Santander

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Brazil – Sovereign Risk

Feeling Junk

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1) **Chronicle of a Death Foretold: How did we end up here?**
2) **Market reaction: Junk status seems mostly priced in.**
3) **A fundamental look: where do we stand among our peers? How do we compare to our past selves?**
4) **What is the expected impact on capital flows?**
5) **What has to be done to recover the investment grade status? Will other agencies follow S&P?**
6) **What is the impact on the economic outlook? *We are changing our forecast for the BRL at the end of 2015 to BRL 3.70/USD from BRL 3.40/USD.* For 2016, we maintain our projection at BRL 3.60/USD. *We are also adjusting our forecasts for GDP growth to -2.8% from -2.3% for 2015 and to -1.0% from -0.5% for 2016.***

Conclusion

S&P acted on its negative outlook and downgraded Brazil to BB+, maintaining the negative outlook and suggesting a 1/3 chance of a new downgrade over the next few months. This further distances S&P from other rating agencies, but in the absence of positive news, particularly on the fiscal front, it may be a matter of months for them to follow S&P's move.

We believe this downgrade was mostly priced in, but this does not rule out a short-term negative reaction from most assets, BRL included. More importantly, markets should react to the potential impact of the downgrade not only on the economic variables, but also in terms of economic policy response.

In our view, it is unreasonable to assume that the current political standstill will be long lasting: the most reasonable assumption, in our view, is a scenario in which political forces converge to one where the administration regains control of the agenda. A prolonged legislative standstill tends to be so negative for markets and the real economy that it seems unlikely the political forces would sustain such a situation for a long time.

At some point, we expect policymakers to be able to come up with a policy response, if not enough to restore previous fiscal credibility, at least enough to prevent further deterioration, which is expected to lead to the improvement of risk assessment. Therefore, our scenario still embeds an improvement of business confidence in 2016 and the re-anchoring expectations regarding the outlook for debt dynamics, although at a higher than previously expected level. This will likely lead to a stronger BRL, according to our forecasts.

We do not believe that economic policy will take a turn toward heterodoxy. But, we have to admit the downgrade has come sooner than expected, and, the perception that a reinforcement of a government coalition coupled with an effective policy response will take longer than we have been assuming. For this reason, we are adjusting some forecasts according to the following table:

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Forecasts

	2014	2015	2016
Risk Premium (5 yr CDS eop)	188	~~260~~ 300	270
PIB (%)	+0.1%	~~-2.3%~~ -2.8%	~~-0.5%~~ -1.0%
Exchange rate (BRL / USD)	2.66	~~3.40~~ 3.70	3.60
Inflation (IPCA %)	6.4%	9.5%	6.5%
Selic (% p.a.)	11.75%	14.25%	11.50%

Sources: IBGE, Brazilian Central Bank and Santander estimates.

1) Chronicle of a Death Foretold: How Did We End Up Here?

S&P downgraded Brazil to BB+ on the back of the country's poor fiscal performance, which, combined with negative growth and high interest rates, is jeopardizing public debt dynamics. Furthermore, the political environment is not supportive of an improvement in this scenario, at least for now.

As the agency puts it: "The political challenges Brazil faces have continued to mount, weighing on the government's ability and willingness to submit a 2016 budget to Congress consistent with the significant policy correction signaled during the first part of President Dilma Rousseff's second term. **We now perceive less conviction within the President's cabinet on fiscal policy" [emphasis ours]**.

A sequence of policy and political mistakes was certainly decisive for such a perception: (1) the downward revision of fiscal targets for this year and the next (announced last July), (2) the sequence of trial balloons for revenue raising (IoC, higher CSLL brackets, CPMF[1]) that were inexpertly launched and failed to gather political support, (3) problems within the government coalition that led Vice President Michel Temer to step down from his role in political coordination, (4) the submission of a budget proposal with a primary deficit which, *per se*, would already be very negative but it was, on top of that, a visible indication of weakening in Finance Minister Joaquim Levy's power, (5) the clumsy attempts to show support to Levy and to amend the budget proposal, which so far (10 days after the budget proposal) have produced no material results.

This all contributed toward forming a perception, shared by most in the market, that Levy's pleading for more fiscal austerity was not finding support, either because the President lacks political support or because she does not share his belief in the need for further austerity ("willingness"), or perhaps both. In any case, it is difficult for a rating agency to envisage improvement in the fiscal performance if they do not believe there is willingness or ability to do so, which justifies the decision to downgrade.

