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Brazil Macro
Propositions for 2020

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Harvesting the fruit of the reforms

Santander Brazil's macro propositions for 2020

This year, we believe the country will see even more clearly the benefits of economic reforms. But to sustain more robust growth without setbacks, it will be crucial to keep moving forward on the path of adjustment.

Geopolitical conflicts and electoral polarization seen diluting impact of trade truce and monetary stimulus

We expect Brazil to face neutral global conditions in the economy and markets. Latent risks still fuel the potential for volatility, in our view.

Balance of payments expected to remain sustainable, but with a riskier composition

We see a lower trade balance and slight deterioration of the current account deficit. The latter will continue to be covered by direct investment.

Exchange rate expected to remain volatile, but trend is of modest appreciation

Domestic factors should prevail and generate mild FX appreciation, in our view; international reserves should mitigate any volatility.

Hangover of real activity seen in the first quarter; firm resumption expected afterward

Following the effects of adjustments made in recent years, economic recovery should continue to be gradual but a little faster in 2020.

Recovery expected, with formal job creation

We anticipate continued improvement in the labor market, in both general numbers and composition.

Central Bank expected to focus efforts on the regulatory agenda

With the end of the easing cycle, we expect the Central Bank to turn to Agenda BC #, seeking greater efficiency (and lower costs) in bank credit.

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Brazilian capital market should continue to deepen, in our view

As firms await tax reform and trade liberalization, we see access to capital markets as key for the business environment in 2020.

Reallocation of domestic assets to stock market expected to intensify in 2020

The exposure of local investors to equities should increase, in our view, as interest rates fall and economic growth accelerates.

Inflation not expected to be a concern this year

We see anchored inflation expectations, high economic slack, a flat FX rate, and volatile prices resulting in IPCA below the midpoint target (4.0%).

Monetary stimulus expected to peak in 2020

Monetary policy stance means a good level of accommodation, in our view. We believe better activity implies normalization starting in 2021.

The reform agenda unlikely to be abandoned, in our view

Discussions around the reform agenda will continue, in our view, but we expect few bills to clear Congress this year.

Concerns about fiscal consolidation may dissipate prematurely, in our view

Structural adjustment of public spending will not be completed by end-2020, in our opinion, with the benign trend of government debt reducing a sense of urgency.

Privatization agenda expected to advance slowly

While we expect sales of state-owned assets in 2020, further advances in concessions and privatizations are more likely in 2021 and beyond.

Propositions for 2020, in short

- ***Benefits of economic reforms are likely to become even clearer by end-2020, in our view. We believe further advances are needed to sustain growth and prevent setbacks.***

We believe a focal point in 2020 will be the composition, intensity, and speed of the structural reforms that are expected to move Brazil toward a more stable macroeconomic environment, with higher sustained growth, controlled inflation, low interest rates, more equity, and greater social cohesion.

If complacency regarding the good growth figures outweighs focusing on the tough reforms needed on the fiscal front, in a year of mid-term (municipal) elections, we believe the legacy for 2020 will be more uncertainty and a strained cyclical recovery. If Brazil is able to move forward boldly not only with tax reform, but also with privatization, regulation, and the business environment, and even in trade liberalization, we believe the legacy will be an economy more resilient to external shocks as well as more robust structural growth, between 2.5% and 3.0%.

Brazil's high and ineffective public spending means that it has a unique opportunity, in our view, to cut expenditures and simultaneously better redistribute spending from a social standpoint, both through the elimination of privileges for certain segments of the population and through improved design of social programs. The fact that the Brazilian economy ranks 124th (among 190 peers) in the World Bank's "ease of doing business" survey provides a strong impetus, in our opinion, to address its high transaction costs, lack of infrastructure, legal uncertainty, restrictions on access to credit, and low educational outcomes.

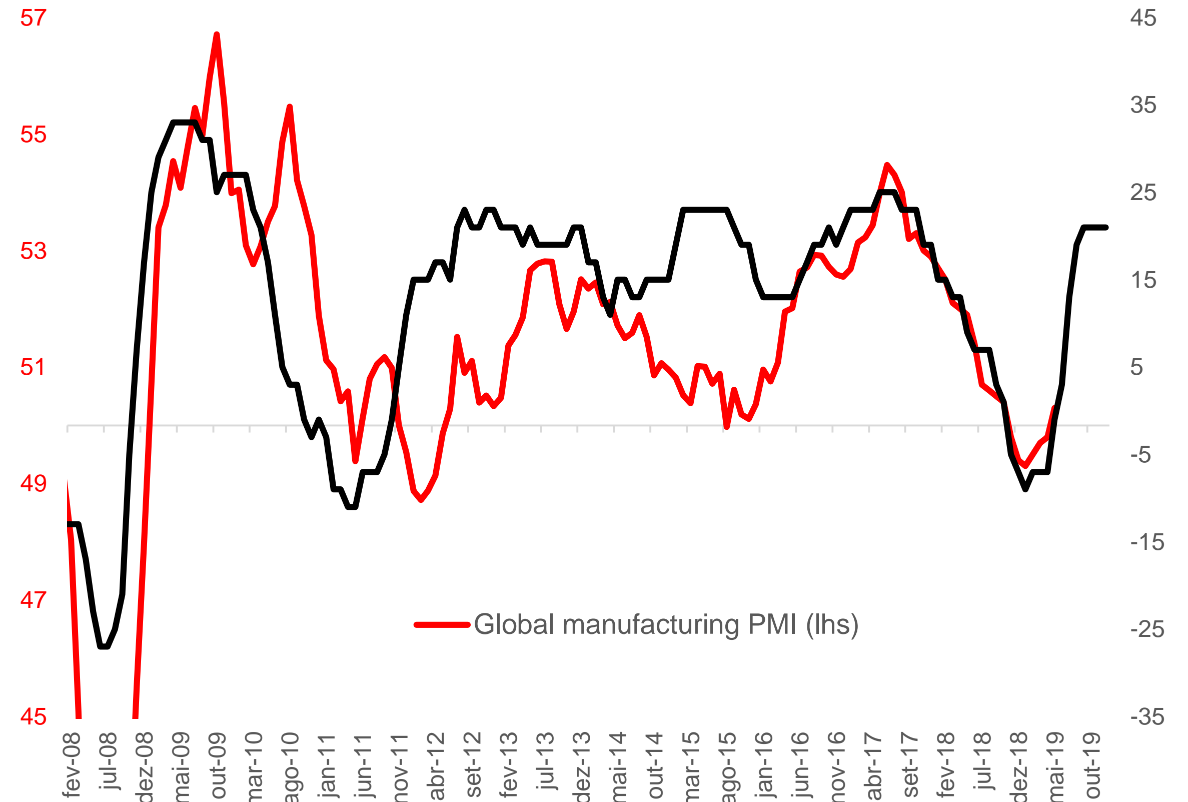
For an emerging economy facing the volatility of the international economy, it will be critical to remain resilient on delivering more reforms. The global scenario, in our view, will increasingly be associated with geopolitical conflicts of different natures: regional military conflicts, disputes over technological and commercial hegemony, and political polarization.

