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Brazil – Macro Scenario

President-elect Trump: What Now for Brazil?

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- **Trump's victory does not have immediate implications for our Brazil baseline economic scenario, although it adds uncertainty and widens the specter of possible negative outcomes, in our view.**
- **In the short term, we believe that the main consequences for Brazil of Trump's victory will manifest if markets remain volatile and increasingly risk adverse. We believe that prolonged instability and persistent BRL weakening could influence Brazil's Central Bank to adopt a more cautious stance with respect to the ongoing monetary easing cycle; although, in our view, the effects of a wide output gap are more important for inflation and the monetary policy outlook.**
- **A persistent increase in global risk premia could also jeopardize the investment-led recovery we anticipate for Brazil in 2017.**
- **Over the medium term, in our view, the key variables are the Federal Reserve's monetary policy stance and the reaction of the U.S. yield curve. Brazilian rates are particularly sensitive to U.S. gyrations, and external funding is fundamental to many large Brazilian companies.**
- **Changes in the U.S. trade policy are unlikely to hit Brazil hard, in our view, as the country does not particularly depend on exports to the U.S. as a source of hard currency or economic growth.**
- **Brazil, in our opinion, should be one of the countries least affected by a retraction in global trade, given its relatively small share of merchandise trade in aggregate income.**

Fundamentals - A Brave New World

Donald Trump's victory in the U.S. presidential election appears to have had a less intense impact on markets than initially expected. Nevertheless, we see important, although not drastic, consequences for the fundamentals of the global economy.

1) Considering that the outcome of the election was far from fully priced in by asset prices, a **higher degree of risk aversion** should be expected. Furthermore, we believe that a more volatile environment may not be limited to the short term and could last as the new administration's main economic policy guidelines (foreign, fiscal and monetary) are being established. The ultimate impact could depend upon the degree to which Trump moderates his policies vis a vis his campaign speeches.

2) Based on statements made during his campaign, we expect a **looser fiscal policy** to be pursued. We also expect increased fiscal deficits, due to a combination of higher spending and tax cuts. According to a September 26 2016 *Wall Street Journal* article ("Donald Trump Would Boost Debt More Than Hillary Clinton, Report Says"), planned fiscal tax cuts could amount US$6 trillion over the next decade, drastically increasing the risk of a poor debt-to-GDP dynamic.

3) **Monetary policy** could also be biased toward a looser stance, in our view, at least in the short term, and the more uncertain economic environment could lead to a reduction in the likelihood of a rate hike in December. Moreover, it is hard to see current chairman Janet Yellen remaining after the end of her current term in February 2018, which adds a

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layer of uncertainty to the future orientation of Fed policy. Lastly, a temporarily dovish monetary policy could spur the buildup of inflationary pressures, thus leading to a call for higher interest rates in the future.

4) As the British vote to leave the EU already signaled, the U.S. (and the world) seems to be about to enter a period of **more protectionist foreign policies**. During his campaign, Mr. Trump already pledged to label China as a currency manipulator, reject the Transpacific Partnership (TPP) and renegotiate NAFTA. We believe that Congress is also likely to refrain from passing further free trade deals.

Asset Prices

1) Although the outlook for global growth may be ambiguous in the short term (higher risk aversion vis a vis looser fiscal and monetary policies), we believe that **equity price** indexes in the U.S. would be negatively affected by increased protectionism, as companies would face lower profits and efficiency related to restrictions on imports. Moreover, we believe that the outlook for global growth from a longer-term perspective would be damaged as a result, leading to a less optimistic outlook for inflation and global trade.
2) In terms of **Treasury yields**, we believe that the outcome of the election will weigh on longer-term USTs, favoring bear steepening positions, as looser economic policies in the short term increase the probability of higher inflation in the future. Moreover, we believe that the risk of potential tensions with China must also be considered, which could lead to a reduction in USD holdings by that country (China currently holds US$1.2 trillion in U.S. Treasuries).
3) The impact of a Trump administration on **commodity prices** will likely be more ambiguous, in our view. We expect **gold** to be gain favor, as the demand for safe haven instruments increases, while we expect agricultural prices to be negatively affected in the medium term by increased protectionism and a more difficult environment for China. We find it much more difficult to see a net impact on the demand-supply balance for industrial and energy commodities, although statements made during Trump's campaign incline us to believe that his administration could ease restrictions on the exploration of U.S. energy reserves, thereby significantly increasing the supply of fossil fuels.
4) With respect to **FX**, the USD has weakened significantly, as the market reaction appears to perceive a Trump presidency as reducing risk appetite. Hence, non-USD safe havens, the EUR, CHF and, in particular, the JPY have rallied. The biggest currency loser has been the MXN, with some spillover to other emerging currencies. Over the long term, we believe that valuations will depend on future U.S. monetary and fiscal policy decisions, as highlighted above.

Brazil

Over the short term, the main risks to our scenario stem from market reactions (although it is still way too early to call any trend reversal):

1) If the BRL continues to weaken, we believe that the Central Bank could weigh in the effects on inflation in its future rate decisions and act more conservatively during the ongoing easing cycle. Nevertheless, we believe that the wide output gap will dominate the effects of a depreciating exchange rate and continue to provide ample space for interest rate cuts throughout 2017, toward a single-digit Selic (for more details, see our October 19 report, *On the Way Back to Single-Digit Rates*).
2) For the next Copom meeting (on November 30), we acknowledge that the persistence of market volatility and a weaker BRL could reduce the probability of a more rapid pace in monetary easing (from 25 bps per meeting to 50 bps per meeting), per our call.
3) A persistent reduction in global risk appetite and consequent widening in credit spreads presents a risk to our investment-led economic recovery scenario in Brazil (for more details, see our September 13 report, *Climbing Out of the Hole: The End of the Recessionary Cycle*); however, this could be mitigated by a looser-than-expected monetary policy in the U.S., as aforementioned.

