Pablo F.G. Bréard, 1.416.862.3876
pablo.breard@scotiabank.com

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CAPITAL MARKET DYNAMICS

Foreign Exchange ► Brazil enjoys a stable exchange rate environment. The Brazilian real (BRL) remains the best performing currency in the Americas, having appreciated by 17% against the US dollar over the past 12 months. The primary factors leading to such strength are the following: 1) steady improvement in the country's terms of trade (booming iron prices in focus), 2) excess global liquidity (courtesy of ultra-low interest rates in the developed world) seeking high yielding investing assets, 3) market reversal of the overshooting forces which were exacerbated by a recessionary environment and, 4) swift return to primary and secondary global fixed-income markets (pulling Argentina alongside) leading to active rebalancing of emerging-market portfolios.

Sovereign Debt & Credit Ratings ► The global perception of Brazilian sovereign credit risk has improved substantially. Financial market metrics implied in credit default swaps (CDS) have shown a strong investor preference for Brazilian government debt assets and strong resilience to US-inspired political uncertainty; indeed, the five-year Brazilian CDS reached a low mark of 212 basis points (bps) in Mar-2017, down from 500 bps in Feb-2016. Credit agencies will align their Brazil ratings to the marked improvement in financial market conditions. In fact, Moody's upgraded the outlook of Brazil's "Ba2" country rating to "stable" from "negative" last month. Also, investors welcome the fact that the central bank has US$354 billion in foreign reserves (20% of GDP).

ECONOMIC OUTLOOK

Growth ► The economy is showing evidence of a gradual recovery. Confidence indicators are improving in line with solid price stabilization. Formal employment has reversed a negative growth trajectory. Foreign investment inflows are accelerating as the government advances structural (fiscal and pension) reforms. After declining by 3.6% in 2016, real GDP will expand by 0.5% this year before accelerating to 2.5% in 2018. The public sector earmarked a large-scale infrastructure investment programme as a key driver of economic activity through the remainder of the decade. Industrial production is estimated to recover positive growth rates in 2017-18. Domestic consumption will also benefit from an ultra-stimulating monetary policy adopted by the central bank.

Inflation & Monetary Context ► The process of disinflation is advancing successfully. After peaking at 10.7% y/y in Jan-2016, consumer price inflation (measured by the market-sensitive IPCA index) declined to 4.6% y/y in Mar-2017. Looking ahead, a marked improvement in inflationary expectations will lead monetary authorities to execute more aggressive stimulus to guide the inflation-adjusted policy rate to the 5% mark. A recent central bank survey hints at inflation ranging between 4% and 4.5% y/y in 2017-18. In this regard, the monetary policy committee opted to reduce its benchmark (SELIC) policy rate by 100 bps to 11.25% at its April meeting. Market participants are positioned for aggressive rate cuts pushing the SELIC rate to near 9% by year end.

Fiscal & Current Account Balance ► Brazil remains in a state of fiscal emergency. The public sector deficit was 8.5% of GDP in the 12 months ending Feb-2017. The debt service burden still remains high, at 6.2% of GDP, while the primary fiscal balance (very relevant to investors) still shows a deficit of 2.3% of GDP. Structural fiscal reforms are at the core of the deficit reduction; in this regard, ongoing progress to seek pension fund reform approval is a positive development. However, the fiscal situation of regional states may delay the fiscal adjustment ahead of the presidential elections. On a positive note, the current account deficit narrowed to 1.2% of GDP over the past 12 months fully funded by foreign investment flows (equivalent to 4.6% of GDP).

INSTITUTIONAL FRAMEWORK & POLITICAL ENVIRONMENT

Governance ► The administration of President Michel Temer remains committed to the process of structural reforms despite the political storm caused by corruption scandals. Presidential elections, scheduled for October 2018, will increasingly become a factor in policy making decisions and relations with congress. However, we believe that the Brazilian economy will enter a path of sustainable growth based upon major structural reforms under implementation. It is worth mentioning that the country has been relatively immune to the policy shifts and uncertainties linked to the newly elected USA administration. A more pragmatic approach to global trade policy might reinvigorate the role of both Brazil and Argentina in regional economic integration initiatives.

Financial Sector ► The Brazilian financial sector remains well capitalized in compliance with more stringent international rules. Nevertheless, the deposit-taking financial institutions have been adversely affected by a prolonged economic recession which led to a decline in profitability and moderate erosion in asset quality (the non-performing loan ratio stands at 3.7%). Aligned to a weakened business cycle, total financial sector credit declined by 3.5% over the past 12 months. Moreover, the latest financial stability report highlighted that the fragile fiscal situation of regional governments might require remedial policy adjustments.

INTERNATIONAL ECONOMICS GROUP

Pablo F.G. Bréard, Head
1.416.862.3876
Scotiabank Economics
pablo.breard@scotiabank.com

Erika Cain
1.416.866.4205
Scotiabank Economics
erika.cain@scotiabank.com

Tuuli McCully
65.6305.8313
Scotiabank Economics
tuuli.mccully@scotiabank.com

Estela Molina
1.416.862.3199
Scotiabank Economics
estela.molina@scotiabank.com