ANDBANK RESEARCH

Global Economics & Markets

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Working paper - 69

Why financial markets do not love Dilma?

Our Outlook for the Brazilian Economy and Financial Markets

ANDBANK Private Bankers

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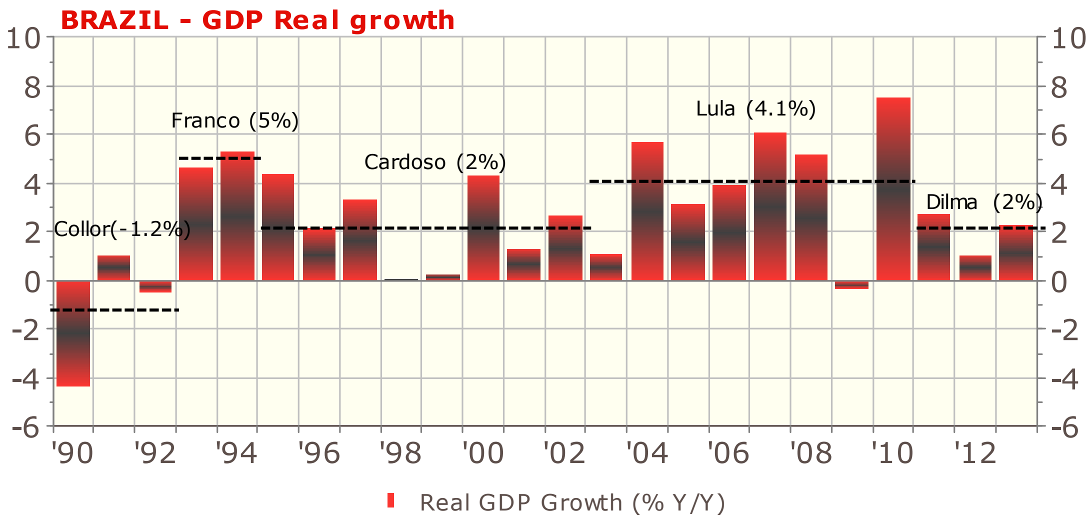
1st. GDP Growth under Dilma has been disappointing

- When she took office, the expectation was for GDP to grow at an average pace of 4% to 5% during her first mandate. Growth has actually averaged just 2% under Dilma's first mandate.
- The average growth under Dilma has been the lowest since Cardoso (who had to deal with the EM crisis of 97-98). If we isolate the observation of the EM crisis, growth under Dilma has been weaker than under any president since Collor in the 1990-1992 period.
- The slower pace has not been caused by a weaker demand (private consumption has averaged 3.5% y/y growth during Dilma). Instead, **lower growth has been caused by constraints in the supply–side of the economy, and this is indeed a structural aspect that has much to do with poor governance.**
- These constraints are at the same time the cause and the consequence of Brazil's chronically low investment rate (equivalent to just 18% of GDP. Much lower than the 30% average in the EM universe and even lower than when she took office).



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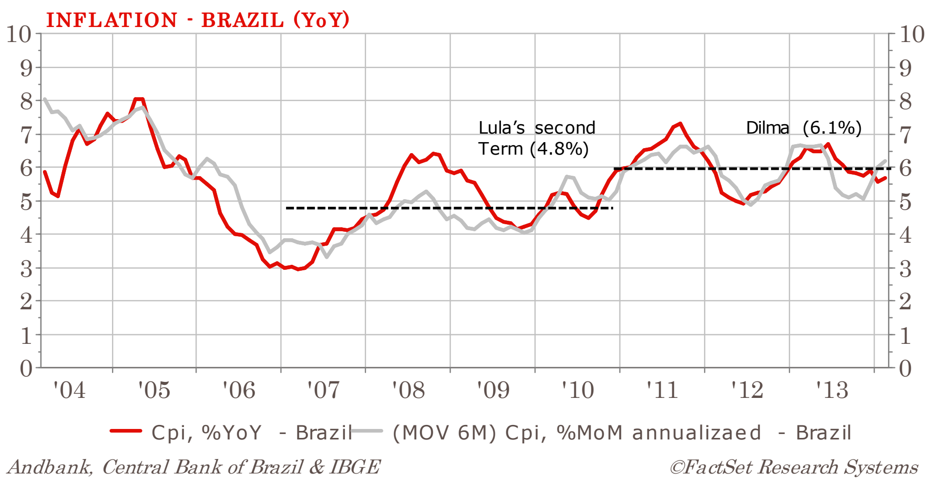
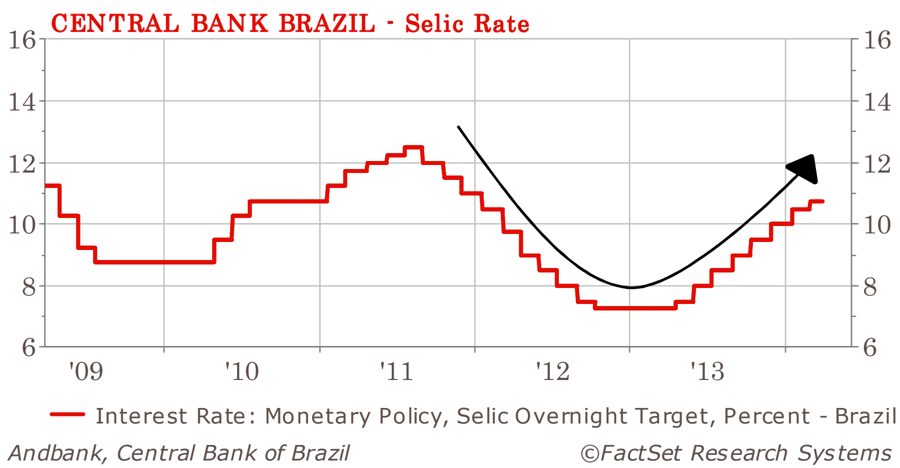
2nd. Inflation remains stubbornly high despite the slower structural growth

