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Brazil—FX

We're Not in 2002 Anymore (Caution Advised, Though)

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- **Perceptions of Brazil's public sector solvency are, in our view, still highly dependent on expectations regarding the commitment of the next government to a fiscal consolidation agenda.**
- **Although we believe the next president faces strong incentives to maintain responsible economic management and restore market confidence, bringing the BRL back to around 3.50/USD (our year-end forecast), uncertainties and the potential impact of a negative scenario are likely to keep investors worried during the lead-up to the elections.**
- **Improved external fundamentals and the (so far) absence of large foreign currency outflows are important differences from another episode of high pre-electoral market stress, in 2002.**
- **We believe the Central Bank will resume intervening in the FX market only if high volatility leads to poor market liquidity, affecting the supply of foreign currency for hedging or remittance purposes. We do not believe that the Central Bank will target any particular level for the BRL.**
- **With a large output gap contributing to well-anchored inflation expectations in the medium term, we do not believe the Central Bank will have to hike the overnight rate before the elections.**

Figure 1. Brazil, Selected Economic and Market Indicators

	Latest	Aug-02
Current account deficit (% of GDP, last 12 months)	-0.8	-3.0
Current account deficit (USD bn, last 12 months)	15.0	15.3
Foreign direct investment (USD bn, last 12 months)	64.2	20.1
External debt (total, % of GDP)*	32.2	45.3
International reserves (USD bn)	382.4	38.8
International reserves (% of GDP)	*17.9*	*7.7*
Public sector net USD exposure (USD billion)	-175.1 (creditor)	152.7 (debtor)
Gross debt/GDP (%)**	87.3	78.9
Gross debt/GDP (net of international reserves, %)	69.4	71.2
Domestic debt, % of outstanding maturing within 12 months	20.4	42.5
12-month primary budget balance (% of GDP)	-1.3	2.8
CPI inflation (%, last 12 months)	4.3	7.5
One-year fixed rate (%)	7.9	23.3
Selic rate (%)	6.0	18.0
Credit rating (S&P Global)	BB-	B+
Currency - spot return vs. USD, YTD (%)	-19.1	-23.1
5-year CDS (bps)	287	2,843

Market data as of August 27. * Year-end data. ** Year-end data, IMF estimates. Sources: Brazil Central Bank, National Treasury, IIF, IBGE, Bloomberg, Santander.

What's Going On?

Global liquidity conditions are worsening while Brazil is running a primary budget deficit not compatible with a stable debt-to-GDP ratio. That would require an annual surplus of around 2% of GDP, which means that a sizable fiscal adjustment (of around 4% of GDP) is still due. Although mechanisms such as the spending ceiling and the fiscal responsibility law can constrain further fiscal expansion in the short term, the current institutional framework is not immune to bouts of economic populism. A government not committed to orthodox economic management could increase government spending through (i) a constitutional amendment revoking or loosening the spending ceiling; (ii) administrative measures circumventing limits imposed by existing legislation (as observed in the past); (iii) increased investments from state-owned companies and banks; and/or (iv) financial repression, the combination of artificially low policy rates (set by a non-independent central bank) and debt issuance concentrated in short maturities.

