Fixed Income & Economics Daily

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ECONOMICS RESEARCH

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LATAM & CEE ECONOMICS

BRAZIL: Macro Compass: Credit Rating Downgrade: *Plus Ça Change*
MEXICO: 2018 GDP Forecast Revised Downward
MEXICO: New YE2018 FX Forecast
POLAND: CPI at 2.1% in December 2017
POLAND: Acceleration of Imports Caused a Decrease in the Trade Surplus

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Brazil Macro Compass

Credit Rating Downgrade: *Plus Ça Change*

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S&P Downgrades Brazil to BB-

Yesterday, S&P Global cut Brazil's long-term credit rating by one notch, to BB-. The agency cited "delays in advancing corrective fiscal measures" and "uncertain policy prospects following the 2018 presidential elections" as the main explanations for its action. The outlook is stable, reflecting a "comparatively solid external profile" and the flexibility and credibility of monetary and exchange rate policies.

The downgrade, in our view, was largely expected, given recent comments by S&P analysts to the press and the gridlock in the negotiations to vote on pension reform (see our December 22, 2017 report, *Deeper into Junk?*, for more details). On Friday, Brazilian asset prices traded mostly flat, with low volatility, confirming the view that the downgrade was already priced in. Indeed, in terms of CDS spreads, there is no discontinuity between BB and BB- countries. Brazil's spread was trading in line with the higher yields among BB (Turkey, South Africa), and is now close to the median of its BB- peers (Costa Rica, Guatemala, Vietnam). S&P now rates Brazil one notch below the equivalent ratings at Moody's and Fitch. If the recent past serves as a guide, the split rating may prevail for some months: S&P cut Brazil from BB+ to BB on February 17, 2016. Moody's matched that rating (Ba2 on its scale) one week later (in a two-notch downgrade), and Fitch went to BB on May 5, 2016.

We do not believe the downgrade will have further negative consequences for asset prices, nor do we expect it to have any significant impact on the odds of the pension reform getting approved. Subsequent rating actions, in our view, are highly dependent on the results from the presidential elections and the continuation (or not) of the fiscal consolidation process under the new president in 2019.

In-Depth Research: Why Has the BRL Weakened in 2017?

The BRL weakened slightly against the USD in 2017, despite improving fundamentals: (i) commodity prices rose, contributing to a record-high trade surplus; (ii) country risk (CDS spreads) collapsed, despite domestic uncertainties and reflecting confidence among international investors; and (iii) the USD weakened in global currency markets, losing 10%

against a basket of major currencies. Under this backdrop, foreign currency inflows were higher than (already high) expectations: FDI was 3% higher than the current account deficit, suggesting a very comfortable external funding position.

According to our models, which relate those and other variables to the exchange rate, the BRL should have gained around 11% against the USD in 2017 (which would translate to a BRL/USD exchange rate close to 3.0). In our view, the divergence between these models and the market is explained by monetary policy easing. Brazil's falling interest rates, coupled with U.S. rate hikes, substantially reduced the interest rate differential in favor of BRL-denominated bonds, which reversed hot money flows, offsetting the other factors that pointed to BRL appreciation.

Read more in our report *Why Has the BRL Weakened in 2017?* (January 8, 2018).

What's New: Below Target Inflation; Strong Retail Sales

November retail data surprised market consensus and our forecasts to the upside. Core retail sales grew 5.9% y/y, while the broad index (including autos and construction material) performed even better, surging 8.7% y/y. These numbers reinforce our view that household consumption should continue to lead the economic recovery throughout 2018, reflecting improvements in the job market, looser credit conditions, and purchasing power gains following lower-than-expected inflation.

December CPI inflation was above expectations (0.44% m/m, versus 0.31% in our forecast). 12-month inflation, the official measure for the inflation target regime, fell to 2.95%, below the bottom of the target range for the first time since the system was implemented. We continue to expect 2018 year-end 12-month inflation at 3.8%.

Forthcoming: Monthly GDP Gauge

The economic calendar is quite light: only November IBC-Br deserves attention. We expect +0.3% m/m and +2.4% y/y, equivalent to 2.3% y/y GDP growth in 4Q17 – led, in our view, by a 2.7% y/y expansion in household consumption.

