ECONOMICS

January 7, 2019

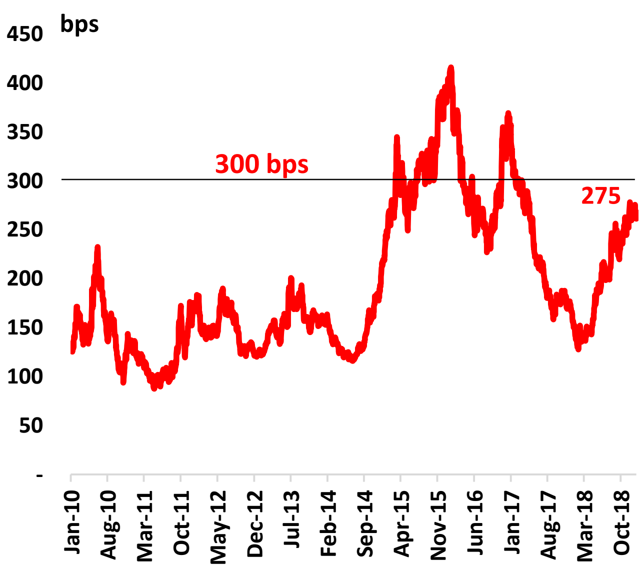
Brazil: Macro Scenario

Maurício Molan*
mmolan@santander.com.br
5511-3012-5179

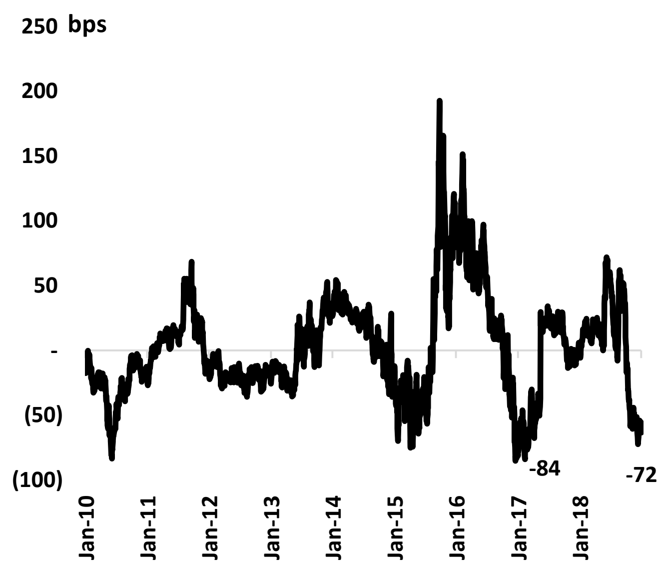
10 Macro Propositions for 2019

1. **Brazil cannot run away from the social security reform – necessary but not sufficient.**
2. **Social security reform is no panacea – fiscal imbalances extend beyond.**
3. **In politics, the good is the enemy of enough – no walk in the park.**
4. **We believe the primary deficit will be eliminated before the end of 2020.**
5. **A challenging global environment, characterized by risk repricing – but there are important mitigating factors. Interest rates in the U.S. may not go as high as previously thought.**
6. **Brazilian CDS: risk premium repricing globally vs. the idiosyncratic component. Opposing vectors: the external component usually prevails.**
7. **BRL: low interest rates coupled with a weaker-for-longer BRL – an unusual combination in Brazil.**
8. **Inflation: don't worry, be happy. Going for the 3rd year in a row with inflation below the target midpoint**
9. **Monetary policy: beyond the Selic. Focusing on the causes of large banking spreads, reducing reserve requirements.**
10. **Confidence + credit = consumption. Our above-consensus forecast for GDP growth is 3%.**

Common (EM) Component of Brazilian CDS (bps)



Idiosyncratic Component of Brazilian CDS

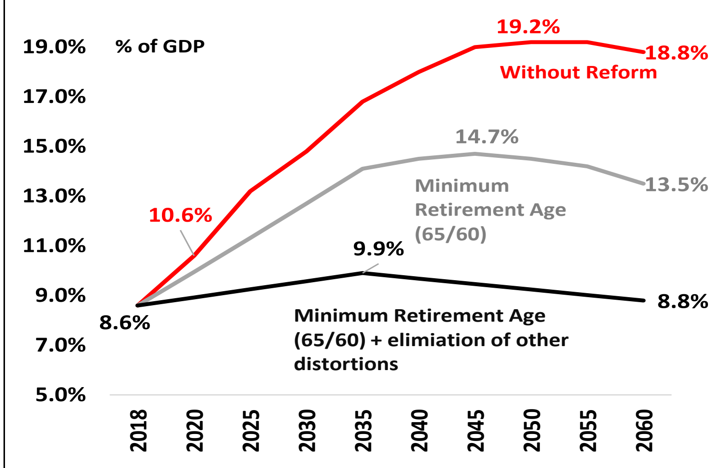


Sources: Santander estimates based on Bloomberg data.

Proposition 1. Brazil Cannot Run Away From Social Security Reform – Necessary but Not Sufficient

Social-security-related expenditures account for more than 40% of total primary outlays of the general government, and will likely increase by 0.4 p.p. of GDP per year in the near future. This dynamic is clearly an impediment for bringing fiscal accounts back to a sustainable path. The new framework must aim at correcting important distortions, such as defining a minimum age for retirement (average retirement age is currently 59) and a establishing a single system for civil servants and private-sector employees. Changes may also include the elimination of the rule that links the adjustment of benefits to the minimum wage and forbid the accumulation of pensions. Transition rules will be key in determining the magnitude of fiscal savings in the short term. The new government has been signaling that this reform is considered a top priority on the political agenda. But be aware that **social security reform is a necessary, but hardly sufficient, condition for fully restoring investors' confidence in Brazilian sovereign debt.**

Social Security Spending (Federal Government), % of GDP

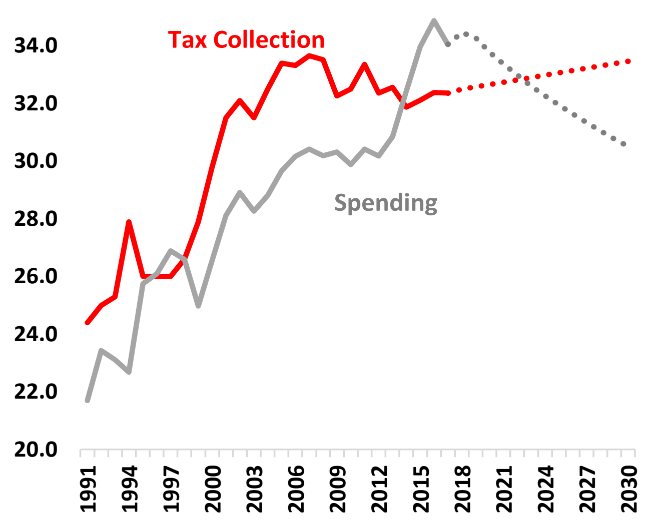


Source: Paulo Tafner and IFI.

See Appendix Figure A1: Average Retirement Age by Country.
More about social security reform at **www.santander.com.br/economia**: *Social Security Reform: Well Beyond the (Necessary) Fiscal Impact*, September 13, 2017. *Let's Try Again: The Positive and the Negative in the Latest Attempt to Pass Social Security Reform*, November 28, 2017. *Same proposal. Different probability?,* February 8, 2018.

