

Subject: FW: Faria: Brazil Daily Update [C]  
From: Paul Morris <[REDACTED]>  
Date: Thu, 10 Sep 2015 11:28:12 -0400  
To: jeffrey E. <jeevacation@gmail.com>

Classification: Confidential

Let's follow-up on our chat last week

Paul Morris

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From: Daniel Sabba  
Sent: Thursday, September 10, 2015 10:49 AM  
To: 'jeffrey E.'  
Cc: Paul Morris; Vahe Stepanian; Stewart Oldfield; Ariane Dwyer; 'Richard Kahn'  
Subject: RE: Faria: Brazil Daily Update [C]

Classification: Confidential

CDS at highs again. Your position at last night's close was at 1,017,400.

{cid:image001.png@01D0EBB6.3909E770}

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

From: Daniel Sabba  
Sent: Friday, September 04, 2015 2:32 PM  
To: 'jeffrey E.'  
Cc: Paul Morris; Vahe Stepanian; Stewart Oldfield; Ariane Dwyer; 'Richard

Kahn'  
Subject: FW: Faria: Brazil Daily Update [C]

Classification: Confidential

Relevant Brazil update.

5y on the run CDS at 384.

USDBRL 3.8485.

My impression is that there is still time to short more, if you are up to it Jeffrey.

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

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

Sent: Thursday, September 03, 2015 4:50 PM

Subject: Faria: Brazil Daily Update

Brazil's economic outlook deteriorates further

According to newspaper Folha de S.Paulo, Finance Minister Joaquim Levy told President Dilma Rousseff on Wednesday that he was becoming increasingly isolated in the federal administration and losing support to implement his fiscal adjustment plan, and concluded that, under these circumstances, it would be difficult for him to stay in the government. Shortly afterward, Rousseff publicly defended Levy, claiming that he was not isolated in the government. As speculation about Levy's possible resignation continued on Thursday, the beleaguered Finance Minister cancelled a trip to Turkey (for

the G-20 meetings) in order to have a meeting with Rousseff, Planning Minister Nelson Barbosa, and Chief of Staff Aloizio Mercadante.

We expect Rousseff to repeat that Levy has her total support, and also to send to Congress an addendum to the 2016 federal budget reducing the projected deficit. Nevertheless, the reality is that Levy has lost a sequence of important fights in the government (especially the watering down of the fiscal measures, the change in the fiscal targets, and more recently the 2016 budget forecasting a federal primary deficit of 0.5% of GDP), and his position is becoming increasingly difficult day by day, as he remains under intense friendly fire (especially from the President's own party, the PT) and Rousseff seems to be having second thoughts about his fiscal austerity plan. As a matter of fact, we believe Levy has not left yet because the government fears that his departure could speed up Brazil's downgrade below investment grade, and because Levy himself knows that his departure would aggravate the crisis.

The impression that we have at this point is that the federal government has indeed abandoned Levy's fiscal adjustment plan. According to newspaper Valor Econômico, the government is no longer willing to cut fiscal spending, believing that it is necessary to use expansionary fiscal policy (including subsidized loans) to rekindle growth. The authorities believe that, as economic growth picks up, tax revenues will improve, alleviating the fiscal situation. It seems that the farthest the government is willing to go to cut the primary fiscal deficit is to raise taxes, "especially on those sectors that gained the most during the Lula years," preserving its welfare programs. According to newspaper Estado de São Paulo, Rousseff has not given up on the CPMF tax idea, and allegedly wants to convince Congress to propose reinstating the tax on financial transactions. According to the same source, some congressmen of the ruling coalition are warming up to the idea, in light of the aggravation of the economic crisis. However, resistance against the tax remains quite strong in the private sector and opposition, so it remains to be seen whether Rousseff will manage to muster enough political support to pass it in Congress.

When the Rousseff administration announced Levy's appointment and its fiscal adjustment plans at the end of last year, we warned that the president began her first mandate in 2011 by tightening fiscal and monetary policies as well, but eventually gave up on those as growth faltered, promoting a combination of rapid fiscal and monetary easing that was dubbed the "new macroeconomic matrix." Thus, we warned that there was a significant risk that history could be repeated in Rousseff's second term. It seems, however, that the austerity-based strategy is unraveling much faster than we could have expected, probably because of the convoluted political environment and repercussions of the Petrobras bribery scandal (the "Car Wash" investigation). Under these circumstances, it is hard to believe that the economy will recover if the government returns to the same populist policies that were mainly responsible for the crisis in the first place. In the absence of a comprehensive fiscal adjustment and without a significant economic recovery, the risk is that Brazil might have to generate increasing inflation rates to cope with its ballooning public debt, a perverse process

that we all remember very well from the 1980s.

In light of the latest developments, we are updating our macroeconomic forecasts to take into consideration the higher risks. While our scenario is not one of uncontrolled inflation, it envisages a much slower economic recovery, weaker exchange rate, and higher inflation. We are optimistically assuming that, despite the latest setbacks, the government will manage to obtain a minimum support from Congress to at least avoid another consolidated primary fiscal deficit in 2016 (most likely through higher taxes), gaining time to slowly work on structural measures that could produce better fiscal results in the coming years. In our scenario, we assume that President Dilma Rousseff will complete her second mandate, but we expect Brazil to lose its investment grade status in 1Q16. That said, the scenario remains quite volatile due to high political uncertainty reflecting Rousseff's lack of support in Congress, the "Car Wash" investigation and the economic crisis. Therefore, the risk remains on the downside, as the government could fail to obtain political support to minimally shore up the fiscal accounts, leading to greater financial and economic instability.

We cut our 2015 GDP forecast to -2.8% from -2.3%, and our 2016 GDP forecast to -0.5% from -0.2%. We expect fixed-asset investment to plunge roughly 11% this year, and the external sector's positive contribution will prevent a larger economic contraction. We raised our 2015 IPCA consumer price index forecast slightly to 9.4% from 9.3%, and our 2016 IPCA projection to 5.9% from 5.4% (mainly due to the weaker FX). We now expect the BRL to finish 2015 at BRL3.70/USD, and 2016 at BRL3.90/USD (instead of BRL3.40/USD and BRL3.65/USD, respectively). Despite the higher inflation, we continue to expect the BCB to cut the SELIC rate to 11.50% in 2016 (with the easing cycle still beginning in April), as we expect the authorities to throw in the towel and postpone convergence of inflation to the 4.5% target again (although we still do not see inflation at 4.5% in 2017). The silver lining is that the deeper recession and weaker FX will produce a larger adjustment in the external accounts: we cut our current account deficit forecast to USD70.0bn from USD76bn for 2015, and to USD63bn from USD76bn for 2016.

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