Geopolitical conflicts and electoral polarization seen diluting impact of trade truce and monetary stimulus

- ***Brazil expected to face neutral global conditions in the economy and markets. Latent risks still fuel potential for volatility, in our view.***

After facing two years of significant slowdown, we think the global economy is poised for a slight recovery. The trade war between the U.S. and China, the most important catalyst for the slowdown, has come to a truce with the Phase 1 deal. Moreover, the weakness of the global economy has led many central banks to loosen monetary policy, especially in the three major economies (U.S., Eurozone, and China), and therefore we believe global activity should reap the benefits of this monetary stimulus. Additionally, we think Brexit is now more likely to reach a non-disruptive conclusion. These positive factors will be important in mitigating the volatility brought about by the U.S. elections, which must once again take place under conditions of strong polarization and legal disputes, and against a tense backdrop with geopolitical conflicts of many kinds (e.g., military conflict in the Middle East; the "cold war" between the U.S. and China). Some of these conflicts are likely to slow global growth in the long term, in our view, and may generate volatility in the short term. Yet **we expect the monetary policies of major countries to remain unchanged in 2020, so favorable financial conditions should help put the world economy on a firmer footing.**

Global PMI and Net Number of Central Banks Cutting Rates



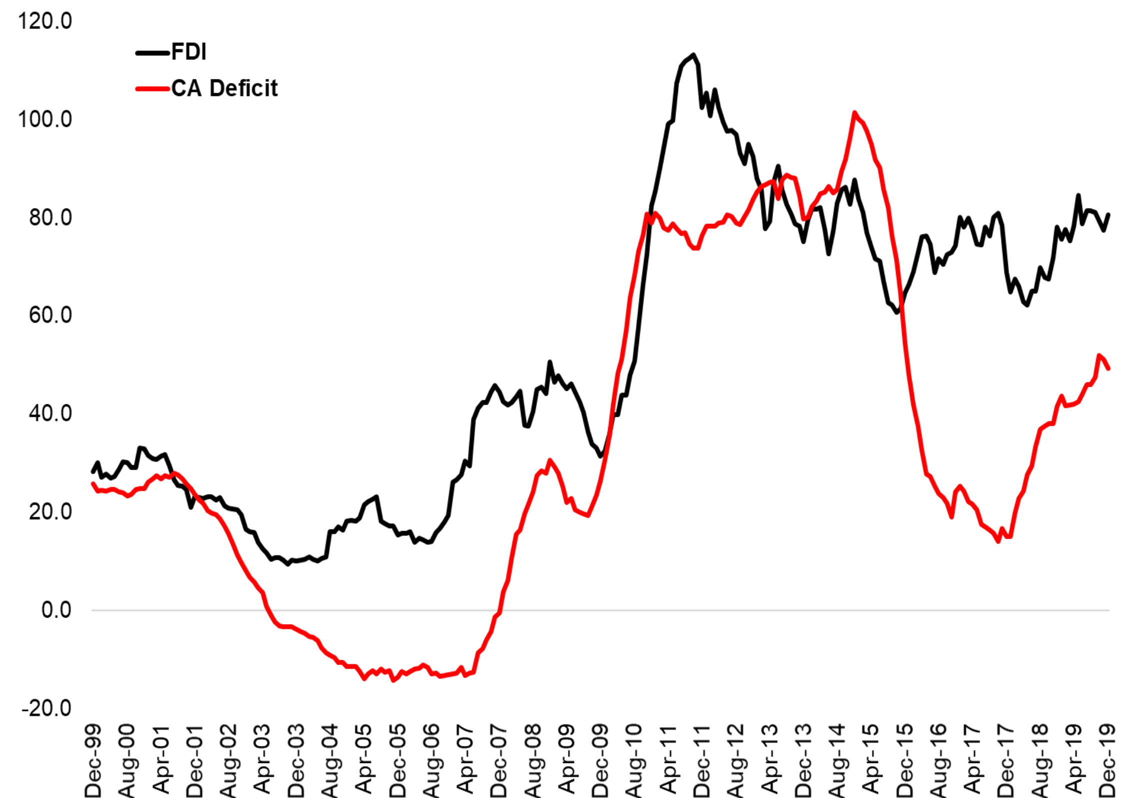
Sources: JPM and Bloomberg.

Balance of payments expected to remain sustainable, but with a riskier composition

- ***We see a lower trade balance and slight deterioration of the current account deficit. The latter will continue to be covered by direct investment.***

Recent revisions of external sector data have raised concerns among investors about the deterioration of the current account deficit because, given prospects for a faster pace ahead, there have been fears that the CA deficit may become hard to finance – although FDI net inflows have been able to do so thus far. It is important to highlight that the bulk of the worsening was related to the trade balance decline resulting from the Argentine economic crisis and sluggish international trade, which hit Brazilian exports. While it is hard to envision an upturn in exports, the gradual recovery we anticipate for Brazil is expected to lead imports to grow in tandem. Thus, although we see the trade surplus as likely to shrink further, we think it will do so at a slower pace than that seen in 2019, which means the deterioration of the current account deficit is likely to decelerate. However, we see the balance of risks as tilted to the downside, as the drag on exports may continue and imports may grow faster than expected. **Thus, the importance of monitoring the trade balance will become greater henceforth,** as we do not believe that net financial outflows will be reversed in 2020.

Current Account Deficit vs FDI (USD billion, 12M-to-date)



