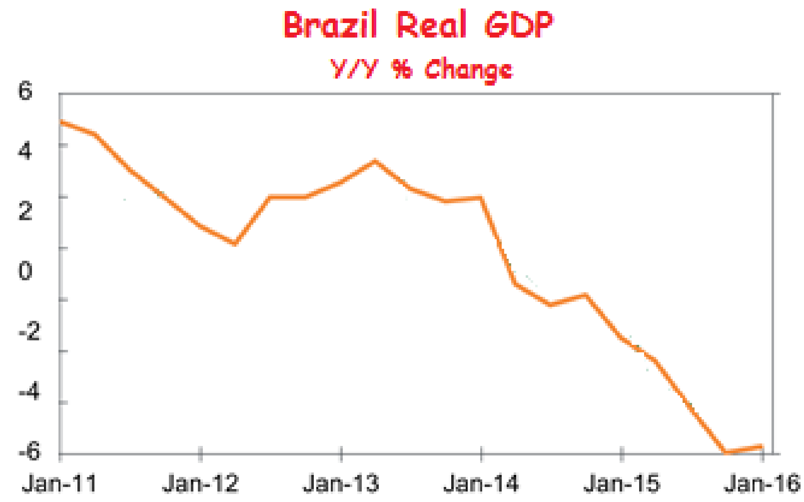
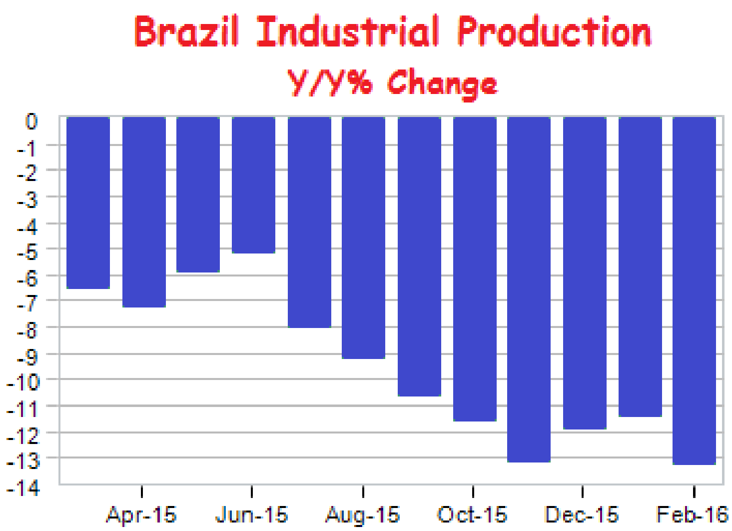
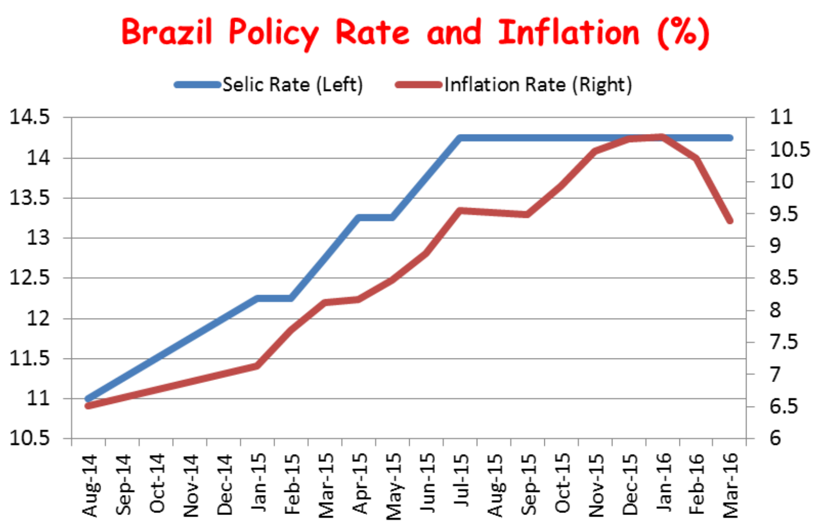
Brazil's Economic Outlook



