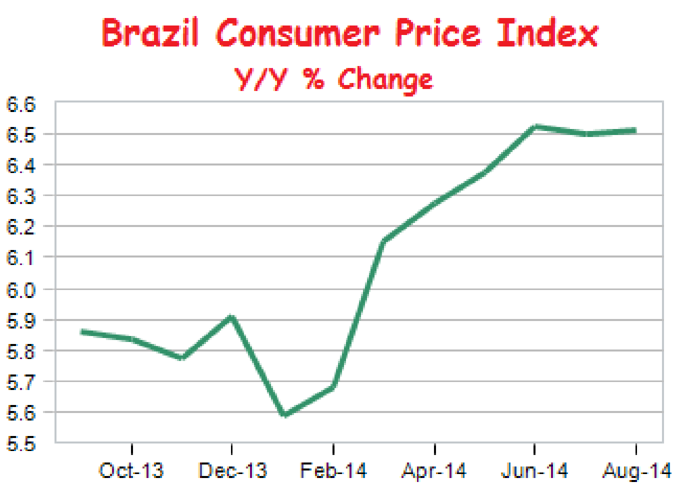
Brazil's Economic Outlook

Source: Brazilian Institute of Geography and Statistics-IBGE, Moody's Analytics



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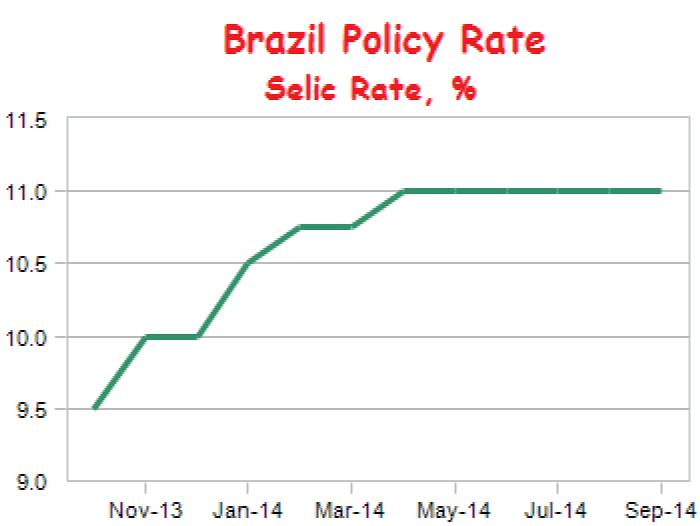
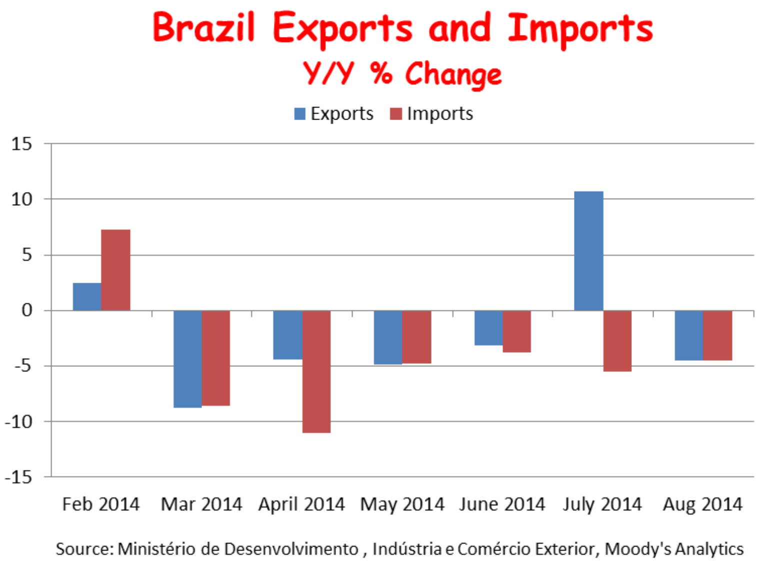


Source: Banco Central do Brazil (BCB), Moody's Analytics

Brazil, Latin America's largest economy, has entered a recession. Tighter monetary policy, declining exports, high inflation and a depreciating currency have all weighed on demand. While the economy received some stimulus from the World Cup, growth still dropped to negative territory. The country also faces upcoming presidential elections. Since this usually marks a time when public spending drops significantly, the economy will most likely weaken further in the coming months. Overall, economic growth this year is expected to be weak with GDP expanding by less than 1%.

Fiscal stimulus measures have been in effect to support the domestic economy, including the privatization of some of the nation's railways, roads and ports as well as tax incentives and lower energy costs. However, these efforts have fueled inflation and imports more than production. Persistently above-target and rising inflation prompted the central bank to tighten its monetary policy in April 2013. Interest rates have been hiked to 11%, its highest rate since early 2012, and have remained the same since April.

Policy efforts have helped stabilize consumer prices over the last few months, with inflation remaining around the upper limit of the central bank's 2.5-6.5% target range. However, until the inflation rate drops to a more comfortable level, the central bank is expected to maintain its monetary policy stance. As a result, the government's efforts to revive the economy will continue to be limited in the near term.