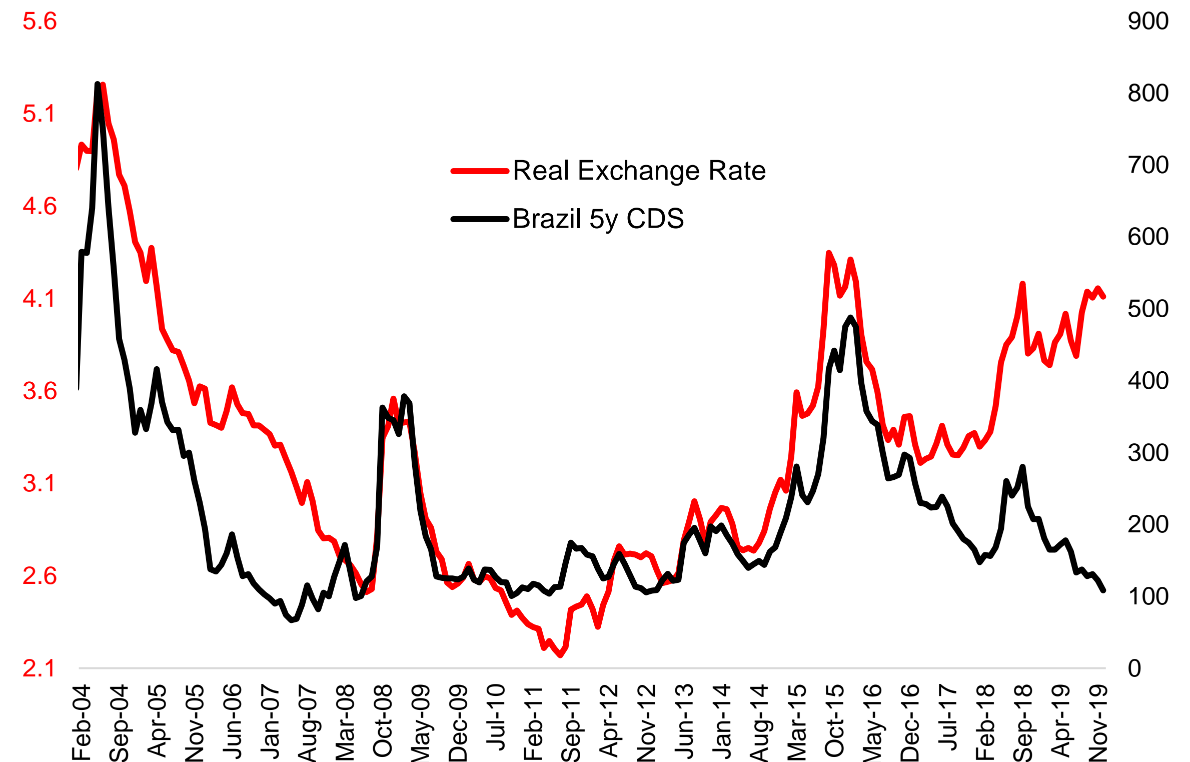
Source: Central Bank of Brazil.

Santander Corporate & Investment Banking

Exchange rate expected to remain volatile, but trend is of modest appreciation

- ***Domestic factors should prevail and generate modest appreciation, in our view; international reserves should mitigate any volatility.***

Strengthening USD, especially against emerging currencies, combined with a substantial reduction in the interest rate differential, offset the improved perception of domestic risk, leading to BRL depreciation in 2019. For 2020, we do not expect further deterioration in the global environment (even if volatility remains high), or a reduction in the interest rate differential. Thus, **we expect the positive impact of a more consistent domestic economic recovery will prevail, allowing for:** (i) a further decline in risk perception (upgrade from rating agencies); (ii) reduction in net capital outflows; (iii) increase in international commodity prices; and consequently (iv) **slight appreciation of the exchange rate**. However, uncertainty remains high, as intensification of geopolitical tensions associated with the U.S. elections could lead to further risk aversion and FX depreciation. On the other hand, we believe a positive surprise about the reformist agenda in Brazil could increase the domestic economy's resilience to external shocks and lead to a stronger FX appreciation.

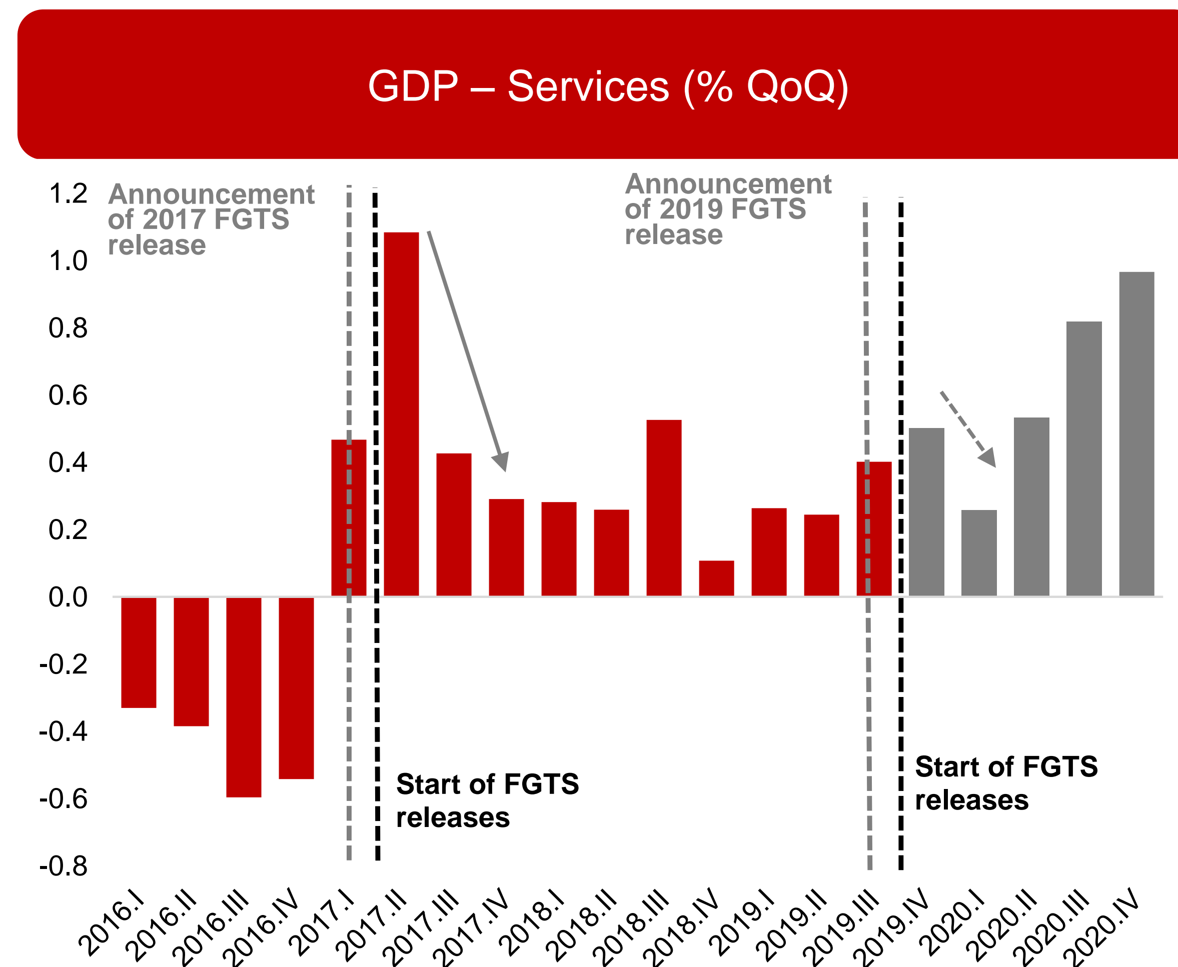


Sources: Bloomberg and Santander.