Proposition 2. Social Security Reform Is no Panacea – Fiscal Imbalances Extend Beyond

General Government Tax Collection and Primary Spending (% of GDP)



Source: IBGE, Brazilian Central Bank and Santander estimates.

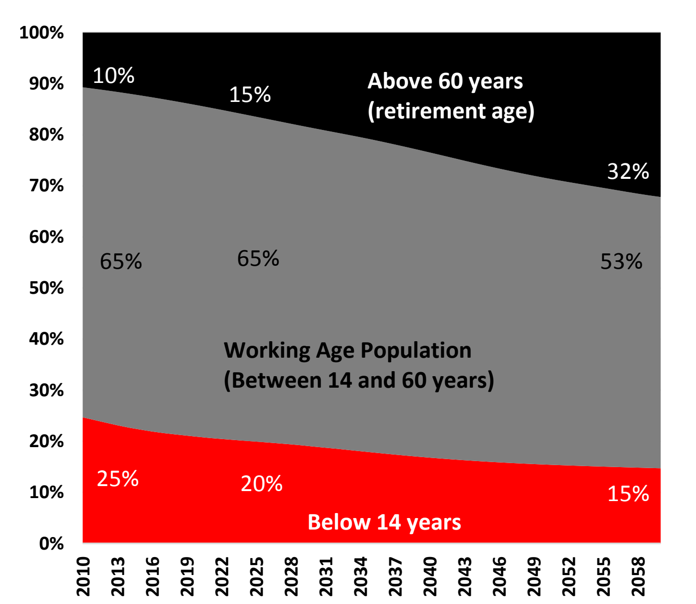
We do not agree with the view that the approval of the social security reform in 2019 will represent a critical juncture, or a catalyst, of a new era for Brazil in terms of market confidence associated with fiscal accounts (leading to significant capital inflows and speculation about an imminent sovereign rating upgrade). First and foremost because, as the previous chart illustrates, any prospect of adjustment considered so far implies slower spending growth of social security benefits in the near future than contemplated by the baseline "no reform" scenario. It does not seem feasible to actually reduce the magnitude of disbursements as a percentage of GDP in the near future. And second, because **Brazilian fiscal imbalances extend well beyond social security**. Other non-discretionary types of spending are growing at a dangerous pace due to substantial indexation and earmarking. The finance minister already stated the intention to address excessive payroll spending. Finally, fiscal dynamics will always be dependent on economic growth, which means that measures aimed at improving productivity are also important to improve solvency conditions.

See Appendix Figure A2: Expected Trajectories of Discretionary and Mandatory Spending, with and without Social Security Reform, and Figure A3: Public Sector Gross-Debt-to-GDP Ratio.

Proposition 3. In Politics, the Good Is the Enemy of Enough – No Walk in the Park

According to our scenario, an adequate social security reform will be approved by the end of the year. This optimistic view is based on the fact that Brazil has managed to deliver important institutional changes and reforms whenever required by circumstances (to prevent chaos) in the majority of episodes during the last 30 years. The new government has been signaling strong willingness to address this subject. But we do not expect the final reform to be ideal or even great. It will likely be just "enough for the moment". **Political difficulties will be significant.** 1) Some changes to the current framework are still considered very unpopular. (2) The government does not have a comfortable majority in Congress. We estimate potential government support (number of Congress representatives not aligned with opposition parties) to be 352 in the Lower House and 62 in the Senate. This means any constitutional amendment will require fidelity rates above 80% to surpass the thresholds of 308 and 49, respectively, in both houses. (3) It is still uncertain how the government leadership will coordinate support in such a fragmented Congress.

Population Age Profile

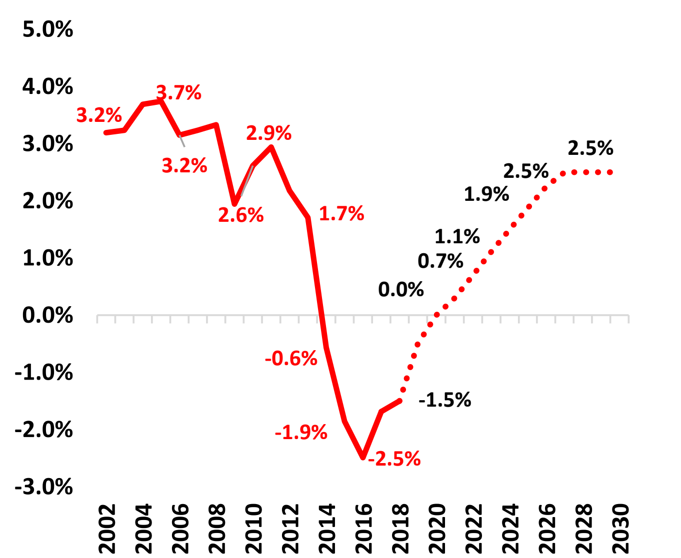


Source: IBGE.

More on the political agenda at **www.santander.com.br/economia**: *What to Watch in Brazil in 2019*, December 5, 2018. 20 *Charts that Explain Brazil's New Political Power Structure*, October 29, 2018. *Brazil Post Elections: Honeymoon and Marriage*, October 25, 2019.

Proposition 4. We Believe The Primary Deficit will be Eliminated Before the End of 2020.

General Government Primary Result (% of GDP)



Source: IBGE, Brazilian Central Bank and Santander estimates.

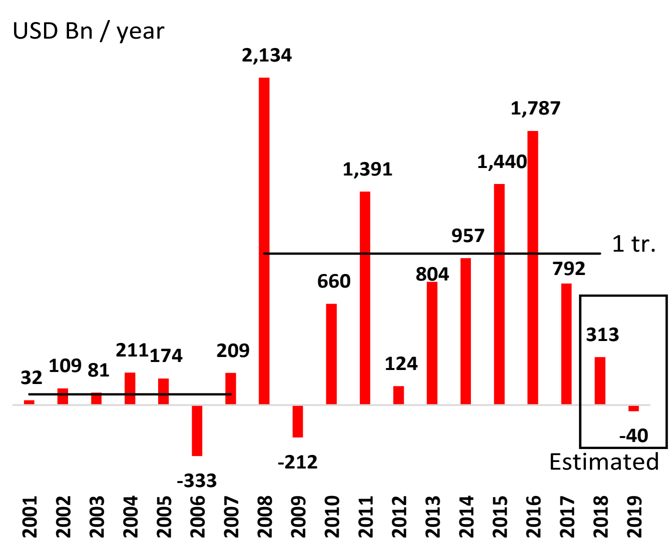
Apart from social security, the fiscal imbalance encompasses other important challenges, which must be timely addressed in order to turn the current primary deficit of 1.7% of GDP into a surplus of at least 2%, in order to be compatible with a downward trend for the public sector debt-to-GDP ratio. We are confident in favorable news flow coming from this front, particularly in the following areas: 1) Public **administration reforms** aimed at containing payroll expenditures. 2) **Privatization and concessions** generating resources to reduce debt and improve economic efficiency. 3) Tougher requirement and improved fraud-detection schemes to contain wastage of resources allocated to social programs. 4) Modified tax schemes aimed at reducing inefficiencies increasing proceeds in order to obtain a faster fiscal adjustment. According to our estimations, Brazilian consolidated public sector needs to generate a primary surplus of, at least, 2% of the GDP in order to prevent public sector debt to GDP ratio from increasing. If the above mentioned adjustment ends up happening in next couple of years, it is very possible that a resulting consolidation of confidence and economic growth will do rest (generate the remainder 2 p.p. before 2023).

