Brazil | A more negative outlook

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Last week's downgrade to high-yield by S&P was one of the symptoms of the ongoing economic deterioration, which will likely continue ahead. After reviewing our prospects for Brazil, we now expect GDP to drop 2.5% in 2015 and 0.5% in 2016. A weaker exchange rate and a lighter fiscal adjustment should maintain inflation under pressure and prevent SELIC cuts until 2Q16.

Recession will be sharper than expected in 2015 and will continue in 2016

GDP declined more than we forecasted in 2Q15 (observed: -1.9% QoQ; BBVAe: -1.4% QoQ), mainly due to a larger-than-expected contraction in investment. In addition, 1Q15 GDP was revised downwards to -0.7% QoQ from -0.2% QoQ. On top of that, economic activity is now expected to continue to lose momentum in the second half of the year and beginning of 2016 rather than to stabilize, as a consequence of more negative political and economic dynamics. The outlook was affected by the government inability to tight fiscal policy as previously announced (see more on this issue below): fiscal slippages prevented the government from paving the way for a recovery of confidence and, therefore, of economic activity. They also triggered the S&P decision to withdraw Brazil's investment grade, which represents an additional obstacle to growth recovery. The recent developments in China as well as the further declines in commodity prices also contribute to the worsening of the prospects for the Brazilian economy. Taking all these factors into consideration, we revised our GDP forecasts from -1.5% in 2015 and 0.5% in 2016 to -2.5% and -0.5%, respectively. We expect both consumption and investment to contribute negatively to growth in both 2015 and 2016. However, external demand should contribute positively thanks to the impact of the exchange rate depreciation and the effect of the contraction of domestic demand on imports. That should prevent an even more severe GDP contraction and favor the reduction of the current account deficit from 4.5% of GDP in 2014 to no more than 3.0% of GDP in 2016.

We do not expect fiscal targets to be fulfilled

Even though the government reacted to the S&P downgrade by announcing some measures to cut expenditure and increase revenue, we are skeptical about their implementation, mainly because Congress will likely oppose them. Moreover, the sharper-than-expected contraction of domestic demand implies that public revenues will drop more than previously forecasted. Therefore, in our view, the most likely is that the public sector will exhibit primary deficits of 0.3% and 0.2% of GDP in 2015 and 2016, respectively. That means that primary surplus targets (0.15% of GDP in 2015 and 0.70% of GDP in 2016) will probably not be met and that the gross public debt should move above the 70% level next year. In this environment, additional sovereign rating downgrades should not be seen with surprise.

Weaker exchange rate and more pressure on inflation

As a reaction to the recent domestic and external developments, the exchange rate is now around 3.85 (vs. 2.45 one year ago). As China and commodity markets are now less supportive, as the Fed should soon start to increase interest rates, and as the domestic environment will remain turbulent, we see few reasons to believe that the exchange rate will appreciate significantly going forward. We expect the Brazilian real to end the year close to recently observed levels and to average 4.0 in 2016. A weaker currency, as well as a lighter fiscal adjustment, should create additional pressure on inflation. Even though we expect inflation to have already peaked, we adjusted our forecasts slightly up to 9.2% and 5.5% at the end of 2015 and 2016, respectively. The negative tone of economic activity should prevent inflation from reaching even higher levels.

The Selic is likely to remain unchanged for some time; upside risks are higher now

We do not change our view regarding BCB's monetary policy: we continue to expect the Selic to remain at the current 14.25% level until 2Q16. However, as the monetary authority has already been acknowledging, further exchange rate depreciation or additional fiscal slippages could require new doses of monetary tightening.