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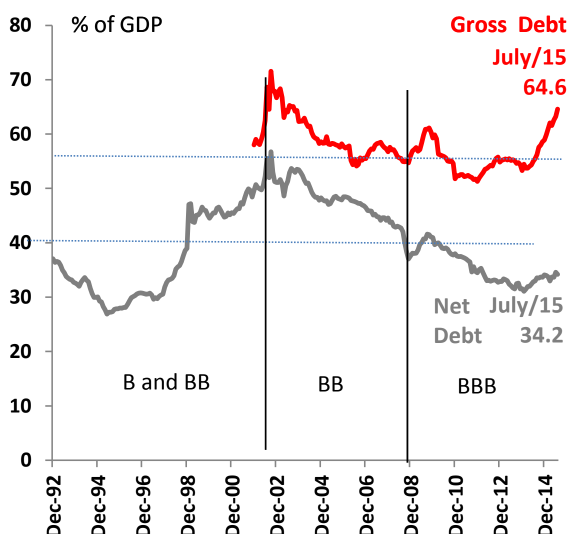
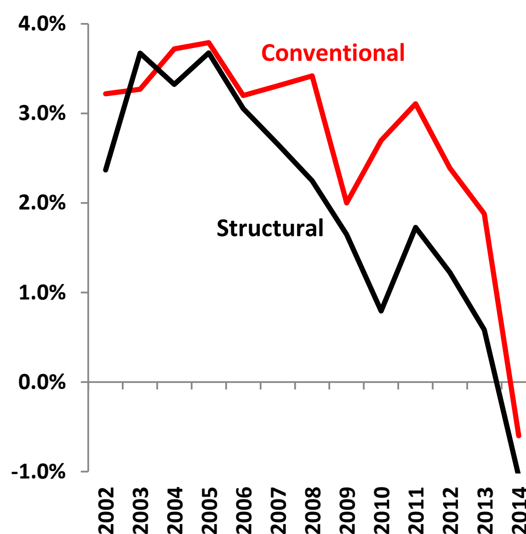
[1] **IoC: interest on capital** – a Senator from the coalition base proposed phasing out deductions of interest on capital from the base on which corporate income tax is charged; the proposal faced a strongly negative reaction and was withdrawn within a matter of a week.
CSLL: social contribution on net income – last May, the government published a provisional measure raising the CSLL tax bracket charged on banks from 15% to 20%; the same Senator decided to raise it further to 23%. At the end of two weeks, the Senator was forced to step back and ended up with a proposal weaker than the original (20%, but only on a temporary basis).
CPMF: financial transaction tax (launched in 1993 meant to be temporary, but expiring only in 2007 after the government failed to renew it yet again in Congress) – as the CPMF is a type of tax that raises significant revenue with an easy implementation, the government signaled its intention to resubmit it to Congress, again, on a temporary basis. The idea faced such a hugely negative reaction that it never became a formal proposal.
The negative reaction to these ideas reflects a mix of problems in political coordination and of the Congressmen refusal to approve an increase in taxation in the absence of meaningful spending cuts.

Gross and Net Debt (% of GDP)



Primary Surplus (Actual and Structural) (% of GDP)



Source: Brazilian Central Bank.

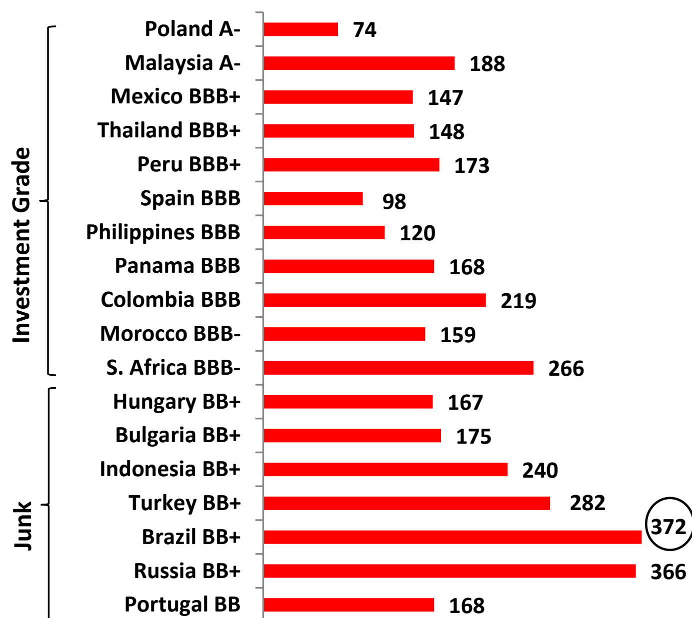
Sources: Brazilian Central Bank, The Ministry of Finance, Santander estimates.

