

Brazil—Macro Forecasts**Unusually Low Risk Aversion Triggers a More Bullish Scenario in the Short Term**

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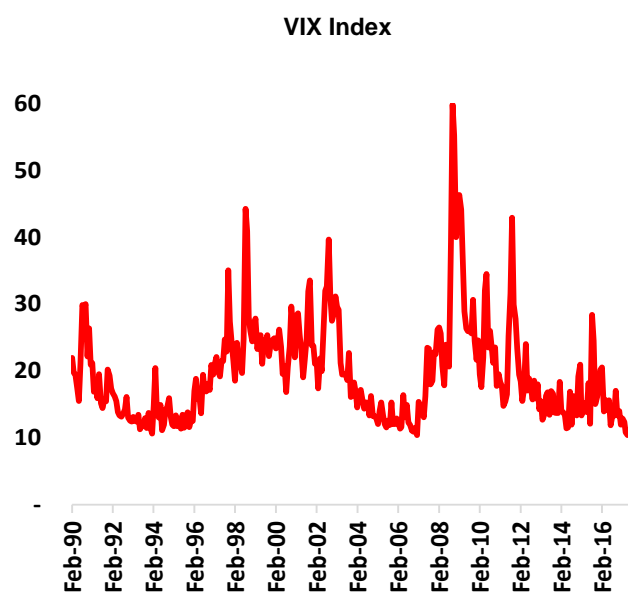
- So far this year, global financial markets have experienced a quite unusual period of low volatility.
- In our view, this has been the most important factor behind the failure of our bearish call for the BRL during the year.
- We are still not convinced that this low-volatility environment will improve further or even remain favorable for long, on either the external or the domestic front.
- However, we have incorporated the assumption that the current benign environment will probably continue to be an important driver for Brazilian assets in the very near term.
- Therefore, we are revising our forecast for the BRL at YE2017 from BRL 3.50/USD to BRL 3.20/USD, closer to the current level.
- For next year, a less favorable set of assumptions may prevail, in our opinion, which would lead to a non-negligible depreciation of the currency, in our scenario, toward BRL 3.50/USD at YE2018 (revised from 3.84/USD).
- We are also revising downward our 2017 inflation forecast to 3.8% from 4.2% and our year-end Selic forecasts for both 2017 and 2018 to 7.5% from 8.5%.
- According to our models, a neutral interest rate in Brazil may be somewhere between 3.5% and 5.5%. The ample slack existing in the economy (in terms of both unemployment and capacity utilization) indicates, in our view, that interest rates could slide below neutral and remain there for one or two years.
- Finally, we have adjusted our GDP growth forecast for 2017 to 0.5% from 0.7% and our forecast for 2018 to 2.5% from 3.0%.

“Mare Tranquillitatis”

So far this year, global financial markets have been experiencing a quite unusual period of low volatility, despite all the noise surrounding geopolitics and uncertainties related to monetary policy in the US. Accelerated global growth, coupled with still tamed inflation and wages, has been sustaining strong valuations for risky assets and virtually stable yields in developed economies. **In our view, this has been the most important factor behind the failure of our bearish call for the BRL during the year.**

