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Brazil – Loss of Investment Grade

Back to the Past: Brazil Loses Investment Grade Status

Tatiana Pinheiro*
tatiana.pinheiro@santander.com.br
5511-3012-5179

After seven years of investment grade status, Brazil has now lost this status from two of the three main rating agencies (S&P and Fitch). Both agencies have a negative outlook for the country's sovereign credit, meaning that another downgrade may come soon. Usually, S&P revises ratings up to 18 months after it has modified the country's outlook.

The country's credit is now "formally" classified as junk, since only Moody's still rates Brazil as investment grade. Moody's signaled that its rating will be revised over the next three months, and it's fair to expect it will already downgrade Brazil to one notch below the investment grade cut.

All the rating agencies highlighted the widening primary fiscal deficit and the growth of the gross debt/GDP ratio. This deteriorating trend in fiscal accounts will likely continue over the short term.

International history

Given Brazil's loss of its investment grade status, it's important to take into account the experience of other countries that went through the same process recently. The countries considered here are Russia (2015), Portugal (2011), Hungary (2011), Croatia (2011), and Greece (2010).

- GDP contracts both in the year of the downgrade and the following year;
- Fiscal adjustment is usually implemented, but it's not strong enough to stabilize or reduce the debt/GDP ratio, which continues to rise in the years following the downgrade;
- Currency loses value against the USD before the downgrade, and the trend is reversed only after the downgrade, without offsetting all the devaluation. The correction stimulates competitiveness and leads to a faster adjustment in the external accounts;
- Inflation in the analyzed countries rises, on average, 2 percentage points in the year of the downgrade, falling through the year following;
- Risk perception (CDS spreads) skyrockets, anticipating the investment grade loss, and stabilizes at a higher level after the event;
- Domestic interest rates go up in the period before the downgrade, but this movement usually is short lived.

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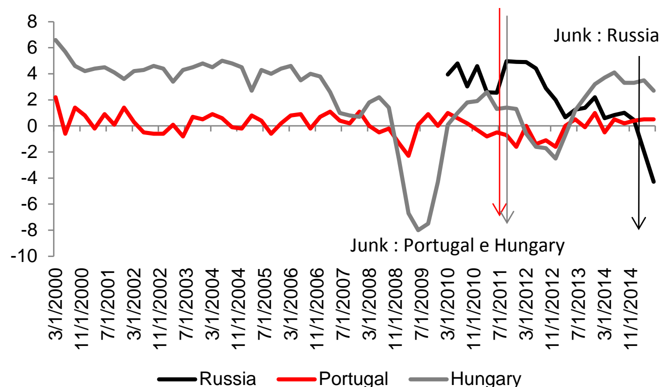
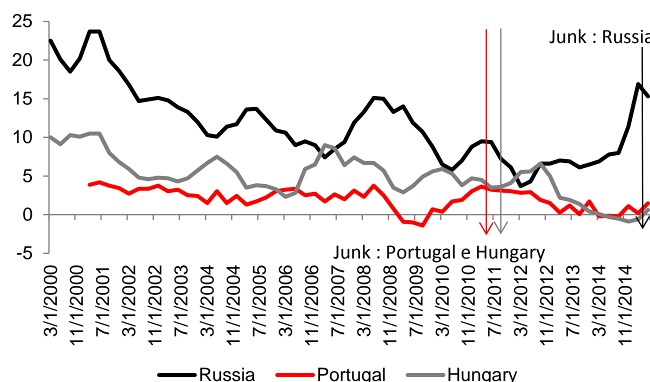
GDP (y/y)



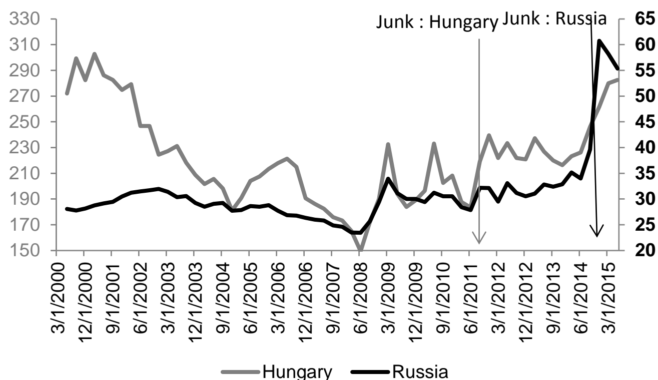
Source: Bloomberg.

