BRAZIL UPDATE

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BRAZIL'S LONG AND DEEP RECESSION LOOKS POISED TO GIVE WAY TO MODEST GROWTH IN 2017

Slowing inflation has created an opening for interest rate cuts

Brazil has turned a corner. CPI inflation slowed to 7.9 percent in October 2016, its slowest since February 2015, and inflation in "sticky" services prices, which tend to follow inflation's underlying trend, slowed to 6.9 percent, the slowest since September 2010. The government's hikes to residential electricity rates in 2014 have dropped out of the year-ago comparison in the CPI index, and the less-weak Brazilian real (After depreciating 33 percent in 2015, the currency appreciated over 20 percent in the first half of 2016) has tamed the inflationary pass-through of more expensive gasoline and other globally-priced goods. A turning point in inflation created an opening for the Central Bank of Brazil to cut its benchmark Selic rate 0.25 percentage points at both its September and December meetings to 13.75 percent, ending the central bank's tightening cycle which began in April 2013.

The economy contracted sharply in 2016, but silver linings have started to appear in the output data

Silver linings also have begun to appear in growth data, although the headlines were still bleak at the close of 2016 (See chart 1). Real GDP contracted a seasonally-adjusted and annualized 3.3 percent in the third quarter of 2016, worse than the first and second quarter's 1.8 percent and 1.7 percent respective contractions, though not as bad as the 6.1 percent annualized contraction in the third quarter of 2015. In year-ago terms, Brazil's economic contraction slowed to 2.9 percent in the third quarter from 3.6 percent in the second and 5.4 percent in the first. Real GDP in the third quarter of 2016 was 8.3 percent below its pre-recession peak in the first quarter of 2014. Gross fixed capital formation fell 11.9 percent annualized in the third quarter of 2016 and was down 27.7 percent from its prior peak in the third quarter of 2013. The silver lining of Brazil's cratering capital spending is that Brazilian import demand has fallen sharply; fewer imports, combined with more exports, are helping to narrow Brazil's current account deficit. In year-ago terms, real exports grew and real imports fell for seven straight quarters through the third quarter of 2016, and (despite a drop in the most recent two quarters after very strong growth in early 2016) real exports were 6.9 percent higher in the third quarter of 2016 than when Brazil's recession began.

CHART 1: BRAZIL IS EDGING OUT OF A DEEP DEPRESSION

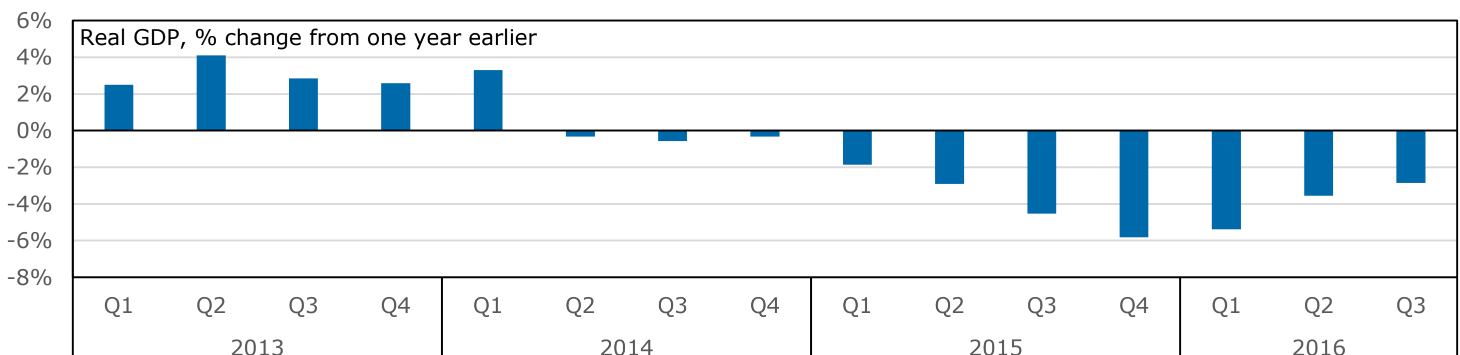

Chart sources: IBGE, CEIC, The PNC Financial Services Group

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Capital spending and exports should improve in the year ahead, but fiscal austerity and low commodity prices are still headwinds