Over the medium/long term, we see the following potential developments:

1) The main risk for Brazil stability is, in our view, a significant change in how U.S. monetary policy is conducted should Chairman Yellen resigns or is not reappointed in 2018. According to a recent IMF study[1], Brazil is the Latin American country that would be more affected (through a rise in domestic interest rates) by an increase in U.S. 10-year rates, a scenario that could materialize if Yellen's successor is perceived as hawkish. Higher USD rates would also be negative

[1] To Hike or Not to Hike? Monetary Policy in Latin America During Fed Liftoff, Carlos Caceres, Yan Carrière-Swallow, and Bertrand Gruss, *IMF Regional Economic Outlook: Western Hemisphere* (2015)

for investments in Brazil, affecting the cost of capital of companies that rely on external funding and the relative attractiveness of returns in BRL.

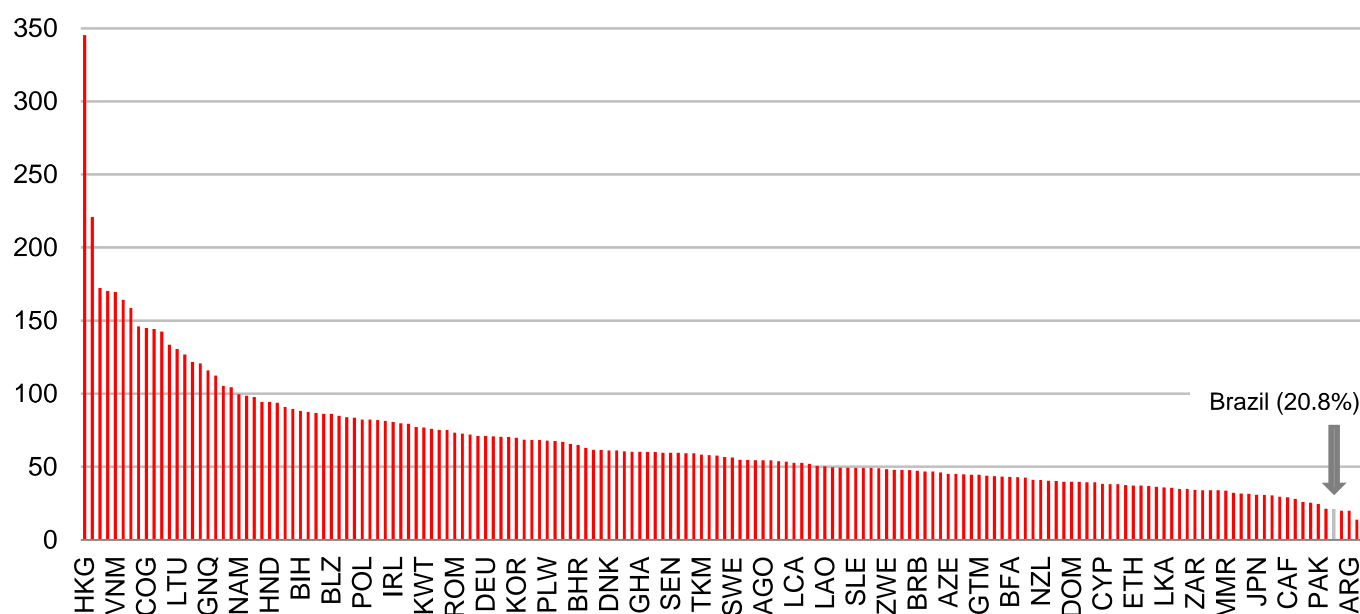
2) An increase in term risk premium in the U.S. because of a more lax fiscal policy would have similar effects, in our view, potentially also contributing to a negative global environment for fiscal consolidation and austerity policies in general and pressure for deficit spending. This would be detrimental to the Brazil government's current agenda.

3) The BRL would also be negatively affected by an environment of higher U.S. rates, in our view. In terms of trade flows, the main effect would indirect, dependent on whether China decelerates and/or reduces imports of Brazilian products. Our current 2017 year-end forecast (BRL/USD at 3.65) already takes into account a riskier external environment (see our report *Once Again, the External Factor* for more details) and limited upside potential from improvements the domestic scenario, so we believe it still adequate.

4) Changes in external trade with the U.S. are likely to have limited impact to Brazil's aggregated growth, in our view. In 2015, Brazil exported US$27 billion in goods to the U.S., a little more than 1.5% of Brazil's GDP. Exports were mainly mineral fuels (US$2.9 billion), aircraft (US$ 3.0 billion), iron and steel (US$ 2.9 billion), articles for repair and returns (US$ 2.6 billion), machinery (US$1.7 billion) and unroasted coffee (US$1.3 billion)[2].

5) We also believe that Brazil should also be only slightly affected, relatively, by a potential retraction in world trade, as it is one of the least exposed countries to international trade (see chart below).

Figure 1. Merchandise trade, % of GDP (2015) – sample of 167 countries



Source: World Development Indicators.

[2] Data from the Office of the United States Trade Representative.

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