CPI inflation (y/y)



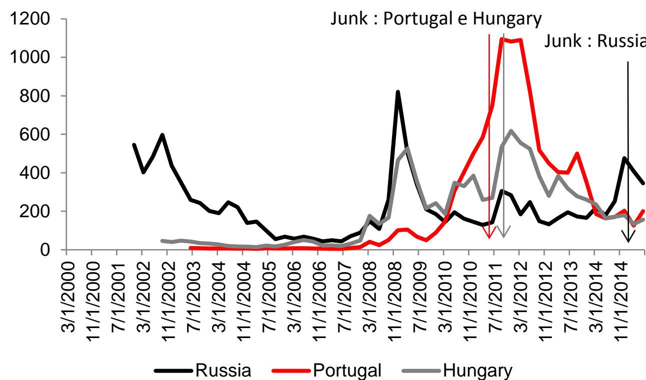
Source: Bloomberg.

FX rate



Source: Bloomberg.

5y CDS (bp)



Source: Bloomberg.

Brazil's Case: the current situation

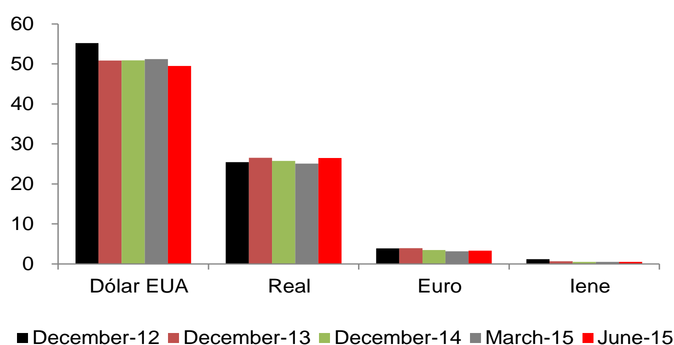
It's worth highlighting that the elements mentioned above are already being observed in the Brazilian economy: GDP contraction this year and likely continuing next year; widening of CDS spreads (around 250bps up since the end of 2014); strong currency depreciation; inflation accelerating; and a steepening yield curve, pricing 5-year interest rates around 16.1%, around 300bps above 2014 year-end prices.

This year the BRL lost around 45% against the USD, mostly before the first downgrade (by S&P), hence anticipating the downgrade and in line with the international experience. Also, the 5-year CDS spreads have been trading at levels close to that of junk status countries since late 2014, also anticipating the loss of investment grade. Market consensus points to 2 consecutive years of GDP contraction. Inflation this year should be around 4 p.p. above that observed in 2014, and median expectations anticipate a deceleration next year. The fiscal adjustment has yet to be fully implemented: the debates in Congress have been making this process more difficult; and domestic interest rates still haven't fallen. The most likely scenario is that this will happen only if the announced austerity policy materializes.

The deterioration in the fiscal accounts, illustrated by the evolution of the debt/GDP ratio, will be the main reason behind the investment grade loss. Since December 2013, gross debt/GDP jumped 13p.p., from 53% of GDP to 66% of GDP in September 2015. This fast growth of public debt leads to questioning regarding its sustainability in the medium term.

The external accounts look quite robust, with external solvency indicators in positive territory because of the increase in international reserves at a faster pace than the sovereign external debt. The improving composition of the external debt, now partially BRL-denominated (3%), and of the domestic debt (fully BRL-denominated) helped with a solid external solvency, whereas in 2005 (before the investment grade) the external debt was 100% in foreign currency and 5% of the domestic debt was still USD-linked.

Currently, gross external debt, including intercompany loans plus local debt held by foreigners, represents 26% of the outstanding debt.



Source: Bloomberg.

The return of speculative grade does not necessarily lead to a worsening external debt solvency, unless the government chooses to fight FX depreciation with interventions in the spot market (selling international reserves, now amounting to USD370 bn). This year's BRL depreciation already translates into a trade balance surplus of around USD13 bn and a narrowing current account deficit, from 4.42% of GDP in 2014 to 4.02% of GDP in the 12 months until October 2015. This dynamic favors the external solvency position.

