

LatAm Macro Wire

ECONOMIC RESEARCH

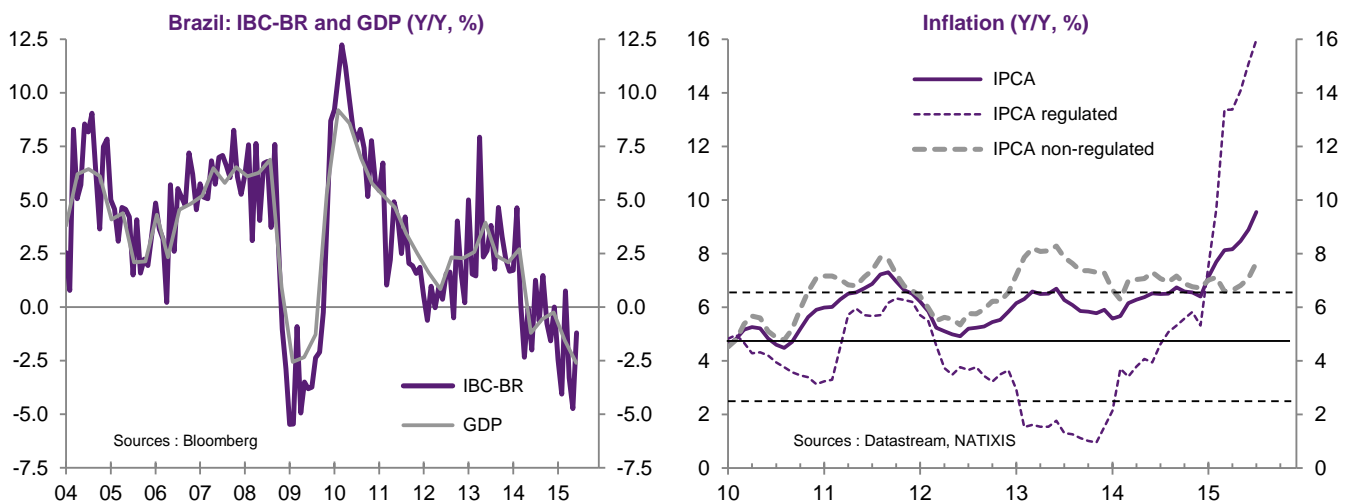
September 9, 2015

Brazil: downgraded to junk by S&P, what should we expect?

S&P downgraded Brazil's sovereign rating to junk (BB+) with a negative outlook. The decision was clearly in line with the worsening of Brazil's fundamentals. From a rating perspective the numbers were just too bad.

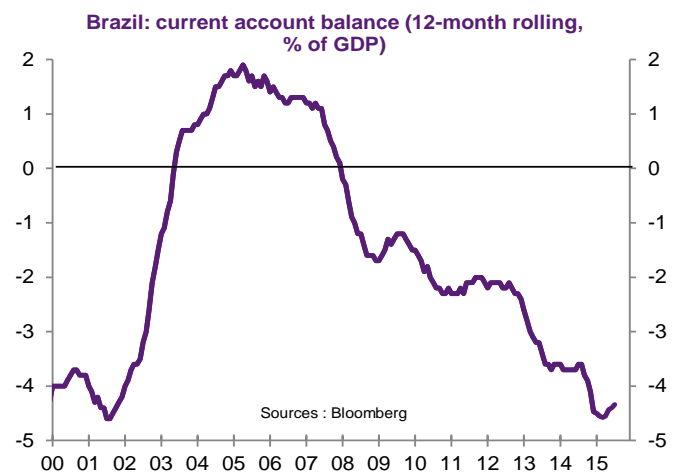
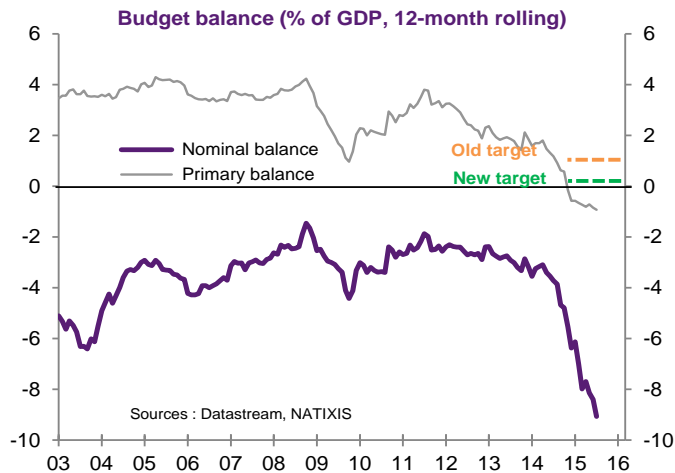
1/ Growth and inflation

The country headed into its deepest recession in 25 years. The GDP decline in Q2 2015 (-2.6% Y/Y) is not only explained by falling terms of trade but also fiscal and monetary tightening. This comes along with several issues on the structural side: lack of infrastructures, still high level of unit labor costs and years of BRL overvaluation. **IPCA reached a 12-year high in August at 9.6% in Y/Y.** Brazil inflation is structurally high due to wage indexation, local content laws, infrastructure bottlenecks.... The normalization of regulated prices and the strong depreciation of BRL have also contributed to the high level of prices.