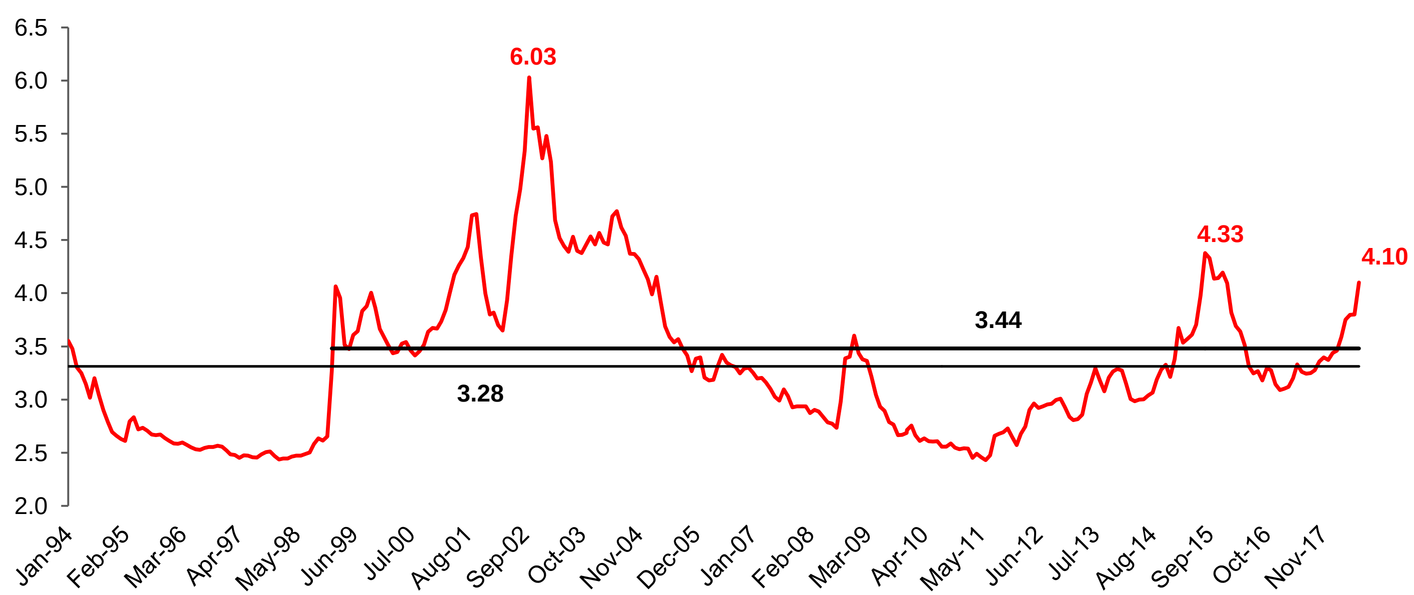
In this context, the market assessment of public sector solvency is, in our view, highly dependent on expectations and credibility, i.e., the president to be elected in October must be perceived as willing and able to keep pursuing a fiscal consolidation agenda. However, the current environment is characterized by extreme uncertainty regarding future political leadership and corresponding economic policies, to the extent that we must recognize that market players have incentives to be prepared for the worst, even if that is not the most likely outcome. The potential upside of investments at current prices, assuming some continuity of the current policies, may be dwarfed by the downside in a scenario of perceived insolvency.

What to Expect?

In our view, whoever wins the October elections will have incentives to keep responsible economic management and restore market confidence, as we have seen in 2002 and 2014. Particularly at this point of the business cycle, following a long recession and a deep process of deleveraging (both external and domestic), with relatively low inflation and stimulative monetary policy, Brazil is, in our view, "fit to grow." Most of the next presidential term may happen under a cyclical economic recovery, which would probably give the next president a good likelihood of reelection in 2022. With that in mind, we see the current level of the BRL/USD exchange rate as well above the one that should prevail after the electoral process.

Figure 2 shows Brazil's real effective exchange rate (versus a trade-weighted basket) at constant August 2018 price. Recent history shows that the currency has traded weaker than the BRL 4.10/USD during only 15% of the time since 1994, meaning, in our view, that the BRL can be considered cheap from this long-term fundamental perspective. Another important aspect is that inflation is currently low and anchored by a wide output gap, so the nominal BRL depreciation translates almost fully into a real depreciation—an important difference from Turkey and Argentina, for example. A weaker BRL should contribute to a narrower current account deficit in the future, counterbalancing the effects of occasional portfolio outflows.

Figure 2. BRL Real Effective Exchange Rate (Aug '18 = 4.10)



Source: Santander estimates based on BCB data.

However, we have to recognize that the scenario of a fiscally less responsible economic management in the next term is not fully out of the picture. The varying probability associated with this "stressed" scenario is being reflected by increased asset volatility, particularly exchange rate depreciation. The campaign for the presidency has barely started, and experience from past elections suggests that a lot can still happen in the next 60 days. Hence, we expect uncertainty to remain high, probably even increasing in the latter part of this period.