Back to speculative grade: effects in markets and fundamentals

The loss of investment grade (mainly because of deteriorating fiscal accounts) will have effects over the composition and maturity profile of domestic debt, country risk perception (and, consequently, interest rates), exchange rate, and investments.

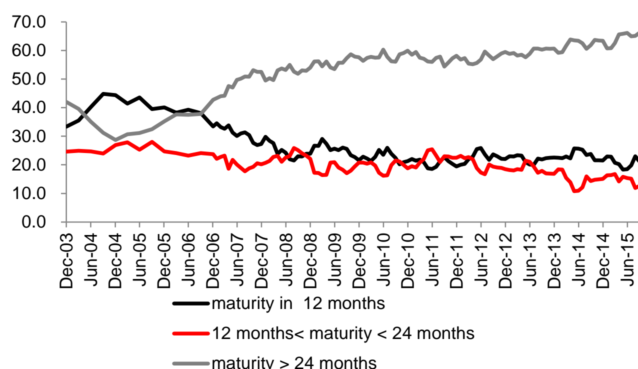
1. Composition and maturity profile of domestic debt

We believe that the main effects of the investment grade loss will be:

- The share of floating rate debt should increase;
- Debt duration should fall (concentrated in maturities up to 2 years);
- Assuming that external fundamentals won't deteriorate, it's unlikely that Brazil will resume issuing domestic USD-denominated debt

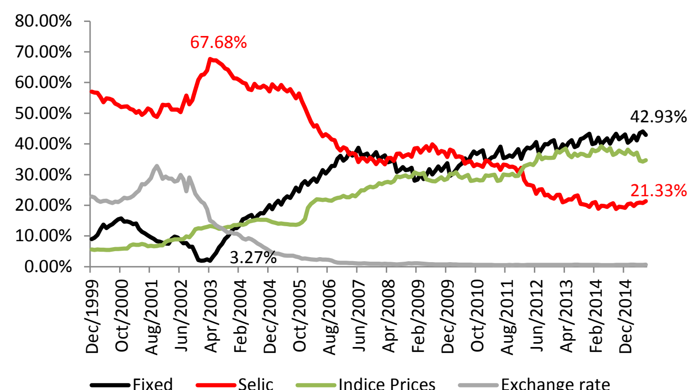
History: before the investment grade, domestic debt was concentrated in floaters (LFT) and USD-linkers (NTN-D). Until 2004, domestic debt outstanding was around 60% floating and 25% USD-linked. In 2004, 71% of domestic debt expired within 24 months, with 40% having maturity inferior to 12 months.

Domestic debt average maturity (months)



Source: BCB.

Domestic debt composition



Source: BCB.

For several years, debt issuance followed a duration lengthening and profile improvement strategy, concentrated in fixed rate and inflation-linked bonds. However, the target for the share of floaters is 22% of the outstanding debt, and until June 2015 it already reached 21.3%. Furthermore, the National Treasury has been selling short duration fixed rate bonds with the rational of not distorting the long end of the curve. Recently, it intensified the selling of floaters, with changes in the Central Bank repo auctions. In early September, 6-month repos were suspended and 3-month repo auctions ceased to be daily and became weekly. These changes, mainly the suspension of 6-month repo auctions, intensified the selling of floating rate bonds.

National Treasury plan for debt composition - 2015

	Domestic Federal Debt Breakdown - Jun/15	Domestic Federal Debt limits for 2015
Fixed	42.9%	44.0%
Selic	21.3%	22.0%
Price index	34.7%	37.0%
Exchange rate	0.6%	6.0%

Source: National Treasury.

This strategy of not ratifying higher interest rates because of rising country risk, reducing the issuance of fixed rate bonds and rolling over part of the debt with floaters still didn't change significantly the composition of the outstanding debt. However, if this strategy continues over the medium term, it should have effects in the composition and maturity. Therefore, we believe that, under speculative grade, the share of floaters in the domestic debt should increase, moving back to levels close to those observed in 2004 (50%-60%); and that debt duration should fall, concentrated up to 2 years. We don't believe that USD-linked bond issues will resume, assuming external accounts and external debt solvency won't deteriorate.

