Cyclical position of the economy is conducive to growth if there is progress on the reforms agenda

- The cyclical position of the Brazilian economy creates favorable conditions for a recovery. Inflation and interest rates are low; households and businesses are less leveraged; the trade deficit has decreased; and there is significant excess capacity in the labor market and the industrial sector. In addition, credit and the capital market are starting to see more consistent growth and even job creation has delivered positive surprises in recent months. Based on these developments, it is possible to say that, if there is progress on the economic reforms – especially on the fiscal and growth-enhancing agendas –, it is likely that the improvement in financial conditions seen in recent months, such as the decline in interest rates, exchange rate appreciation, lower country risk levels and a surge in the stock market, will translate into higher growth.

- In our view, the 2019 reform agenda is more significant to determine the price of Brazilian assets in the short term – especially the country risk and exchange rate. In a reforms environment, the exchange rate could appreciate more and monetary normalization could occur at some point during the first half of 2019, or be pushed back, depending on the degree to which reduced fiscal uncertainty is able to drive investments and economic growth.

- When revising our base macroeconomic scenario, we made only minor adjustments to reflect the recent improvements in financial conditions and risk premiums. We kept our 2018 growth forecast at 1.1%, but upgraded the 2019 forecast from 2.5% to 2.8% due to improvement in financial conditions. In the same vein, we revised our December 2018 and 2019 exchange rate forecasts to BRL/USD 3.70, incorporating the effects of recent movements (with improvements in risk premiums and terms of trade). In our inflation projections, we believe that the effects of higher GDP growth and a more appreciated exchange rate offset each other. Therefore, we have kept our inflation forecast at 4.4% for 2018 and 4.25% for 2019, reflecting a more balanced risk assessment and some downward bias for 2018. In the same vein, we left the interest rate normalization scenario unchanged for 2019.

Global instability likely to continue

- The external scenario has become more challenging in recent months, with increased risk aversion and a downgrade to the 2019 growth forecast, despite the significant recovery of assets in some countries with idiosyncratic responses to the negative shocks of the first semester (Argentina and Turkey).

- In the United States, we expect the monetary policy normalization process led by the Federal Reserve to continue for a while, disrupting some of the global liquidity that helped sustain asset prices in recent years. We predict that the Fed will deliver one more 0.25% hike in 2018, followed by two additional increases in 2019 – in line with market expectations. In Europe, the final stages of negotiations on the United Kingdom’s withdrawal from the European Union could lead to renewed tension. There is also the ongoing clash between Italy and the European Commission on the 2019 budget. In China, the economy has been slowing down since the end of the first quarter, which has led the government to respond with a stimulative fiscal and monetary policy.

- This environment will most likely persist in the coming months, with a gradual reduction of global liquidity, increased trade and geopolitical tensions (particularly between the U.S. and China), and potential political instability in Europe and the Middle East.
Cyclical position of the economy is conducive to growth if there is progress on the reforms agenda

The cyclical position of the Brazilian economy creates favorable conditions for growth recovery. Inflation and interest rates are low; households and businesses are less leveraged; trade deficit has decreased; and there is significant excess capacity in the labor market and the industrial sector. In addition, credit and the capital market are starting to see more consistent growth and even job creation has delivered positive surprises in recent months. Based on these developments, it is possible to say that, if there is progress on the economic reforms—especially on the fiscal and growth-enhancing agendas—it is likely that the improvement in financial conditions seen in recent months, such as the decline in interest rates, exchange rate appreciation, a lower country risk rating and a surge in the stock market, will translate into higher growth.

Brazil has great challenges ahead, starting with the need to regain control of its public finances and bring the debt-to-GDP ratio closer to the emerging market average over the long term. Social security reform is part of the fiscal agenda, along with other measures aimed at ensuring compliance with the spending cap. The proposals for achieving higher levels of productivity in the economy include restoring solvency to public finances, tax simplification, reducing red-tape, a more favorable business environment, greater budgetary flexibility and increased trade integration. If this agenda is successfully implemented, the country could experience faster economic, labor market and wage growth in the next few years. When revising our base macroeconomic scenario, we made only minor adjustments to reflect the recent improvements in financial conditions and risk premiums.

