end of 2015. In our scenario, 12-month inflation would drop below 6% only in January 2016, allowing the BCB to initiate another easing cycle then.
- Nevertheless, after raising the SELIC by 50bps to 11.75% in December, the COPOM issued a surprisingly dovish communiqué claiming that the “additional effort of monetary policy tends to be implemented with parsimony.” While this dovish comment may have aimed at defusing expectations of further acceleration in the pace of tightening in January, it has arguably kept the door open for a shorter tightening cycle. Thus, an alternative scenario where the BCB ends the cycle with a 25bp hike in January seems possible as well.

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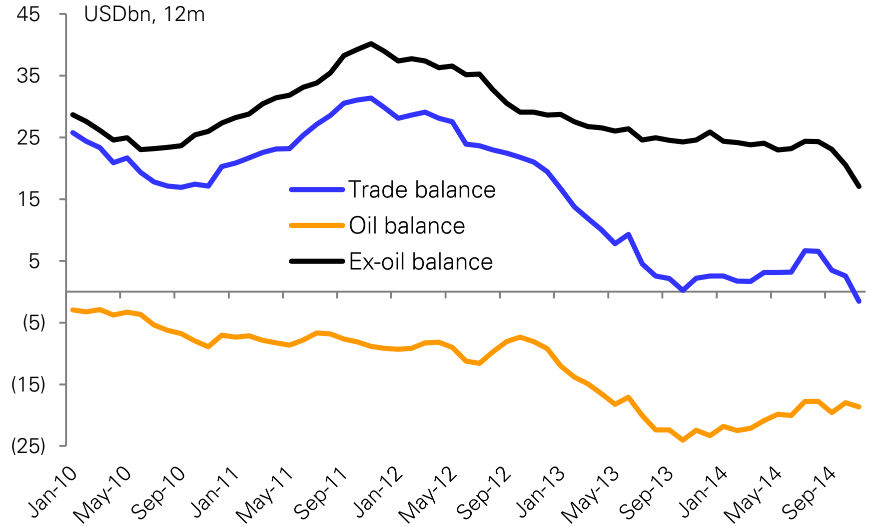
Lower commodity prices are taking a toll on exports

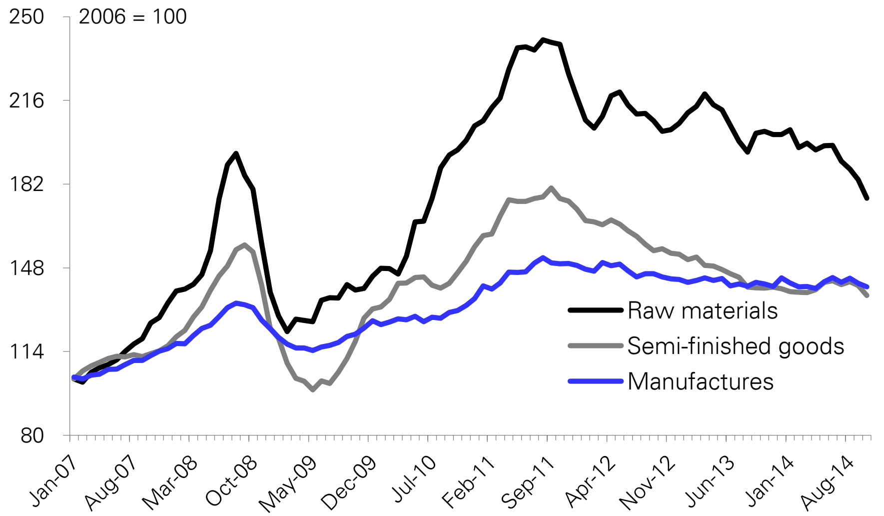
Trade balance (12 months)