Recent Publications (Available on Our Website)

- *Why Has the BRL Weakened in 2017?* (January 8, 2018)
- *The Unstoppable Force of Consumption* (January 2, 2018)
- *It's Raining Cats and Dogs; Impact of Hydrology on Tariffs and Inflation* (November 29, 2017)
- *Let's Try Again: The Positive and the Negative in the Latest Attempt to Pass Social Security Reform* (November 28, 2017)

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Mexico—GDP Forecast Revision

2018 GDP Forecast Revised Downward

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- **We revised our estimate for Gross Domestic Product growth for 2018 to 2.4% from 2.7%, amidst the weakening of investment (private and public), as well as the uncertainty about the evolution of oil production.**
- **We believe that during the first half of the year, financial volatility could be high, but we expect that in the second half of the year, if some of the premises that we estimated come to fruition, we could observe a better mood in the markets and in the economy.**

We revised our estimate for Gross Domestic Product growth for 2018 to 2.4% from 2.7%, amidst the weakening of investment (private and public), as well as the uncertainty about the evolution of oil production, which in 2017 registered its worst fall.

We have said that during 2018, the performance of the economy and financial markets in Mexico will be exposed to a series of factors of an economic and political nature. Particularly, we believe that during the first half of the year, financial volatility could be high, but we expect that in the second half of the year, if some of the premises that we estimate are fulfilled, we could observe a better mood in the markets and in the economy.

We highlight the following factors: (1) the conclusion or at least a significant advance in the negotiations of the North American Free Trade Agreement; as well as (2) the outcome of the internal electoral process that includes the Presidential election and both Houses of Congress, Governors in eight states and the Head of Government of Mexico City.

We still think that the negotiations of the Free Trade Agreement with Canada and the United States will have a successful outcome and that this trade association will prevail with benefits for all parties. But, it is also true that the negotiations have taken longer than anticipated and in the next months, complicated issues such as rules of origin, dispute settlement topics, as well as the duration and revision of the Agreement will have to be addressed.

Of course, one of the greatest risks for the evolution of Mexico's economy would be a unilateral rupture of NAFTA. Although it has been assumed that the "soft" rules of the World Trade Organization would enter into effect, an uncertainty “chapter” about the new patterns of the trade relationship could be triggered, especially with the “constant threat” of confronting protectionist policies.

It is undeniable that under such a scenario there would be a significant impact on investment and consumption decisions, as well as on exports and this would lead to a process of economic and market adjustments that would imply a slowdown of economic activity toward the end of 2018 and a significant drop in the economy in 2019-2020.

In the short term, this issue has resulted in high uncertainty that, besides affecting financial markets, has caused a weakening of productive investment. Private sector investment stagnated in 2017 (e/0.0%) and for 2018, we estimate barely moderate growth (1.0%) considering that in the second half of the year there will be better news about NAFTA (although not necessarily a conclusion of the negotiations), as well as an internal political transition that implies the continuity of economic policy. To this, we add reductions in estimated government investment (public sector, states and municipalities) of 8.3% in 2017 and 4.5% in 2018.

Additionally, we estimate that there will be a very intense and competitive electoral process, where local and foreign investors will be attentive to its evolution and resolution. It will be essential that markets perceive that there will be continuity in the macroeconomic stability policy, which includes (1) sustainable, healthy public finances, and (2) a strengthening of the autonomy of the Central Bank, as well as a promotion of structural reforms. An eventual rejection of the fiscal and monetary discipline, as well as of the reforms, would lead to an uncertain process about the future design of public policies.

On the other hand, the authorities in Mexico will have to evaluate the potential impact of the recently approved fiscal reforms in the United States for Mexico, the purpose of which will be to assess if the current tax scheme in Mexico is sufficiently “robust” to face the approved changes by the US Congress.

To these elements, we must add the persistent high uncertainty about the performance of oil production. At the end of 2017, the daily platform of oil production was at its lowest level in decades, at around 1.9 million barrels. In the year, oil production fell 10% and now we expect that if it remains at a level of 1.9 million barrels in 2018, there would be a 2.6% drop vs. the average production of 2017 (1,951 million barrels).

The weak performance of private investment, the fall in public investment and the uncertainty about the evolution of oil production drove us to review the estimated GDP growth expectation for 2018 to 2.4% from 2.7% previously.

However, there are some positive elements that lead us to believe that the economy can continue growing above 2.0% as we have mentioned. The first one is that the growth of the United States economy is expected to expand again around 2.5%, which consequently implies a favorable outlook for non-oil exports. Second, we anticipate moderate growth in government spending (public sector, states and municipalities), although lower than that in the same final years of each presidential term.

Third, we estimate that private consumption will continue to grow, with the possibility of a moderate recovery in real wages (decrease in inflation in 2018 versus 2017) and employment growth (e/3.5% versus 4.3% in 2017).

Finally, as we have mentioned, in the second half of the year, the risk associated with the electoral process will have "disappeared", and we consider that there will be greater progress in the negotiations of the Free Trade Agreement, which will also imply a better environment for business.