2. Risk perception

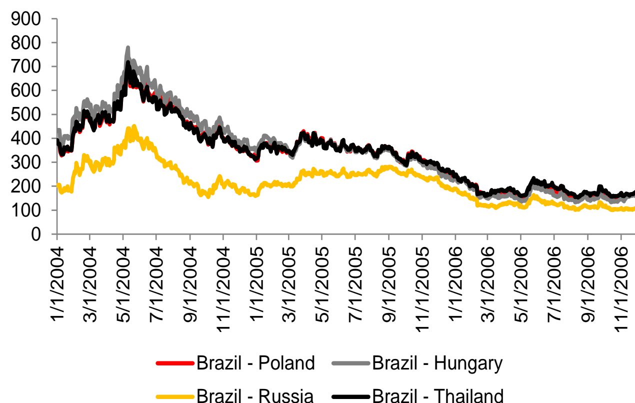
We believe that the effects of the investment grade loss will be:

- Country risk should not deteriorate significantly

Historical view: before investment grade, Brazil's country risk traded around 280bps above investment grade (BBB-) names—we compared Brazil's country risk to an average of Russia, Hungary, Thailand, and Poland in 2005. Currently, the spread between Brazil's 5-year CDS and BBB- countries appears in line with that observed between 2005 and 2006. With no further

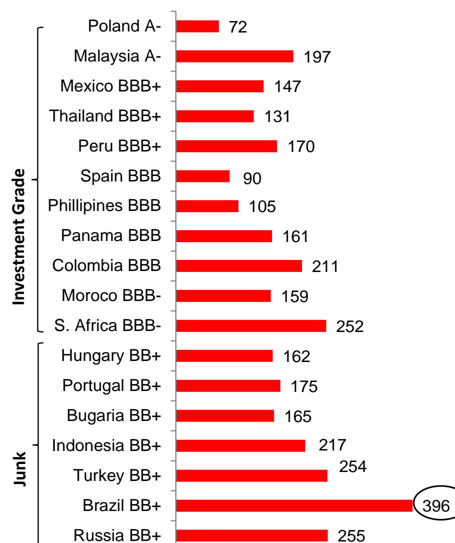
deterioration in the fiscal and political fields, it seems that the country risk pricing should not deteriorate from current levels once the country becomes junk.

Spread between Brazil EMBI and other countries



Source: Bloomberg.

5-year CDS



Source: Bloomberg.

3. Interest and Exchange rates

We believe that the effects of the investment grade loss will be:

- Domestic yield curve should remain around the current levels, with high breakeven inflation premia;
- The exchange rate should keep depreciating, adjusting for the inflation differential. We believe that adjustments in the real exchange rate are already done.

Historical view: assuming the non-arbitrage between markets over the long term, the conclusion is that current 5-year CDS pricing is already aligned with the new junk rating stance. Furthermore, also taking into account the international experiences, in which both interest and exchange rates adjust over the short term (before and immediately after the loss of investment grade), **there's no space for BRL strengthening. The exchange rate should keep depreciating, but at a much slower pace than that observed this year. The local yield curve should remain largely unchanged, with high inflation premia.**

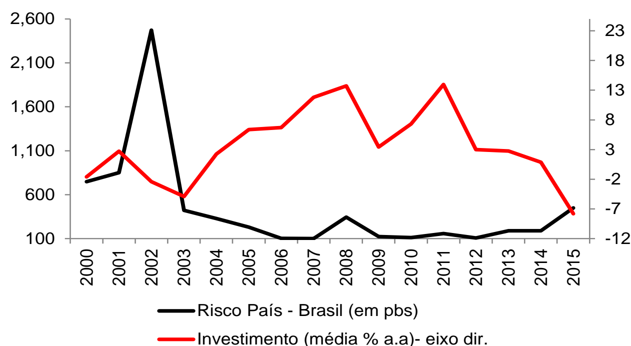
4. Investments

We believe that the effects of the investment grade loss will be:

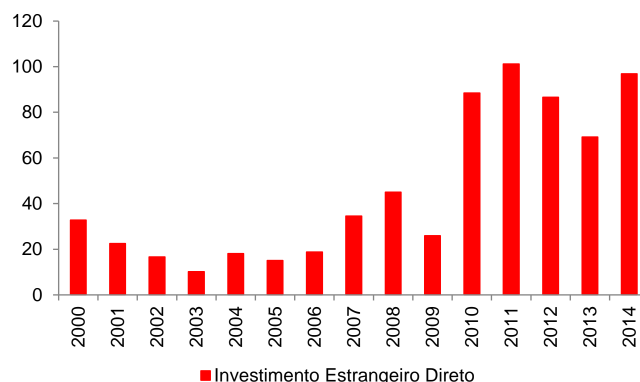
- Foreign direct investment (FDI) should average around USD40 billion per year, below current levels;
- Brazil should no longer be one of the main destinations of international capital;
- Foreign portfolio investment tends to be most impacted, with potential net outflow as institutional investors who face constraints to invest on speculative assets.
- Medium and long-term financing may remain relatively stable in terms of volume, but will likely see their profile worsen, leaning toward a shorter, more expensive credit, with less capital market operations and more bank loans.
- The loss of investment grade should affect negatively and permanently potential GDP, so the country's growth should be limited to around 2% per year over the medium term;
- Capital flight potential is around USD18 billion.

Historical view: there's an inverted relationship between country risk and investments. As mentioned above, our evaluation is that country risk should stay around current levels, determining a new pattern of capital inflows and rate of investment in the country. FDI volume, around USD73 billion/year (since 2008, with the investment grade), should return to a lower average, around USD40 billion, observed before 2008.

Investments vs. Country risk



FDI (USD bn)



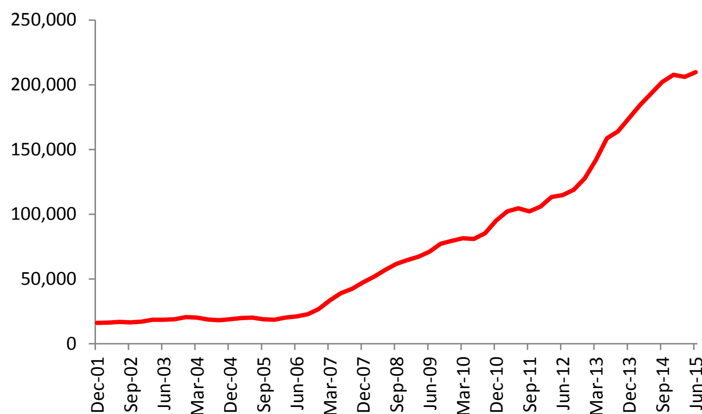
Sources: IBGE and Bloomberg.

Foreign direct investment tends to be least impacted, as these investors focus less on the rating and more on the prospect of profits remittance: in that sense, volumes may decline but only moderately, as the cheap USD value of local assets partially offset the downward revisions to economic growth, and given that high international reserves minimize the risk of capital controls.

The worsening in Brazil's credit rating should lead to a revaluation of the Brazilian multinationals' ratings. Currently, the portfolio of intercompany loans is around USD250 billion. We believe that at least 5% of this amount should leave the country—a potential flight of USD12 billion.

Intercompany loans, outstanding volume

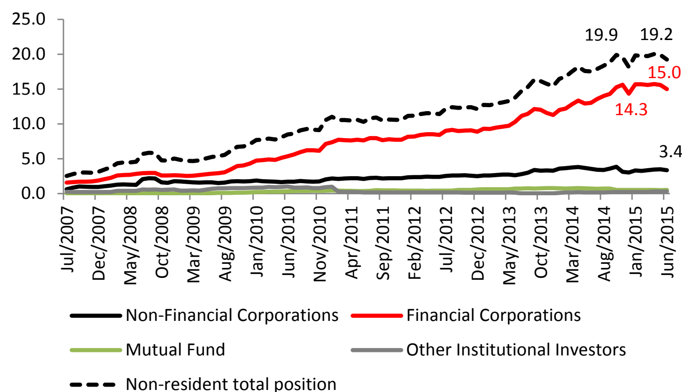
USD billion



Source: BCB.

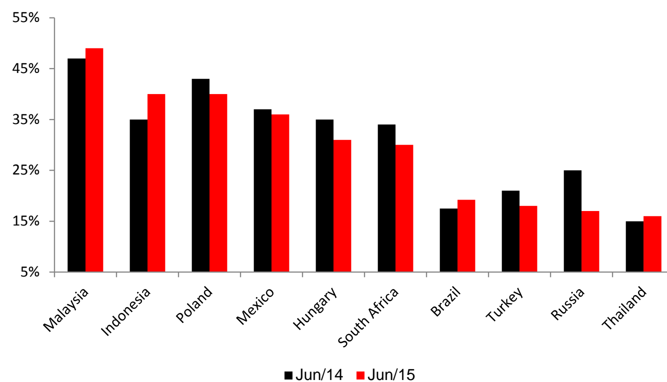
Other than that, foreign investors hold 19% of the domestic debt—a lower share to international standards, which is good news. However, this share should also fall under the new credit classification. In other difficult economic times, the share of foreigners among domestic debt holders was reduced by 1p.p., which represents BRL24 billion (around USD6 billion).