Source: SECEX

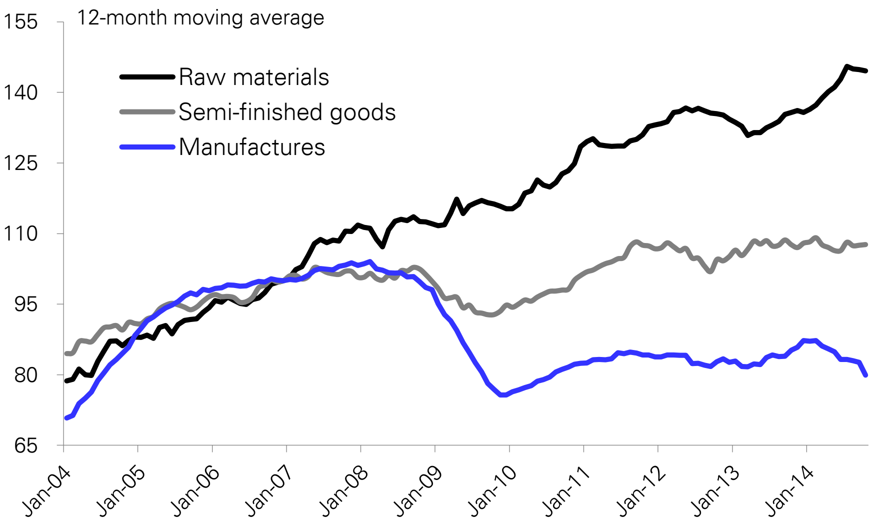
- The trade balance posted a deficit of USD2,350mn in November. Daily exports plunged 25% YoY, reflecting slow global growth and lower commodity prices.
- The trade deficit reached USD4,221mn in 11M14, compared with a deficit of USD268mn in 11M13, as exports fell 5.7% YoY and imports declined 3.9% YoY. The fall in exports was led by manufactured goods (-12.4% YoY). Shipments to China fell 9.3%, exports to Argentina plunged 26.9% (led by automobiles) and exports to the European Union fell 11.5%.
- In light of the latest numbers, we revised our 2014 trade balance forecast to a deficit of USD4bn from zero.
- We expect the trade balance to improve in 2015 due to the weaker BRL and increase in domestic oil production. However, due to declining commodity prices, we lowered our 2015 trade surplus forecast further to USD4bn from USD8bn.

Export prices



Source: FUNCEX

Export volumes (12 months)



Source: FUNCEX

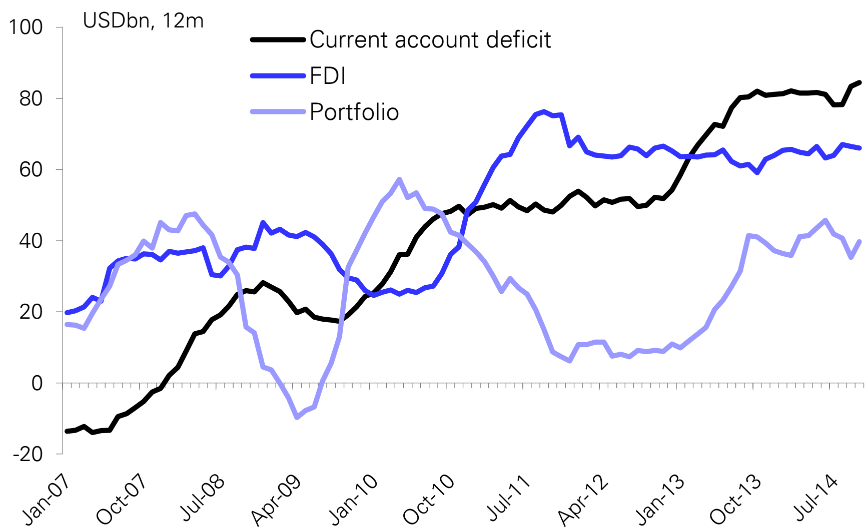
A relatively large current account deficit despite slow growth

Balance of payments (USDbn)