See on Appendix Figure A2: Expected Trajectories of Discretionary and Mandatory Spending, with and without Social Security Reform (BRL bn), and Figure A3: Public Sector Gross-Debt-to-GDP Ratio.

Proposition 5. A Challenging Global Environment, Characterized by Risk Repricing…

Volatility drastically increased in 2H18 amid fears of a hard landing of the global economy. The adjustment of equity markets in the U.S. has been intense, and high-yield spreads are still on the rise (see Figures A5 and A6). Our baseline scenario for Brazil does not incorporate a hypothesis of a drastic global recession, a debt crisis in China or major disruptions in Europe (be it associated with a disorderly Brexit, an escalation of Italy-EU relationship or other types of extreme events). **But we assume global trade will expand at a slower pace, risk aversion will be higher and commodity prices are biased to the downside (particularly as the Chinese economy weakens and reduces the demand for agricultural and industrial metals).** All those factors are expected to conspire against a more important improvement of Brazilian asset prices, that could result from a benign domestic environment. In our view, these less favorable global conditions won't be strong enough to prevent the recovery of local consumer and business confidence and economic growth. But it may end up affecting the currency and the long end of the yield curve.

FED, ECB and BOJ Balance Sheet Variations (USD bn per year)

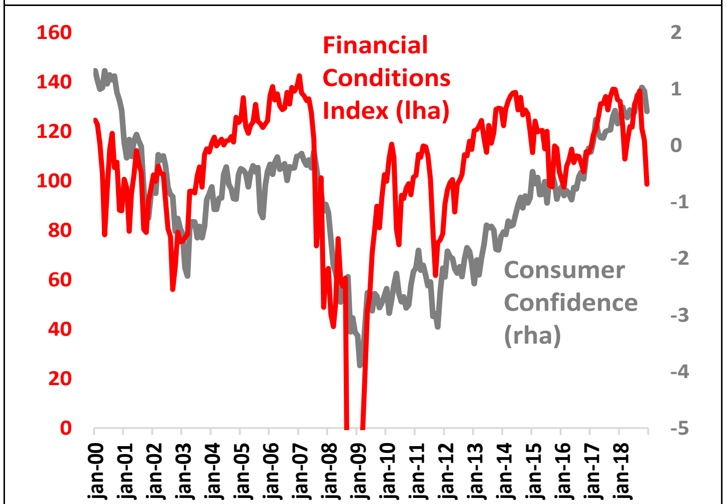


Source: Bloomberg.

See on Appendix Figure A4: S&P, Figure A5: VIX, Figure A6: High Yield, Figure A7: USD Yield Curve Inclination, Figure A8: World GDP Growth, and Figure 9: Global Trade.

…But There May Be Important Mitigating Factors – Interest Rates in the U.S. May Not Go as High as Previously Thought

The US: Financial Conditions Index and Consumer Confidence



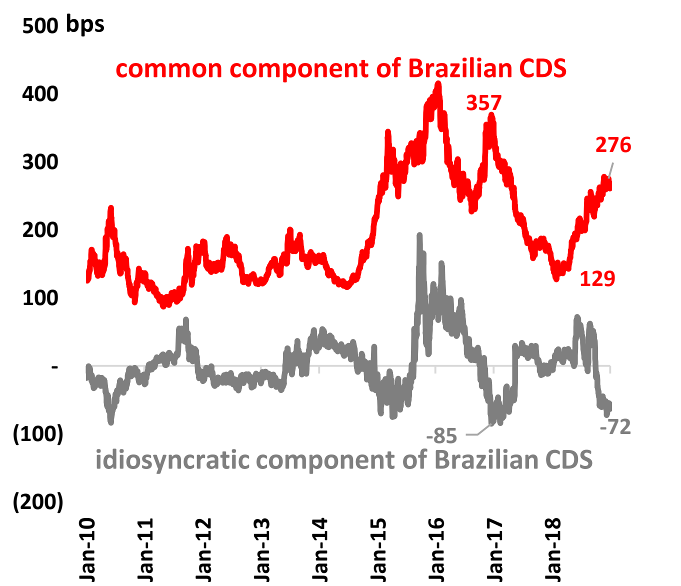
Source: Bloomberg.

But if a slowdown of world GDP seems unavoidable, it is possible that this process has been brought forward by market action in a sort of self-fulfilling prophecy. **Deteriorated financial conditions and falling confidence in the US will likely anticipate the slowdown and prevent the Fed from raising the base rate as high as planned**. Moreover, lower commodity prices (particularly gasoline) may contribute to sustain consumption and anchor inflation in the American economy, which would reduce any sense of urgency from the point of view of policymakers in bringing the stance monetary policy toward neutrality. A not-so-fast process of interest rate normalization also means a not-so-dangerous global environment for Brazil, reducing the chances of extreme scenarios for asset prices, particularly the BRL, as long as a minimal reform agenda is addressed domestically

Proposition 6. Brazilian CDS: Risk Premium Repricing Globally vs. the Idiosyncratic Component; Opposing Vectors: The External Component Usually Prevails

Although optimistic about the evolution of the fiscal adjustment, we expect global conditions to dominate. 1) Brazil is a high-beta country (according to our estimation, variations of average EM CDS spreads tend to affect this measure for Brazil by twice the magnitude). 2) The global risk repricing process, chiefly associated with the normalization of liquidity conditions, seems to be in its initial stages, with ample room to intensify. 3) Conversely, the Brazilian idiosyncratic component of its risk premium is already close to its best readings in the decade (see chart). In our view, markets already price in a more than 50% probability of a favorable evolution of the fiscal adjustment and reforms in Brazil. Only a sizable positive surprise could drive the Brazilian risk premium substantially lower in a context of adverse global conditions. According to our scenario, Brazilian CDS will evolve toward 250 bps in 2019, from the current 204 bps, as a result of common factors converging towards 300 bps and the idiosyncratic component at -50, not very far from the current upbeat -72 bps.

Brazilian CSD Decoupled by Common (EM) and Idiosyncratic Components (bps)

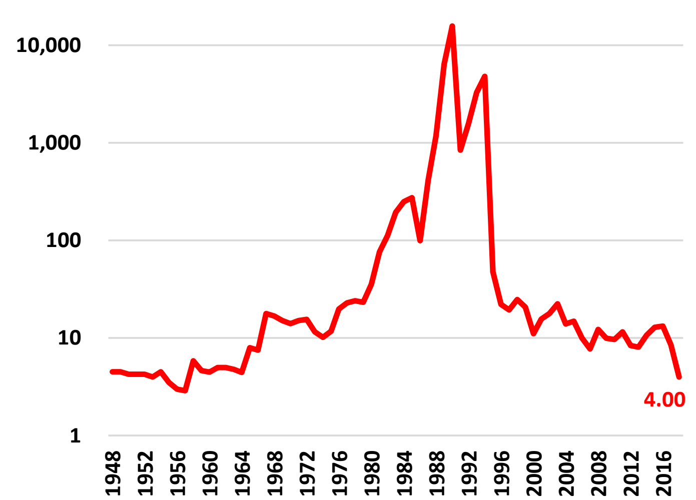


Source: Santander estimates based on Bloomberg data.

