BRAZIL

THE REAL ECONOMY AND MARKETS: THE QUEST FOR SYNCHRONICITY

The messages sent out by the Brazilian financial markets and those of the real economy have become increasingly incongruent. Robust economic growth, low unemployment and relatively subdued inflation have become steadily overshadowed by rising political and fiscal risks, which have weighed more heavily on the currency, equity prices and the yield curve. Lula's parliamentary setbacks, his frictions with the Central Bank and increased interventionism have rattled investors already shaken by major revisions to global and local interest rate projections. The challenge for the second half of the year will be to bolster economic agents' confidence in an effort to stabilise expectations.

CONSUMPTION, BOOSTED BY FISCAL POLICY LEVERS

Activity data for the first half of the year show that consumer spending remains very dynamic. Household consumption – which has been at the heart of the Lula government's measures to support activity – has relied on three main levers to emerge as the main engine of growth: i/ the rescheduling of household debt via the *Desenrola*[1] programme, designed to prevent the over-indebtedness of the COVID years from hindering consumption, ii/ wage growth, supported by a buoyant job market (the unemployment rate was again down in May reaching 7.1%); and iii/ transfers to households (in addition to the Q1 settlement of court injunctions, or *precatorios*, social security spending and other forms of assistance increased from BRL 1,000 bn in 2021 to BRL 1,300 bn in 2024 at constant prices). The credit lever – which Lula wishes to stimulate further – remains modest for now and is coming up against the interruption of the monetary easing cycle. The creation of a guarantee fund (FGO), as part of the new *Acredite* programme, should however allow banks to provide up to BRL 12 bn in loans to individuals and businesses.

Meanwhile, investment – which had returned to growth in Q4-2023 – accelerated further in Q1 2024 (+4.1% q/q and +2.7% y/y). As a sign of a vigorous domestic demand, imports grew faster than exports over the same period (+6.5% vs. +0.2% q/q). On the supply side, growth in services remained strong while industry experienced a slight decline. Despite lower cereal harvests, agricultural output proved resilient, buoyed by the beef and soybean sectors.

The damage caused in May by heavy storms and flooding in nearly 90% of the municipalities of the state of Rio Grande do Sul[2] is expected to shave off some 0.2 pp from annual GDP growth figures. The shortfall (i/ in terms of agricultural production – the state accounts for about 70% of the national rice production an 48% of wheat production and represents some 12% of Brazil's agricultural GDP – and ii/ in terms of vehicle production – factories have stopped production, and vehicle sales in the state fell by 64% in May compared to April) should, however, be partially offset by reconstruction efforts. Activity should also benefit from increased financing in the agricultural sector (BRL 476 bn in subsidized credits under the new *Plano Safra* 2024/25, +7% y/y) as well as the launch of a new initiative (*Rota Quadrante Rondon*) aimed at developing infrastructure at the country's borders in order to boost trade in South America.

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	5.1	3.1	2.9	2.2	2.0
Inflation, CPI, year average, %	8.3	9.3	4.6	4.1	4.1
Fiscal balance / GDP, %	-4.3	-4.6	-8.9	-7.0	-6.9
Gross public debt / GDP, %	77	72	74	77	80
Current account balance / GDP, %	-2.8	-2.9	-1.3	-0.9	-1.3
External debt / GDP, %	42	36	37	42	40
Forex reserves, USD bn	362	324	355	348	350
Forex reserves, in months of imports	14	11	12	13	12

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: RISING BOND YIELDS AND SHARP WEAKENING OF THE BRL

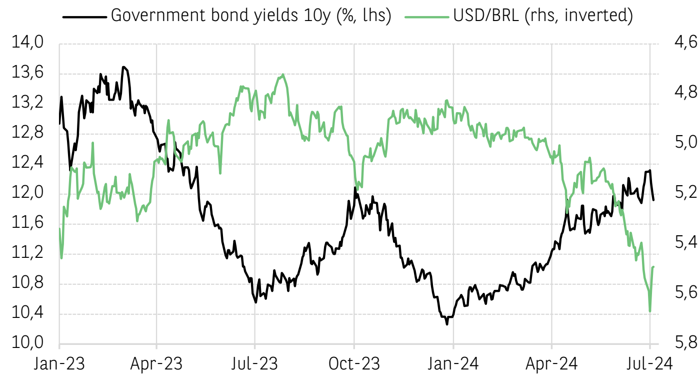

CHART 1 SOURCE: MACROBOND

SHIFTS IN THE RATES OUTLOOK

Despite inflation remaining within its target range (3% +/-1.5pp), the sharper deterioration in inflation expectations in recent months led the Central Bank to halt its monetary easing cycle in June, thus putting an end to 7 consecutive cuts to the SELIC policy rate

1 The programme, which was implemented in 2023 and affects 70 mn Brazilians who recorded unpaid bills between 2019-22, has been extended until May 2024.
2 The country's southernmost state, whose economy is comparable in size to those of Uruguay and Paraguay put together, accounts for about 6.5% of the national GDP. The human toll has been high with nearly 180 deaths and more than 50,000 victims who have lost their homes. The cost of reconstruction has been estimated between BRL 110 bn (USD 21 bn) and BRL 176 bn by the Federasul business association.

(cumulative decline of 325 bps between August 2023 and May 2024 to 10.5%). Markets are no longer anticipating rate cuts this year (after having forecast a terminal rate at 9% at the start of the year). Aside from the evolution of the external scenario, the revised outlook on Brazilian rates is based, above all, on a triptych of factors affecting expected inflation.