	2011	2012	2013	2014F	2015F
Current account	-52.5	-54.2	-81.1	-92.0	-87.0
Trade balance	29.8	19.4	2.4	-4.0	4.0
Net interest payments	-9.7	-11.8	-14.2	-14.5	-15.0
Profits and dividends	-38.2	-24.1	-26.0	-27.0	-28.0
International travel	-14.7	-15.6	-18.3	-19.0	-19.0
Other services	-22.7	-24.9	-28.3	-29.5	-31.5
Transfers	3.0	2.8	3.4	2.0	2.5
Financial account	111.1	73.1	75.2	91.0	86.0
FDI	66.7	65.3	64.0	61.0	65.0
Portfolio investment	7.1	10.7	37.0	45.0	45.0
Long-term disbursements	83.6	57.8	60.8	70.0	76.0
Brazilian assets abroad	-20.9	-29.3	-45.0	-50.0	-50.0
Short-term capital, others	12.3	8.4	18.4	15.0	15.0
Long-term amortization	-37.7	-39.7	-60.1	-50.0	-65.0

Source: BCB, DB forecasts

Current account and capital flows



Source: BCB

- Brazil posted a current account deficit of USD8.1bn in October, up from USD7.9bn in September. The current account deficit totaled USD70.7bn in 10M14, compared with USD67.4bn in 10M13.
- The larger deficit this year has been mainly due to increases in equipment leasing (USD18.2bn vs. USD15.5bn, which reflects growing leasing of equipment for oil extraction) and in profit remittances (USD19.7bn vs. USD18.4bn). In 12 months, the current account deficit amounted to USD84.4bn (3.7% of GDP).
- The 12-month deficit has been rising very gradually since 4Q13 (when it stood at 3.6% of GDP), as slow domestic growth has prevented the deficit from expanding faster. However, lower commodity prices mean that a weaker BRL will be necessary to constrain the current account deficit.
- We raised our current account deficit forecast to USD92bn (4.2% of GDP) from USD89bn for 2014, and to USD87bn (4.2% of GDP) from USD85bn for 2015. Thus, despite slow growth and the weaker FX, we expect the current account deficit as a percentage of GDP to remain unchanged.
- So far, foreign direct investment (FDI) and foreign portfolio flows have been able to finance a relatively stable current account deficit and a massive outflow of Brazilian assets abroad (Brazilian assets abroad increased by USD41bn in 10M14, mainly due to offshore deposits).
- We expect FDI to reach USD61bn and USD65bn in 2014 and 2015, respectively, thus not enough to finance the projected current account deficits. Consequently, Brazil will continue to rely on volatile foreign portfolio flows to finance its balance of payments, remaining vulnerable to changes in global liquidity conditions.

