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Forecast Changes

Brazil Post Elections: Honeymoon and Marriage

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The planning fallacy is that you make a plan, which is usually a best-case scenario. Then you assume that the outcome will follow your plan.
— Daniel Kahneman

- **We have maintained our confidence in Brazilian fundamentals for a long time. See *Rely on Fundamentals and Carry On* (June 8, 2018), *We're Not in 2002 Anymore* (August 28, 2018), and *Apples and Oranges* (October 9, 2018).**
- **Therefore, we expect the end of general elections in Brazil to trigger another cycle of improvement for expectations and asset prices.**
- **Immediately after the elections, with a definition of the new leadership and the basic guidelines for the macro policies to be pursued in the next few years, uncertainties should diminish considerably.**
- **Moreover, we believe the new president will have strong incentives to foster a general belief in the new administration's willingness and ability to rebalance fiscal accounts in order to reap "low-hanging fruit" (particularly in the form of below-average confidence) in the Brazilian economy.**
- **We expect the announcement of a market-friendly economic team, the building of a political coalition and the gradual disclosure of more detailed plans in the coming weeks to be well received by investors.**
- **For this reason we are revising our forecast for the BRL/USD at the end of 2018 to 3.50 from 3.80.**
- **However, we acknowledge that 2019 will be a challenging year, not only due to difficulties related to the execution of economic plans, but also due to a less favorable global environment. This assessment should justify a real depreciation for the currency during the year (we are revising our 2019 BRL/USD forecast to 4.0 from 4.10).**
- **In any case, the expected improvement of expectations and financial conditions should be enough to unlock investments and release repressed consumption, thereby accelerating GDP growth to 3.2% in 2019 (well above consensus), according to our forecast.**
- **With the BRL sustainably below 4.00, the unusually wide output gap, and inflation expectations well anchored, the IPCA will likely remain below the target in both 2018 (we are adjusting our forecast to 4.3% from 4.1%) and 2019 (we are revising our forecast down to 3.8% from 4.0%).**
- **As this scenario implies inflation below the center of the target for three years in a row, we believe the Brazilian Central Bank will not increase the base rate in 2019, even considering that we forecast GDP growing well above consensus. We are also revising our forecast for the Selic at the end of next year to 6.5% p.a. from 7.5% p.a.**

Figure 1. Forecasts

	2018		2019	
	Santander	**Consensus**	**Santander**	**Consensus**
GDP Growth (% p.a.)	1.5	1.3	3.2	2.5
IPCA (%)	~~4.1~~ 4.3	4.45	~~4.0~~ 3.8	4.25
BRL/USD (eop)	~~3.80~~ 3.50	3.75	~~4.10~~ 4.0	3.80
Selic Rate (% p.a.)	6.50	6.50	~~7.5~~ 6.50	8.0

Sources: Santander forecasts and market consensus based on BCB's Focus Survey.

Introduction

After a period of unusually high volatility of Brazilian asset prices, we believe the conclusion of general elections will substantially reduce uncertainties related to politics and make clearer the outlook related to the basic guidelines for the macro policies that will be pursued by the government in the next few years.

Although the elected president will not be inaugurated until January 1, his actions, signaling and announcements will be increasingly crucial in defining market trends in 2018.

In terms of macroeconomic fundamentals, the country enjoys a comfortable position in terms of inflation and external accounts. We do not believe households and companies are excessively indebted, and monetary policy is expected to remain accommodative in the near future.

The fiscal position is clearly the Achilles' heel of macro policy. Restoring fiscal credibility should be the top priority for policymakers. This is the key for improving financial conditions and confidence, which would be more than enough to unlock economic growth in the short term.

