VotorantimAsset

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Monthly Economic Outlook

The fall in confidence in the Brazilian economy

In June 2014, the ICI and ICC fell to the lowest level since the 2008-09

The charts on this page illustrate the sharp fall in the indicators of confidence in the Brazilian economy - among both manufacturing executives (ICI) and consumers (ICC). A very similar trend could have been illustrated for the construction industry, the service sector and commerce. The charts show a significant decline in both the current conditions and expectations components in 2013 and 2014.

In June 2014, the ICI and ICC fell to the lowest level since the 2008-09 international crisis sparked by the collapse of Lehman Brothers. Indeed, in our view they have now begun to reflect an overpessimistic view of the economic outlook on the part of manufacturers and consumers. True, there is widespread frustration with the performance of the Brazilian economy – GDP growth is currently forecast to be less than 1.5% p.a. this year and next – and with persistently above-target inflation, yet the risk of an acute crisis is far lower than during the 2008-09 crisis itself. It is worth recalling that the bursting of the US housing market bubble triggered a collapse in a substantial proportion of the financial system in the developed countries, leading to a global recession almost as deep as the Great Depression of 1929. Hence the view that the present low level of confidence is overpessimistic, since it is so close to the rock-bottom level seen in 2008-09.

FGV: manufacturing executive confidence index (ICI)
Seasonally adjusted

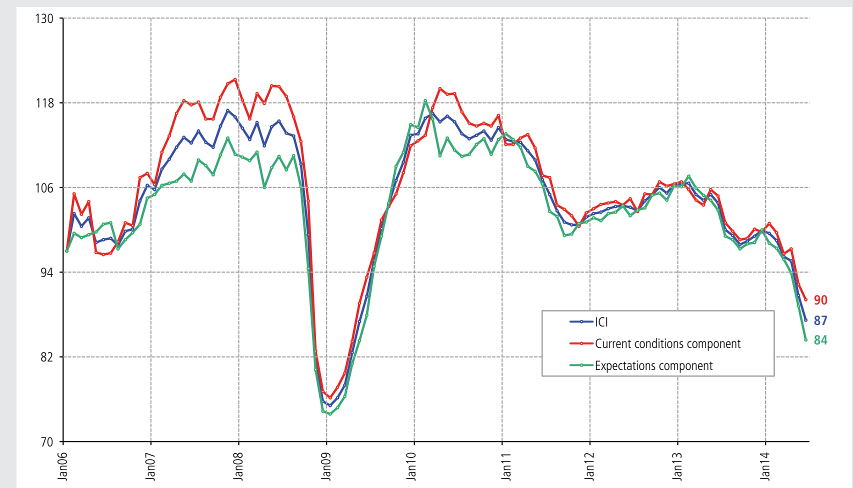


Chart: VAM

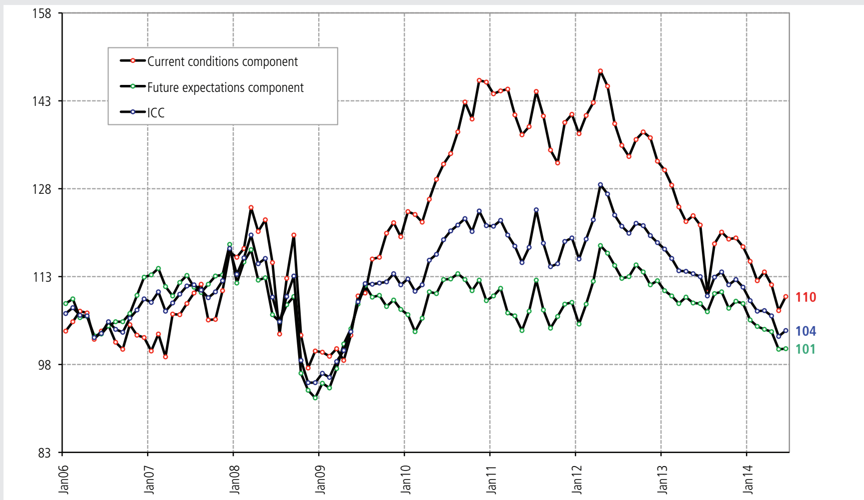
Source: Fundação Getúlio Vargas

A more detailed analysis of the recent movement in these indicators shows that the ICI and ICC are starting to behave differently. While the ICI remained in free fall in June, the last data point presented by the charts, the ICC displayed an incipient recovery. Under our base scenario, the ICC will continue to recover moderately in the months ahead, for three main reasons: (i) inflation, which came under strong upside pressure early in the year (with the annualized IPCA rising 8.2% on average in the period January-May), will enjoy seasonal relief in the coming months (we project an annualized average of 5.1% in the period June-December, taking the 12-month IPCA to about 6.35% at end-2014); (ii) concurrently with this short-term deceleration of inflation, pay awards are set to remain substantial in second-half 2014, given that the unemployment rate is still close to the all-time low, and the resulting average real earnings growth will bolster consumer purchasing power, which has fallen in recent months; (iii) the downside impact of the

World Cup on consumer confidence was a less structural factor whose effects did not last long – a Datafolha poll published on July 3 showed the strong concerns about the risks of the event expressed in June largely dissipating as the first few weeks of the event proved successful.

In contrast with this improvement in the ICC, however, the ICI has remained very weak, as stressed above. Two persistent problems appear uppermost in the minds of decision makers in the manufacturing sector. The first is the array of structural difficulties faced by a sector that has displayed negative growth in the past six years: the level of industrial production measured by IBGE in the past few months is below the level seen before the collapse of Lehman Brothers in 2008. The structural bottlenecks that must be resolved if the industrial sector is to resume growth include deficient infrastructure, a scarcity of skilled labor, and an adverse tax structure, among others. The second problem, which appears to be limiting investment decisions in the sector in the near term, is uncertainty due to the approach of the Brazilian electoral period, with the main presidential candidates proposing to implement different economic policies if they win. In actuality, however, whether President Dilma Rousseff wins re-election or one of the opposition candidates is elected president, economic policy will have to take into account the importance of restoring confidence in the economy to levels more consistent with an advance in investment decisions by private enterprise. This will require more intense efforts to combat the imbalances that have fueled inflationary pressure in recent years, as well as a strong signal that the new administration means to implement reforms capable of eliminating at least some of the obstacles to greater competitiveness for Brazil. In a market economy, expectations and confidence create an environment akin to self-fulfilling prophecy. To a significant extent, Brazil's weak economic growth is due to this decline in confidence, which prevents consumers from spending and businesses from investing. To improve GDP growth rates in the years ahead, economic policy will certainly have to prioritize strengthening consumer and business confidence.

FGV: consumer confidence index (ICC)
Seasonally adjusted



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