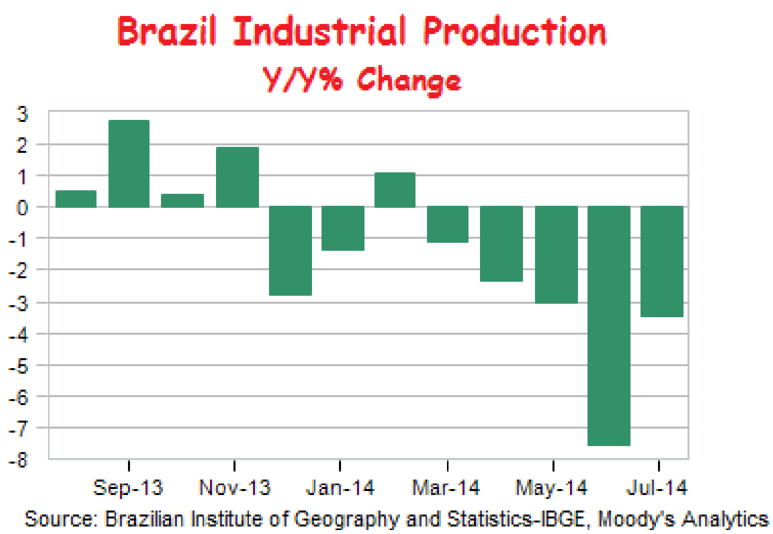


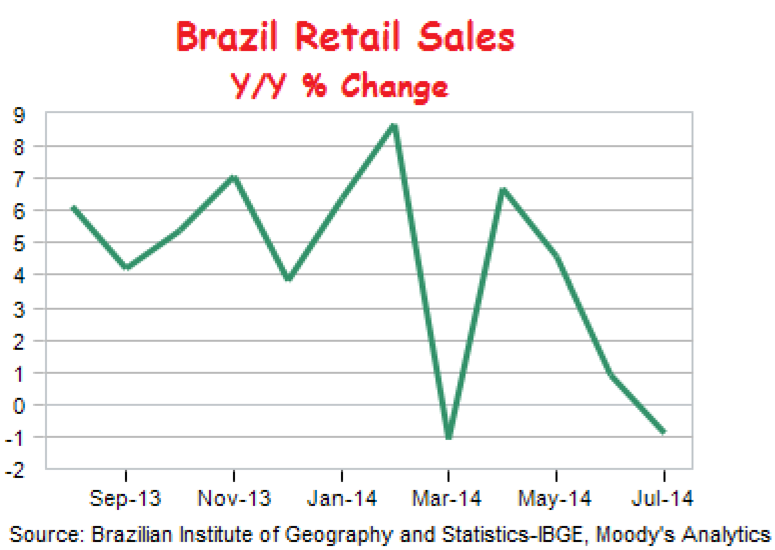
Brazil's exports have also been struggling, mainly due to falling regional demand. Brazil exports mostly manufactured goods to its regional trading partners, and demand for durables, such as autos, has decreased across the region. Trade between Argentina and Brazil, the region's two largest trading partners, has fallen to its lowest level since 2010. While this is mainly the result of both economies struggling with new recessions, trade regulations by both governments designed to increase local producers' competitiveness have also crimped trade. Trade between the two countries is expected to remain weak in the near term.

There is hope that the recent trade sanctions against Russia, which has resulted in an import ban on some food items from the EU, U.S. Canada, Australia and Norway, will boost exports for Latin American countries. Currently, Russia imports about 16% of its food value, so this could be a major trade opportunity for Brazil in the near term. However, this opportunity will dissolve if Latina American countries are asked to join the sanctions against Russia.

The weak currency should gradually have a positive impact on exports. The Brazilian Real has been on a downward trend for a few years as a result of the deterioration in policymaking by the current administration and chronically high inflation. Recently, the Real has been especially volatile as investors respond to news regarding the economy's recession. The anticipated tapering of quantitative easing by the Federal Reserve and the back-and-forth election poll results have also caused the currency to weaken, with the Real recently experiencing its biggest weekly drop in over a year.

Meanwhile, Brazil's imports have also been falling due to the depreciation of the Real and weak domestic demand. Government regulations designed to increase local producers' competitiveness have also crimped imports. Imports are expected to remain weak in the near term, until domestic demand picks up and the Real strengthens.





Brazil's industrial production has been struggling, mainly due to a decline of manufacturing production over the last few years as manufacturers face stronger import competition. While the recent sharp drop in production is the result of the World Cup, which created more holiday time for workers and reduced retail sales since consumers were busy watching games, overall the trend of production has been faltering. High interest rates are raising the cost of doing business and causing firms to cut back on production and investment.

As a result of the decline in production by firms, job creation has also been weak. Although the unemployment rate in Brazil is very low at around 4%, the economy created less than 12,000 jobs in July, the lowest July performance in 15 years. Unfortunately, this trend will continue in the near term, until business confidence improves and the central bank loosens its monetary policy stance.

The combination of high inflation and low job creation has significantly lowered income growth and household spending. As a result, Brazil's retail sales experienced its sharpest seasonally adjusted month-over-month decline in over 6 years in July. This is especially troubling since private consumption has been a main driver of economic growth for Brazil over the past decade. Consumers are expected to continue to retrench until economic conditions improve and job creation picks up.

Overall, we see that Brazil's economy is experiencing a slowdown. GDP is contracting as a result of tighter monetary policy, declining exports, high inflation and a weakening currency. The country also faces upcoming presidential elections and an end in the current administration in October. Economic growth this year is expected to be very weak with GDP growing by less than 1%. A Silva administration, if elected, could introduce more market-oriented economic policies.