So far, it seems that currency derivatives have been the main hedging instrument for equity and fixed income investors, given the historically low interest rate differential and, consequentially, carry cost. (For more information, see our report *Falling Interest Rate Differentials Leading to BRL Weakness*, March 28, 2018.) This may lead to the BRL performing relatively worse than bonds and equities in the pre-election period.

Fundamentals as a Buffer for FX Depreciation

In our view, there are currently important buffers that should play a role in preventing the BRL from reaching new lows in real terms.

- External indicators are quite solid. Net external debt to exports ratio is at its lowest level since 1960.
- FDI is currently running well above the current account deficit. This means a strong position in terms of the ability to generate foreign currency to service external debt.
- Brazil's public sector is a net creditor in foreign-currency-denominated instruments. This means that (i) a BRL depreciation reduces the net public sector debt to GDP ratio and that (ii) the ability of the monetary authority to intervene is still considerable. (For more information, see our report, *Lethal Weapon: How Far Can the BCB Go with Swaps?* June 15, 2018.)

Figure 3. Foreign Direct Investments and Current Account Deficit (12-month rolling, USD billions)

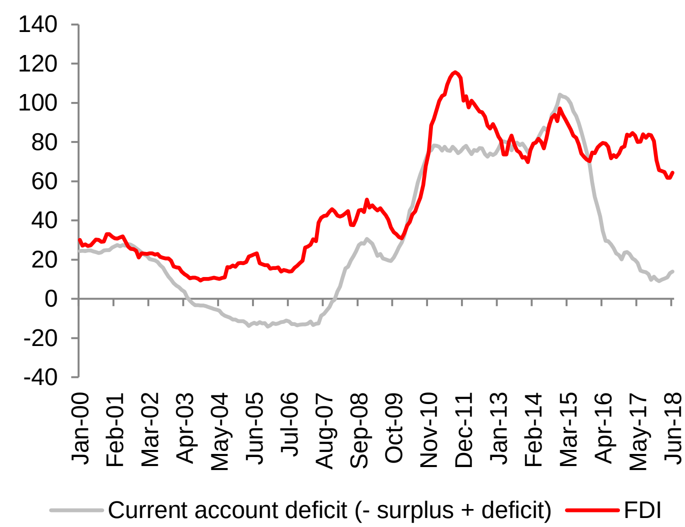
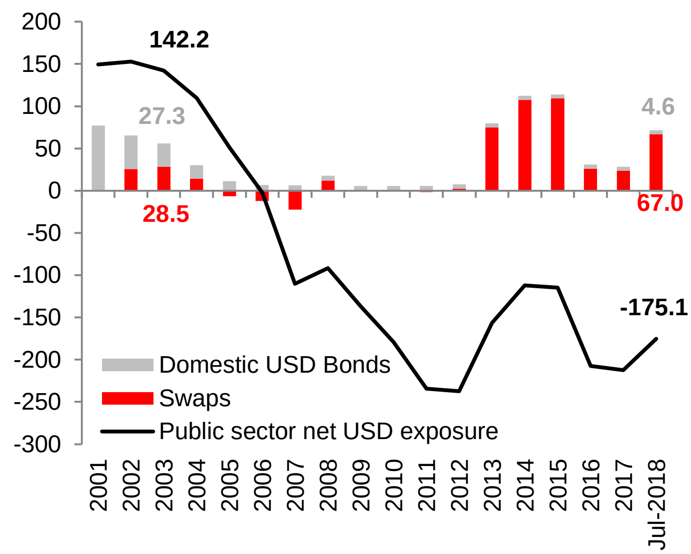


Figure 4. Public Sector USD Exposure (USD billions)



Source: Brazil Central Bank.

