Santander

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Brazil – Market Assessment

It's Not About Social Security Reform

Maurício Molan*
mmolan@santander.com.br
5511-3553-1859

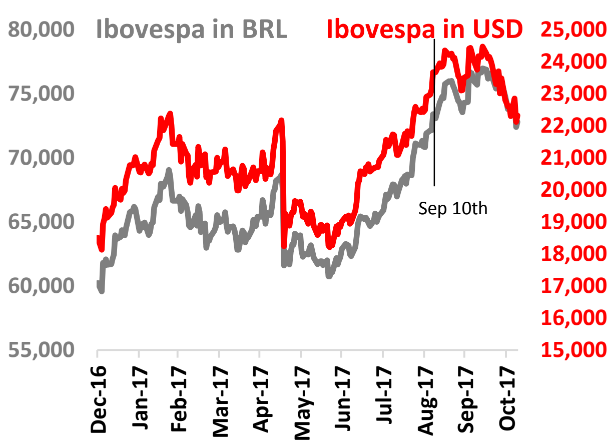
- **There is little doubt that Social Security Reform is the most important factor for Brazil to restore its fiscal equilibrium and reverse the current increasing ratio trend of public sector debt to GDP.**
- **We do not believe, however, that the recent deterioration of Brazilian asset prices is chiefly related to the assessment that it may be difficult to approve the Social Security Reform before the 2018 elections.**
- **In our view, the recent negative mood in Brazilian financial markets could be associated, to a great extent, with (1) external factors and (2) an ongoing reversion of the downward trend in inflation and expectations in Brazil.**
- **Considering we do not expect the external adjustment (industrial commodity prices and currency/yields in the US) to be reversed soon, it is likely that the BRL and local yields are also not going to return to their better moments of 2017.**
- **As for inflation, in spite of considering that the cycle of falling inflation has come to an end, we believe core measures will remain comfortably below 4% for the next two years, providing comfort for the monetary policy to remain expansionary.**
- **We believe that, since the political situation deteriorated last June, Brazilian assets ceased to price in the approval of the Social Security Reform before 2019.**
- **This means we see important upside risk for asset prices in the event policymakers and the congressional groups advance toward an agreement.**
- **The downside risk will likely be associated with the prospects of reforms advancing after 2019, and, therefore, a consequence of the outcome of next year's election.**

Poor Price Action

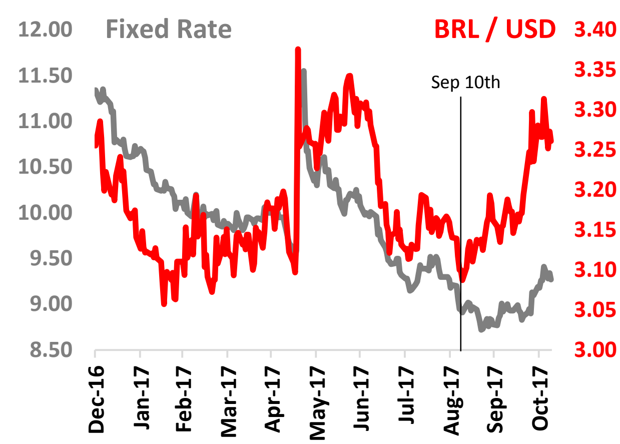
The equity market has adjusted sharply since mid-October. The Ibovespa lost 5% in local currency and 7.5% when measured in USD in the period. This movement has attracted attention to the idea that Brazilian fundamentals would be in jeopardy as a consequence of the government's alleged decision to abandon efforts to approve the Social Security Reform before the 2018 elections.

But, the following charts suggest a more generalized price action related to Brazilian assets happened well before any noise associated with the Social Security Reform. According to the figures, the Ibovespa may have lagged a negative market reaction that was already underway in other asset classes, notably fixed income and currency.

IBOVESPA (in BRL and USD)



BRL and Fixed Income (Yield 2021)



Source: Bloomberg.