More on the Brazilian risk premium decoupled by global factors and the idiosyncratic component at **www.santander.com.br/economia**: *Apples and Oranges,* October 9, 2018.
See Appendix Figure A10: Brazilian CDS and Average CDS of a Sample of 24 EM Economies.

Proposition 7. BRL: Low Interest Rates Coupled with a Weaker-for-Longer BRL – an Unusual Combination in Brazil

Brazil vs. U.S. Base Rate Difference (% p.a., logarithmic scale)



Source: Bloomberg

There may be room for BRL appreciation in the short term, in our view, as fiscal initiatives have been announced and optimism regarding social security reform prevails. Moreover, as stated previously, we believe the process of global risk reprising is currently in its initial stages. **But we see a weakening bias for the Brazilian currency in 2019.** 1) As already mentioned, global conditions should weigh on risk premiums. 2) Slowing growth in the world, particularly in China, implies a downside bias to the prices of commodities. 3) Brazilian interest rates are expected to remain at their lowest levels in 60 years. The importance of this factor should not be underestimated, as it reduces both the absolute and relative attractiveness of the BRL in the so-called "carry trade". Expected returns from holding BRL longs are currently the lowest in many years, and BRL returns are expected to be lower than those of a basket of other high-yield currencies. We believe the BLR could reach 3.6 at some point in 1Q19 but will close the year around 4.0 / USD.

More on short- and long-term trends for the BRL at **www.santander.com.br/economia**: *Brazil Post Elections: Honeymoon and Marriage*, October 25, 2018. Regarding the impact of lower interest rates on the BRL: *Falling Interest Rate Differentials Leading to BRL Weakness*, March 28, 2018.
See Appendix Figure A12: Real Exchange Rate and CRB (Commodities) and Figure A13: Real Exchange Rate and DXY (Dollar Index).

Proposition 8. Inflation: Don't Worry, Be Happy. Going for the 3rd year in a Row with Inflation Below the Target

In spite of expected strengthening of domestic demand, **there are no compelling reasons to envisage meaningful pressure on core inflation measures**, as the output gap (Figure A14) will likely remain wide until the end of 2020. Moreover, the contribution of administered prices to overall IPCA (mostly as a result of electricity and gasoline) is not going to be even close to what we saw last year. Our forecast for the IPCA in 2019 is 3.7%, well below consensus (currently at 4.1%), even incorporating a year-end BRL estimate of 4.00 / USD and food inflation of 4.7% (above the average IPCA). In our view, only a BRL sustainably above 4.50 / USD could drive the trajectory of the IPCA away from current comfortable stance and trigger a monetary policy reaction. In terms of dynamic for the medium term, it is important to highlight that YoY IPCA figures will show a relevant decrease between 1H19 and 2H19, as consequence of base effects (important price hikes that happened last year, during the truck strike). At the margin, we are probably going to see seasonally adjusted core measures trending up as the economy gains traction.

IPCA (Inflation)

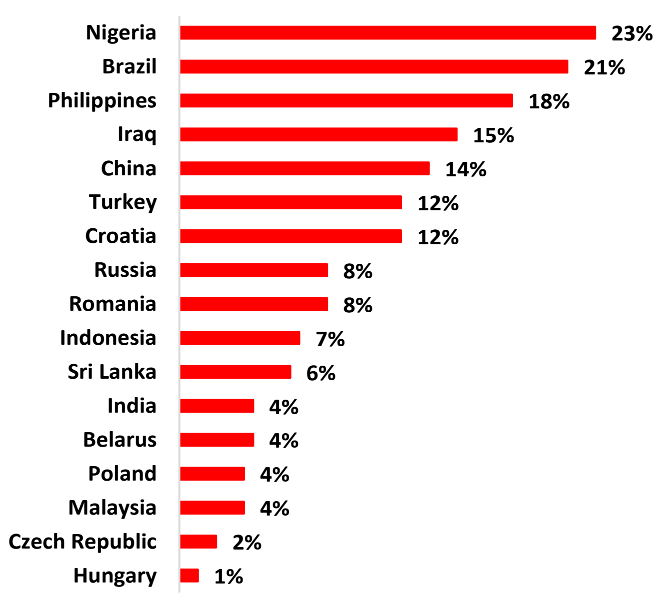
		2017	2018	2019
IPCA	weights	2.9	3.8	3.7
Managed Prices	26.2	8.0	6.2	4.3
Gasoline	4.6	10.3	6.9	1.2
Electricity	3.9	10.4	8.9	4.5
Market Prices	73.8	1.3	2.9	3.4
Durables	7.7	-1.7	1.6	1.2
Semi Durables	7.5	2.3	0.4	1.9
Services	35.5	4.5	3.4	4.0
Non Durables	23.2	-2.7	3.4	3.9

Source: IBGE and Santander estimates.

See Appendix Figure A14: Output Gap, and Figure A15: IPCA Inflation (YoY) (Core and Services).

Proposition 9. Monetary Policy: Beyond the Selic; Focusing on the Causes of Large Banking Spreads, Reducing Reserve Requirements

Reserve Requirements on Cash Deposits, Selected Countries



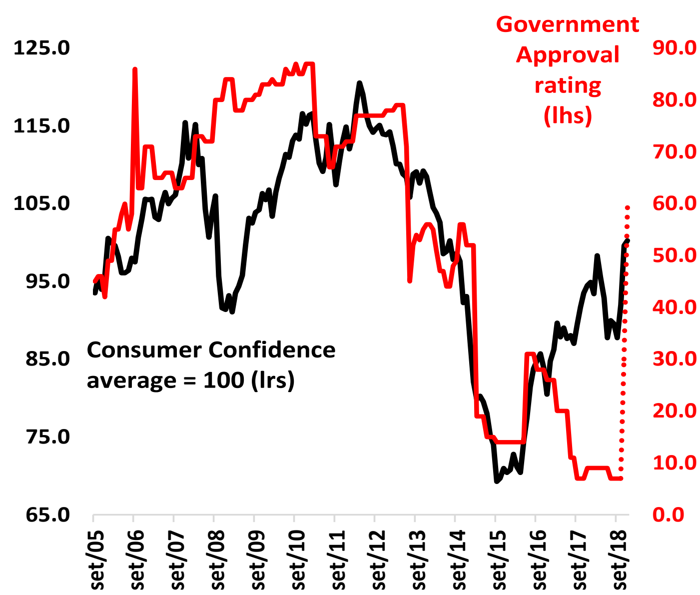
Source: Trading Economics.