2) Market reaction: junk status seems mostly priced in

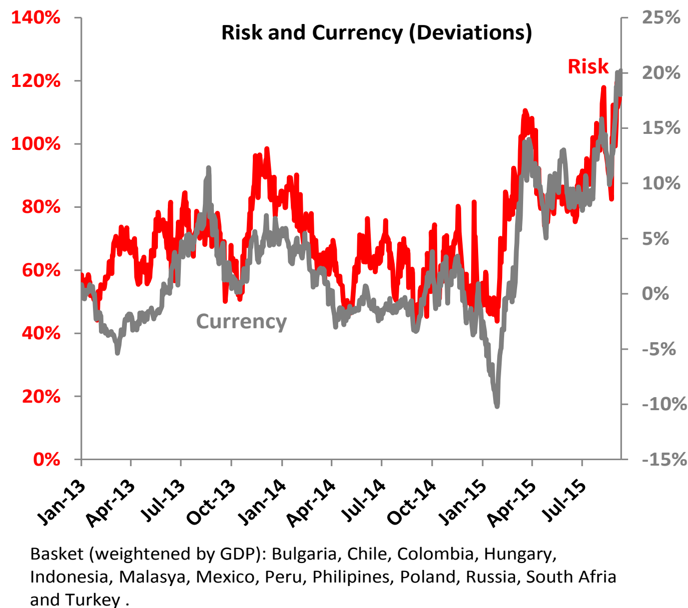
S&P's downgrade was highly expected, considering that the agency had put a negative outlook in March 2015 and particularly after the budget event. In any case, it is interesting to note that Brazil's CDS was already trading at levels broadly consistent with a junk bond (actually, for quite a while, and this decoupling from IG levels only increased in recent days): as shown by the charts below, Brazil's CDS was already the highest among the emerging markets rated BB+.

Although it is difficult to perform the same exercise for the currency, it seems reasonable to assume that the BRL is similarly pricing in a non-investment grade status (see chart on the right hand side).

Ratings (S&P) and 5 years CDS (as of Sep. 10)



Brazilian Risk (CDS) and Currency (BRL) Deviations from a Basket of EM Countries



Sources: S&P and Bloomberg.

Source: Bloomberg.

Another way of estimating potential market impacts is by looking at what happened to other countries that lost their investment grade status. Such a comparison always has an important caveat: each country has a particular story, a specific variable driving the negative perception and the downgrade. Bearing this in mind, the comparison can be very useful.

Selected Countries and Variables (Equity Markets, CDS and Currency)
Downgrades from Investment Grade to Junk Market in Red (Moody's and S&P)

Russia — Hungary — Croatia

Currency / USD — Currency / USD — Currency / USD

MICEX — Budapest Index — Crobex

5-year CDS — 5-year CDS — 5-year CDS

Red dots represent the date of loss of investment grade status by Moody's and S&P. Sources: Bloomberg, Moody's and Standard and Poor's.

Indeed, the examples of Russia, Hungary and Croatia (charts below) suggest that, while there could be further losses in asset prices in the aftermath of the downgrade, currency and stock prices had largely anticipated the downgrade. This would be the classical reaction, predicted by theory, as markets tend to price in deteriorated expectations not in a discreet but rather in a continuous way.

In the case of Russia, the continued weakness could be explained by the persistent uncertainty in oil prices, an important driver for that economy. In the case of Brazil, a potential driver for further losses could lie also in the prices of commodities but mostly on politics. Even if policymakers reinforce the commitment to fiscal austerity ("willingness"), that commitment will lack credibility unless they are able to demonstrate improvement in terms of political support.

3) A fundamental look: where do we stand among our peers? How do we compare to our past selves?

Looking at some key debt sustainability indicators for a group of BB+/BBB- countries, Brazil's higher CDS spreads and recent downgrade come as no surprise. Compared to Russia, South Africa, and Turkey, **Brazil has the highest debt/GDP ratios** (even discounting its relatively high international reserve position), worst budget balance, a sizeable current account deficit, and poor GDP growth prospects.

Brazil's relative strength is its high level of international reserves as a share of total external debt — almost double that of South Africa and Turkey. This provides sound ground for the reluctance of Brazil's Central Bank to sell dollars to smooth the current currency depreciation wave.

Brazil's 5-year CDS spreads have been surging since late May, and this week they traded (slightly) above Russia's for the first time in the past 18 months. From the perspective of market prices, protection against a default of Russia or Brazil costs essentially the same — perhaps a good measure of how deep Brazil's fiscal problems became recently.

