VotorantimAsset

Monthly Economic Outlook

February | 2015

2015, a year of adjustments

Expectations of negative growth in the year that is only just beginning have recently become increasingly unavoidable. The first chart below presents our forecast for GDP growth in 2015, alongside the estimate for last year. Many challenges lie ahead. In addition to the necessary fiscal adjustment already being implemented by Joaquim Levy, the new finance minister, rainfall is well below average and there is still acute uncertainty regarding the outlook for Petrobras. The water shortage will have multiple effects on a range of factors from electricity supply to the supply of food products such as vegetables and grains, all of which will have consequences for both economic activity and inflation.

The core of our analysis remains the same, however. Our projections assume decelerating consumption, by both households and government. At the same time, however, a recovery of confidence during the second half should prevent investment from falling as sharply as estimated in 2014 (-8%). In other words, our revised forecast is based not on a substantially different outlook but on a change in the intensity of these negative factors.

Detailing the projections a little more, our expectations take into account the adjustment that has been under way since end-2014 in manufacturing and construction. Among the reasons for this movement we would stress high inventory levels and growing credit restrictions due to monetary tightening by the Central Bank, which has raised the Selic interest rate to 13.0% p.a. in response to strong realignment of administered prices. The stimulus measures introduced in 2013 and 2014, such as payroll tax exemption for a swathe of industries, kept employment levels high in both manufacturing and construction, so that layoffs will be the focal point of their adjustment now.

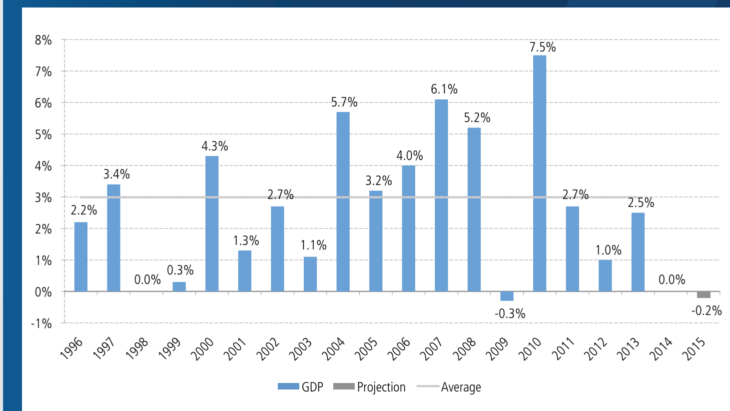
The initial expectation was that layoffs would gradually spread to high-street commerce and other segments of the service sector during the course of 2015. This would inevitably lead to a rise in unemployment and offset part of the positive effect on household consumption due to real pay rises, correlating closely with the minimum wage. However, the December data (the latest available from IBGE's monthly employment survey, PME, and the Labor Ministry's formal employment statistics, CAGED) point to a sharper and more generalized drop in job creation already in 2014. This is a significant indication that the more credit-dependent segments apparently adjusted payrolls earlier than anticipated, potentially producing a stronger final effect than originally expected

We would highlight the tone of the government's rhetoric and the acceleration of inflation as key factors determining this behavior. Both will be closely correlated in 2015, given that most of the measures announced by the economic team in the direction of more fiscal austerity and a restoration of confidence entailed tax hikes and a reduction in tax breaks. These measures will raise the cost of living and hence reduce consumer spending propensity. In addition, the language used by the government has also pointed to a reduction in public spending as a significant part of the adjustment, another key assumption underpinning our scenario for economic activity this year. The government is expected not only to rationalize its running costs but also to lower the level of federal investment.

An improvement in credibility resulting from effective pursuit of the declared targets will contribute positively to business confidence, and with the appropriate lag this in turn will attract new investment. However, it is important to stress the growing possibility that investment will recover more slowly than we initially expected. The negative factors weighing on this recovery include a potential deterioration in the situation of Petrobras, one of Brazil's largest corporate investors, and the increasing risk of electricity rationing due to insufficient rainfall, especially in the Southeast and Center-West. The hydroelectric power system is in a fragile situation as a result. Dam reservoirs are at very low levels and only the use of thermal power plants has so far averted rationing. Unless reservoir levels rise considerably in the early months of the year, which correspond to the rainy season, the entire production chain may be impaired. This would result in economic contraction and inhibit new investment. The potential negative impact of electricity rationing under certain conditions is estimated at 0.5% of GDP.

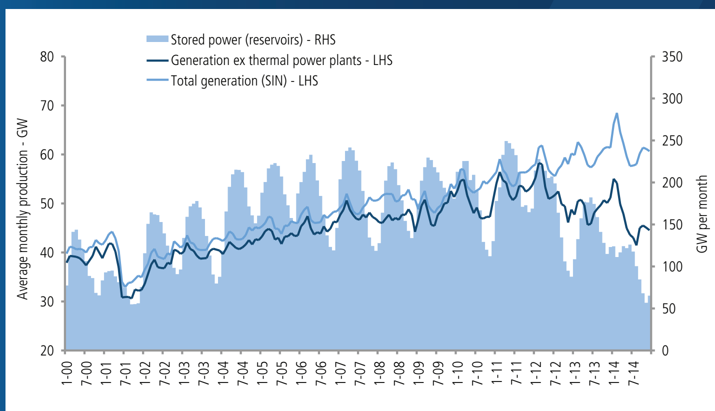
Finally, we do not anticipate a significant contribution from the external sector to GDP growth in 2015. Local currency depreciation will inhibit import growth, while exports will proceed at a slower pace due to the global economic slowdown, especially in light of weaker demand from Brazil's main trading partners, such as Argentina. In sum, 2015 may be characterized as a year of important adjustments in which expansion of domestic consumption will no longer be sufficient to offset falling investment and the sluggish world economy.

GDP: annual change (%)



Source: IBGE; Banco Votorantim

Electricity generation, grid (SIN), in %



Source: National Grid Operator (ONS)