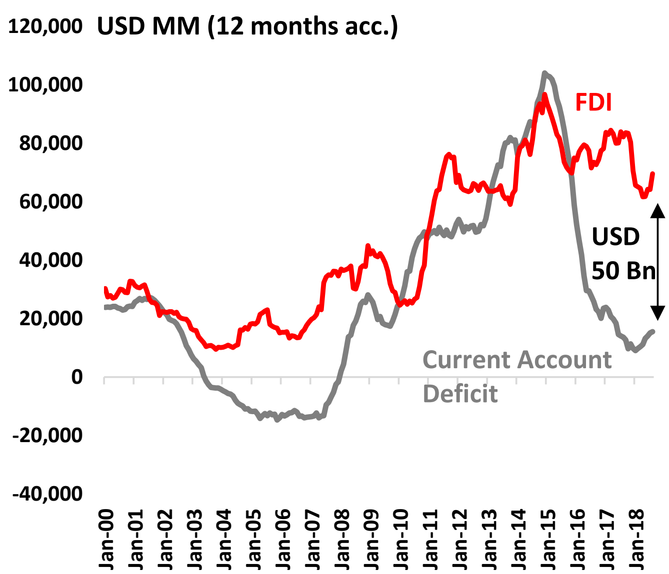
However, are incoming policymakers going to move toward this direction? We see strong incentives for doing so.

What Is NOT a Problem

In spite of recent high volatility of Brazilian assets and uncertainties surrounding the evolution of fiscal accounts in a context of elections, we have been emphasizing the importance of the existing strong external position and consolidated low inflation for the macro outlook (see *We're Not in 2002 Anymore (Caution Advised, Though)*, August, 28, 2018).

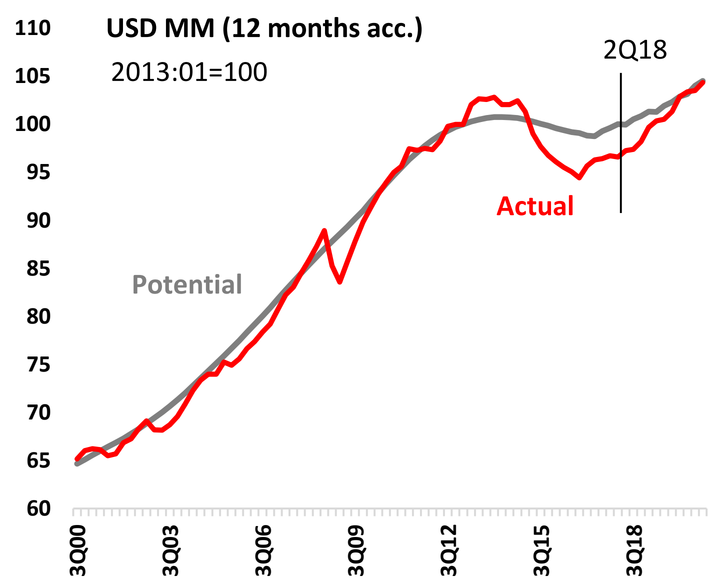
We have also argued that a still wide output gap should maintain inflation expectations well anchored in spite of the depreciation of the BRL we have seen so far. We have expected that the basic interest rate (the Selic) would not be increased by the Central Bank unless the BRL surpassed 4.30 to the USD (*Rely on Fundamentals and Carry On*, June 8, 2018), and that view has recently been reinforced by the monetary authority.

Figure 2. Foreign Direct Investments and Current Account Deficit



Source: Brazilian Central Bank.

Figure 3. GDP: Actual and Potential



Source: Brazilian Central Bank.