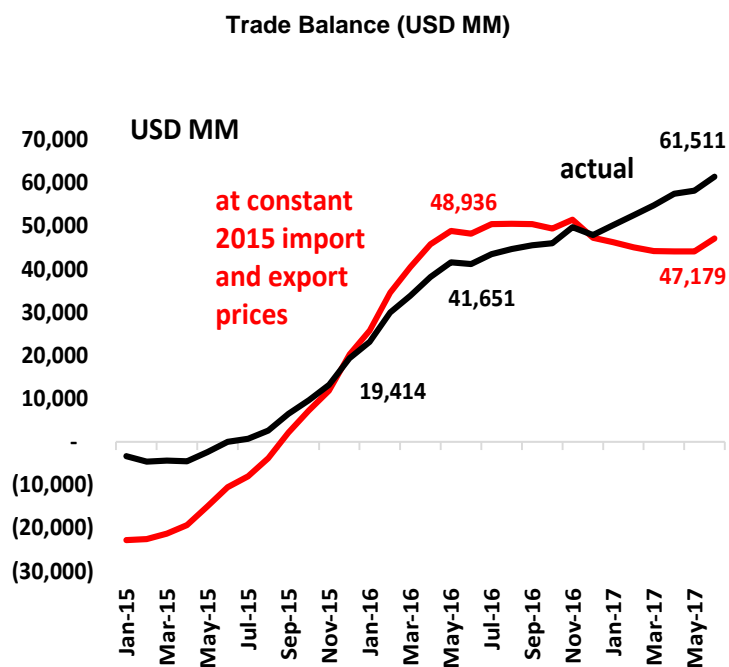
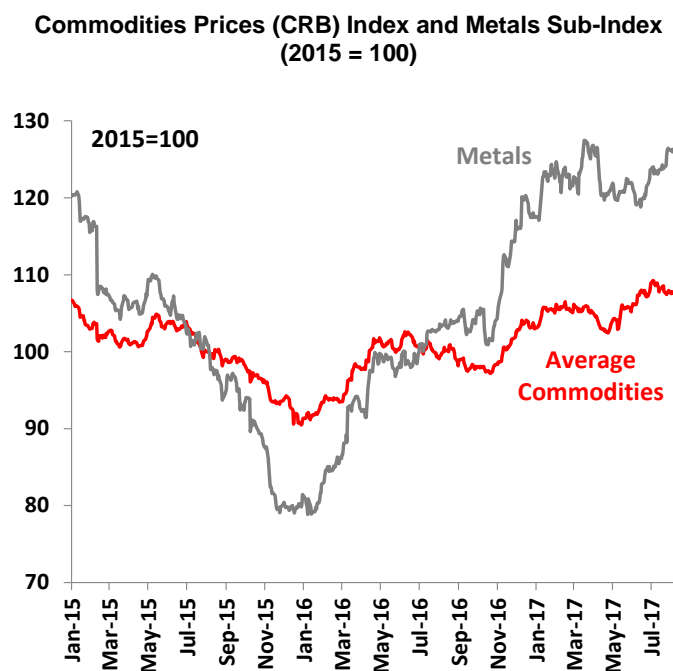
The following figures show the evolution of the VIX (the weighted average of implied volatilities for a sample of option strikes for assets traded in the Chicago Board Options Exchange), which could be seen as a proxy for global risk aversion and the performance of the DXY (the USD value against a basket¹ of six important currencies). **The VIX is indicating that near-term expected volatility is among the lowest since this measure began to be calculated.**

¹ Euro (EUR), 57.6%, Japanese yen (JPY), 13.6%, Pound sterling (GBP), 11.9%, Canadian dollar (CAD), 9.1%, Swedish krona (SEK), 4.2%, and Swiss franc (CHF), 3.6%.



Source: Bloomberg

The external factor seems to have prevailed by anchoring risk premiums and sustaining the prices of commodities, particularly iron ore (the product with highest weight among Brazilian exports, at 10% of the total). The following charts illustrate the evolution of metal-related commodities prices and the resulting impact on Brazilian external accounts, through the impact of terms of trade on the trade balance. If average prices for imports and exports had remained stable since 2015, the trade balance would likely be trending down, in our view, in contrast to the recurrent improvement of last two years.



Source: Bloomberg.



Moreover, we believe the market's assessment of domestic fundamentals has also become more favorable during the year. Apart from the temporary impact of political turmoil in Brazil in the last few months, we believe asset prices are implying favorable prospects for the elections in 2018 and the evolution of structural reforms. In our opinion, an interesting indication of existing complacency regarding fiscal risk can be seen in the absence of an impact on asset prices from the fiscal target revisions and the postponement of social security reform.

Priced for Perfection?

We are still not convinced this benign environment will improve further or even remain as favorable for long, on either the external or the domestic front. Among other factors, we still expect (1) strong demand and low unemployment in the US to put pressure on wages and call for a faster monetary policy normalization process, (2) the current fiscal tightening and credit restrictions in China to reduce its activity and its demand for raw materials, (3) geopolitics and protectionism to be a source of additional volatility for financial markets, and (4) Brazilian assets to incorporate a more cautious stance on fiscal dynamics and on the expected evolution of reforms.

However, we have incorporated the assumption that the current benign environment will probably continue to be an important driver for Brazilian assets in the very near term. Therefore, we are revising our forecast for the BRL at YE2017 from BRL 3.50/USD to BRL 3.20/USD, closer to the current level. For next year, a less favorable set of assumptions may prevail, in our opinion, which would lead to a non-negligible depreciation of the currency, in our scenario, toward BRL 3.50/USD at YE2018 (revised from 3.84/USD).