As the BRL strengthened after its lows of 4.20 / USD reached in mid-September, and inflation surprised to the downside in 3Q18, investors have begun to wonder whether the next monetary policy move could be a reduction of the Selic. In fact, our favorable outlook for 2019 could mean an opportunity for the Copom to go forward into this direction. However, considering that monetary policy is already expansionary, **we expect policymakers keep relying on their "caution, serenity, and perseverance" mantra. In our view, this means focusing more on inflation forecasts and expectations than reacting to extreme movements of financial markets** (particularly to BRL variations). In any case, we believe the BCB will take advantage of this benign scenario and pursue improvements of the financial system framework in order to further reduce the cost of credit for final borrowers. **A more aggressive process of reduction of reserve requirement may be in the cards. We expect the Selic to remain at 6.5% p.a. during the year. In our view, the dynamic of economic activity is going to be the key factor in defining the Copom's next move. Our optimism with consumption reinforces that a rate reduction may not be necessary. Accelerating growth and closing output gap suggests hikes for 2020.**

Proposition 10. Confidence + Credit = Consumption; Our Above-Consensus Forecast for GDP Growth is 3%

GDP growth was perhaps the greatest disappointment in the Brazilian economy last year. In our view, the country enjoyed robust conditions for domestic demand to accelerate: deleveraged households and companies, not-so-tight fiscal policy, substantially reduced interest rates and a solid banking sector willing to increase credit supply. So, what went wrong? In our view, confidence. We believe that if it was not for the inflection of confidence by mid-2018, the economy would be expanding at a pace near 4% at the margin by the end of 2018. The truckers strike, elections and the deterioration of financial conditions associated with global uncertainties have played a role. What to expect for 2019? In spite of a still-volatile global financial market, a much more favorable political outlook in Brazil is almost a certainty at the beginning of a new administration. Moreover, outstanding credit remains accelerating and NPLs are reaching record lows, which means that supply will be comfortable in 2019. In our view, **restored consumer and business confidence will accelerate GDP growth to 4% y/y by the end of this year, which means an average expansion not far from 3% in the year.**

Consumer Confidence and Government Approval ratings

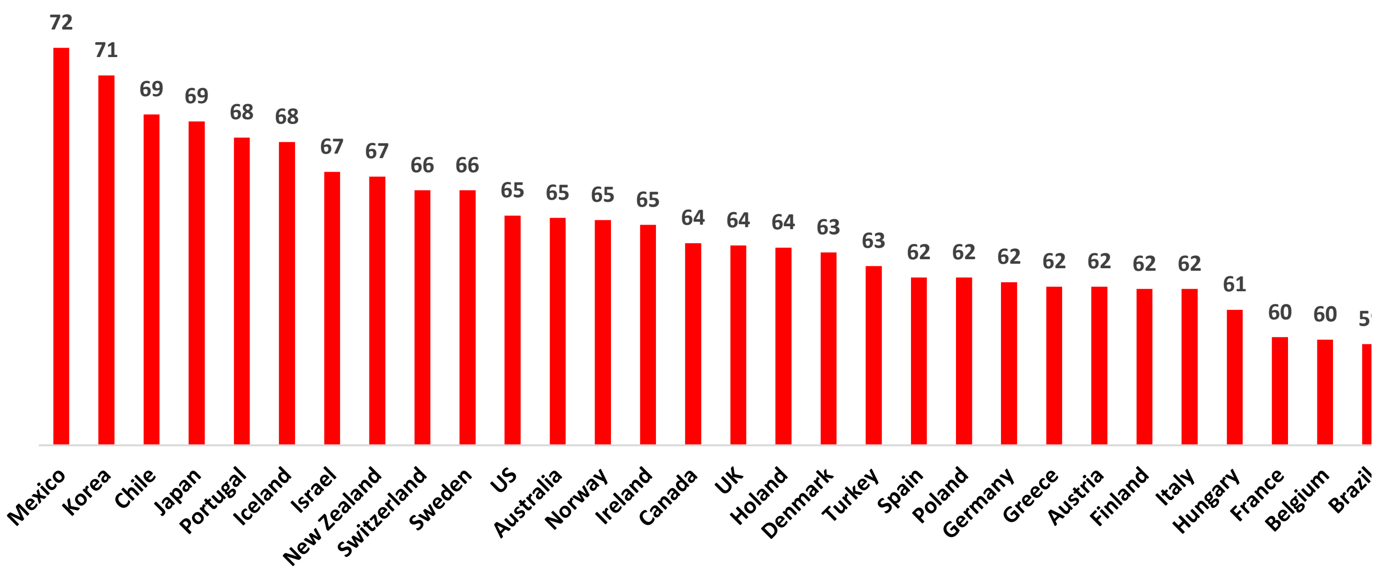


Source: FGV and IBOPE.

For more on financial conditions see **www.santander.com.br/economia**: *Worse Financial Conditions at the Margin Reinforce the Likelihood of Selic Remaining "Low for Long"*, August 30, 2018. See Appendix Figure A15: Financial Conditions Index, and Figure A16: Business Confidence and IBC-Br.

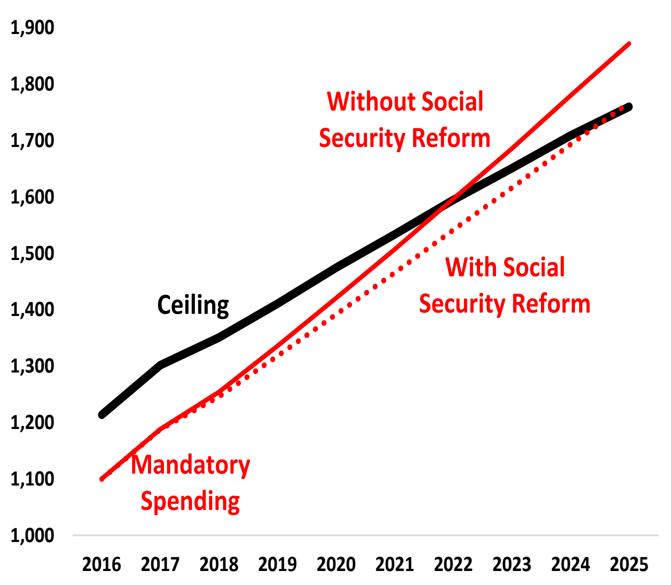
Appendix

Figure A1. Social Security – Average Retirement Age by Country (Years)



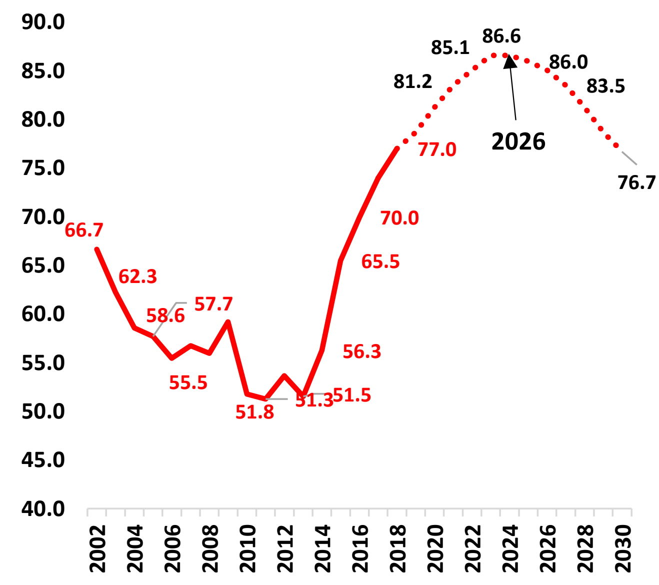
Source: Secretary of Labor and Social Security