Hangover of real activity expected in first quarter, firm resumption afterward

- ***Following the effects of adjustments made in recent years, economic recovery expected to remain gradual but a little faster in 2020.***

The latest economic activity data has been encouraging, in our view. However, it is important to note that the economy is benefiting from a temporary income stimulus because of the FGTS (mandatory savings fund) releases. In 2017 Brazil released FGTS funds in similar amounts, and at that time the services GDP (accounts for over 60% of Brazil's GDP) increased substantially, only to slow in subsequent quarters. We expect to see a similar trend in 2020, **which could result in market frustration regarding economic growth in the first half of the year.** Such a hangover means that we will not reach 3%, in our view. Nevertheless, there has been significant improvement in economic growth, and **we think it is unlikely that Brazil GDP will grow less than 2% in 2020.** Among the factors that give us confidence that growth will continue to improve substantially, we highlight the **private sector as a driver of growth, the improvement in financial conditions, and the progress in the recovery of construction and investments.**

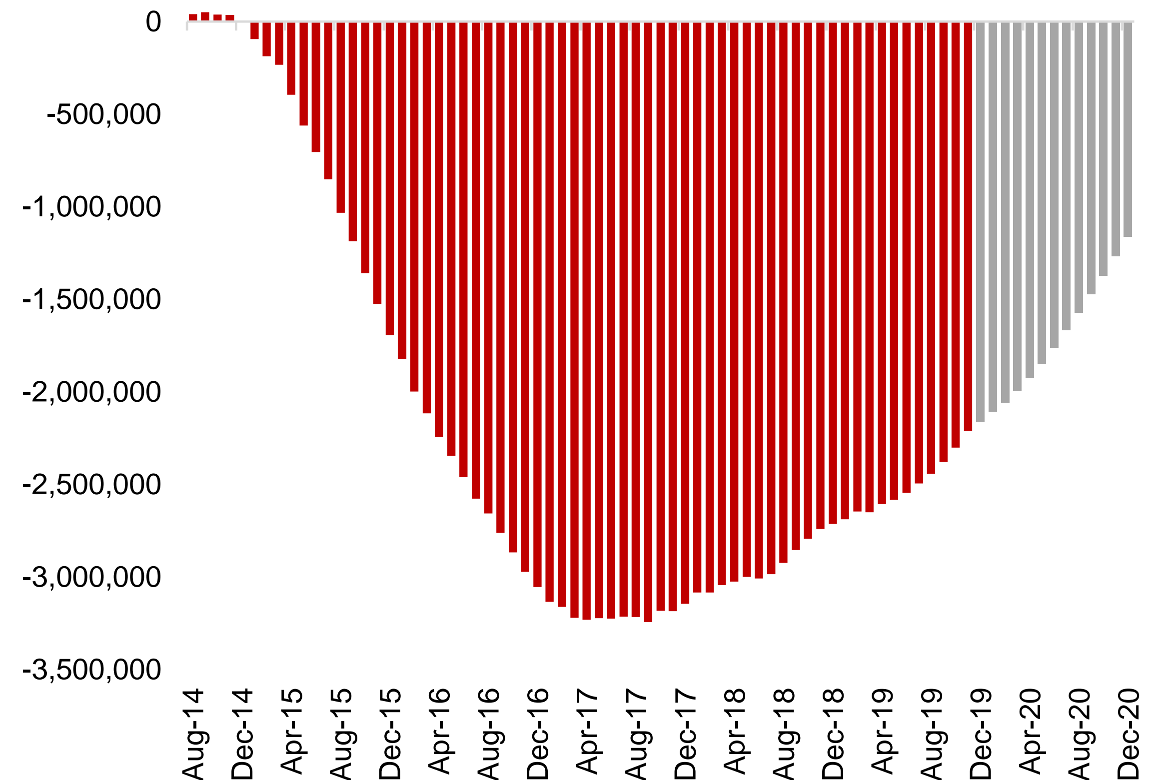


Sources: IBGE and Santander estimates.

Recovery expected, with formal job creation

- ***We anticipate continued improvement in the labor market, in both general numbers and composition.***

The jobless recovery has been an issue for many countries throughout the last decade. Brazil lost over 3.2 million formal jobs during the recent crisis, and since then we have seen only a weak improvement in the labor market (as well as in economic growth). **We believe that in 2020 we will see a change in this dynamic, with the pace of job creation almost doubling, creating approximately 1 million net formal jobs** – especially in the second half. We acknowledge that Brazil will still be over 1 million jobs below the pre-crisis level, but this improvement should not be dismissed. The labor reform approved in 2017 (we expect further easing in 2020) has formalized new occupational categories, such as intermittent and part-time jobs, which account for approximately 20% of the net formal jobs creation in the last 12 months. We believe such new categories will speed up the generation of jobs, in tandem with the improvement of economic activity. We expect the construction sector in particular to contribute to the recovery of the labor market. After losing over 1 million jobs from 2014 to 2018, it gained momentum in 2019, and we expect it to accelerate during 2020.



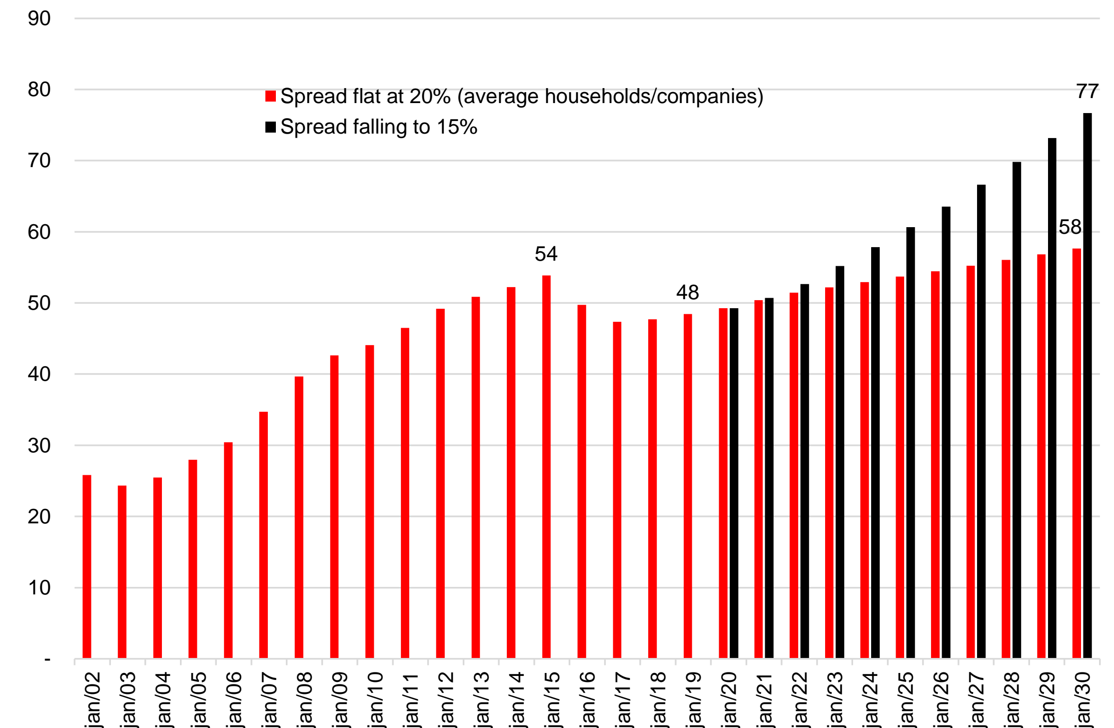
Source: MTE and Santander.