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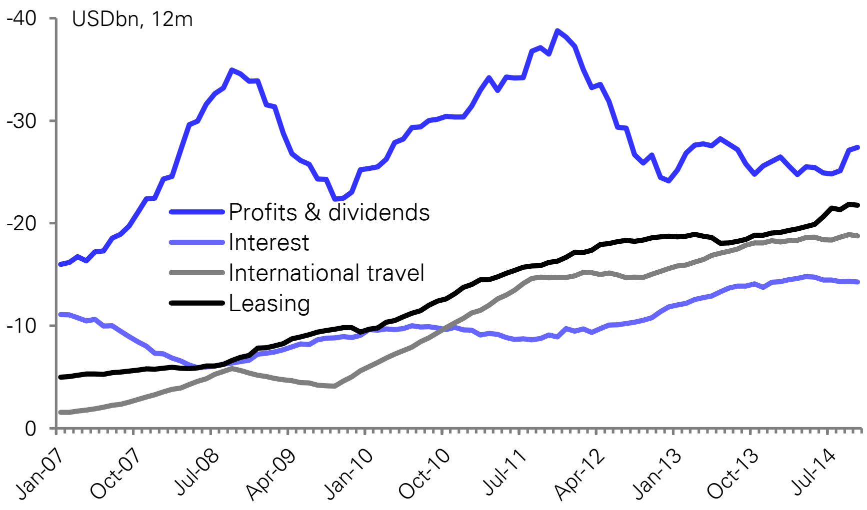
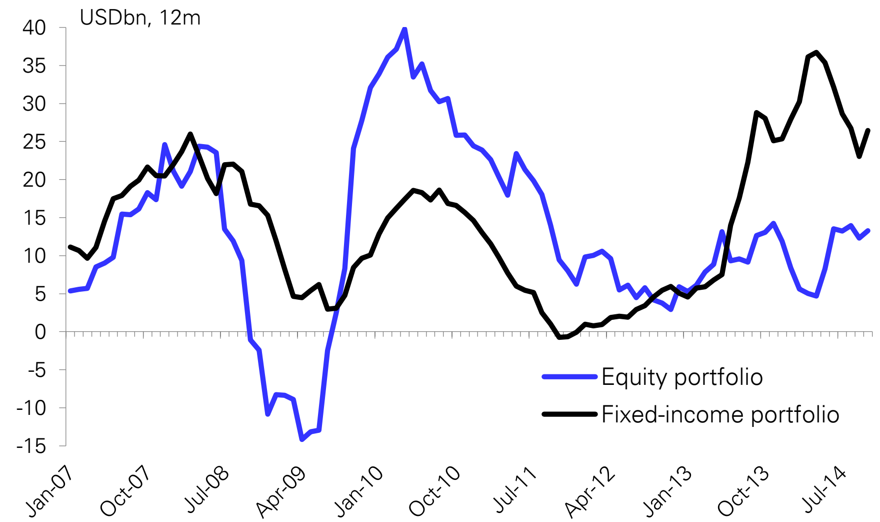
More data on the balance of payments