Figure A2. Expected Trajectories of Discretionary and Mandatory Spending, with and without Social Security Reform (BRL bn)



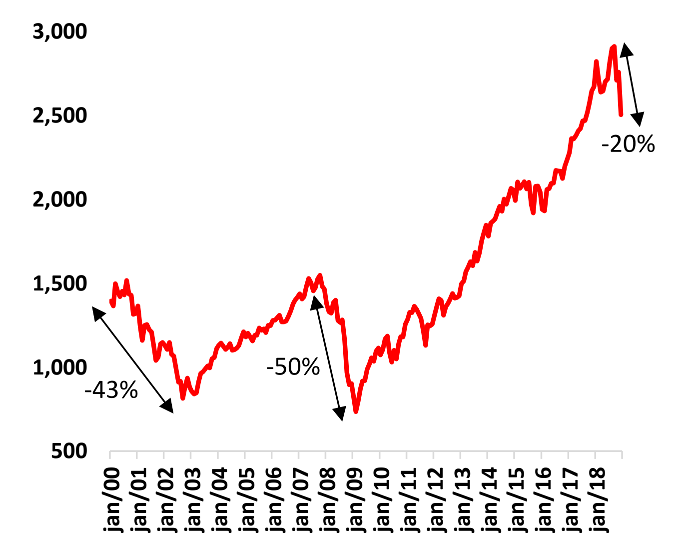
Source: Santander estimates based on Ministry of Finance data.

Figure A3. Public Sector Gross-Debt-to-GDP Ratio



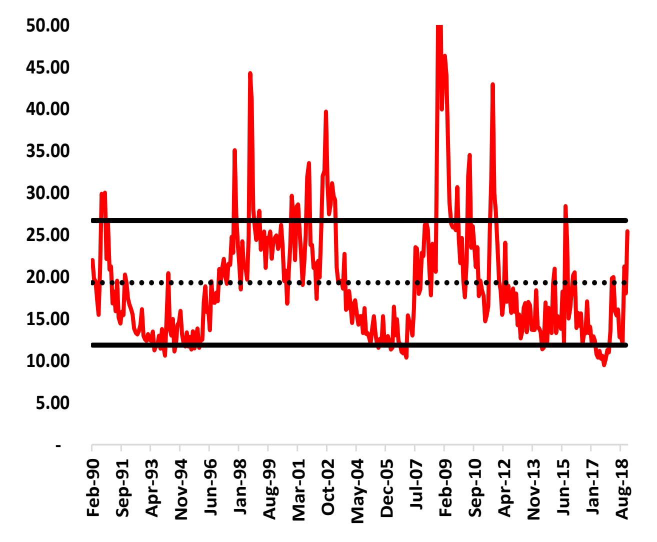
Source: Brazilian Central Bank and Santander estimates.

Figure A4. S&P500 (points)



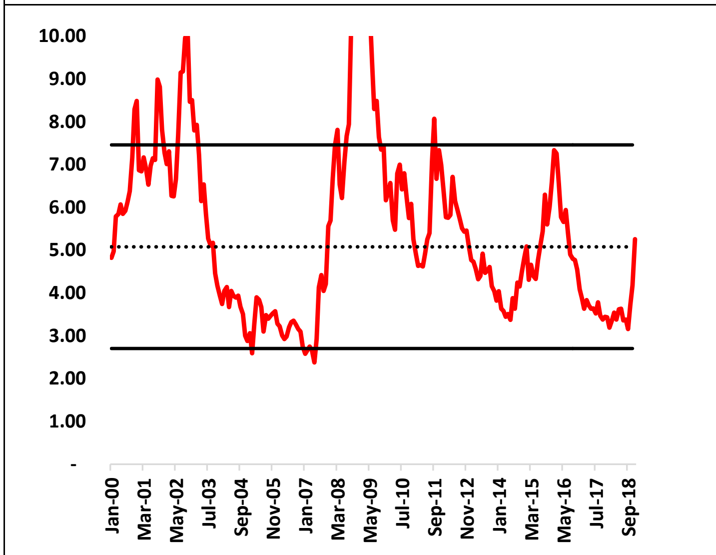
Source: Bloomberg.

Figure A5. VIX (Implied Volatility S&P)



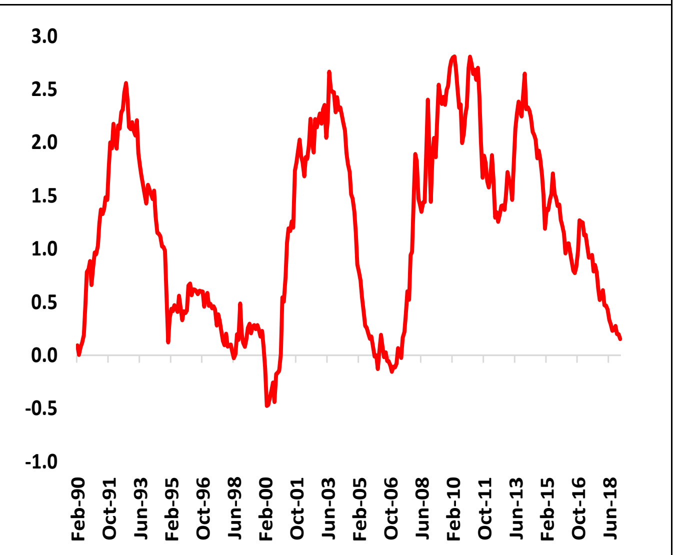
Source: Bloomberg.

Figure A6. US High Yield Spreads (bps)



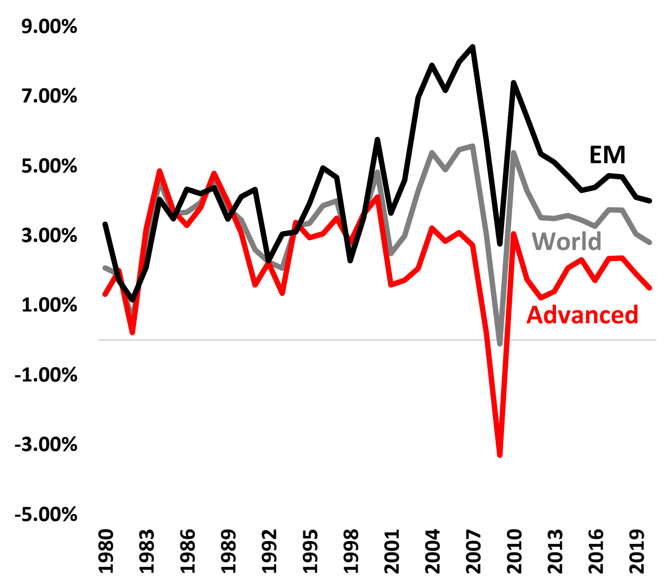
Source: Bloomberg.