With that in mind, it is possible to see a marked qualitative difference between current pressure on the BRL and that experienced in 2002. It seems that the current excess demand for USD has been concentrated predominantly in derivatives, instead of in hard currency (as in 2002). FX flows data illustrate that, despite the substantial depreciation, the current episode has (so far) not been driven by massive capital outflows. (See Figure 4.) Other evidence of that is the dynamics of the spread between *cupom cambial* (onshore USD rates, a fairly liquid market used by domestic players as a hedging instrument, since the BRL is not a convertible currency) and USD LIBOR rates. In contrast to 2002, that spread has been trading at relatively low levels, an indication, in our view, that there are no major imbalances between the markets for cash USD and BRL-settled derivatives. (In other words, cross-border risk has been perceived as low.)

Figure 5. Net FX Flows (five-day rolling, USD billions)

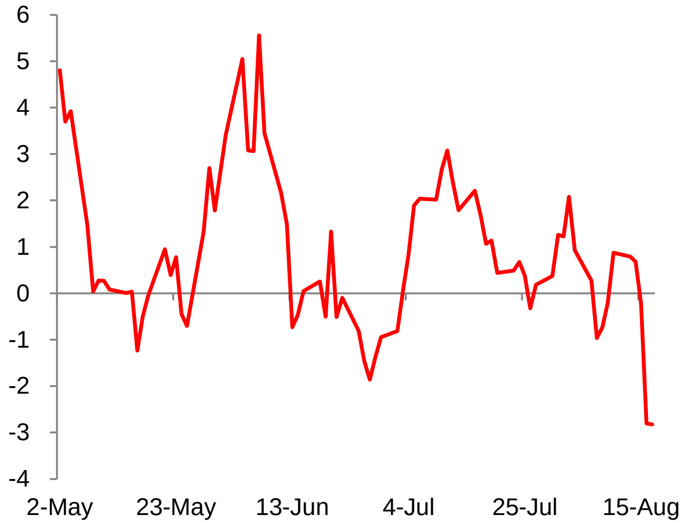
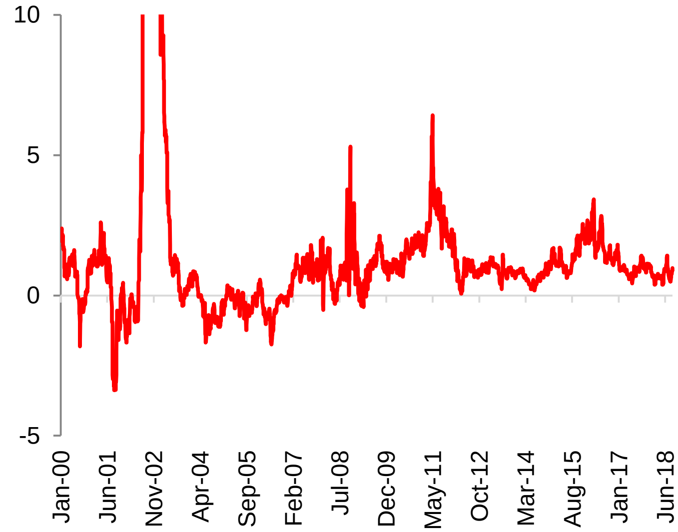


Figure 6. Onshore ("Cupom Cambial") – Offshore (LIBOR) Three-Month USD Rates Spread (%)



Sources: Brazil Central Bank, Bloomberg, Santander.

The Role of the Central Bank

The Central Bank (BCB) has been out of the market (i.e., not adding to the outstanding amount of FX swaps) since June 22. We believe that recent interventions have not been led by any particular level of the BRL/USD rate but by a subjective perception of the FX market "functionality". In our view, BCB will resume selling FX swaps only if market players are not able to keep the market liquid, either because of increasing volatility or because of large outflows/demand for hedging. Under these conditions, we believe BCB will allow the BRL to float, even knowing that a weaker BRL may cause inflation expectations to deteriorate.

We believe that inflation expectations and model forecasts are little affected by short-term FX fluctuations—the change in the currency level needs to be perceived as reasonably permanent to raise estimates of future inflation. Moreover, medium-term expectations seem to be well-anchored, still relying on a wide output gap. We think it is unlikely that the Central Bank will have to hike rates before the elections (at the September 19 meeting), and we still see 2018 and 2019 inflation rates below the target midpoint. (See our report *The Power of Trade-Off*, August 2, 2018, for our recently updated forecasts.)

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