Current account components



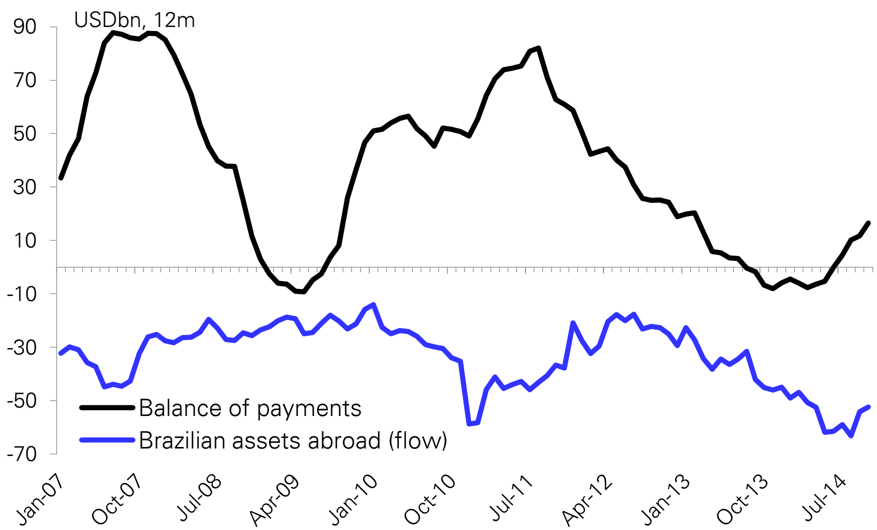
Source: BCB

Foreign portfolio investment



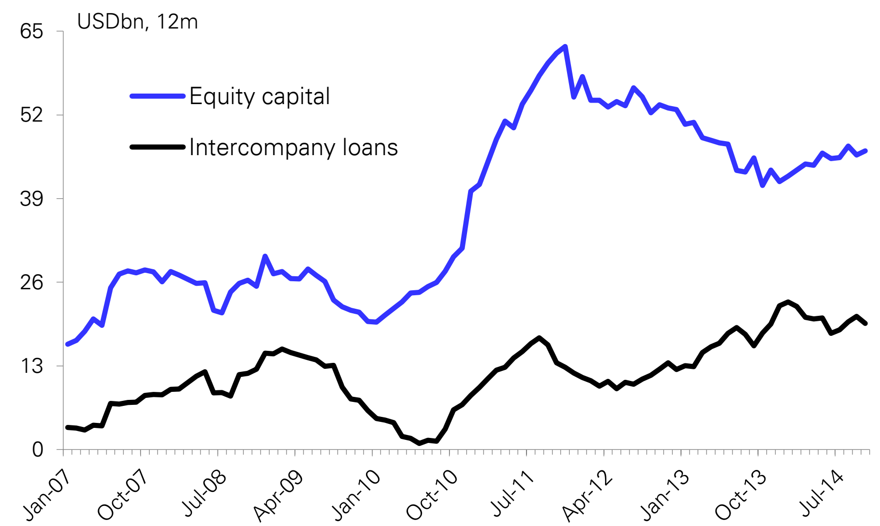
Source: BCB

Balance of payments



Source: BCB

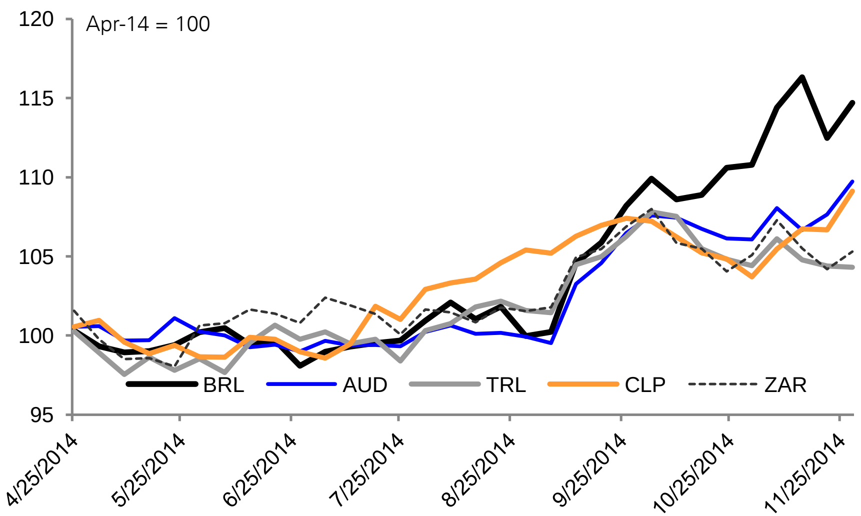
Foreign direct investment



Source: BCB

How will the BCB manage the FX swaps next year?

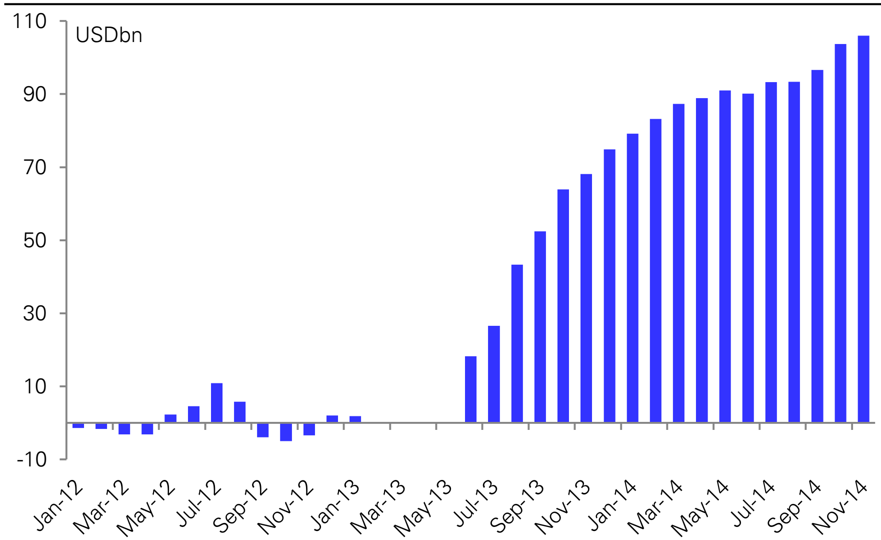
BRL and selected currencies



Source: Bloomberg Finance, L.P.