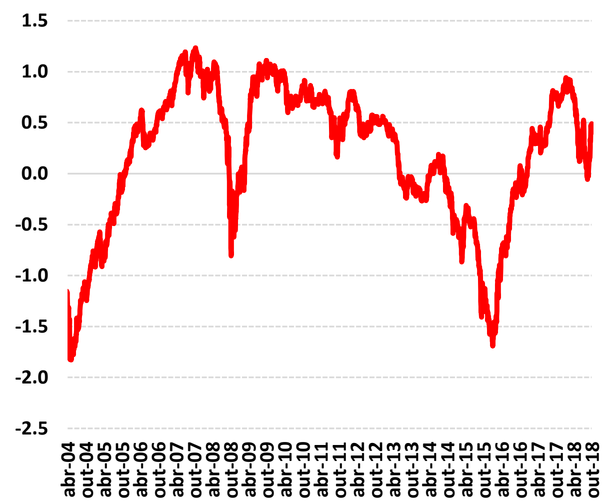
Therefore, we strongly believe that measures aimed at containing domestic demand in order to prevent prices from accelerating and to reduce the current account deficit will <u>not</u> on policymakers' macro agenda. Furthermore, we also believe that interest rate hikes will <u>not</u> be required to anchor inflation expectations and/or to attract short-term foreign capital in order to close the external financing gap.

Economic Growth: Picking the Low-Hanging Fruit

Under these circumstances, in our view, **the main challenge for accelerating GDP growth is confidence**.

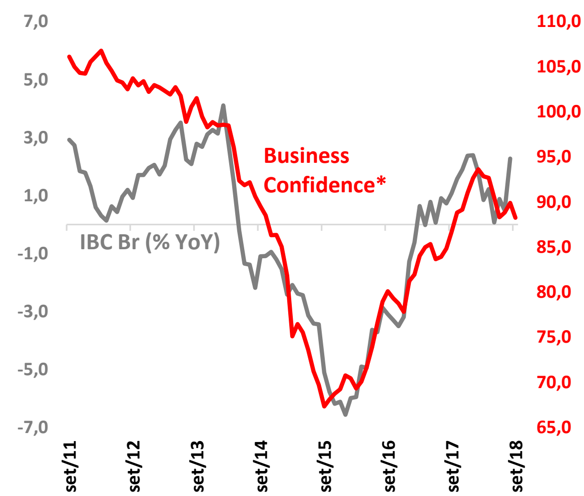
After two years of recovery, the overall mood regarding the Brazilian economy has turned much less favorable in recent months. The truckers' strike in 2Q18 was the initial catalyst, but the deterioration of financial conditions (see Figure 4) due to higher global risk aversion and uncertainties associated with local elections has been crucial to the disappointment related to GDP performance this year (see Figure 5).

Figure 4. Financial Conditions Index



SAN-ICF is constructed using financial markets variables in a way such that positive values indicate stimulative financial conditions, whereas negative values suggest contractionary conditions. Sources: BCB and Santander.

Confidence and IBC Br

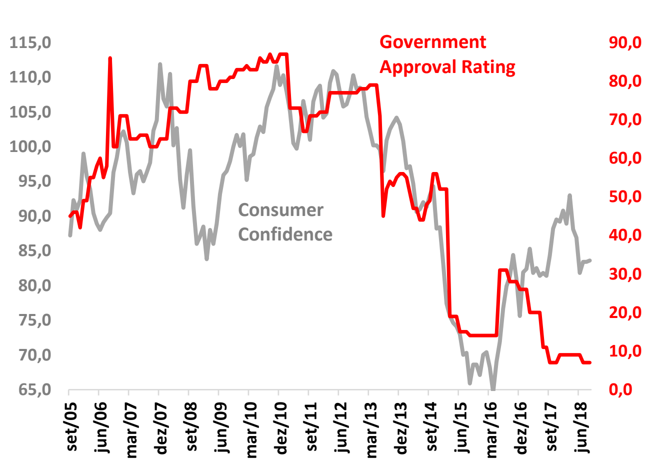


Source: Santander estimates based on BCB and Bloomberg data. * FGV data for Confidence on Services, Construction and Industrial Sectors (weighted by GDP).