We kept our 2018 growth forecast at 1.1%, but upgraded the 2019 forecast from 2.5% to 2.8% due to improvement in financial conditions. On the positive side, we highlight: (i) surprises with the short-term data, suggesting third-quarter GDP growth of approximately 0.5% (up from our previous forecast of 0.3%); (ii) tighter country risk spreads and exchange rate appreciation, bringing financial conditions back to an expansionary level—albeit still below the levels seen in the beginning of the year. On the short-term data, we highlight the positive surprises with retail sales and the volume of services in August, both of which increased on the margin. In addition, the IBC-Br (a monthly GDP proxy) remained on an upward trend, rising 0.47% from July to August. In the same sense, labor market data have improved in the quarter, with Caged showing positive formal job creation and a slight decline in the unemployment rate, reflecting an increase in the number of self-employed workers.

Chart 1: IBC-BR, seasonally adjusted
On the other hand, there are two negative factors affecting our outlook: (i) the prospects of recession in Argentina; (ii) the fiscal challenges facing states and the absence of expansionary effects such as FGTS and PIS. In our view, the positive factors – particularly tighter risk spreads – will prevail; therefore, we have upgraded our GDP forecast for next year. However, it is important to note that the improvement in financial conditions and risk premiums depend on the implementation of reforms that will address the main challenges facing the country.

In the foreign exchange market, the BRL appreciated this past month. The exchange rate eased from BRL/USD 4.10 in September to BRL/USD 3.70 in October, despite a still challenging environment for emerging markets, which included rising risk premiums and an outflow of portfolio investment. The BRL was once again performing more in line with external account fundamentals, coming down to levels closer to those of its commodity-exporting peers. Another highlight was the significant increase in terms of trade in October, which also contributed to the appreciation of the BRL, albeit to a lesser extent than the decline in risk premiums. External accounts remain solid, with a low trade deficit, high levels of foreign direct investment and a jump in foreign debt rollover rates in recent months, allowing the Brazilian economy room to accelerate growth without generating external restrictions. Therefore, we have revised our December 2018 and 2019 exchange rate forecast to BRL/USD 3.70, incorporating the effects of recent movements. External accounts fundamentals still suggest that the "fair value" of the BRL is below BRL/USD 3.70 despite heightened global uncertainty, but these levels depend on increased allocation from foreigners and the progress of the reforms agenda.

Chart 2: BRL vs. currencies of commodity-exporting countries - base 100 = 01/01/2018

Source: Bradesco, Bloomberg

On the inflation side, we see an improvement in the balance of risks to the scenario, which has become more symmetrical. The appreciation of the BRL to close to BRL/USD 3.70, the fall in the price of oil (WTI) to below USD 70/barrel, a less-than-expected impact of shipping costs on prices (so far), anchored inflation and the increased water levels at hydropower plant reservoirs have helped move the balance of risks to neutral. On the other hand, we remain uncomfortable with the recent dynamics of core wholesale inflation. With the recent change in the exchange rate, we could reasonably expect that core wholesale prices will slow their growth in the coming months. However, even if that happens, the recent trends for wholesale and consumer prices are quite different. In other words, retail companies continue to face significant pressure on their margins. If higher growth is achieved, we will have to monitor whether retail companies will attempt to shore up their margins, which would bring pressure to core consumer prices.
Based on this information, we kept our inflation forecast unchanged at 4.4% for 2018 and 4.25% for 2019, acknowledging a more balanced risk assessment and some downward bias for 2018. For this year, an exchange rate below BRL/USD 3.70 could result in a downward bias to the Broad Consumer Price Index (IPCA) from gas prices (which is pegged to foreign gas prices in BRL). For 2019, our adjustments reflecting a more appreciated exchange rate (BRL/USD 3.70) and stronger growth (2.8%) canceled each other out; therefore, we continue to forecast that consumer inflation will end the year at 4.25%.

