VotorantimAsset

Monthly Economic Outlook

August | 2015

The economy has not yet stabilized

The economy is still in movement, and unfortunately it is moving in an undesirable direction. Adjustments are proceeding, be it to inventories, production or the labor market. The vicious circle has not been broken and the economy has not yet stabilized. If the industrial sector has been in difficulty for years, the same has not been true of the sectors closest to consumers, such as commerce and services. Only this year, therefore, has the labor market begun to feel the effects of economic contraction. The unemployment rate trendline has already inverted, both on the side of job creation and in terms of the numbers seeking work, according to data from IBGE. Both effects are important, since the second tends to influence incomes faster and incomes have indeed displayed a weak performance this year, not least owing to high inflation. In real terms, average earnings fell 2.1% year over year in first-half 2015.

We were recently obliged to revise down our GDP growth forecast for 2015 to -2.5%, pointing to a far deeper recession than anticipated at the start of the year. The sharp contraction seen in the second quarter will be followed by at least another quarter in negative territory. Business and consumer confidence is still very low. In the former case, margins are affected by steadily rising cost pressures and manufacturers are starting to believe in a more lasting decline in domestic demand via the labor market. Meanwhile, in the absence of tax breaks, especially for durables, consumers are retrenching.

Industrial inventories are very high, according to FGV's survey of the sector (Sondagem da Indústria), which also shows that capacity utilization is low – it reached 78.2% in July. This means new investment in production capacity is unnecessary at present. It also means the weakness of economic activity will last for a long period, as it will take time to absorb this amount of slack.

Thus even when the economy recovers it will be a slow process, and it is starting to become apparent that GDP will again contract in 2016, even if some sectors begin to recover before others thanks to the stimulus of local currency depreciation. Our simulations point to an average fall of 0.5% in GDP compared with this year's already low level, but only if the economy stabilizes by end-2015 and there is at least a minimum of quarter-on-quarter growth throughout 2016. For the time being, however, no signs of this reversal are visible.

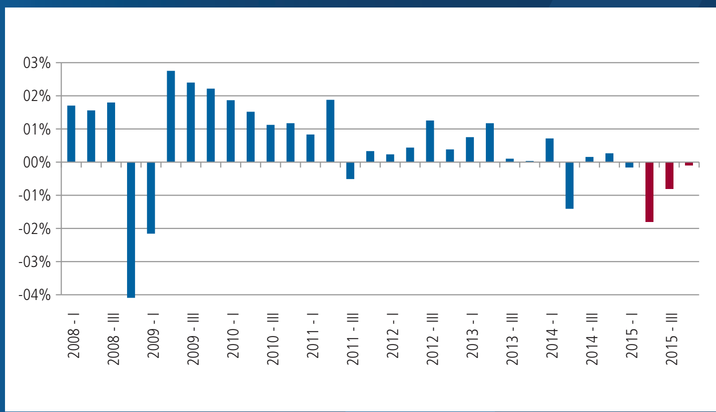
The vicious circle in the economy is reinforced by the strife-riven political scene. Anti-fraud and corruption investigations have deepened and broadened considerably, with negative consequences for the activities of Congress. This is fueling uncertainty, impairing the process of decision-making by economic agents, who are more frequently putting all decisions on hold. Not all the fiscal adjustment measures have been passed, and it is also hard to predict the fate of important reforms proposed by the economic team, such as a comprehensive overhaul of the ICMS state-collected sales tax as well as PIS/Cofins. Meanwhile, Congress is constantly pushing for measures of its own that will inexorably drive up public expenditure, and the process of auctioning infrastructure project concessions is moving more slowly than it should.

The federal government's fiscal situation is directly affected by these developments. Weak economic activity means falling tax revenue, making it impossible to meet the primary surplus target announced at the start of the year. Many expenses carried over from previous years are being paid now. Moreover, central-government net revenue fell 3.3% in the first half in real terms (-5.3% in 12 months). The primary result accumulated in the period fell far short of everyone's expectations, so that the fiscal target was practically eliminated or reduced by over 85%.

A key problem arising from all of the above is the possibility of a sovereign downgrade for Brazil, from investment to speculative grade, demonstrating the deterioration in external agents' perceptions and further fueling the prevailing uncertainty. Strictly speaking, domestic assets have already priced in a situation very close to such a downgrade, which would drive up borrowing costs and make an economic recovery even more difficult.

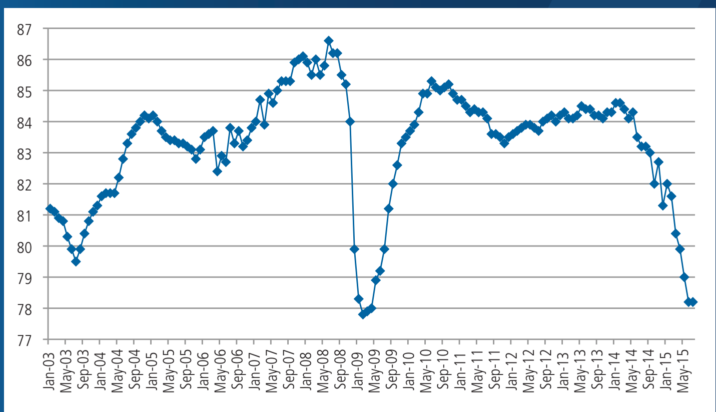
To offset the fiscal deterioration and despite the evidence of economic contraction, the Central Bank raised the basic interest rate to 14.25% per annum, promising to keep it at this level for a sufficiently prolonged period. Its decisions have been aligned with its mandate to assure the stability of the currency and prices, bringing annual inflation back to the midpoint of the target range. The question that arises, therefore, is when the next monetary policy move will occur and what it will be. Based on the above analysis, we believe the economy will require normalization of interest rates to start early in 2016.

Quarterly GDP growth: actual and projected (QoQ)



Source: IBGE

Manufacturing capacity utilization



Source: FGV