Central Bank expected to focus efforts on the regulatory agenda

- ***With the end of the easing cycle, we expect the Central Bank to turn to Agenda BC #, seeking greater efficiency (and lower costs) in bank credit.***

According to our estimates and market analysts, the cycle of cuts in the base interest rate is coming to an end. Under an anchored inflation environment – inflation is expected to remain below target over the next two years – we expect the Central Bank to turn to the regulatory agenda, known as BC#. Even though far from its highest level, delinquency has shown slight growth in recent months, mainly reflecting the slow recovery of the labor market. In an environment of greater uncertainty, bank spreads tend to rise, given the costs of debt recovery and credit analysis. With a more favorable outlook for economic growth in 2020 and the BC# regulatory agenda for capital market development and open banking, **we believe there is room for sustained growth in the Brazilian credit market**, driven by shrinking bank spreads and increase of access to different forms of financing for companies and individuals.

Domestic Credit to Private Sector (% of GDP)

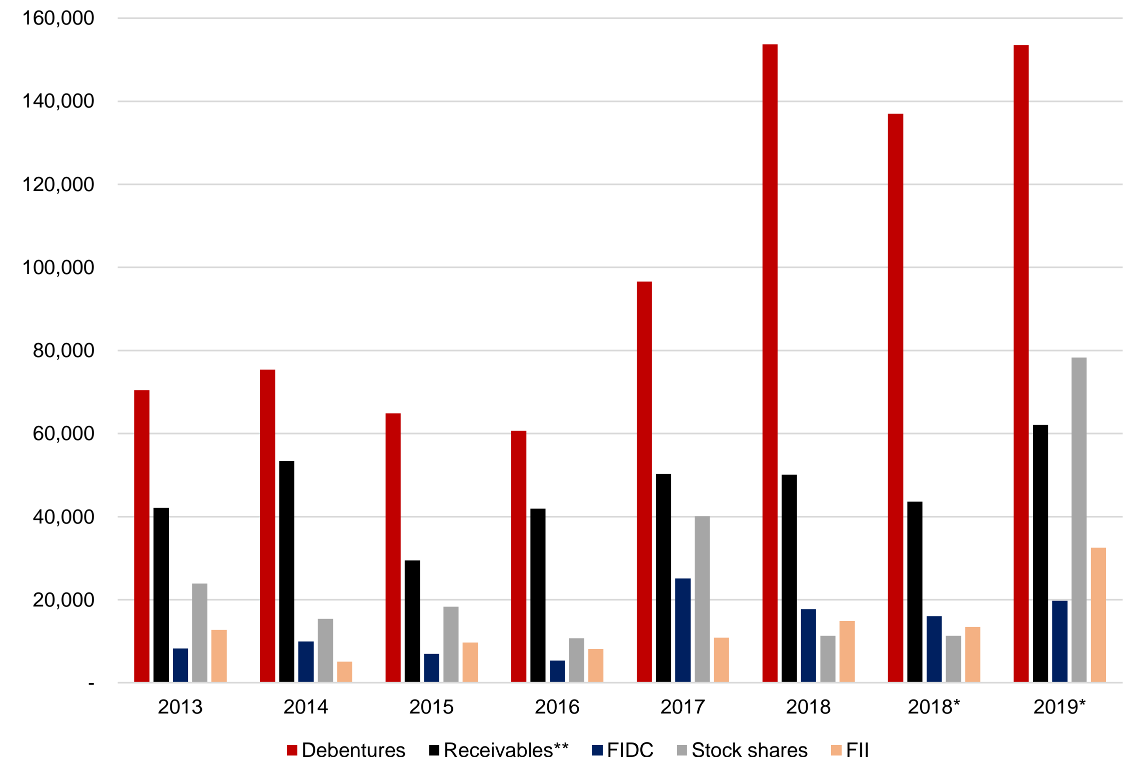


Sources: Central Bank of Brazil and Santander.

Brazilian capital market should continue to deepen, in our view

- ***As firms await tax reform and trade liberalization, we see access to capital markets as key for the business environment in 2020.***

The capital market has as its main objective the allocation of the financial savings of economic agents among assets that encourage an expansion in the country's economic activity. With the reduction of public investment since 2014, especially in the infrastructure sector, alternative sources of short- and long-term financing have become necessary – the capital market has exceeded BNDES annual disbursements since 2016. **With an environment of a lower Selic rate for a much longer period, the room for this market to grow is expanding.** In addition to the development of the incentivized and non-incentivized debenture market, the issuance of real estate risk-linked assets has been extremely strong for the past two years, and this is the sector we believe will develop in 2020. The gradual recovery of economic activity, the Ministry of Infrastructure's concessions agenda, and the continuation of the reform agenda to keep public investment low could boost the sector and, hence, the development of the capital market, in our opinion.



* Issuances from January to November
** Receivables: NC, LF, CRA and CRI
Sources: Anbima and Santander.

Reallocation of domestic assets to stock market expected to intensify in 2020

- ***The exposure of local investors to equities will increase, in our view, as interest rates fall and economic growth accelerates.***

We believe riskier assets, such as equities, should account for a larger share of investors' positions in the coming years. In our view, the low rate "phenomenon" should continue to be a driver of further inflows into equity funds throughout the next several quarters. Assuming that equity funds can return to the level of 12% of the total Brazilian funds industry (currently at 8.2%), ceteris paribus, that could imply inflows of R$202 billion into equities, reaching R$643 billion of AUM (compared to the current R$440 billion of assets under management (AUM) in equities – or +46% higher AUM), according to our estimates. In a more positive scenario, considering that equities could reach 20% of Brazilian total funds' industry AUM (equities reached 14.6%, an all-time high, in 2007), that could imply R$631 billion inflows into equities. For the sake of comparison, there were inflows of R$30 billion and R$66 billion into equities in 2018 and 2019, respectively. In this context, **we reiterate Brazil as Overweight with an Ibovespa target price of 135,000 points for YE2020,** offering 18% total-return potential.