On monetary policy, we have left the interest rate normalization scenario unchanged for 2019. On the one hand, the fall in risk premia and currency appreciation could postpone the start of the cycle in 2019. However, if economic growth exceeds expectations, there is some risk that the cycle will be moved forward or even extended. In other words, we will need to keep a close eye on these elements of the balance of risks to inflation, as well as on the pass-through of wholesale price pressures to retail, in order to try to predict the Central Bank’s next moves. For now, we believe that the interest rate normalization process will start in the second half of 2019 at increments of 0.25 p.p., which should bring the Selic benchmark rate to 8.0% at year-end.

Fiscal data has been better than anticipated: we expect the deficit to end the year at BRL 132 billion, below the BRL 161 billion target. The better-than-expected results are due to non-recurring revenues, such as oil royalties and concessions, as well as tax increases enacted last year and the economic recovery. The government continued its efforts to control expenditures, which should allow it to stay under the spending cap.

As already discussed, however, the government needs to make difficult adjustments to the budget over the next few years in order to comply with the cap. In this context, a top priority is social security reform, which by itself would yield significant savings. Other adjustments are needed, including reworking some expenditures and subsidies. The recent trajectory of public debt, which reached 77% in recent months, underscores the need to return to a primary surplus. In order to stabilize the debt-to-GDP ratio, we need an adjustment of at least 3% of GDP – i.e., to move from a deficit of almost 2% to a surplus of almost 1% of GDP. Making this adjustment on the spending side tends to be a preferable route given the high tax burden and low productivity of the Brazilian economy. Therefore, complying with the spending cap and reducing the debt-to-GDP ratio will continue to be one of the main challenges facing the new government.

In short, the country needs to implement structural reforms in order to address these challenges. However, within-target inflation, anchored expectations, as well as ample room in the external accounts and the cyclical position of the economy create conditions conducive to economic recovery, if progress is made on the economic reforms. The new administration will have to push through this agenda against an international environment that is more challenging to emerging markets, in addition to the traditional challenges of formulating and implementing the reforms over the next few months.
**Global instability likely to continue**

There are several indications that a high risk aversion environment will persist in the global market. This environment is mostly associated with deteriorating growth prospects, a significant factor in the IMF’s downward revision of the GDP forecast, from 3.9% in 2018 to 3.7% in 2019. This is quite a different scenario than the one laid out in the beginning of the year, which suggested synchronized growth in developing economies. There are already signs of a more severe slowdown in Asia and Europe, in addition to falling asset prices in developed markets.

In the United States, we expect the monetary policy normalization process led by the Federal Reserve to continue for a while, reverting the global liquidity that helped sustain asset prices in recent years. Unemployment is at its lowest level since 1969 and GDP growth is projected to approach 3% in 2018. So far, inflation has moved gradually towards the Fed’s target: inflation measured by the PCE deflator stands at 2%, in line with the target, while the CPI reached 2.7%.