First, the conditions for stabilizing the public debt ratio – which has risen by some 20 percentage points in 10 years – seem less and less in place. Lula is keen to maintain a certain level of public spending but is struggling to approve a rise in revenues in Congress. In particular, his attempts to tackle tax loopholes have so far been unsuccessful. In addition to downward revisions to budget targets for the period 2024-2028, markets have become more concerned about the rise in mandatory spending (social security, health, education) and the retention of optimistic growth assumptions in the budget orientation bill. The fiscal losses and increased spending incurred to respond to natural disasters in the south of the country are also of concern (approval of extraordinary credits, suspension of Rio Grande do Sul's debt repayments to the federal government for three years, launch of *Auxílio Reconstrução*, a programme designed to transfer funds to families who have lost their homes, etc.). At a time when rising market rates in both nominal and real terms are pushing up interest payments, the government seems less equipped to rein in a deficit that could near 7% of GDP this year.

Second, markets fear a more dovish stance by the Monetary Policy Committee (COPOM) on inflation by 2025 (by which time Lula will have appointed the majority of COPOM members). This fear is fuelled by tensions between the executive and the Central Bank[3], but also by the memory of the past: between 2011 and 2016, the BCB, then closer to the Government, opted to lower its key rate in a context of rising inflation expectations, which ultimately contributed to accentuate some macroeconomic imbalances.

Third, the more persistent than expected tensions in the labour market could suggest a more lasting bias on inflation (particularly in services). Several signals indicate that the economy may be operating closer to full employment and therefore that the gap between potential and real GDP (i.e., the output gap) may in fact be lower than measured by the Central Bank. Some evidence from the national accounts and the balance of payments seem to support this thesis. Indeed, the economy has not been able to expand output fast enough to meet internal demand (i.e., growth of domestic demand has outpaced that of real GDP). This has led to an increase in imports, which profile reveal insights into some of the underlying tensions at work in the economy. The widening trade deficit in manufactured goods reflects the competition between industry and services for scarce labour in particular. Unlike the manufacturing sector (which is more exposed to international competition), the service sector can more easily pass on the increase in unit labour costs to its prices. Therefore, the tertiary sector has greater flexibility in increasing its production capacity in the face of an expanding domestic demand, as substantiated by the data (with GDP growth in services outpacing that of manufacturing). If indeed the signs that the economy may be operating closer to full employment withstand the test of time, this could limit the prospects of witnessing further rate cuts to avoid overheating the economy.

BRAZIL: UNDERPERFORMANCE OF THE EQUITY MARKET

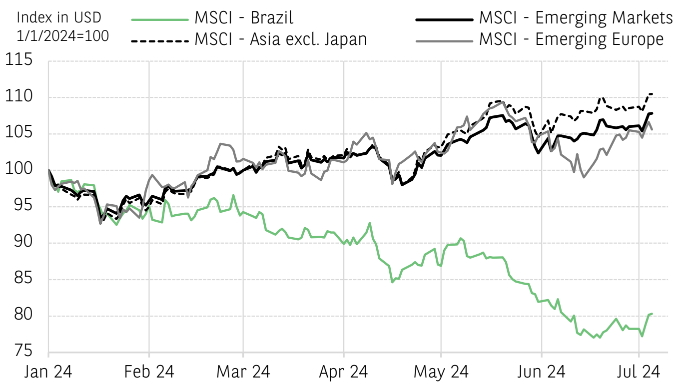

CHART 2 SOURCE: MACROBOND, BNP PARIBAS

THE EQUITY AND FX MARKETS UNDER PRESSURE

Despite overall positive economic results, the recovery in commodity prices, and the relative attractiveness of Brazilian equities compared to other emerging markets, the stock market and the currency have undergone a significant correction since the start of the year. The main stock index, B3 Ibovespa, lost nearly 15% in dollar terms whilst the MSCI Emerging Markets index gained 5%. The decline in the stock market, valued in dollars, is partly attributable to the depreciation of the *reais*, which has lost more than 12% against the greenback this year, the third worst performance among emerging markets. The *reais*, which has hit its lowest level against the USD since Lula took office, is suffering from the effects of the strengthening dollar following the changing interest rate outlook in the United States. But it also reflects a reassessment of political and fiscal risks on the part of local and foreign investors. Notably, the government's interference with large listed companies such as Petrobras or Vale – to influence investment strategies, alter dividend distribution policies, steer fuel pricing policies, and decide on new appointments – largely explains the turmoil on the FX and stock markets in recent months, especially since Vale and Petrobras together account for 25% of the B3 Ibovespa index.[4]

This interference, combined with the attraction of better risk-adjusted returns in North American markets, led to net sales of equity securities by non-residents (estimated at USD 6.6 bn from January to May according to IIF data). Non-residents, who account for about 55% of the daily trading volume on the stock market, were joined in their selling spree by local counterparts, drawn, amongst other factors, by rising government bond yields.[5] A high interest rate environment has historically channelled private savings into government debt instruments, diminishing the capital pool available for private sector investment and slowing the development of the local capital market.

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3 Lula's Workers' Party recently filed a lawsuit against the governor of the BCB for being too political and close to the markets.
4 Vale's share price has also been affected by the downward trend in iron ore prices since the start of the year and that of Petrobras, by the announcement of a 24% (t/t) drop in its net profit in Q1 (-38% y/y).
5 To preserve the real value of their investments in the face of anticipated higher inflation, investors have, in recent months, been demanding an additional risk premium to hold medium- to long-term government debt securities.