Mexico. Gross Domestic Product (YoY%)

	2015	2016		2017e/		2018e/	
	%GDP	change	contribution	change	contribution	change	contribution
Consumption	66.0%	3.7%	2.4%	3.0%	2.0%	2.8%	1.9%
Government Spending	12.0%	2.4%	0.3%	0.5%	0.1%	2.0%	0.2%
Public Investment	3.6%	-4.2%	-0.2%	-8.3%	-0.3%	-4.5%	-0.1%
Private Investment	18.0%	2.2%	0.4%	0.0%	0.0%	1.0%	0.2%
Exports	34.2%	3.5%	1.2%	5.8%	2.0%	6.8%	2.4%
Imports (-)	34.3%	2.9%	1.0%	5.6%	1.9%	6.5%	2.3%
Net Exports	-0.1%		0.2%		0.1%		0.1%
Change in inventories	0.8%		-0.2%		0.4%		0.1%
Total GDP			2.9%		2.3%		2.4%

Source: INEGI and Santander.

MEXICO

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New YE2018 Exchange Rate Estimate at MXN$18.20/USD vs. Our Previous Estimate of MXN$17.50/USD

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Our new estimate for the YE2018 exchange rate is MXN$18.20/USD vs. our previous estimate of MXN$17.50/USD. Inflation will likely close the year at 4.2% in 2018. We expect Banco de México will raise its target interest rate twice in the first half of the year, pressured by the exchange rate and inflation. Risk factors: impact of the fiscal reform in the United States on Mexico's economy, as well as uncertainty surrounding domestic oil production. We continue to assume that the North American Free Trade Agreement will prevail and that there will be continuity in the economic policy after the electoral process in Mexico in 2018.

Pressures on the MXN peso in the short term (1st half of 2018) as a result of the following factors:

1. Greater perception of risks related to the negotiation of the Free Trade Agreement with the United States and Canada, due to controversial proposals of the US government.
2. Risks of financial volatility associated with the internal electoral process of 2018.
3. Upward pressures on the interest rates of US Treasury bonds due to the impact of the fiscal reform on the budget deficit. We estimate that the Federal Reserve will raise its target interest rate in 75bps throughout the year, beginning at its March 21 meeting.
4. High uncertainty regarding the evolution of oil production in Mexico, which in 2017 recorded one of its worst performances in the recent period (10% drop). For 2018, we estimate an additional fall of 2.6% in the annual average.

We estimate that in the first half of 2018 there will be pressures on the peso/USD parity that would take it to its weakest level around MXN$21-22/USD toward the months of April-May. This would result in additional pressures on inflation: energy, goods (core), coupled with volatility in the prices of some farm products.

Our estimated inflation for the end of the year is now 4.2%, which implies a moderate revision of our previous forecast of 4.1%. This marginal revision is explained by the fact that in the second half of the year, we estimate an appreciation of the peso.

Amidst this, we estimate that Banco de Mexico will raise its interest rate twice (25bps each), the first one in February (day 8 to 7.50%) and the second between May and June (to 7.75%), depending of the pressures on the exchange rate. Previously, we only anticipated the February rise.

For the second half of 2018, we have a positive outlook for the performance of the exchange rate ending at MXN$18.2/USD (our previous estimate was MXN$17.50/USD) based on the following elements:

1. We estimate that NAFTA negotiations will continue throughout 2018, with positive news in the second half of the year. At the end of the agreement, the benefits will prevail for the three economies.
2. Moderate but sustained growth of Mexico's economic activity: growth in the export sector, services, remittances and Foreign Investment.
3. A cautious stance in the monetary policy aiming to consolidate the inflation trend toward the target range.
4. We estimate a cut in the target rate toward the end of the year of 25 basis points to 7.50%, supported by the appreciation of the MXN peso, a downward trend in inflation and expectations below 4% by 2019.
5. Continuity of the economic policy favoring the implementation of the Structural Reforms, consolidation of Public Finances and autonomy of the Central Bank.

The revision for our YE2018 estimate at MXN$18.2/USD replacing the previous MXN$17.5/USD responds to the possible impact of the fiscal reform in the United States in Mexico and the weakness of oil production. As well as, upward pressures on US Treasury bond interest rates due to the expansion of its budget deficit.