The External Factor

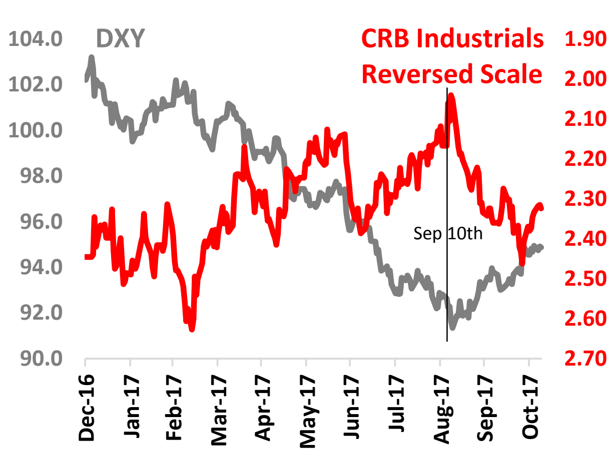
In our view, the heart of the recent mood deterioration is connected with the external scenario. It was not a coincidence that the adjustment of the Brazilian currency and yields took place at the same time as the assessment of the US economy started to change.

On one side, yields have been increasing due to the suspicion that the FED would not sustain such a dovish stance as a consequence of accumulating factors that should increase inflationary risks: (1) Strong economic activity indicators in spite of hurricanes, and (2) Further indications of tightening labor markets and signs of accelerating salaries.

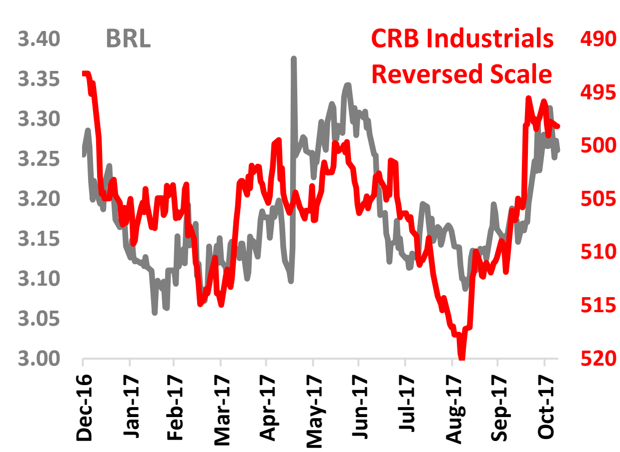
The flip side of this coin has been the strengthening of the USD against major currencies in recent weeks, with obvious consequences for the performance of the BRL.

Moreover, the boom in industrial commodity prices, which has prevailed since the beginning of the year, seems to have come to an end. After months of strong imports from China, associated with increased efforts to sustain infrastructure investments, investors seem to expect some slowdown in the near future as excess capacity mounts.

The US: Gov. Bond Yields (10 years) and Currency (DXY)