Sensitivity of Equity Brazilian Funds' Industry AUM Relative to Total Funds Industry AUM (1)

	Equities as % of AUM	Total Equities AUM (R$ Million)	Implied Inflows/Outflows to Equities	Total Equities AUM Implied Decrease (%)
Bull Case	**20.0%**	**1,072,154**	**631,281**	**143.2%**
	18.0%	**964,939**	**524,065**	**118.9%**
	16.0%	**857,723**	**416,850**	**94.6%**
	14.0%	**750,508**	**309,635**	**70.2%**
Base Case	12.0%	643,292	202,419	45.9%
	10.0%	536,077	95,204	21.6%
	9.0%	482,469	41,596	9.4%
	8.0%	428,862	-12,012	-2.7%
Current	**8.2%**	**440,873**	**0**	**0.0%**
	8.0%	428,862	-12,012	-2.7%
	7.0%	375,254	-65,619	-14.9%
Bear Case	**6.0%**	**321,646**	**-119,227**	**-27.0%**

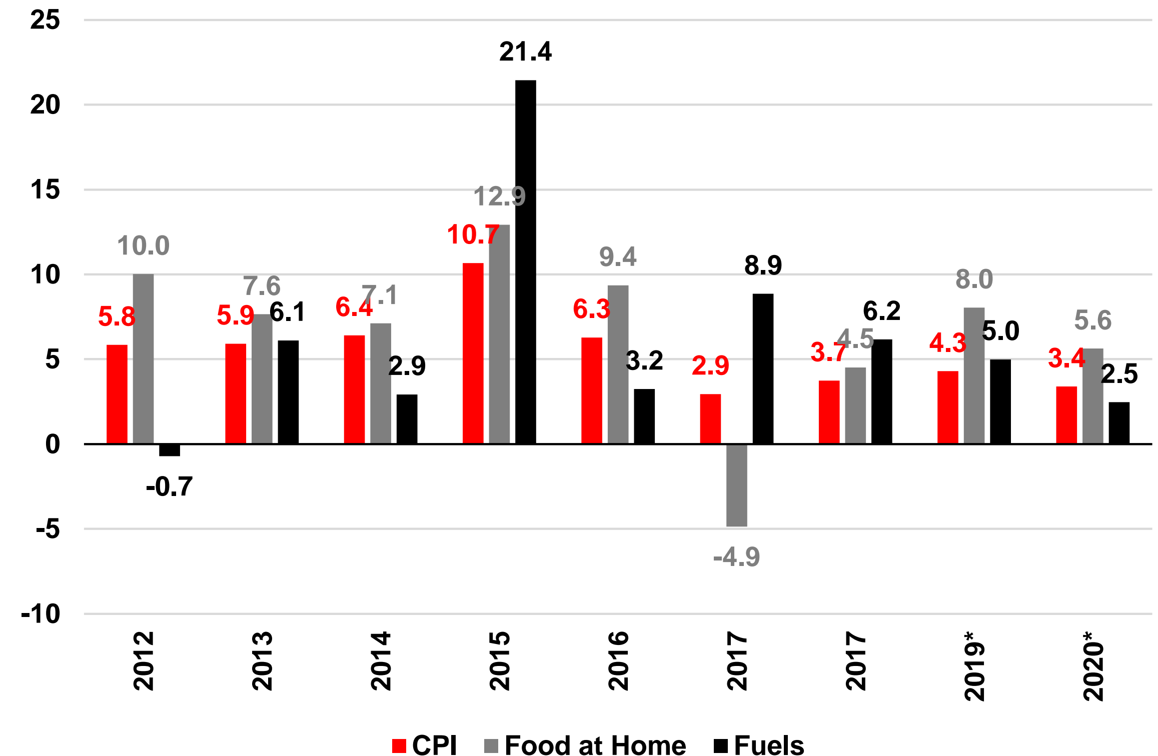
Sources: Anbima, Bloomberg, and Santander estimates.

(1) Note: 2019 data accumulated until the end of November.

Inflation unlikely to be a concern this year, in our view

- ***We expect anchored inflation expectations, high economic slack, flat FX rate, and volatile prices to result in IPCA below the Central Bank's midpoint target (4.0%).***

Despite the significant increase in inflation at the end of 2019 – close to the CMN target (4.25%) – we expect the index to be considerably below the 4.0% target in 2020 (our forecast is 3.4%). **Among the main factors that should underpin the calm scenario, we highlight: (i) anchored expectations and (ii) broad idleness in the economy.** However, some elements of downside and upside risks for this scenario should be taken into account. On the downside, we point out: (i) the non-occurrence of major weather events (neither La Niña nor El Niño is forecast in 2020), which may lead to some relief in the prices of electricity and food; (ii) the record grain harvest expected; and (iii) possible deceleration in the high protein prices observed at the end of 2019, due to partial market normalization. As for the upside risks, we highlight the possible long-lasting shock of higher fuel prices due to geopolitical tensions and possible further pass-through of prices along with the acceleration of economic growth.



