

From: Daniel Sabba <[REDACTED]>

To: "'jeevacation@gmail.com'" <jeevacation@gmail.com>

Subject: Fw: Faria: Brazil Daily Update [I]

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See below. Called you back.

----- Original Message -----

From: Isin Sumengen-Ziel (DEUTSCHE BANK AG, LO) [mailto:[REDACTED]]

Sent: Thursday, September 24, 2015 04:33 PM

Subject: Faria: Brazil Daily Update

Friday highlights:

FIPE will release the third September preview of São Paulo's inflation, and we expect 0.40%. The Labor Ministry could release its CAGED survey on formal employment for August and we expect a net loss of 50K jobs, which would be the fifth consecutive monthly decline.

Tombini hints that the BCB could use international reserves to intervene in the spot market

BCB President Alexandre Tombini stated on Thursday that the central bank intervenes in the market to ensure that it continues working properly, adding that the authorities could use all the instruments at their disposal to ensure the proper functioning of the FX market. According to the BCB president, the "reserves are insurance that can and should be used." The BRL regained some ground after Tombini's comments (it was up 4% to BRL4.01/USD as of this writing), because market participants priced in a higher probability of direct intervention in the spot market.

Although we do not rule out the use of reserves in case the political crisis continues to worsen, we believe the BCB will prefer to stick to the FX swaps and repo lines for now. Although Brazil has currently a comfortable USD370bn in international reserves, depleting them to stabilize the FX could send a negative signal to the market. It is important to stress that the potential FX outflows are quite significant. The short-term external debt by residual maturity, for example, amounts to USD119bn, according to BCB data. Furthermore, foreign investors currently hold approximately 20% of the Treasury's domestic debt (roughly BRL500bn or USD125bn at the current FX rate) and around USD110bn in stocks. The stronger the BRL, the easier it would be for these holdings to be converted into USD and leave the country. As long as the usual balance of payments flows are concerned, the current account deficit has declined significantly, but there are signs that foreign direct investment is decelerating as well.

We believe the BRL depreciation reflects several factors, including concerns about the Chinese economic deceleration and decline in commodity prices, and especially the domestic political turmoil and consequent government inability to fix the fiscal accounts. In our opinion, the first-best policy option would be to introduce a credible fiscal adjustment package to be implemented mostly without congressional support, which would require drastic spending cuts (instead of the re-allocation of expenditures recently announced) and an increase in taxes that would have a more direct negative effect on inflation (especially the CIDE tax on fuel sales). A credible fiscal package would allow the BCB not only to further raise interest rates in order to control inflation and tame the FX, but also to step up intervention in the spot market even by using international reserves if necessary. Without a fiscal anchor, the Brazilian economy will remain vulnerable, and intervention in the FX and Treasury bond markets will buy the authorities some precious time, but will hardly reverse the negative trend.

Inflation Report suggests the BCB will remain on the sidelines for now

According to the quarterly Inflation Report published on Thursday, the BCB's passive inflation forecast for 2015

climbed to 9.5% from 9.0%, while the forecast for the 2016 IPCA rose to 5.3% from 4.8%. The GDP forecast for 2015 fell to -2.7% from -1.1%. The key assumptions here are the following: SELIC rate stable at 14.25% (vs. 13.75% in the previous report published in June), FX at BRL3.90/USD (vs. BRL3.10/USD), primary fiscal surplus of 0.1% of GDP for 2015 (vs. 1.1%) and 0.7% of GDP for 2016 (vs. 2.0%). The BCB stresses again that the fiscal impulse is measured as variation in the structural balance that takes into account the business cycle, suggesting that its scenario still assumes a fiscal tightening.

Although the 2016 passive inflation forecast rose to 5.3%, moving further away from the 4.5% target, the BCB repeated exactly the statement published in the September COPOM minutes: "the remaining risks for the COPOM projections to safely reach the 4.5% target at the end of 2016 are consistent with the lagged and cumulative effect of monetary policy on inflation. On the other hand, recent increases in the risk premium, reflected in asset prices (i.e. the exchange rate), require that monetary policy remain vigilant in case of significant deviations of the inflation forecasts from the target." Furthermore, the BCB passive forecast now puts inflation at 4.0% in 3Q17, below the 4.5% target. In our opinion, this could pave the way for the BCB to eventually accommodate the effect of the FX shock on 2016 inflation and postpone the convergence to 4.5% target until 2016.

All in all, the final conclusion is that, for the central bank, the increase in the inflation forecast for 2016 does not yet require further monetary tightening. BCB President Alexandre Tombini reinforced this message by claiming that "the policy is one of stability of interest rates for a prolonged period."

Unemployment remains on the rise

Brazil's unemployment rate rose less than expected to 7.6% in August from 7.5% in July. Our forecast was 7.8% and the market consensus was 7.7%. A slight decline in the participation rate alleviated the increase in unemployment last month. The labor force fell 0.1% MoM (after surging 0.6% in July), while the number of jobs also fell 0.1% MoM. Still, on a seasonally-adjusted basis, according to our estimates, the unemployment rate climbed to 7.4% in August from 7.3% in July, reaching the highest level since January 2010. Unemployment jumped from 5.0% in August 2014, as the number of jobs plunged 1.8% YoY and the labor force grew 0.9% YoY. We do not expect the participation rate to decline much further, as the deterioration in employment conditions is depressing household income, prompting more people to join the labor market. Average real earnings rose 0.5% MoM in August (perhaps because workers who earn lower wages are being dismissed faster), but still declined 3.5% YoY. Total labor income fell 5.4% YoY in real terms, reflecting both the decline in employment and lower real wages. The short-term outlook for employment and economic activity remains very negative.

Consumer confidence fell sharply in September

After falling 1.7% MoM in August, the FGV index of consumer confidence plummeted 5.3% MoM to 76.3 in September, setting another all-time low. The current conditions index plunged 6.0% MoM to 67.1 (as only 3% of the interviewees considered the current economic situation "good"), and the expectations index fell 5.4% to 81.1. The steady decline in consumer confidence has been driven by rising unemployment, high inflation, political turmoil and increase in financial market volatility. We do not expect a major recovery in consumer confidence anytime soon, especially because the labor market is likely to deteriorate further in the next months.

The government has raised the TJLP again

According to Agencia Estado, on Thursday, the National Monetary Council raised the TJLP interest rate charged on BNDES loans by 50bps to 7.0% for 4Q15. It was the fourth consecutive increase, and right in line with market expectations. The gap between the new TJLP and the SELIC rate (14.25%) remains quite large, and we do not rule out additional hikes in the TJLP next year. The increase in the TJLP reduces the subsidies offered by the federal government to the private sector and the implicit interest rate on the federal government's net debt. It is therefore a small but important step towards restoring fiscal sustainability.

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