As inflation slows, the Central Bank of Brazil will likely cut its benchmark Selic rate another 3.0 percentage points by the end of 2017. Lower interest rates will boost consumer spending and business capital investment in 2017, and the Brazilian real (still relatively weak even after 2016's appreciation) should continue to support export growth, likely bringing Brazil's long economic depression to an end. However, other headwinds will persist. President Michel Temer's centrist government plans to cut government spending by approximately 0.5 percent of GDP in 2017, a large restraint on domestic demand. Prices of Brazil's commodity exports – iron ore, soybeans, and oil – are still far below their levels during the 2010-2013 boom years, although they are off of their late-2015 and early-2016 lows. And the stimulative effect of Brazilian interest rate cuts will be partially offset by recent increases in Brazilian long-term interest rates, which have been pulled higher by the rapid increase in US long-term interest rates after the US Presidential election (See Chart 2). Brazilian real GDP will likely grow just 1.0 percent in 2017. Since output was 8.3 percent below its pre-crisis peak in the third quarter of 2016, Brazil's return to modest growth will still leave many businesses and households feeling much worse off than they were before the current downturn began.

Political stability cannot be taken for granted in the year ahead

Partly because of this, Brazil's political stability cannot be taken for granted in the year ahead. Financial markets reacted very positively to the August 31 impeachment of embattled former President Dilma Rousseff and her replacement by now-President Temer. But the contentious politics of the US and European Union since the Great Recession demonstrated that the political fallout from an economic crisis can envelop administrations that take office well past the crisis's peak. More specific to Brazil, President Temer's administration seems exposed to the same problems that brought down former President Rousseff: Between when Temer began acting President in May and the end of November, four of his ministers resigned after accusations of corruption. Fallout from their resignations or from the ongoing investigation into the Petrobras corruption scandal could destabilize Brazilian politics. Alternatively, President Temer's proposal to cut pension benefits and raise the retirement age during the early stages of a recovery from deep recession could stir popular discontent.

The post-election updraft in US rates not only pushed Brazilian long-term interest rates higher, it also triggered a sell-off in the Brazilian real to 3.45 per US dollar; while almost 10 percent weaker than its pre-election peak, the real is still 20 percent stronger than during the commodity price collapse of January 2016. If the Brazilian economy continues to transition into a modest recovery as we forecast, the Brazilian currency will likely appreciate modestly as well, reaching 3.35 per US dollar by the end of 2017 and 3.30 per dollar by the end of 2018.

CHART 2: THE GLOBAL BOND SELL-OFF AFTER THE US ELECTION PUSHED UP BRAZILIAN LONG-TERM INTEREST RATES

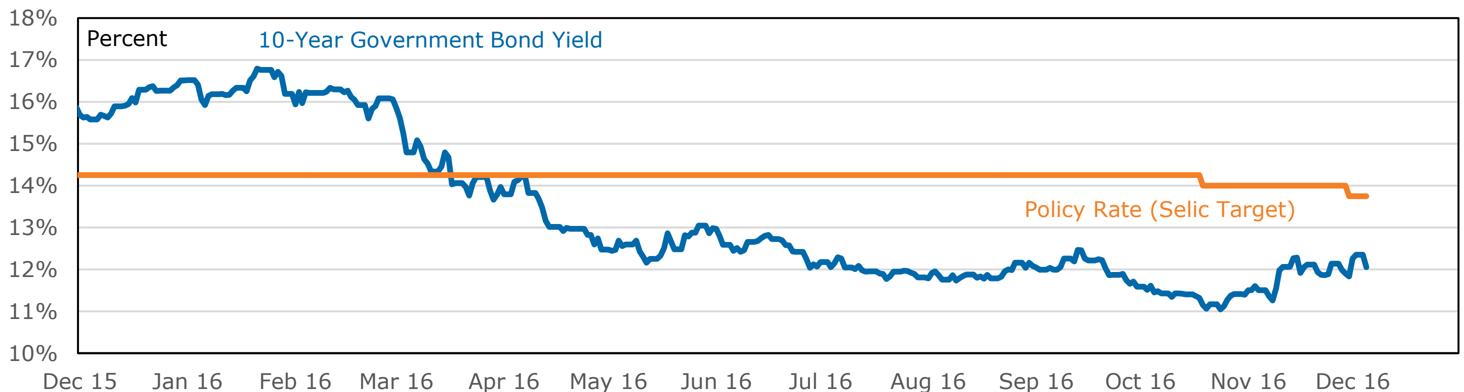

Chart sources: Bloomberg, The PNC Financial Services Group

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