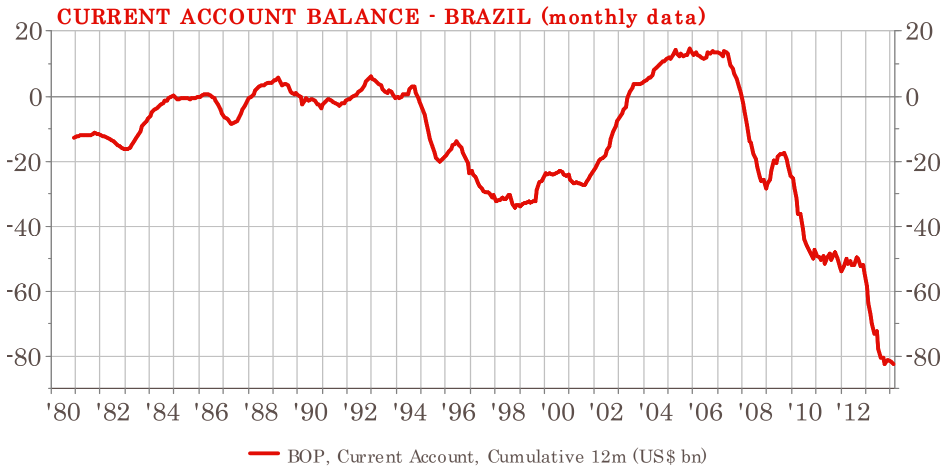
- Under Dilma, inflation has averaged 6.1% y/y (despite having shown a meagre GDP growth of just 2% in average).
- Inflation under Dilma has been higher than the average inflation seen during Lula's second mandate (4.8% y/y). Most importantly, **inflation has been permanently above the central bank's target** of 4.5%.
- This situation has **paralyzed Dilma's objective of lowering borrowing costs** to single digit for companies, since the **central bank has been forced to hike rates sharply again** (see chart 2)
- Once again. The foundations of the economy do not fail. You can not set a lower financing costs lower by simply reducing the central bank rates. Instead, **it is necessary to raise the country's saving rate**. Admittedly, this is something that takes time, but specially **requires the implementation of good policies**





3rd. The current account deficit has widened and seems out of control … despite the high commodity prices

- Spending has leaked into imports (rather than fixed capital investment) against a backdrop of high credit, and this has lead to a continuous deterioration of the current account balance.
- Although current account deficit during Dilma's mandate has averaged -2.6% (the worst average level since Cardoso), **the level posted in the last part of 2013 means the worst reading ever (-80bn usd or -4% of GDP).**
- This simply means that **Brazil has been living beyond its means since 2007**, something particularly concerning if we consider that the terms of trade have remained positive in the last five years.
- Nevertheless, this does not mean that Brazil is on the cusp of a balance of payment crisis (since the authorities are sitting on a $370bn foreign exchange reserves), but **funding both fiscal and current account deficits will become more expensive in a global environment that is clearly tighter.**