Selected macroeconomic fundamentals: a comparison with some peers

	Credit rating (S&P)	5y CDS	Current-account balance, 2015	Budget balance, % of GDP, 2015	General government gross debt, % of GDP, 2015	CPI, % y/y, latest figure (Jun or Jul 2015)	Change on real GDP, 2015/2016 (average), %	Total reserves, % of total external debt (2014)	General govt gross debt minus intl. reserves, % of GDP, 2014
Brazil	**BB+**	**387**	**-3.9**	**-10.0**	**68.1**	**9.5**	**-1.9**	**74.4**	**41.1**
Russia	BB+	374	5.4	-3.7	18.8	15.8	-1.6	56.4	-2.0
South Africa	BBB-	271	-4.6	-4.2	47.5	5.0	2.1	35.5	33.1
Turkey	BB+	294	-4.2	-1.4	33.4	7.1	3.4	33.8	17.1

Sources: Santander forecasts for Brazil and IMF forecasts (as of July 2015) for other countries. World Bank, CIA World Factbook. CDS quotes from Bloomberg as of September 10.

If international comparisons are always subject to caveats, the comparison between Brazil now and Brazil in the past could provide some illustration on how we stand in terms of fundamentals. A look at our external solvency indicators (table below) shows the country boasting international reserves more than twice as high as they were the last time our rating was BB+ (from early 2006 to April 2008). Exports of goods and services, an important variable for external solvency ratios, increased since then but more modestly. However, external debt also increased, albeit less than proportionally.

In net terms, we see an increase in debt service/exports, a slight rise in external debt/GDP, roughly stable (and still negative) net external debt and somewhat better coverage ratios, for instance reserves/short term debt and amortizations due in the next 12 months. In sum, external solvency does not seem to be in jeopardy, but have deteriorated from levels seen when the country had an investment grade.

Select external solvency indicators for Brazil: recent evolution

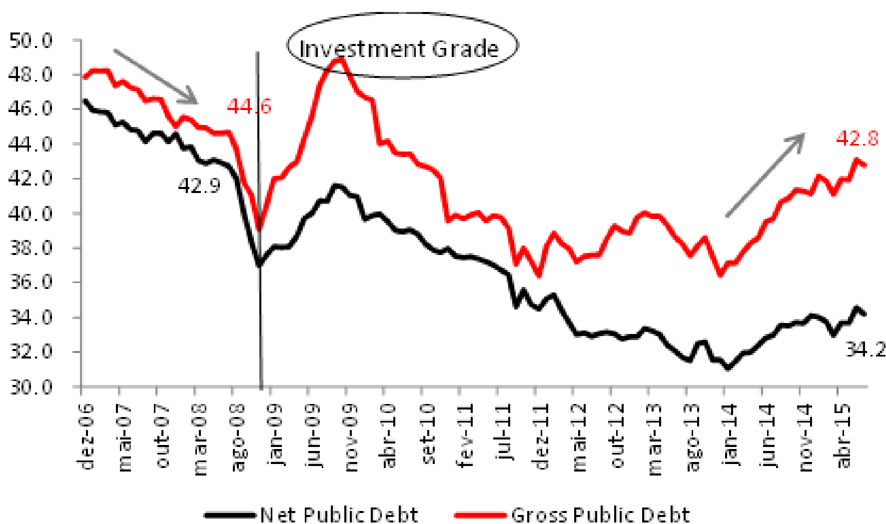
	End-year sovereign rating						
	BB- 2004-05 avg	BB 2006 eoy	BB+ 2007 eoy	BBB- 2008-10 avg	BBB 2011-13 avg	BBB- 2014 eoy	BB+ Jul-15
International reserves (liquidity) (USD bn)	53,367	85,839	**180,334**	244,812	368,806	374,051	**370,752**
Gross external debt[1] (USD bn)	185,412	172,589	**193,219**	217,779	312,770	352,684	**343,221**
Short-term external debt + amortizations due in the next 12 months (USD bn)	46,814	40,542	**62,201**	63,115	75,844	122,622	**112,019**
Debt service/exports of goods and services[1] (%)	48.4	36.2	**28.2**	20.1	21.2	25.2	**41.7**
Gross external debt/GDP[1] (%)	26.3	15.8	**14.1**	12.1	12.9	15.0	**16.7**
Net external debt/GDP[1] (%)	17.0	6.9	**-0.9**	-2.6	-3.3	-2.0	**-2.4**
Reserves/Short-term external debt + amortizations due in the next 12 months (%)	116.4	211.7	**289.9**	392.1	486.7	305.0	**331.0**

[1] External debt and debt service indicators may not be strictly comparable to figures from prior to 2013, due to the recent change in methodology and the absence of revised figures under the new methodology, so far.
The table presents figures for the period in which the country was rated as indicated, considering end-year ratings. For ratings that lasted for more than one year, the figures shown represent a period average.
Sources: BCB and Santander.