Figure A7. US Yield Curve Inclination (GT10 – GT2)



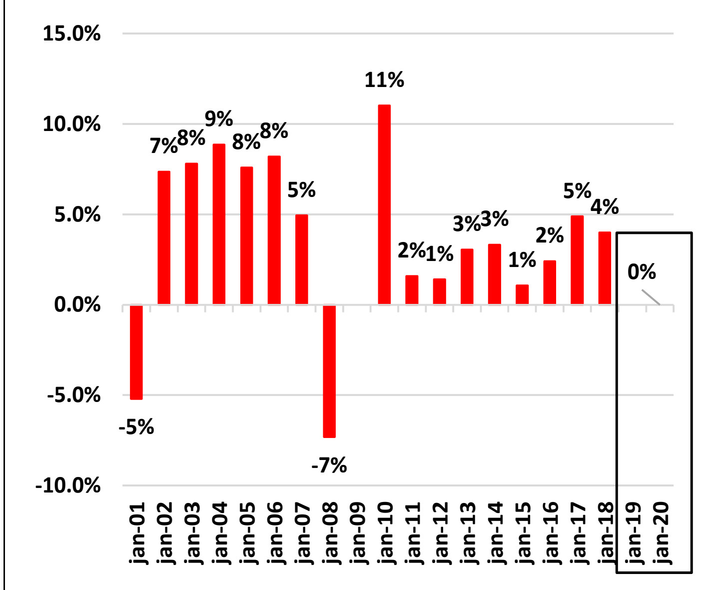
Source: Bloomberg.

Figure A8. World GDP Growth



Source: IMF

Figure A9. Global Trade (Annual Growth)



Source: CPB Global Trade Monitor.

Figure A10. Brazilian CDS and Average CDS of a Sample of 24 EM Economies

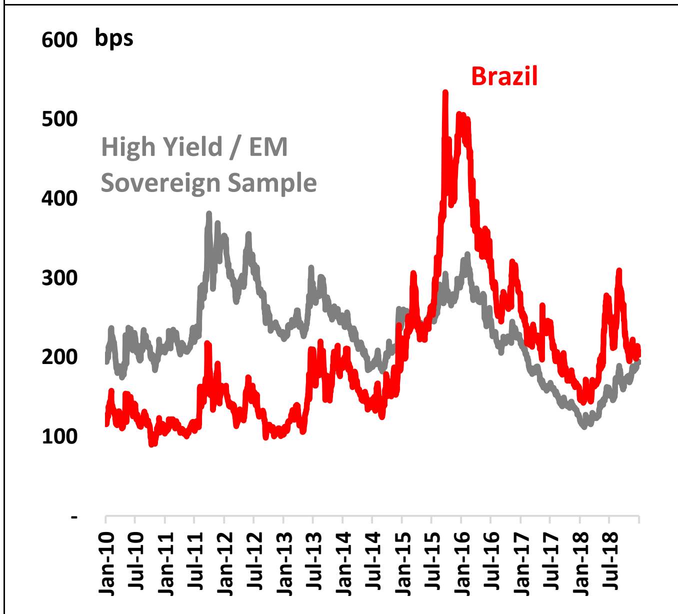
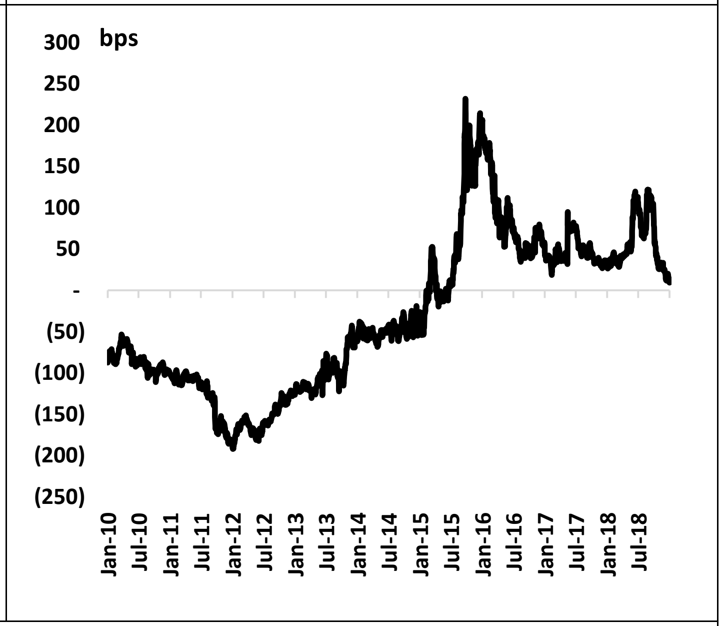


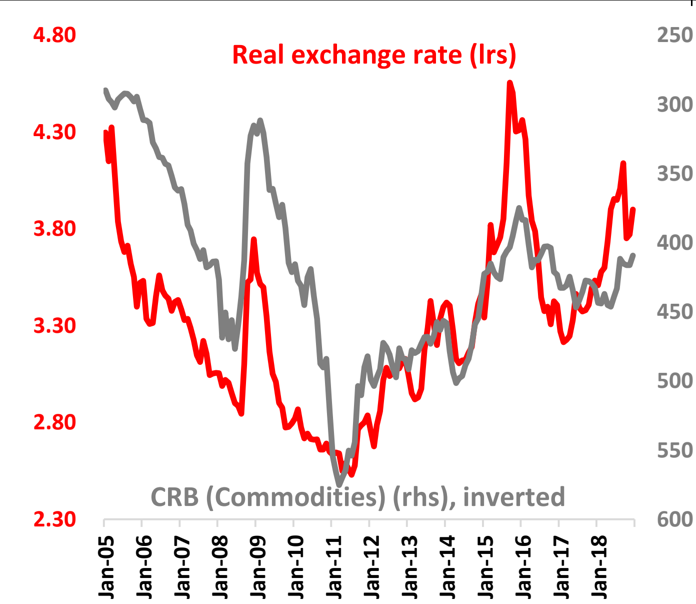
Figure A11. CDS Difference – Brazil and EM

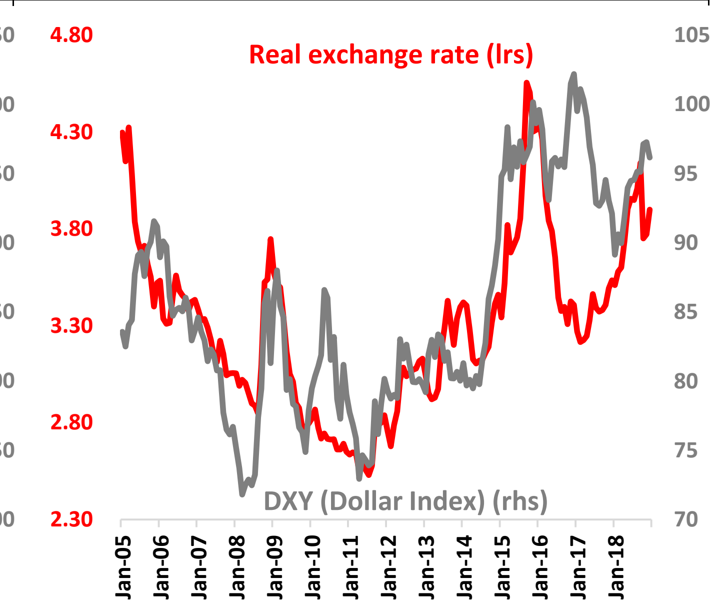


Source: Santander estimates based on Bloomberg data. The EM sample includes Argentina, Chile, Colombia, Mexico, Panama, Peru, Croatia, Greece, Hungary, Poland, Romania, Russia, Turkey, China, India, Indonesia, Malaysia, Philippines, Thailand, Vietnam, Egypt, Morocco, Nigeria and South Africa.