Many More to Go, But One Already Down

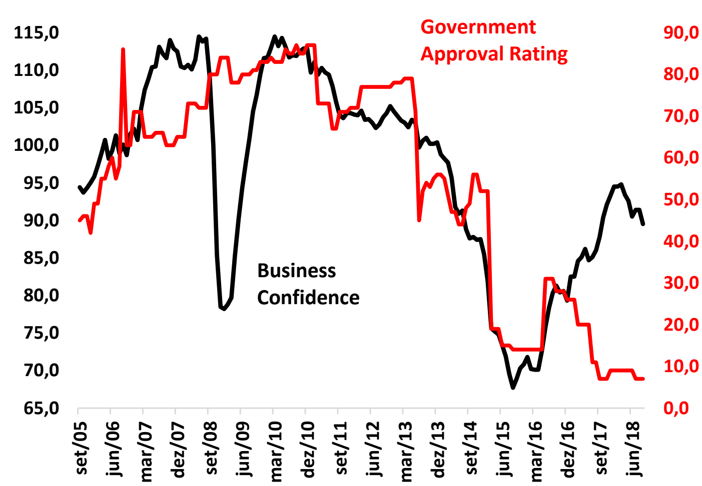
By dawn on October 29, 2018, Brazilian voters will have chosen the next president, who will be inaugurated on January 1, 2019. However, as soon as the elections are over, we expect uncertainties to diminish considerably as a consequence of a much higher degree of certainty regarding the new leadership and a clearer view on the basic guidelines for the macro policies to be pursued in the next few years.

Figure 6. Government Approval Ratings and Consumer Confidence



Source: IBOPE and FGV.

Figure 7. Government Approval Ratings and Business Confidence



Source: IBOPE and FGV.

In order to get a better sense of the importance of this moment, the previous charts depicts historical data for government approval ratings and confidence. Although causality is unknown (or whether there is another exogenous factor driving these two variables), history suggests an opportunity: optimism is usually renewed during the initial period of mandate (approval ratings usually start above 60%). This will certainly have an impact on households' and enterprises' expectations.

New Year's Resolutions

Moreover, apart from the benefit of lower uncertainties resulting from the final determination of the electoral process, we believe there is also ample room for the government to improve expectations through the consolidation of a general belief in its willingness and ability to rebalance fiscal accounts. This could be accomplished by the new president through, among other initiatives:

1) The formal appointment of market-friendly names for the economic team (including executives from publicly-owned companies).
2) The disclosure of a more detailed plan for adjusting the primary surplus (from -1.5% to 0% in one or two years).
3) The design of a framework for reforming the Social Security System.
4) The first steps toward building a coalition in Congress able to support the elected government.

In our view, by leaning toward this approach, it is highly likely that policymakers will benefit from improved confidence and financial conditions even prior to the inauguration, helping to accelerate economic growth at the beginning of 2019.

The Fiscal Adjustment: Difficult but Feasible

Analysts have been intensely discussing all the challenges related to adjusting fiscal accounts in Brazil. In a few words, the country needs to transform a primary deficit of 1.8% of GDP into a surplus in the vicinity of 2.5% of GDP in order to reverse the current upward trend for Public Sector Debt-to-GDP ratios.

But this is not the end of the story. On one hand, Brazilians have been increasingly reluctant to accept increased taxation. And on the other, it is well known that 90% of expenditures are not discretionary (social security payments, payroll, education and healthcare spending and some social programs). This context could suggest that any fiscal adjustment would be impossible to accomplish without major constitutional changes.

In our view, this is not fully true. Although a Social Security reform (which requires a constitutional amendment) is a necessary condition for reestablishing fiscal credibility (by containing the explosive trajectory of imbalances between collections and benefits), there is also a need for more urgent action aimed at correcting the primary result. In our view, short-term measures aimed at eliminating the deficit in one or two years (BRL 130 billion, or 1.8% of GDP) could be a good start in terms of improving credibility. The resulting economic growth and additional actions, particularly related to improving the efficiency of the public sector, would do the rest.

Of course, there is no easy way out. Fiscal adjustments usually require sacrifice from specific sectors of society. And this type of sacrifice is easier to ask at the begining of the presidential mandate, when political capital is stronger.