The picture is, once again, more somber when we look at public debt. Net public sector debt is more than 8pp lower than in April 2008 (when Brazil was first upgraded to IG status). However, the net public sector debt, used as the main debt parameter until a few years ago, was rendered useless since the government opted for conducting quasi-fiscal policy via loans to public banks that affect neither the primary nor the net public sector debt. Therefore, most market participants have been looking at gross debt instead – which is currently at 64.6% of GDP, and therefore 8pp higher than the level seen when the country was upgraded to investment grade.

A common complaint from policymakers is that it may be unfair to evaluate creditworthiness based on this indicator, because one of the drivers of the rise in gross public debt is the rise in international reserves, which per se is something good, not bad, for creditworthiness. Although this is a fair point, **an analysis of the gross debt excluding international reserves** (chart below) **shows deterioration as well,** indicating that the rise in reserves may be part, but certainly not the whole story behind the soaring gross debt. Using this indicator, public debt has been rising steadily since mid-2013 and currently stands a shy 1.8pp below the level seen in April 2008.

Public Sector Debt: Total Gross Debt versus Gross Debt ex International Reserves (% of GDP)



Sources: BCB and Santander.

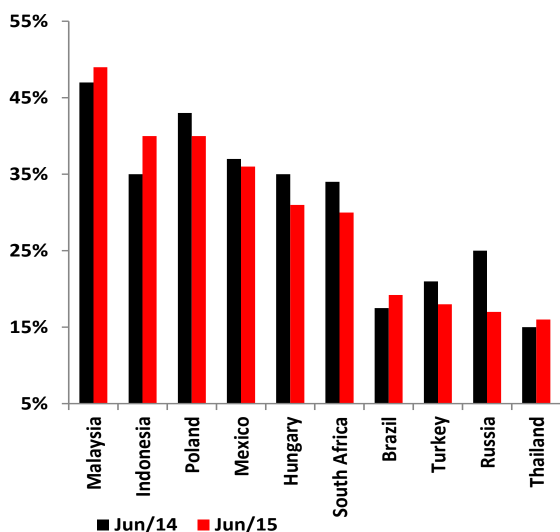
Therefore, a look at fundamentals and comparison with other countries and Brazil's past show vulnerability on the fiscal side and strength in terms of external indicators. This further reinforces the need to focus on solvency from the point of view of public sector fiscal accounts, particularly adjusting the primary surplus to at least stabilize debt to GDP ratios.

4) Expected impact on capital flows

In times of turbulence, market analysts tend to turn their attention to capital movements, particularly in an attempt to gauge potential outflows resulting from increased and persistent uncertainties. Two important metrics usually addressed as a vulnerability indicator are: (1) The share of domestic debt held by foreigners and (2) the stock of intercompany loans. The idea is that foreign investors would be much more sensitive than locals to a deterioration of fundamentals, and, in an extreme scenario, could fully repatriate investments.

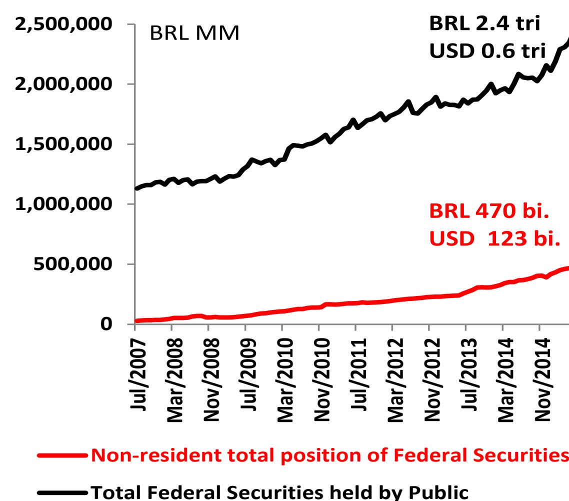
The following charts show that the current exposure of domestic debt to foreign investors is around 20%, which is low by international standards.

% Of Federal Security Held by Non-Resident



Source: S&P and Bloomberg.