**Chart 3: U.S. unemployment (%) is at its lowest level since 1969**

As a result, we predict that the Fed will deliver one more 0.25% hike in 2018, followed by two additional increases in 2019 – in line with market expectations. Monetary tightening and a fading fiscal impulse will cause growth to slow down to approximately 2.5% in 2019. While this is a soft landing scenario, without any significant inflationary pressures, it would nonetheless create a challenging environment for emerging economies, given the higher interest rates and a potential decline in profits for US firms.
The fall in global stock markets – also related to deteriorating growth prospects – creates an additional challenge. In the quarter, several companies underperformed relative to expectations, sparking a stock market adjustment that disproportionately affected technology stocks and contaminated other developed markets. In addition, companies are already reporting cost pressures, partly due to increased tariffs and wage growth. So far, the U.S. government has responded by promising new economic stimulus, such as a 10% cut in income tax for the middle class. Given the current stage of the U.S. economic cycle, low unemployment, and fiscal deterioration, new incentives do not seem to be the most appropriate policy prescription at this time. After all, the U.S. economy is already at full employment, and the stimulus of recent corporate tax cuts have not fully materialized. The risk is that these economic policy contradictions and the consequences of the protectionist agenda will result in additional inflationary pressure, which would lead to more aggressive monetary tightening by the Federal Reserve, further worsening international financial conditions and investor confidence.

**Chart 4: NASDAQ and S&P 500 (Jan-2014 = 100)**

There are other risks in developed markets. In Europe, the final stages of Brexit negotiations lead to renewed tension, especially with regard to the border between Northern Ireland and the Republic of Ireland and growing demands for a new referendum to sanction the final agreement. In addition, there is the ongoing clash between Italy and the European Commission on the 2019 budget. The budget approved by the Italian parliament, and defended by the government, set a primary deficit target that violates the fiscal constraints imposed by the Growth and Stability Pact. The risk premium paid by Italian bonds on the German bund has increased significantly in recent weeks, already reflecting higher risk perception in global markets. In Germany, the Grand Coalition parties were defeated, while support for opposition parties surged. In short, the European political environment remains unstable, and new negative surprises may emerge over the course of 2019.
In China, the economy has been slowing down since the end of the first quarter, which has caused the government to respond with a stimulative fiscal and monetary policy. The highlights include cuts to the reserve requirements and the decision to speed up issuance of local government bonds (as a source of funding, especially for infrastructure projects). Nonetheless, the currency has depreciated significantly (almost 7%) in 2018, the stock market has fallen 35% in the year-to-date, and activity indicators suggest a more moderate growth rate. This challenging domestic environment partly reflects the early effects of heightened trade tensions with the US, which has impacted manufacturing output and increased financial instability in the country.

Chart 5: Spread between Italy’s 10-year bonds and equivalent German bunds (b.p.)

Chart 6: Chinese Stock Exchange (Shanghai Composite)
Going forward, we believe that the slowdown in China’s economy is expected to moderate over the coming months, with a gradual recovery in infrastructure investment. However, the economy’s reaction to the stimulus will probably be slower than in other occasions, since it is not likely that the deleveraging process will be fully reversed. In addition, we can expect additional declines in exports due to new tariffs imposed by the U.S. and the slowdown in the European and Japanese economies – which will have a negative effect on GDP. In our assessment, tensions between China and the U.S. will remain on the radar for quite some time. These factors represent a downside risk to China’s economic performance and can create a feedback loop in the risk aversion process in the coming months.

In October, assets of emerging markets that were hit hardest by the downturn in the global environment in the previous months saw a rebound, but only after the respective governments implemented more stringent measures to address their vulnerabilities. That includes Turkey, where the Central Bank raised its benchmark rate by 6.25 p.p. (to 24% p.a.), and Argentina, which dropped its gradual approach to fiscal adjustment and closed a new agreement with the IMF, in addition to adopting strict monetary targets to bring inflation under control and stabilize the currency. In Mexico, on the other hand, a referendum conducted by the transition team of newly elected president López Obrador rejected the completion of a new international airport in Mexico City. Cancellation of the project, for which bonds have already been issued and billions of dollars already invested, raises concern among investors.

Therefore, the external scenario has become more challenging in recent months, with increased risk aversion and a downgrade to the 2019 growth forecast, despite the significant recovery of assets in some countries with idiosyncratic responses to the negative shocks of the first semester (Argentina and Turkey). This environment will most likely persist in the coming months, with a gradual reduction of global liquidity, increased trade and geopolitical tensions (particularly between the U.S. and China), and potential political instability in Europe and the Middle East.
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