Holders of domestic debt



Source: BCB.

Outstanding domestic debt, share of foreign investors



Therefore, the potential capital flight, adding up intercompany loans and domestic debt, would amount to USD18bn, which is limited.

The most damaging effect would be over direct investment, and, consequently, the absorption of external savings (which usually happens when the credit rating deteriorates), negatively affecting the potential GDP growth. In this sense, the permanently low confidence (because of the stably negative fiscal solvency) and stagnating investments create a vicious cycle of low growth and worsening credit indicators in the short term.

Back to speculative grade: Indicators

	Current level	1 year (after loss of IG)
CDS 5 years (bps)	490	350
BRL/US$	3.8	4.1
IPCA (% y/y)	10	7
GDP (% y/y)	-3.8	-2.0
FDI (USD billion)	71	50
CDI 1 year	16.1	14
Spread CDI 1-year and CDI 5-year (bps)	30	-75
Domestic Federal Debt (fixed rate) % of total	44%	34%
Domestic Federal Debt (Selic rate) % of total	22%	32%
Average term to maturity of Domestic Federal Debt (years)	4.4	3.9

Source: Bloomberg, BCB, IBGE e Santander estimativa.

Recovering investment grade

Looking to S&P decisions in 136 countries, only 19 of them experienced the loss of investment grade status, of which only 6 recovered their investment grade status. Namely: Colombia (12 years) , Uruguay (9 years), Romania (9 years), Slovakia (3 years), Latvia (3 years), and South Korea (1 year). On average, it took those countries 6 years to recover the investment grade status. The longest wait was Colombia's (12 years) and the shortest, South Korea (one year). Brazil is likely to take one decade to recover the investment grade, in our view, because of difficulties in the adjustment of fiscal accounts, the perspective of prolonged recession and the current weak governability.

In 2008, the upgrades to Brazil's long-term debt ratings was attributed to the maturity of the country's institutions and to the responsible policies implemented, illustrated by the reduction in the domestic public debt burden and the external debt and the improving growth prospects, according to S&P.

Unfortunately, the current path of the Brazilian economy is the opposite of what is described above. Brazil faces a weakening of institutions; need to increase the tax burden, and the outlook of recession. We believe that the reversal of this route will happen only by the end of the next presidential term, since it depends on the balancing of fiscal policy and structural reforms (public pension, taxes, and labor).

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@bzwbk.pl	48-22-534-1888
Sergio Galván*	Economist – Argentina	sgalvan@santanderrio.com.ar	54-11-4341-1728
Maurício Molan*	Economist – Brazil	mmolan@santander.com.br	5511-3012-5724
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
David Franco*	Economist – Mexico	dafranco@santander.com.mx	5255 5269-1932
Tatiana Pinheiro*	Economist – Peru	tatiana.pinheiro@santander.com.br	5511-3012-5179
Piotr Bielski*	Economist – Poland	piotr.bielski@bzwbk.pl	48-22-534-1888
Marcela Bensión*	Economist – Uruguay	mbension@santander.com.uy	5982-1747-5537
Fixed Income Research			
David Duong	Macro, Rates & FX Strategy – Brazil, Peru	dduong@santander.us	212-407-0979
Brendan Hurley	Macro, Rates & FX Strategy – Colombia, Mexico	bhurley@santander.us	212-350-0734
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Nicolas Kohn*	Macro, Rates & FX Strategy - LatAm	nicolas.kohn@santandergbm.com	4420-7756-6633
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978
Isidro Arrieta	Credit Research	iarrieta@santander.us	212-407-0982
Equity Research			
Jesus Gomez	Head LatAm Equity Research, Strategy	jgomez@santander.us	212-350-3992
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Pedro Balcao Reis*	Head, Mexico	pbalcao@santander.com.mx	5255-5269-2264

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