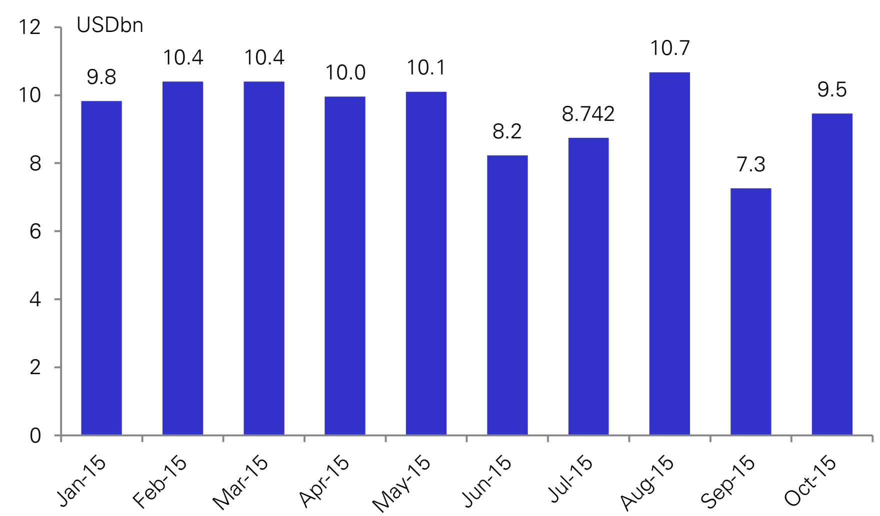
- We expect the BCB to taper its FX intervention program gradually, allowing the BRL to depreciate slowly so as to adjust the balance of payments without putting undue pressure on inflation.
- In a recent speech, BCB President Alexandre Tombini stated that the current stock of outstanding FX swaps (roughly USD106bn) “significantly meets the demand for FX hedging in the economy,” suggesting that the authorities are inclined to keep rolling the existing swaps, but not to renew the program of predetermined daily swap sales.
- In our opinion, the BCB would prefer not to increase the outstanding stock of FX swaps, but at the same time wants to avoid a rapid depreciation of the BRL. The BCB could perhaps cut the size of the daily rations in half to USD100mn/day in 1H15, and then use the rollovers to reduce the net supply of swaps whenever market conditions allow.