2/ Fiscal and external deficit

No need to lie on this point. **The fiscal targets set by the government were just impossible to achieve given Brazil's stagflation.** The primary surplus target for 2016 started the year at 2% of GDP. It was revised down to 0.7% in July and recently to -0.5%. Public debt sustainability is an issue with an 8.8% of GDP fiscal deficit and no growth. The current account deficit reached 4.3% of GDP in July. **The very mild rebalancing is explained by falling GDP despite the massive currency depreciation.** Moreover, other EM currencies are also weakening and world trade is particularly soft which means it will take time before exports drive growth in a sustainable way.



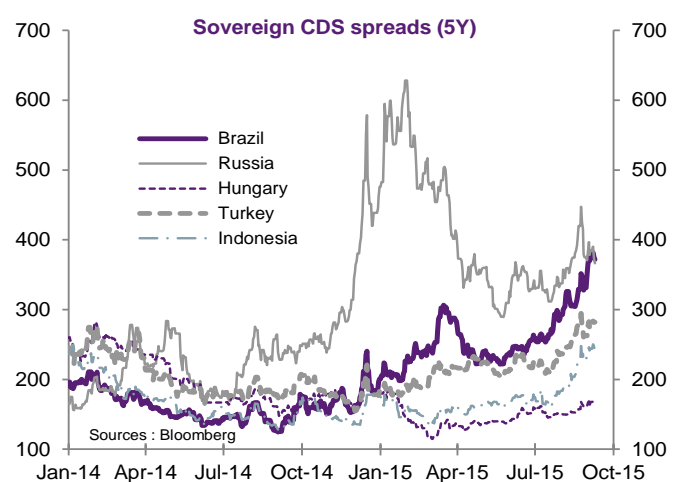
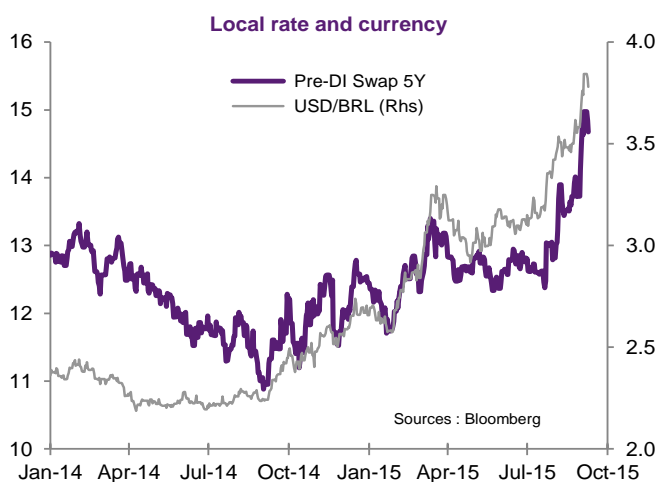
3/ Politics

The political and social climates have significantly deteriorated in Brazil. President Rousseff is the most unpopular leader with a record-low approval rate of 8% and a difficult situation in congress. The different corruption scandals have undermined the credibility of institutions.

Brazil's sovereign rating (year-end)			
	Moody's	S&P	Fitch
2001	B1	BB-	BB-
2003	B2	B+	B+
2005	Ba3	BB-	BB-
2007	Ba1	BB+	BB+
2009	Baa3	BBB-	BBB-
2011	Baa2	BBB-	BBB
2013	Baa2	BBB-	BBB
2015*	Baa3	BB+	BBB

Source: Bloomberg * latest available

Bottom line: The big question is what is next for Brazil. **Equity, rates and BRL are going to sell-off tomorrow.** Now all depends on how you want to see the decision. 1/ In order to lose the investment grade status most funds require at least 2 out of the 3 main ratings agencies to cut to junk the position on Brazil 2/ If as a wise investor you anticipated the movement, you tell yourself that part of the adjustment is already factored in. Brazil was already trading at junk levels like Russia, Indonesia, Hungary, Bulgaria and Turkey which are BB+ according to S&P. **We expect more negative news to come.** The other rating agencies will very likely follow given that the adjustments of Brazil's imbalances will be very progressive. The second important outcome of the decision is that a myth has fallen. **Despite all the good intentions of Finance Minister Levy to restore fiscal credibility, the ugly economic reality took its toll on the country's credit quality.**



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