CEE ECONOMICS

POLAND

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CPI at 2.1% in December 2017

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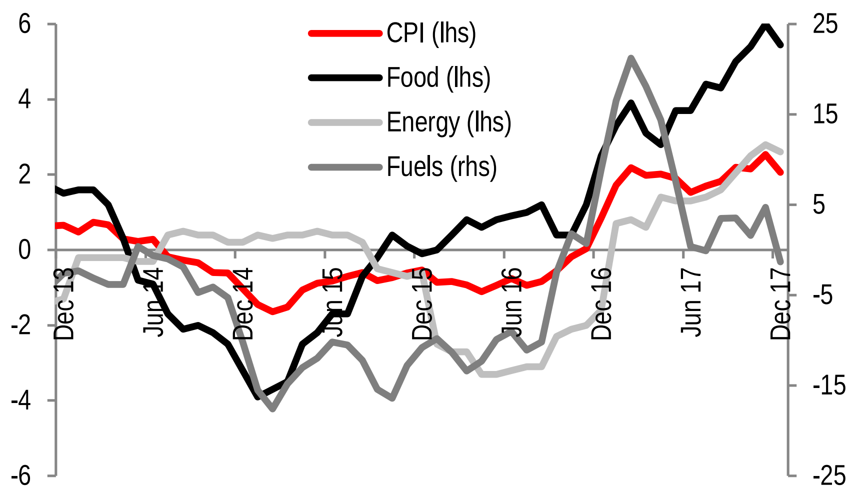
Final December CPI was at 2.1% y/y versus 2.0% shown in the flash update. The flash readings are usually in line with the final one and we have seen the last revision in May 2016. Still, in our view, the revision was actually very slight as the m/m reading showed 0.2% in both cases.

The decline from November's 2.5% was due to the high base effect in food and fuels. Food prices advanced in December by 0.5% m/m. The Stat Office did not release detailed data yet, but, in our view, egg prices still went up, while butter and sugar posted a significant decline. Fuel prices fell by 0.7% m/m, but the whole transport category added 0.7% m/m, most probably due to a rise in air transport. Changes in other categories were more or less in line with our expectations. We estimate core inflation excluding food and energy prices at 0.8% y/y.

In our view, **inflation is likely to oscillate in the 2.0-2.5% range in the months to come with a major change in its breakdown** — from food/energy driven to core driven (we expect core inflation at 2.0% at the end of 2018). The recent rise in oil prices would pose an upward risk to our forecast, if it proves permanent. The data are neutral from the MPC's point of view. Close-to-target inflation will give the MPC the comfort to stick to its 'wait-and-see' mode at least until the end of 2018.

CPI Inflation, % y/y



Source: GUS, BZ WBK.

POLAND

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Acceleration of Imports Caused a Decrease in the Trade Surplus

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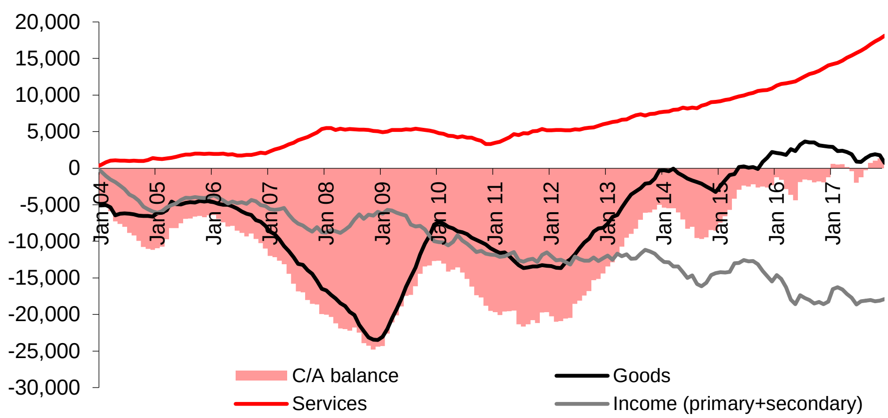
C/A remained in surplus in November (EUR233mn vs. EUR693mn consensus, previous reading revised down from EUR575mn to EUR297mn). **Both exports and imports recorded a higher pace of y/y growth than expected.** In the case of exports (14.8% y/y), this figure reveals how beneficial the current external environment is. The reported pace of imports (15.9% y/y) suits better the very strong domestic demand than the surprisingly weak readings from mid-2017. November's surprise in the trade balance and downward revisions for previous months were caused by higher import figures. Net exports may add less to GDP growth than in 3Q, but we do not feel the November C/A data call for downward growth revisions, as it may reflect some revival in investments as well as continued strong consumption requiring plenty of imported goods.

The trade balance of goods was in the case of our forecasts the only source of surprise. Services balance, primary and secondary income account all behaved as expected in November, registering EUR1.55bn, -EUR1.60bn and EUR0.2bn accordingly.

The 12-month rolling C/A balance to GDP ratio was 0.3% in November, up from 0.2%, and is the new record at least since 2004 (when the data are provided by NBP in the current methodology).

12-month Rolling Current Account, €mn



Source: NBP, BZ WBK.

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