Outstanding stock of FX swaps



Source: BCB

FX swap maturity schedule



Source: BCB

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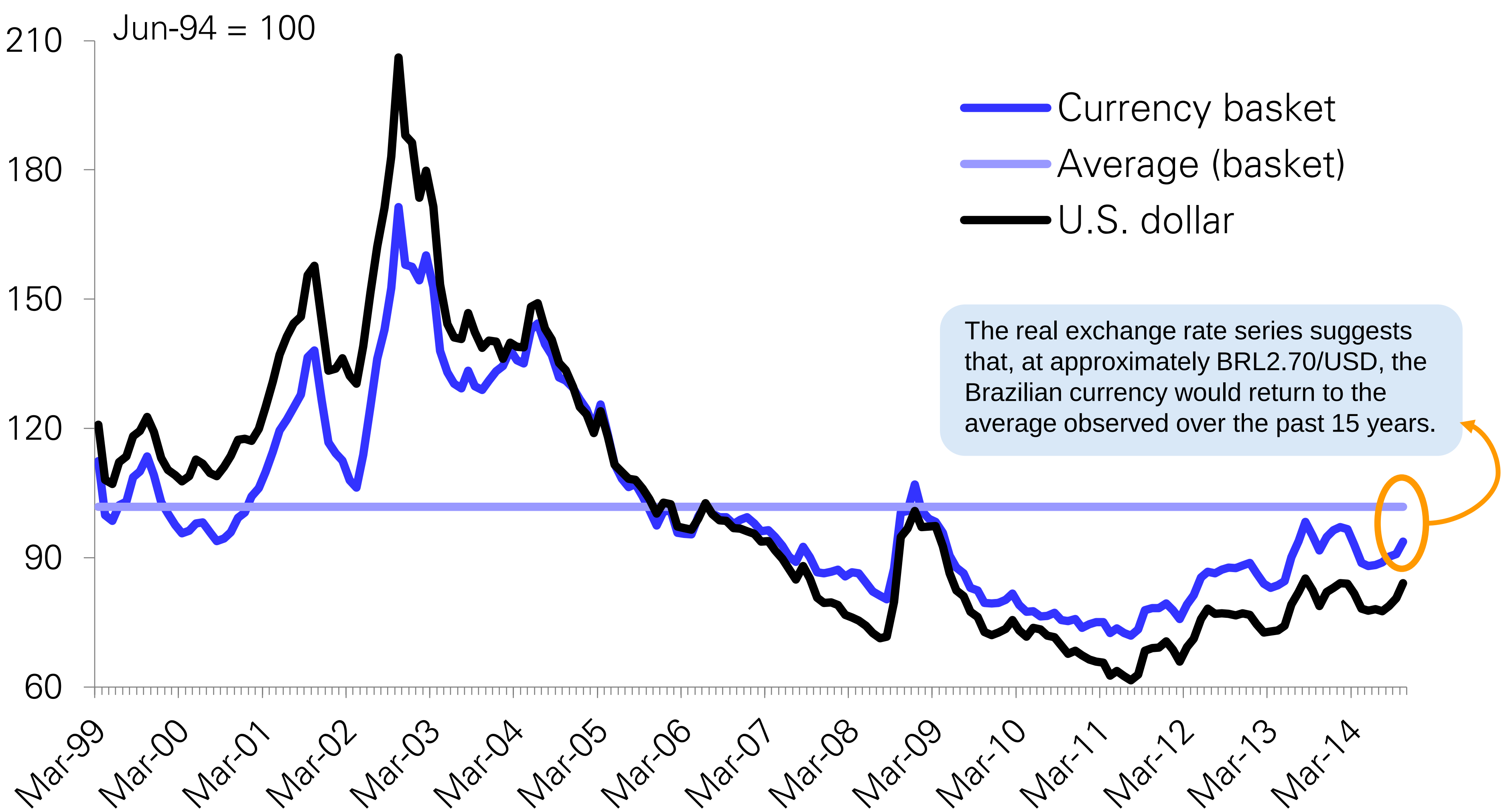
Real effective exchange rate