Central Government Debt (total and held by foreigners)



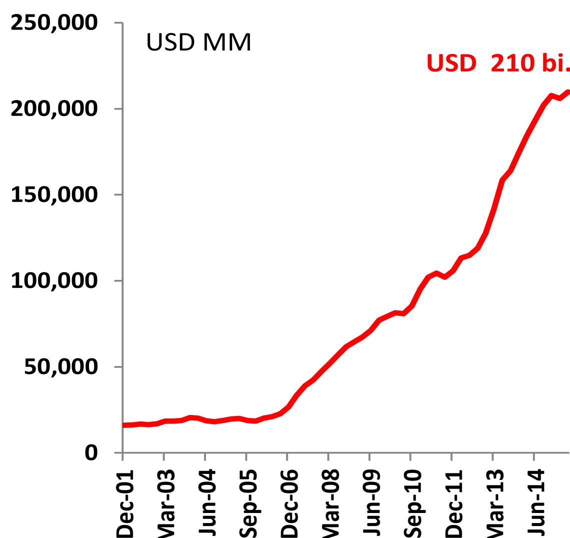
Sources: Bloomberg.

From this point of view, a potential sell-off in the local debt market could lead to outflows of around USD123 billion. If we add to this value an additional of USD210 billion of intercompany loan, we reach a total of USD330 billion of potential capital repatriation just from debt markets, still below USD370 billion reserves.

But, at the end of the day, we believe those figures can be useful in providing some clues as for how foreign investors are exposed to Brazil, but do not bring definitive information of potential outflows. After all, one should also consider not only other types of foreign investments — equity (portfolio) and foreign direct investments — but also the likelihood of domestic investors also increasing their position in assets held abroad. The chart on the left hand side shows that outflows from Brazilian investors, both as direct and portfolio investments have been recently oscillating around USD40 billion per year. Although 80% of local debt, or around USD420 billion, is held by locals, nothing prevents most of those investors from selling federal bonds in order to increase the position in local assets in times of stress.

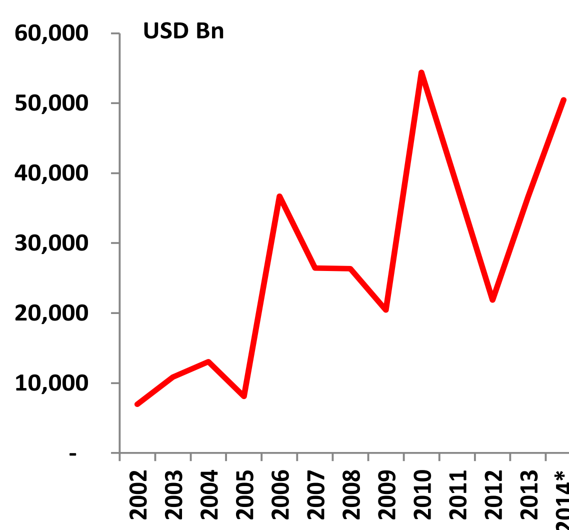
The conclusion is that, even considering foreign investors hold a relatively small portion of local debt, the limit in terms of capital repatriation or outflows from domestic investors easily surpasses the level of reserves.

Outstanding Intercompany Loans



Source: Brazilian Central Bank.

Capital Outflows (Brazilian Investments Abroad), USD Bn

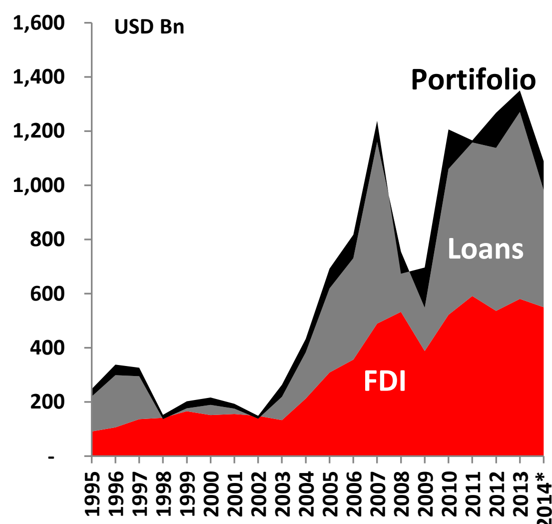


Sources: Bloomberg.

What seems to be a more useful tool to evaluate what may be the impact of the downgrade on expected capital flows – in a non-distressed scenario – is an evaluation of the dynamics of the share absorbed by Brazil from total capital flows to emerging economies. The following charts illustrate that between 2002 and 2006 Brazil used to receive 6% of total capital flows destined for emerging economies. During the investment grade period, this share increased to an average of 14%.