The Age of Low Inflation and Interest Rates

After a (short) period in which the BCB maintained that concerns about uncertainties related to the political environment would restrict a faster adjustment of the Selic, the prevailing “sea of tranquility” (which we now expect to characterize financial markets in the short term) should allow monetary policy to be more aggressive for the rest of this year. Moreover, even the BRL depreciation that we expect to materialize next year may not be enough to threaten the 4.5% inflation target. Therefore, **we are revising downward our 2017 inflation forecast to 3.8% from 4.2% and our Selic forecasts for both YE2017 and YE2018 to 7.5% from 8.5%.**

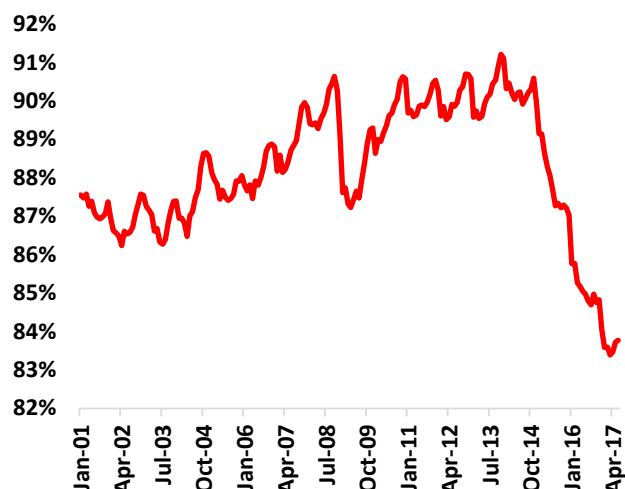
According to our models, a neutral interest rate in Brazil may be somewhere between 3.5% and 5.5%. The ample slack existing in the economy (in terms of both unemployment and capacity utilization) indicates interest rates could slide below neutral and remain there for quite some time. Our 7.5% forecast for the Selic for both YE2017 and YE2018, compared with consensus inflation expectations converging toward 4.25% (the target for 2019), results in a real rate around 3%, easily sustainable for the next 24 months, in our view.

We believe the most likely alternative strategy for policymakers, however, would be to undershoot the neutral level more aggressively in the short term, adjusting the base rate upward if necessary by the end of 2018 or the beginning of 2019. This means the risk to our Selic forecast is biased to the downside.

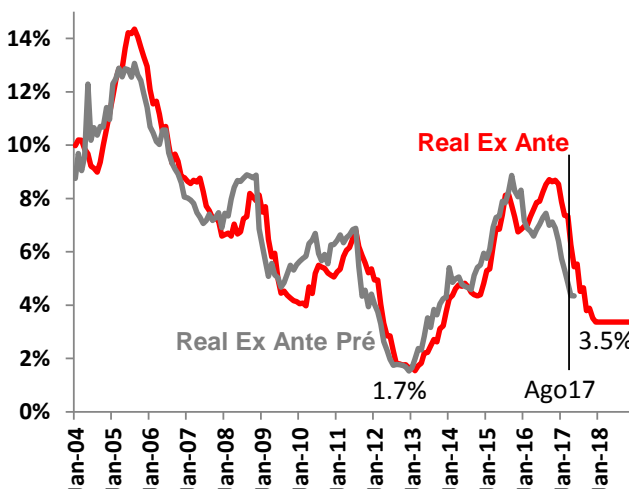
The following charts show a measure of slack, composed of the average between capacity utilization and employment (as a percentage of the labor force) and the expected dynamic for real ex ante (deflated by inflation expectations) interest rates in Brazil.



Slack (Production Factors Utilization)
Average of Employment/Labor Force and Capacity Utilization



Real Interest Rate
Selic and 1 year Swap Deflated by 12 Months Ahead Expectations



Sources: Brazilian Central Bank, FGV, and IBGE.

A Final Note on Revisions

We are also adjusting our forecasts for GDP growth in order to incorporate the evolution of recent data, which shows that investments have not recovered at all since the beginning of the year. In contrast, consumption seems to have improved in the second quarter, as expected, due to the release of funds from FGTS accounts to households and the favorable impact of falling inflation on income.

We have revised our GDP growth forecast for 2017 to 0.5% from 0.7% and for 2018 to 2.5% from 3.0%.

The following table summarizes the changes in our forecasts.

Change in Forecast

	2016	2017f	2018f
GDP Growth (% yoy)	3.6%	0.7% 0.5%	3.0% 2.5%
BRL / USD (eop)	3.26	3.50 3.20	3.84 3.50
Selic (% eop)	13.75%	8.50% 7.50%	8.50% 7.50%
IPCA (% yoy)	6.3%	4.2% 3.8%	4.2%

Source: Santander.



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