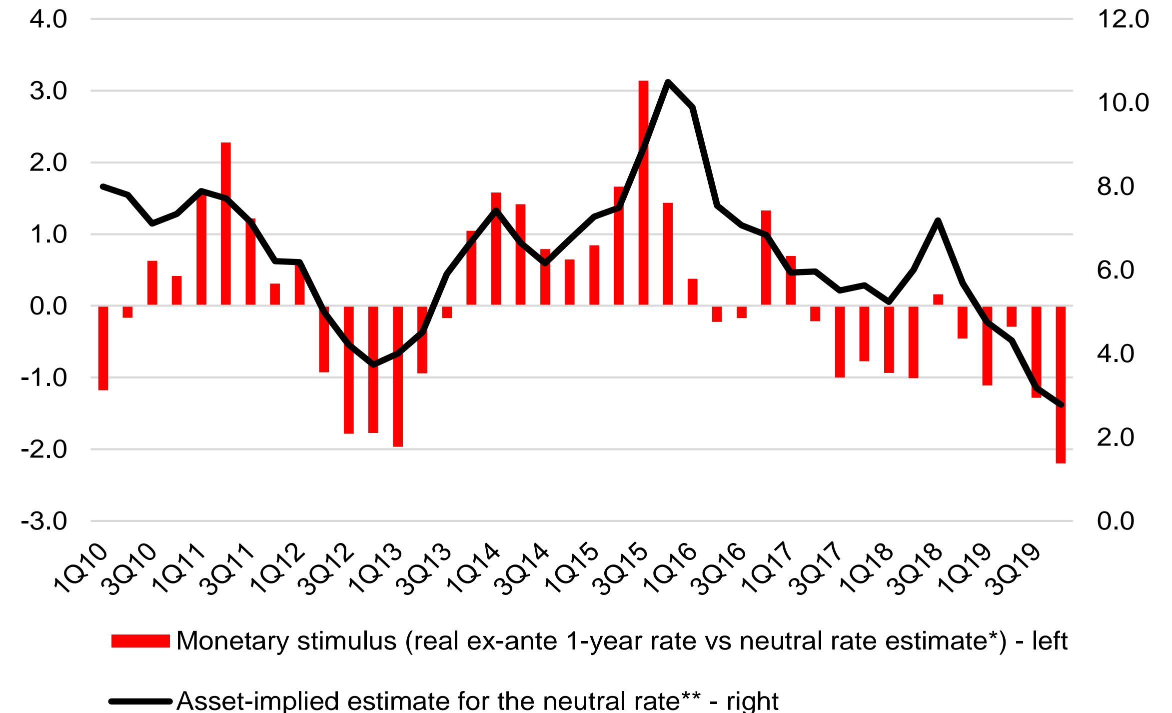
Sources: IBGE and Santander

Monetary stimulus expected to peak in 2020

- ***Monetary policy stance means a good level of accommodation, in our view; better activity implies normalization starting in 2021.***

In 2019 the Copom cut the Selic policy rate by a full 200 bps, taking it to a new historical low of 4.50% p.a. Our scenario projects two additional cuts of 25 bps each this year, leading to a terminal rate of 4.00% for the cycle. We think recent data (especially from activity, whose recovery seems to have gained a little steam) has increased the likelihood that the rate could remain on hold in 1Q20. In any case, we believe the transmission of an expansionary policy stance may continue to gradually kick in during 2020. That is especially the case for the yield curve, which helps determine the financing costs facing firms and households. The ex ante real interest rate[1] has been running below 1% in recent months. Longer yields such as the 5y5y inflation-adjusted forwards – sort of a market proxy for the structural rate – are testing sub-3% levels. All in all, key interest rates stand below estimates for the neutral rate (ours stand near 3%), implying (historically) considerable stimulus. **Yet we continue to anticipate that interest rate normalization will not start until 2021, as the recovery consolidates, the slack wears off, and stimuli become unnecessary.**

Proxies for Monetary Stimulus and Neutral Interest Rate



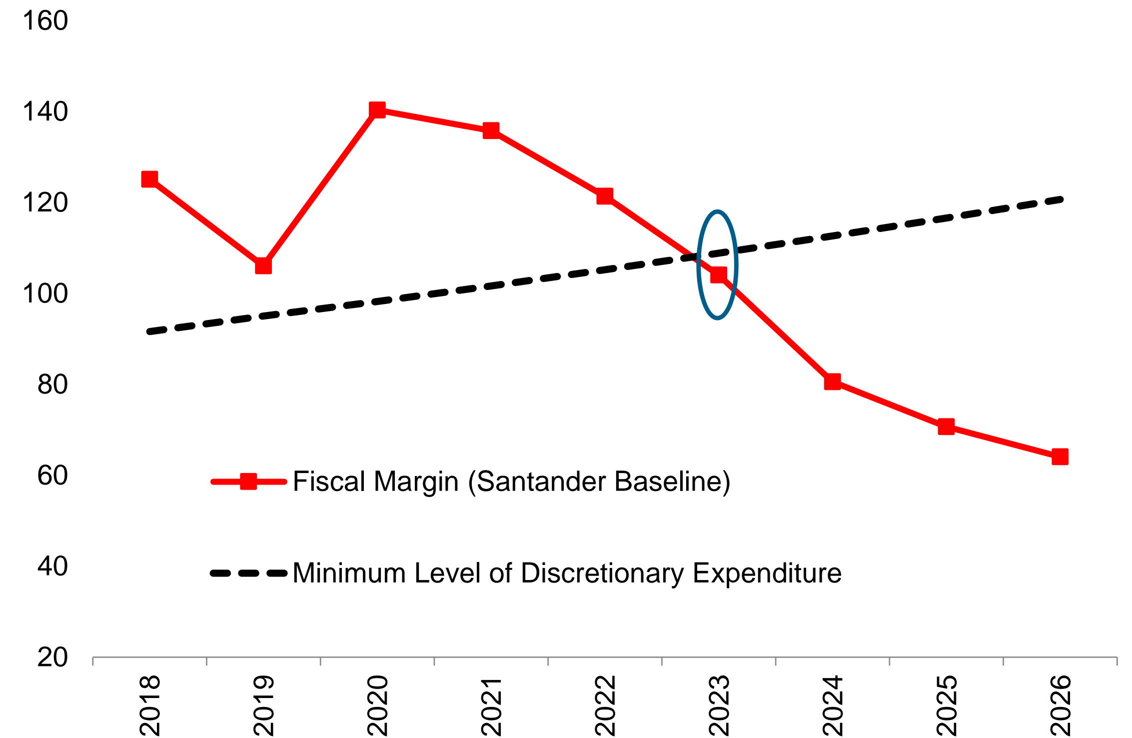
* Santander estimate.
** 5y5y nominal forwards deflated by long-term consensus forecast for IPCA inflation.
[1] Ex ante real interest rate: 1-year nominal swap rates deflated by 1-year ahead inflation forecasts.
Sources: Bloomberg, Brazilian Central Bank, and Santander.

Reform agenda unlikely to be abandoned, in our view

- ***Discussions around the reform agenda will continue, in our view, but we expect few bills to clear Congress this year.***

The adoption, since 2016, of fiscal and parafiscal adjustment measures has contributed to improving the perception of risk regarding the Brazilian economy’s capacity for a balanced and sustained recovery. Following approval of a pension overhaul in 2019, we believe the reform agenda is likely to go forward in 2020. We expect discussions and negotiations on fiscal, regulatory, and productivity reforms in Congress to continue beyond the first half of the year. The municipal elections are not expected to generate (substantial) opposition to such an agenda; that is, we think the electoral schedule is unlikely to create an unfavorable environment for the current economic reform plans. However, we believe **few proposals will be concluded in Congress (approved) by the end of this year,** given the complexity and breadth of the topics. We do expect a diluted version of a fiscal emergency package aimed at containing mandatory expenditures to be approved in 2020, and this is intended to ensure compliance with the spending cap rule by the end of the current presidential term.