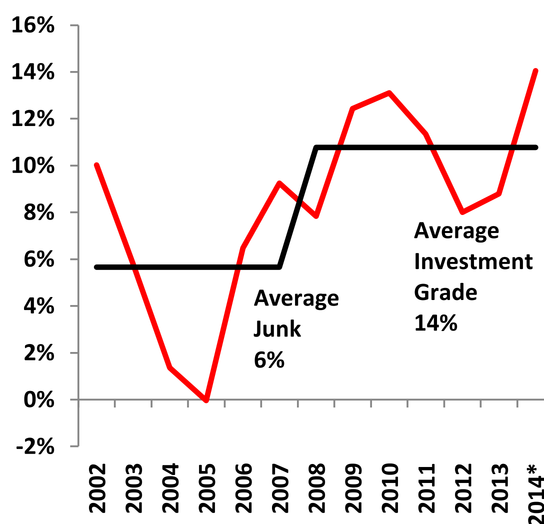
The assumption of net capital flows toward EM falling by 20% and Brazilian shares going back to 6% leads to a potential reduction of inflows from USD140 billion per year to around USD50 billion per year (a reduction of USD90 billion per year). This reinforces the conclusion that the current account deficit will be required to adjust by more than what is implied by our USD70 billion forecast for the end of 2015. A noninvestment grade sustainable level would be around 2.5% of the GDP, still far from last year's 4.5%.

Net Capital Flows to Emerging Economies (USD Bn)



Source: Institute of International Finance.

Brazilian Share of Net Capital Flows to Emerging Economies



Sources: Institute of international Finance and Brazilian Central Bank.

5) What has to be done to recover the investment grade status? Will other agencies follow S&P?

As earlier discussed, the recovery of the investment grade status requires Brazil to restore the same assessment regarding its ability and willingness to service its debt that prevailed between 2007-2013. In more practical terms, we believe this could be translated into increasing the primary surplus towards more than 2% of the GDP. According to our estimates, not very different from consensus, this would be the level required to stabilize the public sector debt to GDP ratio from a long-term perspective, assuming potential GDP growth around 2.5% per year and a real interest rate not far from 5% per year.

In fact, policymakers' original plan in the beginning of the year was to reach this objective already in 2016, and the mere belief that the government would do "whatever it takes" to achieve that seemed to have been sufficient to prevent earlier downgrades.

But reality has proven to be much more painful than expected. As already addressed in our two pieces "Fiscal Maze I: Origins", August 6, 2015; and "The Fiscal Maze II: Divergent", August 13, 2015, both structural factors and the ongoing recession have made it very difficult to bring the primary surplus back to the positive territory.

Our estimates show results of -0.8% of GDP in 2015 and -0.4% in 2016 (already assuming the government will manage to find 1% of the GDP in new revenue). This means a shortfall of almost 1% of GDP for this year and 2.1% for 2016, assuming GDP growth is not going to be much worse than our forecasts of -2.8% and -1.0% for the current year and next year, respectively. So far, measures under discussion for solving imbalances seem insufficient or unlikely to happen, in our view.

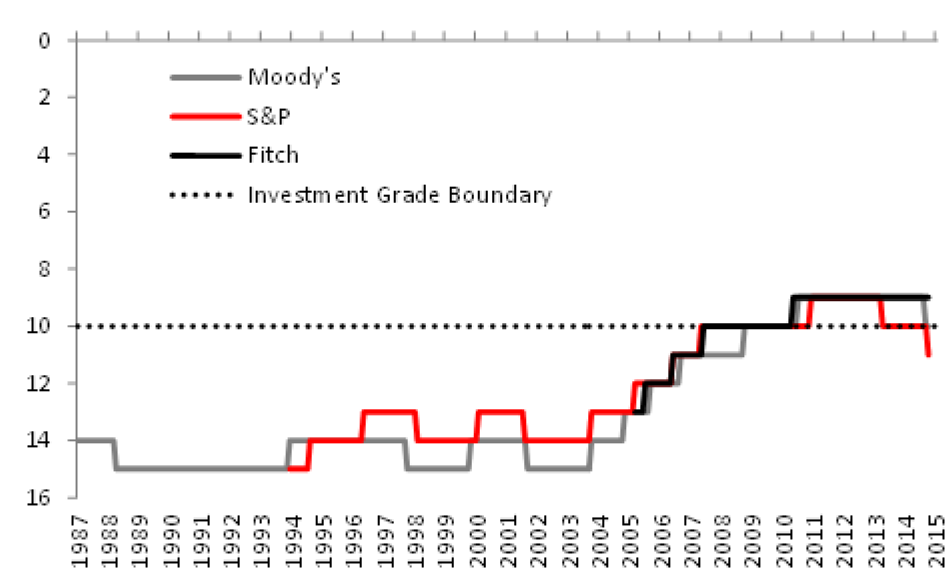
We don't believe it is going to be possible to be anywhere near next year's target without a very aggressive fiscal adjustment plan, which would necessarily require Congressional support. And, even in a scenario of a strong coalition being reconstructed, it seems very difficult to approve, in the short term, an aggressive increase of the tax burden and/or reforms aimed at containing the structural expansion of mandatory spending.