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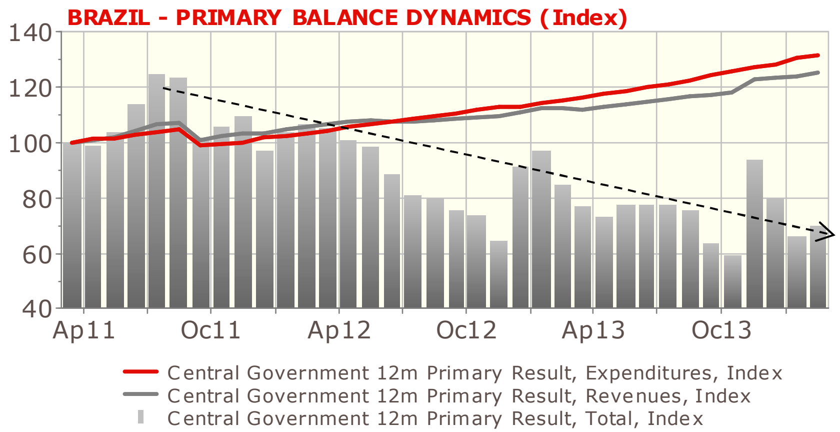
4th. Additionally, the fiscal deficit has widened steadily during Dilma's time in office

- Budget deficit under Dilma has deteriorated from -2.6% of GDP in her first year (2011) to -3.3% of GDP in 2013. Above the average deficit under Lula's second term (-2.8% of GDP).

- Most of **the deterioration appears to reflect a rise in government expenditure**, rather than a shortfall in tax receipts (see the first chart). Admittedly, It could be **hard to understand how the massive increase in government spending (30% in 3 years) has not resulted in a relative improvement of fixed capital investments** (see the second chart).

- Although the primary balance remains in surplus (it was fixed at 1.9% of GDP in 2013), **is at the lowest level since comparable data began**, and is just at the threshold required to stabilize government debt. Put simply, **a further fall in primary surplus would cause the public debt ratio (already among the highest in the region) to edge even higher.**



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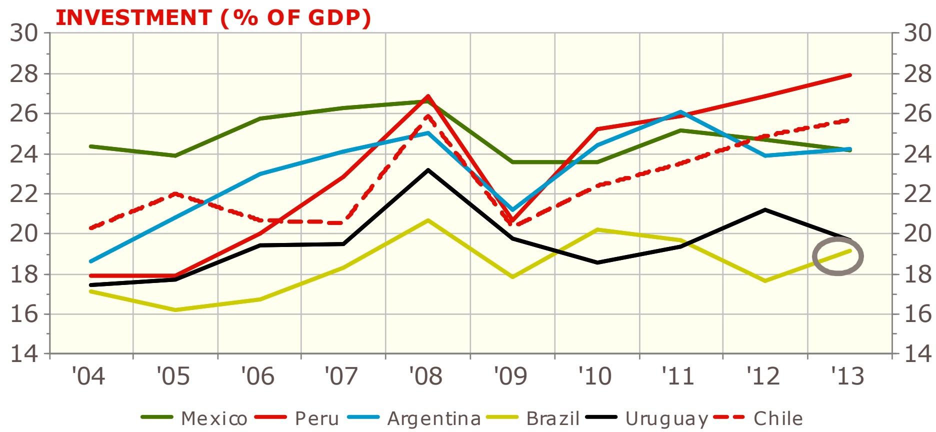

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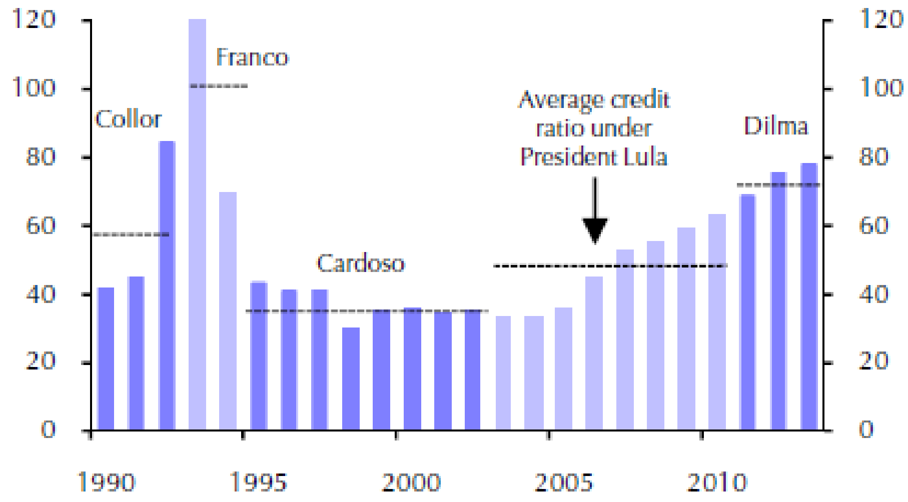
5th. Private sector debt is now higher than at any point since the early 1990s

- Private debt has increased to nearly 80% of GDP and is now at the levels seen in the early 1990s.