Compliance with the Spending Cap Rule (BRL billion)



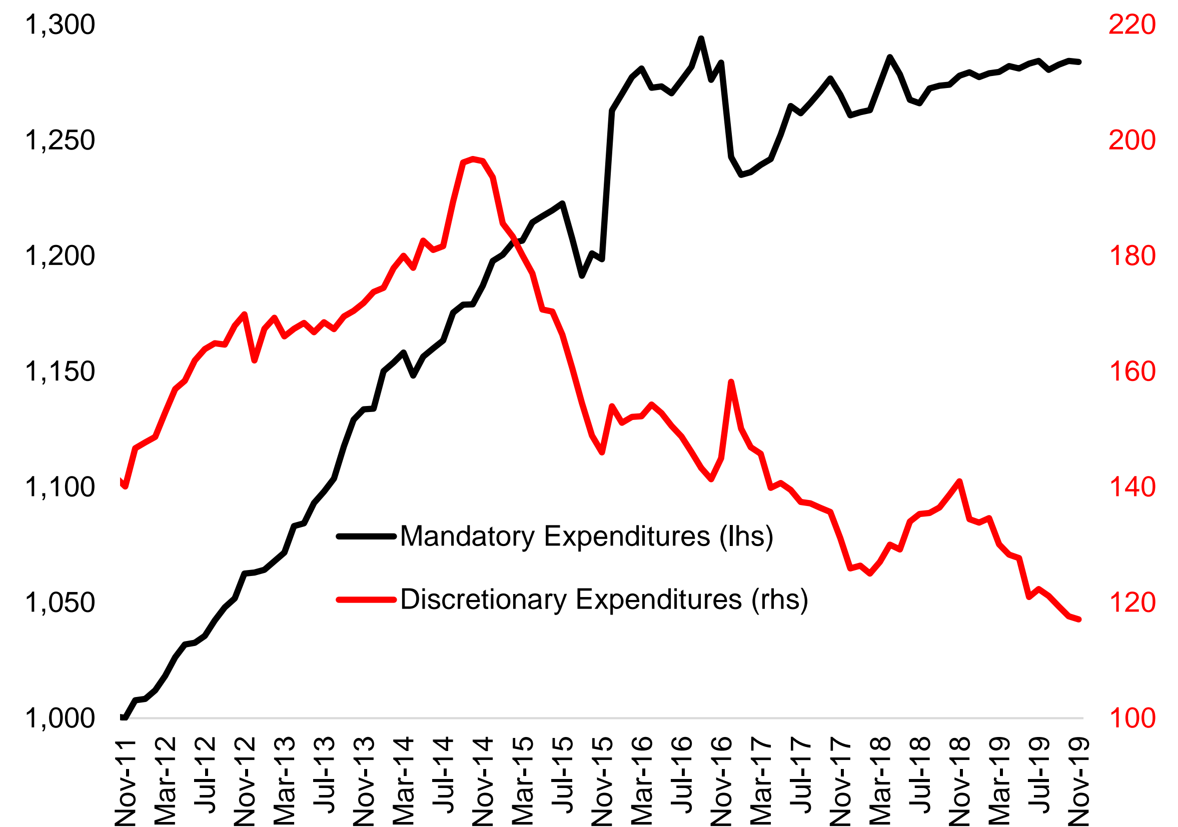
* Fiscal Margin = Spending Cap - Mandatory Expenditure

Sources: National Treasury and Santander.

Concerns about fiscal consolidation may dissipate prematurely, in our view

- ***Structural adjustment of public spending will not be completed by end-2020, in our view, with the benign trend of government debt reducing a sense of urgency.***

Forecasts for the main fiscal indicators have shown improvement in the recent period, especially the expectations for the path of public indebtedness. We believe the sharp decline in the cost of debt rollover – in the wake of much lower interest rates – and a more consistent recovery in domestic activity should lead the gross public-debt-to GDP ratio to peak in 2021 (below 80%), a much more benign scenario than anticipated a few years ago. In addition, the approval of the fiscal emergency measure will enhance the perception of a more favorable fiscal outlook, in our view. However, **Brazilian public accounts will continue to have problems (especially regarding payroll dynamics), which require a structural reform of mandatory spending.** Therefore, in a relatively favorable economic climate, we think the risk of complacency regarding the ongoing need for fiscal reform will increase in the months ahead, opening room for the materialization of significant pressure for more public spending. **Important steps have been taken, but it would be risky, in our opinion, to allow the fiscal adjustment process to fall off the radar.**



Sources: National Treasury and Santander.

Privatization agenda expected to advance slowly

- ***While we expect sales of state-owned assets in 2020, further advances in concessions and privatizations are more likely in 2021 and beyond.***

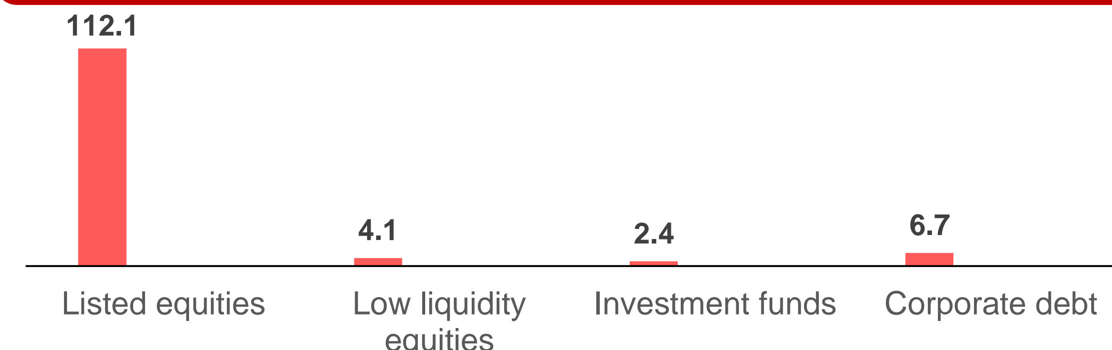
We believe the federal government will keep moving forward under its ambitious guidelines of cutting the size of the state, in an agenda that includes asset sales, privatizations, and concessions/PPPs. However, the bulk of that agenda will require more preparation, political negotiation, and debate in order to materialize. What we believe is more likely to be delivered in 2020, as the most important extension of what was done in 2019, is a continuation of the previous government's plans. **Our base-case fiscal scenario does not take into account revenue from privatizations (e.g., Eletrobras) and other auctions (e.g., oil fields) in 2020. We consider those two events in particular as upside risks that could lead to lower fiscal deficits and a slightly more favorable debt/GDP path.** We see high potential in the government's intention to gradually reduce the asset portfolio of BNDESPar (by around BRL20 bn), with the proceeds used to keep paying down BNDES's debt and reduce the government's gross debt. In addition, we expect the PPP program (PPI) to deliver projects with around BRL21 bn in investments, and state-owned companies should continue to sell non-core assets.

Infrastructure Investment Portfolio (PPI)

Type	Investment (BRL bn)
Airports (22)	5.0
Railways (8)	62.1
Roads (25)	137.9
Ports	4.1
Total	**209.1**

Sources: PPI and Eurasia.

BNDESPar Portfolio (BRL bn market value)



Sources: BNDES and Santander.

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