Source: BCB,

Economic indicators and forecasts

	2011	2012	2013	2014F	2015F	2016F
Economic Activity						
Real GDP (%YoY)	2.7	1.0	2.5	0.1	0.7	1.9
GDP (BRLbn)	4,143.0	4,392.1	4,844.8	5,116.4	5,459.1	5,813.1
GDP (USDbn)	2,475.1	2,252.6	2,245.4	2,188.4	2,092.9	2,076.1
GDP per capita (USD)	12,696.1	11,306.0	11,174.9	10,802.7	10,247.2	10,082.2
Household consumption (%YoY)	4.1	3.2	2.6	0.9	0.7	1.5
Investment (%YoY)	4.7	-4.0	5.2	-7.1	0.5	6.2
Industrial production(%YoY)	0.4	-2.3	2.3	-2.7	1.0	3.0
Unemployment Rate (%)	6.0	5.5	5.4	5.0	5.6	5.9
Prices						
IPCA (%)	6.5	5.8	5.9	6.4	6.2	5.8
IGP-M (%)	5.1	7.8	5.5	3.7	5.5	5.0
Fiscal Accounts						
Primary balance (% of GDP)	3.1	2.4	1.9	0.2	1.2	1.7
Nominal balance (% of GDP)	-2.6	-2.5	-3.3	-5.1	-4.9	-3.7
Net government debt (% of GDP)	36.4	35.3	33.6	35.9	37.2	38.7
External Accounts						
Trade balance (USDbn)	29.8	19.4	2.4	-4.0	4.0	12.0
Current account balance (USDbn)	-52.5	-54.2	-81.1	-92.0	-87.0	-87.0
Current account balance (% of GDP)	-2.1	-2.4	-3.6	-4.2	-4.2	-4.2
Foreign direct investment (USDbn)	66.7	65.3	64.0	61.0	65.0	70.0
Foreign exchange reserves (USDbn)	352.0	378.6	375.8	374.8	373.8	376.8
Debt Indicators						
Gross external debt (USDbn)	404.1	440.6	482.8	517.8	543.8	568.8
Gross external debt (% of GDP)	16.3	19.6	21.5	23.7	26.0	27.4
Interest and exchange rates						
Overnight interest rate (%, eop)	11.0	7.3	10.0	11.8	12.5	10.0
Exchange rate (BRL/USD, eop)	1.88	2.04	2.34	2.50	2.75	2.85
Exchange rate (BRL/USD, average)	1.67	1.95	2.16	2.34	2.61	2.80

Source: National statistics, DB forecasts

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Long-term forecasts

	GDP Growth (%)	IPCA Dec/Dec (%)	BRL/USD year-end	SELIC Average (%)
2010	7.5	5.9	1.67	10.0
2011	2.7	6.5	1.88	11.7
2012	1.0	5.8	2.04	8.5
2013	2.3	5.9	2.34	8.4
2014F	0.1	6.4	2.50	11.0
2015F	0.7	6.2	2.75	12.5
2016F	1.9	5.8	2.85	10.6
2017F	2.7	5.6	2.95	10.0
2018F	3.0	5.5	3.06	10.0
2019F	2.5	5.5	3.16	11.2
2020F	2.5	5.2	3.26	11.0
2021F	2.8	5.2	3.37	10.5

Source: National statistics, DB forecasts

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Appendix 1
Important Disclosures
Additional Information Available upon Request

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Risks to Fixed Income Positions

Macroeconomic fluctuations often account for most of the risks associated with exposures to instruments that promise to pay fixed or variable interest rates. For an investor that is long fixed rate instruments (thus receiving these cash flows), increases in interest rates naturally lift the discount factors applied to the expected cash flows and thus cause a loss. The longer the maturity of a certain cash flow and the higher the move in the discount factor, the higher will be the loss. Upside surprises in inflation, fiscal funding needs, and FX depreciation rates are among the most common adverse macroeconomic shocks to receivers. But counterparty exposure, issuer creditworthiness, client segmentation, regulation (including changes in assets holding limits for different types of investors), changes in tax policies, currency convertibility (which may constrain currency conversion, repatriation of profits and/or the liquidation of positions), and settlement issues related to local clearing houses are also important risk factors to be considered. The sensitivity of fixed income instruments to macroeconomic shocks may be mitigated by indexing the contracted cash flows to inflation, to FX depreciation, or to specified interest rates – these are common in emerging markets. It is important to note that the index fixings may -- by construction -- lag or mis-measure the actual move in the underlying variables they are intended to track. The choice of the proper fixing (or metric) is particularly important in swaps markets, where floating coupon rates (i.e., coupons indexed to a typically short-dated interest rate reference index) are exchanged for fixed coupons. It is also important to acknowledge that funding in a currency that differs from the currency in which the coupons to be received are denominated carries FX risk. Naturally, options on swaps (swaptions) also bear the risks typical to options in addition to the risks related to rates movements.

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