Below, we outline some examples of initiatives that could contribute to eliminating the primary deficit by 2020. These are neither suggestions nor expected actions. Our purpose here is merely to illustrate the feasibility of identifying actions that could boost fiscal results in the very short term, with favorable impacts on credibility and confidence.

- **Privatizations.** E.g. Eletrobras, BRL 10 billion
- **Concessions.** E.g. roads, airports, oil fields (pre-salt; BRL 60 billion per year in two years).
- **Taxation.** Taxes on dividends (BRL 30 billion, but this could be offset by lower income tax rates for corporates), new income tax rules for tailor-made funds[1] (BRL 10.7 billion in the first year, plus an additional BRL 1 billion per year afterwards), increasing the tax rate on the social contribution for public-sector retired employees (from 11% to 14%, BRL 2 billion), increased taxation on inheritances (BRL 3 billion), taxes on financial transactions (a 0.38% rate could generate BRL 60 billion per year), elimination of free tuition at federal universities for the richest 20% of students (BRL 8 billion).

[1] Income taxes on tailor-made funds are currently charged when funds are withdrawn. Taxation on other funds is typically charged on a quarterly basis.

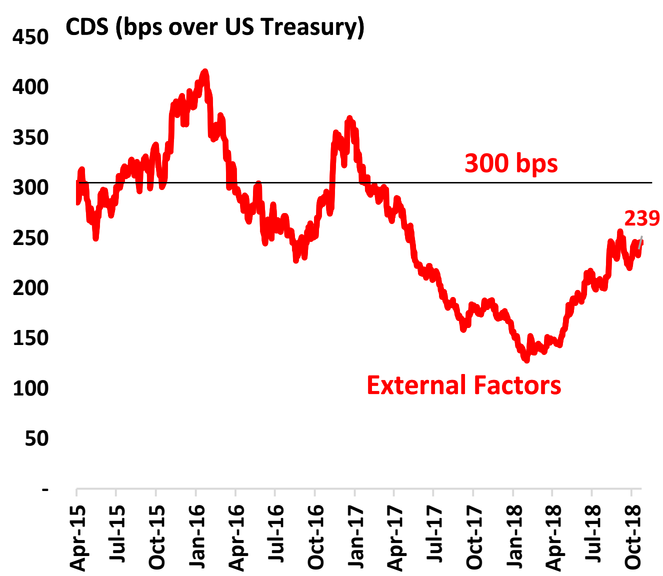
- **Expenditures**. Elimination of a wage bonus[2] (BRL 16 billion), discontinuing remaining payroll exemptions granted during Dilma's government (BRL 10 billion), rationalization and tougher regulation of social programs, setting a cap on the total compensation of public-sector employees, new regulations for the annual readjustment of the minimum wage, reforming the system of career public-sector civil servants.
- Tax exemptions: Partial or total elimination of tax exemptions (e.g. Manaus Free Zone Incentives, BRL 19 billion).

2018 Forecasts: Honeymoon

In this section, we use the framework developed in *Apples and Oranges* (October 9, 2018) to translate our expectations in terms of the macro scenario into numerical values for one of the most important inputs to most of our macro models: the Brazilian risk premium (5-year CDS).