Sources: Datafolha, Moody's Analytics



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

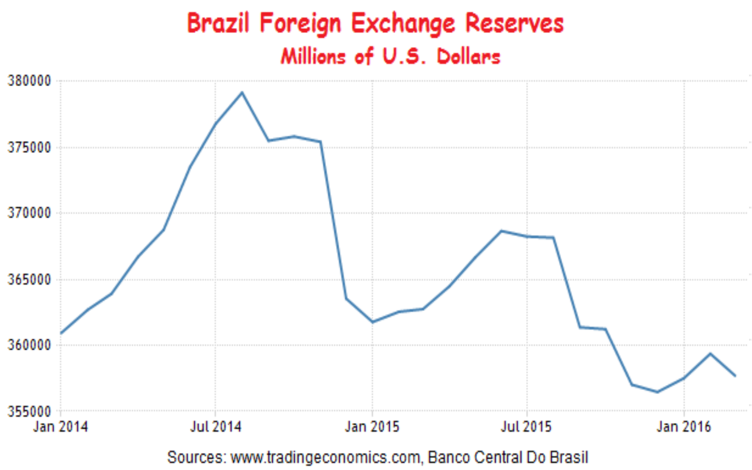


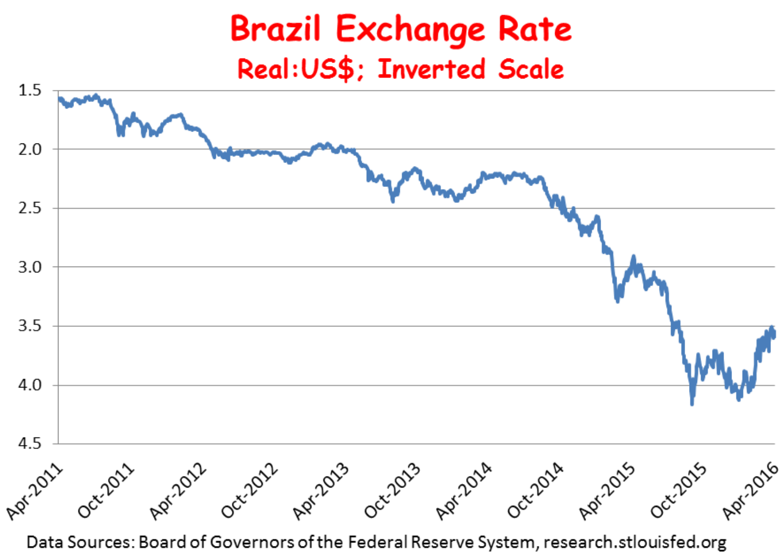
Data Sources: Brazilian Institute of Geography and Statistics-IBGE, Moody's Analytics

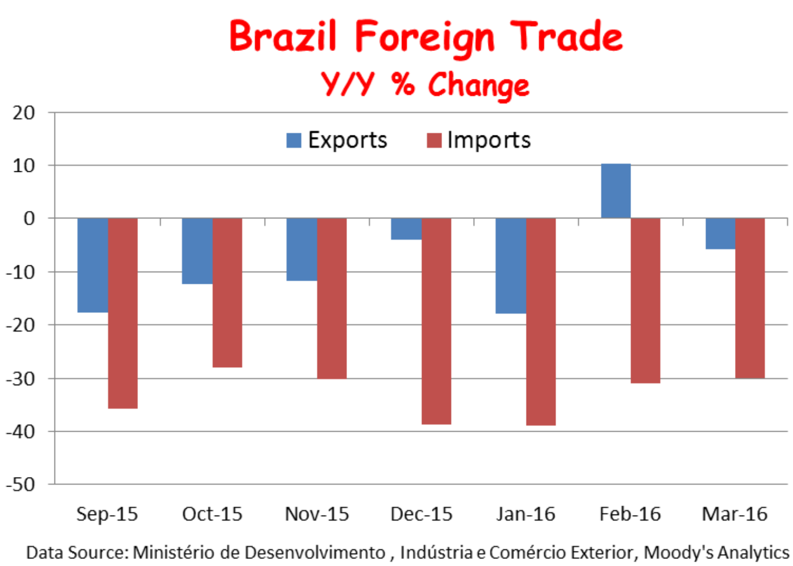
Brazil, Latin America's largest economy, is experiencing a severe recession. Economic growth has remained in negative territory for almost two years and dropped to a record low at the end of 2015. Political turmoil, tighter monetary and fiscal policy, high inflation and a weak currency have all weighed on demand.