Therefore, the probability of recovering the investment grade status before 2017 appears to be low. Considering such difficulties in bringing the primary surplus to required levels, it is more likely that other rating agencies will follow S&P than the opposite.

In fact, recent statements from Fitch suggest a high probability of downgrade from the current BBB rating (with a negative outlook) that Brazil holds at this agency. Moody's currently has a neutral outlook on Brazil. In both cases, in the absence of a proper policy response, a downgrade to junk within this or the next year seems the most likely scenario.

Indeed, rating agencies tend to not diverge for too long, as shown in the chart below.

Brazilian Ratings since 1987 from Different Agencies
(Ratings expressed in a numeric scale 0=higher rating and 16 = default)



Source: Bloomberg.

6) Impact on the macro scenario – Forecast changes

With the fiscal effort being such a key driver for new rating actions and for the economic and market outlook as a whole, it is important to understand how the political environment could be supportive or detrimental to this task.

As explicitly stated by S&P, the current unease with the economic scenario stems from a perceived lack of willingness, but also of ability to approve a fiscal adjustment in Congress. This reflects low popularity but also problems in political coordination. Looking ahead, whatever the scenario is, it seems unreasonable to assume that this political standstill will be long-lasting: the most reasonable assumption, in our view, is that the political scenario converges to one where the administration regains some control of the agenda. A prolonged legislative standstill tends to be so negative for markets and the real economy that it seems unlikely the political forces would sustain such a situation for a long time.

Although this seems to us the most likely scenario, the timing for such convergence represents a much tougher call. We have so far been expecting a relatively rapid convergence, with the political scenario improving toward the end of this year.

In our new forecasts, we incorporate additional convergence delay, where both the economic and the political environment get worse before getting better, with convergence only happening over the course of 2016 (we call this the alternative scenario).

Should the political environment take longer than we are expecting to become supportive for an appropriate fiscal policy, both the CDS and the exchange rate could remain high or even deteriorate in coming weeks.

But, assuming the political environment improved over 2016, this would pave the way for CDS to return to levels compatible with a BB rating, which would be consistent with the currency trading back to the BRL3.60/USD level we currently see at end-2016 (or slightly higher, depending on how commodity prices evolve).

Persistence of CDS at current (or higher) levels will most likely postpone the recovery, in our view, and adds a significant downward bias to our previous GDP forecasts. Under this scenario, we see GDP growth migrating toward -2.8% this year and -1.0% next year – our new revised forecasts.

In terms of monetary policy, the minutes from the last Copom meeting imply that the BCB could tighten the policy further should asset prices (namely, the BRL) deteriorate further. However, at this point, the trade-off between inflation and activity might be discouraging for monetary authorities — not to mention the risk that a higher Selic deteriorates further the outlook for public debt. For this reason, we are not changing our forecast for the Selic; further, a more depreciated currency in the short term is expected to be offset by a deeper recession in order to maintain next year's forecast inflation at 6.5%.

In any case, what seems to be, in our view, highly unlikely is a scenario in which asset prices and risk premiums stabilize around current levels. Either the Brazilian government will come up with bold actions and substantially improve its relationship with Congress in order to improve fiscal prospects, or further deterioration of risk premiums is to be expected. In the first case — our baseline scenario — asset prices would improve. In the second, there would be additional room for deterioration.

Main Forecasts and Revisions

	2014	**2015**	**2016**
Risk Premium (5 yr CDS eop)	188	~~260~~ 300	270
PIB (%)	+0.1%	~~-2.3%~~ -2.8%	~~-0.5%~~ -1.0%
Exchange rate (BRL / USD)	2.66	~~3.40~~ 3.70	3.60
Inflation (IPCA %)	6.4%	9.5%	6.5%
Selic (% p.a.)	11.75%	14.25%	11.50%

Sources: IBGE, Brazilian Central Bank and Santander estimates.

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