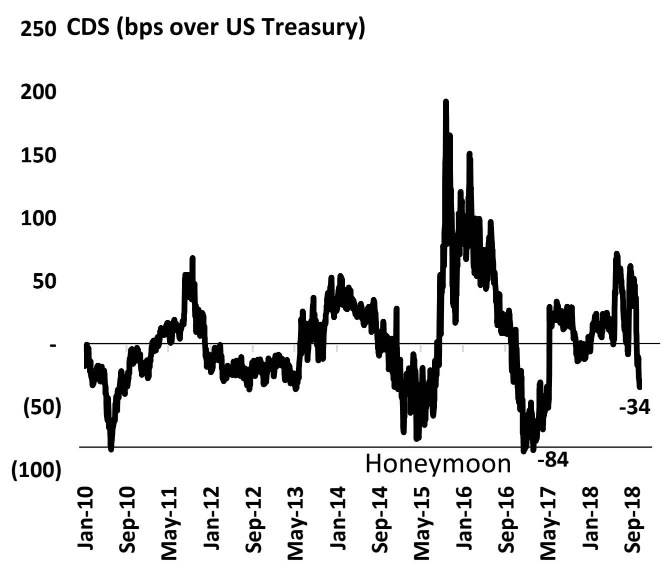
The following charts show the outcome of the Brazilian risk premium decomposed by its idiosyncratic component and a common global factor, which includes emerging markets' overall risk aversion, and other variables such as commodity prices, the value of the USD against a basket of currencies (DXY) and the long-term U.S. Treasury Yield.

Figure 8. The Common Component of Brazilian Risk Premium



Source: Santander estimates based on Bloomberg data.

Figure 9. The Brazilian Idiosyncratic Factor



Source: Santander estimates based on Bloomberg data.

Brazilian Risk Premium. Our assumption is that common global factors, currently contributing with 240 bps to the Brazilian CDS yield, will remain in an upward trend toward 300 bps by the end of 2019. Meanwhile, we expect the individual component of risk to approach its historical lows (-80 bps) by the end of 2018 as a result of our previously detailed positive call regarding confidence. For 2019, we are penciling in the idiosyncratic component returning to the average of latest 10 years (zero). **By construction, those assumptions lead to 5-year CDS forecasts of 180 bps for the end of 2018 (down from 215 bps in Oct 25, 2018) and 310 bps at the end of 2019.**

BRL. The incorporation of this set of assumptions into our BRL model leads to forecasts for the BRL not far from BRL 3.50 / USD at the end of 2018 and BRL 4.00 / USD in December 2019. As such, we are adjusting our forecasts accordingly.

Inflation. Both the dynamics of the BRL and the impact of the truckers' strike will likely lead to higher-than-expected inflation in 2018 and lower-than-expected inflation in 2019. At the end of the day, the more-intense-than-expected depreciation of the currency between 2Q18 and 3Q18 will put upward pressure on the IPCA until the end of the year, while the recovery of the BRL should contribute to reducing the prices of tradables at the beginning of 2019. For this reason, we are increasing our projection for inflation in 2018 to 4.2% from 4.1% while reducing it to 3.8% from 4.0% in 2019.

[2] This bonus is granted for workers with formal jobs with wages below two minimum wages (BRL 2,000 per month).

Selic. As this scenario implies inflation below the center of the target for three years in a row, we believe the Brazilian Central Bank will not increase the base rate in 2019, even considering that we are forecasting GDP growth well above consensus. We are also revising our forecast for the Selic at the end of next year to 6.5% p.a. from 7.5% p.a.

2019: Marriage (Reality Check and Execution)

Although highly optimistic in the short term, emphasizing the incentives that the new government will have to come up with a credible plan to adjust fiscal accounts and reform the Social Security System, we acknowledge that execution will be difficult. First, because fiscal adjustments in general are unpopular and tend to consume substantial political capital. And second, because fragmentation has increased in Congress, which should make coordination and the construction of political agreements and alliances much more difficult than in the past.

Moreover, prospects for global conditions are not bright. The process of monetary policy normalization in important developed economies is already taking a toll on emerging economies with weaker fundamentals, suggesting there will not be room for complacency in the near future. Higher risk aversion should be expected with an adverse impact on Brazilian assets, as usual.

Other sources of risk should not be ignored: overvalued equity markets in some developed economies, fiscal imbalances in Italy, slowing growth in China, Brexit, Geopolitics, etc.

All of these factors have been incorporated into our scenario through the hypothesis of an increasing contribution of the common (external) component of risk premium to Brazilian CDS yields, leading to our forecasts of above-300 bps for country risk and BRL 4.00/USD for the exchange rate at the end of 2019.

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