Thankfully, conditions have improved since recent developments regarding President Rousseff's impeachment. Brazil's Chamber of Deputies has voted in favor of her impeachment on the grounds that she broke fiscal responsibility rules by concealing the budget deficit. The motion has now been moved to Brazil's Senate, where a simple majority is needed to initiate an impeachment trial. During the trial, and permanently in the event of an impeachment, current Vice President Michel Temer would take over as president. Ms. Rousseff's seemingly imminent removal, along with Mr. Temer's business-friendly reputation, has significantly improved confidence levels and given hope that the economy has passed its trough. As a result, economic growth is expected to improve this year, with GDP contracting by around 3% compared to the 3.8% decline in 2015.

Brazil's slowdown is largely the result of conditions in the industrial sector; lack of innovation and stronger import competition over the last several years have caused production to plummet. Meanwhile, previous stimulus efforts failed to lift growth and instead exasperated the issue by fueling inflation. Although Brazil's inflation rate has eased recently, it remains near double-digits and much higher than the central bank's 2.5-6.5% target range. Public finances have also deteriorated, with the public debt to GDP ratio reaching nearly 70%.



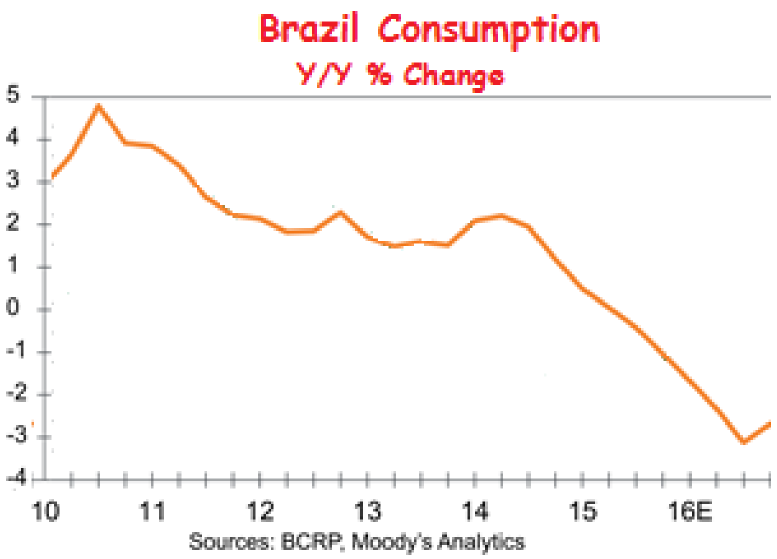


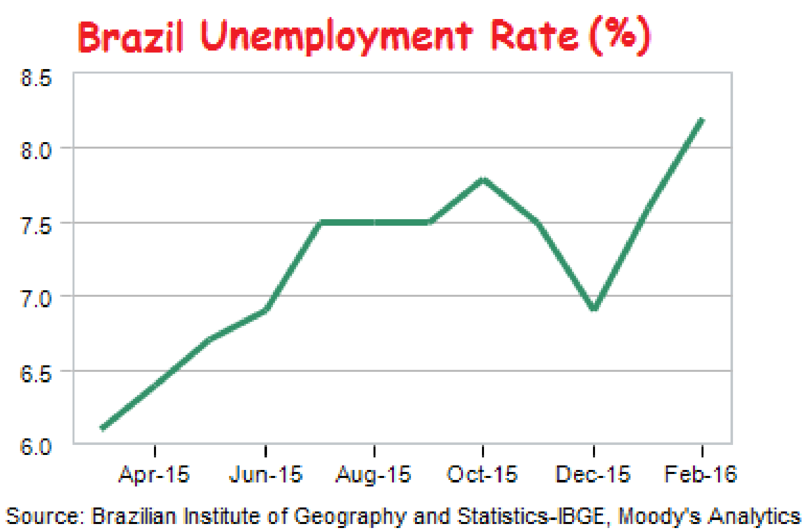


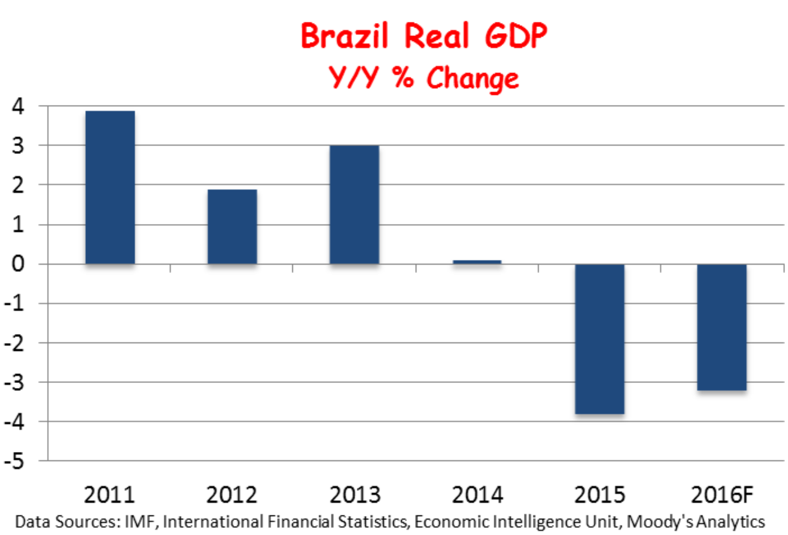
In an effort to restore credibility and stem soaring inflation, the government has tightened its policy stance significantly. Interest rates have been hiked to 14.25%, its highest rate in almost a decade, while fiscal adjustments continue to take place. Unfortunately, however, policy efforts have yet to stabilize consumer prices or reduce the fiscal imbalance. The ongoing economic contraction has significantly lowered public revenue and caused public debt to rise by over 15% in 2015, while the nation's currency depreciation continues to raise import inflation. Although the Brazilian real has moved favorably since the start of President Rousseff's impeachment proceedings, it has been on a downward trend for few years due to the deterioration in policymaking and weak economic conditions. Waning confidence levels resulted in capital flight among foreign and domestic investors, reducing the central bank's holdings of foreign reserves.