- But **it is the pace of credit growth** –rather than the fact that it has returned to early 1990s levels- **that is the greater concern**. After all, **history suggest that problems tend to emerge following a rapid expansion of lending**, rather than when the level of debt crosses a specific threshold.

- Looking at previous EM crises, a common feature is that the ratio of private credit to GDP has increased by at least 30%-pts in the space of ten years**. In Brazil, the credit ratio has risen by nearly 45%-pts over the past decade.**

PRIVATE SECTOR CREDIT (% of GDP)



Capital Economics, Thomson Datastream

Conclusions & Projections

1. The average growth under Dilma has been the lowest since Cardoso. The lower growth has been caused by structural aspects that has much to do with **poor governance.**

2. Dilma's objective of lowering borrowing costs has been paralyzed by the stubbornly high inflation, forcing the central bank to hike rates aggressively again. (IPCA-15 has rised to 5.9% y/y in March from 5.7% in February). We bet for another hike in rates to 11% at April's COPOM meeting. With the inflation rate set to remain above the target for the next quarters, **central bank's rates look set to remain at double-digits for some time, which undoubtedly will weight on growth as well.**

3. Current account remains out of control and is now harder to fund it in a tighter monetary environment, becoming a priority to reduce it. **This simply means that a period of weaker domestic demand growth lies ahead.**

4. The dangerous pace in credit expansion seen during the last decade means that **credit will become less of a prop to economic growth.**

5. The primary fiscal balance has also deteriorated steadily during Dilma's time in office and is just at the threshold required to stabilize government debt. Put simply, **the fiscal policy can not be an engine to boost the economy in the coming quarters or years.**

6. More timely economic data suggest that **the economy remains stuck in a rut.** Some GDP trackers indicate that the economy remained extremely disappointing at around 2% y/y during the 1Q14.

7. **In summary, and according to our figures, we estimate that Brazil faces an era of poor growth (around 2%) and probably larger budget deficits (near the 4%) and rising debt (near the 70% of GDP).**

8. **According to our projections for the economy, we set the targets for the main financial assets:**

   - ✓ **Bovespa:** We keep unchanged our target at 52.000 (to see the calculations, please look at the annex)
   - ✓ **10Yr Government bond yield:** Previous target 12%. New target 13% !!!
   - ✓ **BRL-USD:** We keep unchanged our fundamental target at 2.60

Annex

Andbank's projection for 2014 sales growth in Brazilian corporations: +9.20%

Bovespa	*% of sales (geographical criteria)*	*2014 real GDP estimated*	*2014 inflation rate estimated*	*2014 nominal GDP estimated*	Currency effect on international Sales (%)	*Expected sales growth % 2014 in USD*
Usa	4.0	2.50	1.70	4.20	8.25	12.45
Brazil	82.0	2.00	6.00	8.00	0.00	8.00
Europe	3.0	1.00	1.10	2.10	7.50	9.60
Region Asia Pcific x Japan	8.0	5.80	4.00	9.80	8.25	18.05
Rest	3.0	3.25	3.00	6.25	7.50	13.75
Total world	100.00	3.30				**9.20**

Andbank's projection for 2014 EPS growth: +4.41%

2013 profit margin % (Factset)	7.06
2014 est profit margin % (3)	6.75
Sales base 2013	100
Sales exp 2014	109.20
Profit base 2013	7.06
Profit exp 2014	7.4
2014 expected profit growth %	**4.41**

Annex

Andbank's estimate for BOVESPA target price: 52.300

	2013 EPS local	2013 Projected Growth EPS (%)	2014 Projected (local) (A)	2013 PE ltm	Andbank's estimate for 2014 PE ltm (B)	Target Price (A x B)	Current Price 31-mar-14	Expected Change (%) 2014
Bovespa	4175.7	**4.41**	4359.74	11.28	**12.0**	52,317	49,768	**5.1%**

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