CRB Industrials (Reversed Scale) and BRL



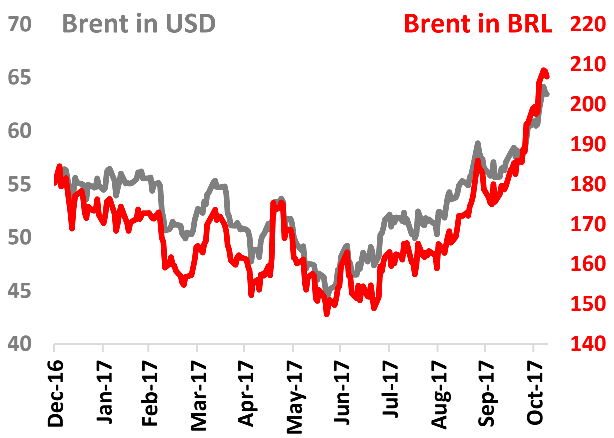
Source: Bloomberg

The Cycle of Falling Inflation and Expectations Is Over

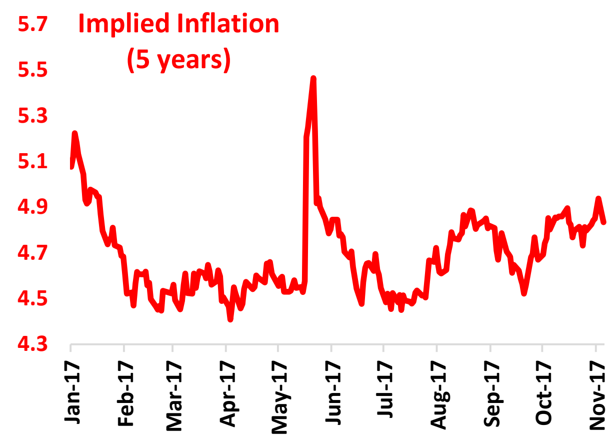
An important and probably understated recent / ongoing development that has certainly affected local markets – particularly fixed income, and indirectly, equities – is the inflection of inflation trends. After falling from 10.7% at the end of 2015 to 2.5% YoY in August 2017, the IPCA will, from now on, increase toward 3.2% (or more) at the end of 2017 and 4.2% (or more) in 2018, according to our forecasts. Meanwhile, expectations will probably undergo the same dynamic, which will affect prospects for monetary policy.

In our view, this new reality for the inflation scenario is defined by: (1) Food Inflation. After 5 consecutive negative monthly readings, from May to August 2017, food prices have begun to increase again in October. And, this process is expected to intensify considering advances already seen in wholesale agricultural prices. (2) Electricity. The low level of reservoirs in the southeast region have already triggered tariff increases, which will have an impact on short-term inflation. (4) International oil prices have been under intense pressure which, coupled with a BRL depreciation, will eventually lead to adjustment in the prices of gasoline, diesel and gas.

Oil Brent (in USD and BRL)



Implied 5 years Inflation



Source: Bloomberg

The bottom line is that headline inflation is destined to increase from now on, with risks to our forecasts biased to the upside. Those upside risks seem to have been incorporated by investors, leading to higher implied inflation as well as increased risks of an earlier-than-expected reversion of the current expansionary monetary policy stance.

In our view, in spite of upward pressures on the IPCA (likely driven by food and controlled prices), the inflation trajectory may remain consistent with targets in 2018 and 2019. Moreover, we believe the monetary authority will assign a higher weight to core measures, particularly the one that excludes food and energy. Those measures, which are a better gauge of demand-related inflation, should remain comfortably below 4% for the next 2 years, according to our forecasts.

Bottom Line

There is no doubt the Social Security Reform is the most important factor for Brazil to restore its fiscal equilibrium and reverse the current increasing ratio trend of public sector debt to GDP. **We do not believe, however, that the recent deterioration of Brazilian asset prices is chiefly related to the assessment that it may be difficult to approve the Social Security Reform before the 2018 elections. In our view, the recent negative mood in Brazilian financial markets could be associated with, to a great extent, (1) the external factors and (2) to an ongoing reversion of the downward trend for inflation and expectations in Brazil.**

Considering we do not expect the external adjustment (industrial commodity prices and currency/yields in the US) to be reversed soon, it is likely that the BRL and local yields are also not going to return to their better moments of 2017. As for inflation, in spite of considering that the cycle of falling inflation has come to an end, we believe core measures will remain comfortably below 4% for the next two years, providing comfort for the monetary policy to remain expansionary.

We believe that, since the political situation deteriorated last June, Brazilian assets ceased to price in the approval of the Social Security Reform before 2019. This means we see important upside risk for asset prices in case policymakers and congressional groups advance toward an agreement. The downside risk will likely be associated with the prospects of reforms after 2019, and, therefore, the outcome of next year's election.

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
Diana Ayala	Economist - Colombia	diana.ayala@santander.us	212-350-0979
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

Diana Ayala	Macro, Rates & FX Strategy – Latin America	diana.ayala@santander.us	212-407-0979
Juan Miguel Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Aaron Holsberg	Head of Credit Research	aholsberg@santander.us	212-407-0978

Equity Research

Christian Audi	Head LatAm Equity Research	caudi@santander.us	212-350-3991
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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