Despite an increase in price-competiveness from the weaker real, Brazil's exports continue to decline. Exports have been particularly hit by lower demand from China, its top trading partner; however, lower commodity prices have also been a main driver to the declining value of Brazil's exports. While commodity prices have recovered slightly over the last few months, they remain significantly lower than a year ago. Brazil's exports are expected to continue to decline in the near term given China's economic slowdown; however, there is hope that the weak currency and upward trend in commodity prices will eventually have a positive impact.

Meanwhile, sky-high inflation and the weaker real have eroded domestic purchasing power and caused Brazil's imports to plummet. Political turmoil and higher interest rates have also hurt imports by causing investment spending to plummet. Imports growth has remained in negative territory for a year and a half and is expected to remain weak until economic conditions improve and the real strengthens.







In addition to faltering external demand, Brazil is also struggling with weak domestic demand. Lower production has reduced the demand for labor and caused the unemployment rate to reach its highest rate since 2009. The combination of high inflation and low job creation has significantly lowered income growth and household spending. This is especially troubling since private consumption has been a main driver of Brazil's economic growth over the past decade.

Although confidence levels have improved since the news regarding President Rousseff's likely impeachment, consumers are expected to continue to retrench until the political climate stabilizes and economic conditions improve. Unfortunately, however, the potential impeachment and presidential transition are likely to be a long, drawn-out process. Once a new government is established, strong and stable policy making is needed to restore confidence levels and lift economic growth.

Overall, we see that Brazil's economy is experiencing a severe slowdown. GDP is contracting as a result of political turmoil, tighter monetary and fiscal policy, declining exports, high inflation and a weak currency. Nevertheless, the economic contraction is expected to slow down this year as the weaker real and rising commodity prices boost Brazilian exports and the government regains credibility through its policy adjustment efforts. The president's seemingly imminent removal, along with Mr. Temer's business-friendly reputation, is also giving hope that the economy has passed its trough. As a result, economic growth is expected to improve this year, with GDP contracting by around 3% compared to the 3.8% decline in 2015.