Figure A12. Brazilian Real Exchange Rate and Commodities (CRB)

Figure A13. Brazilian Real Exchange Rate and Dollar Index (DXY)

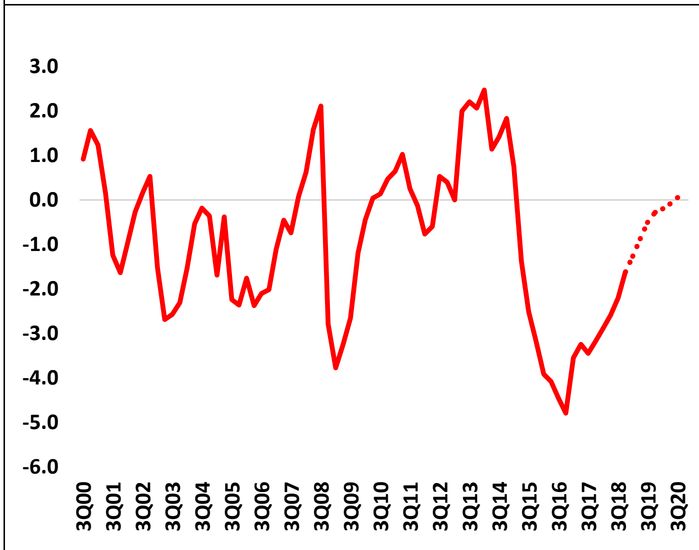


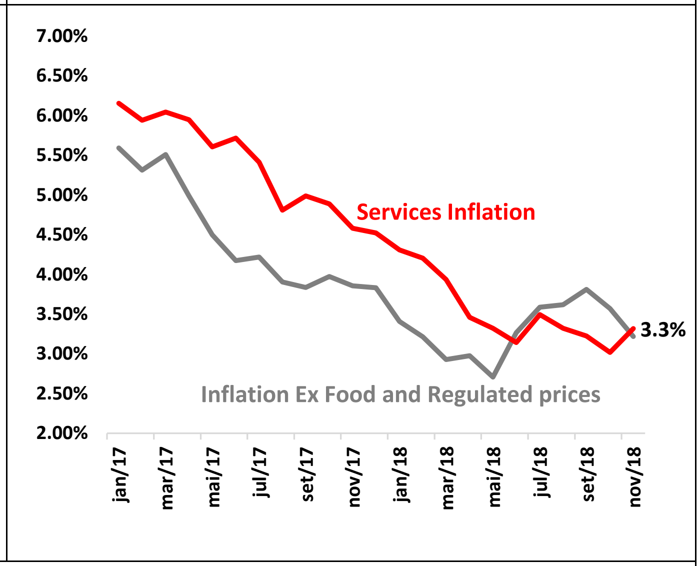


Source: Brazilian Central Bank and Bloomberg. Exchange rate at constant December 2018 prices.

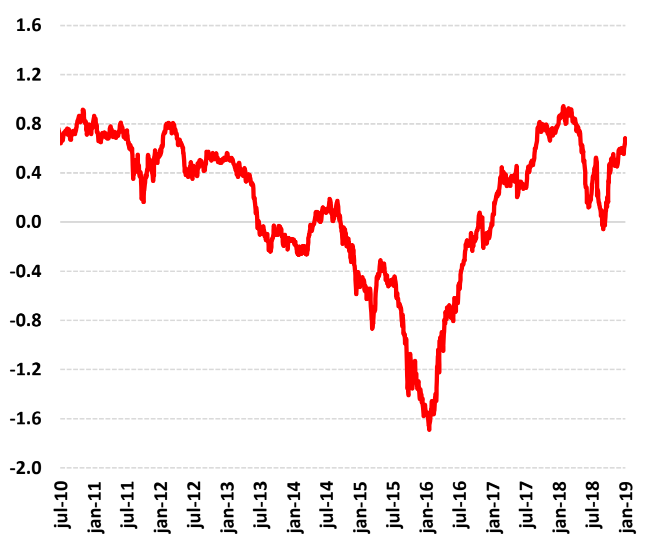
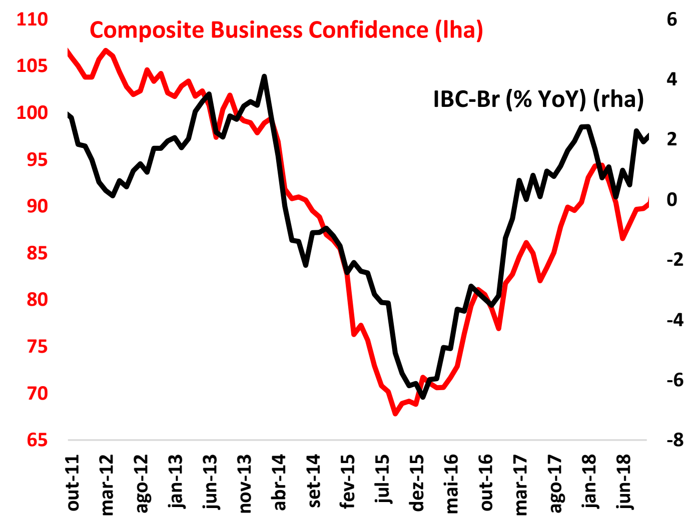
Figure A14. Output Gap (Actual – Potential GDP)

Figure A15. IPCA Inflation (YoY) (Core and Services)





Source: IBGE and Brazilian Central Bank.

Figure A16. Financial Conditions Index	**Figure A18. Composite Business Confidence and IBC-Br**
	

Source: FGV and Santander estimates. SAN-ICF is constructed such that positive values indicate stimulative financial conditions, whereas negative values suggest contractionary conditions. Economic activity as proxied by the IBC-BR, an estimate provided by the BCB of the monthly changes in real GDP, is presented here as the year-on-year changes of its 3-month average. Sources: BCB and Santander. The Composite Business Confidence is the average of confidence in different sectors weighted by their respective importance to the GDP.

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.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, Peru	diana.ayala@santander.us	212-407-0979
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.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 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
David Franco*	Macro, Rates & FX Strategy – Latin America	david.franco@santanderCIB.co.uk	44-207-756-6633
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
Nicolas Schild*	Head, Chile	nschild@santander.cl	5622-336-3361
Valder Nogueira*	Head, Brazil	jvalder@santander.com.br	5511-3012-5747
Cecilia Jimenez*	Head, Mexico	mcjimenez@santander.com.mx	5255-5269-2228
Electronic Media			
Bloomberg	SIEQ <GO>		
Reuters	Pages SISEMA through SISEMZ		

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Mauricio Molan*

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

Santander
Corporate & Investment Banking