

From: Daniel Sabba <[REDACTED]>
To: "jeevacation@gmail.com" <jeevacation@gmail.com>
CC: Vahe Stepanian <[REDACTED]>, Ariane Dwyer <[REDACTED]>
Subject: Fw: Faria: Brazil Daily Update
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Brazil raised rates 50bps. An outlier economy... Since early 2015 we saw over 18 economies cutting rates globally.

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

From: Isin Sumengen-Ziel (DEUTSCHE BANK AG, LO) [mailto:[REDACTED]]
Sent: Thursday, March 05, 2015 01:04 AM
To: Daniel Sabba
Subject: Faria: Brazil Daily Update

Sent From Bloomberg Mobile MSG

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

From: JOSE CARLOS FARIA, DEUTSCHE BANK S.A. B <[REDACTED]>
At: 3/4/2015 23:34

The COPOM raised the SELIC rate by 50bps to 12.75%, as expected. The decision was unanimous and was in line with market expectations, as, despite the gloomy economic outlook, inflation remains significantly above the target and short-term inflation expectations continue to deteriorate due to the ongoing adjustment in administered prices (especially electricity). As we expected, the COPOM repeated the previous meeting's communiqué: "Assessing the macroeconomic scenario and the perspectives for inflation, the COPOM decided, unanimously, to raise the SELIC rate by 50bps to 12.75% per year, without bias." In our opinion, this statement does not signal anything for the next meeting, keeping the door open for another 50bp rate hike, a smaller 25bp hike, or no action at all. While we currently expect no further tightening, we must admit that the relentless pressure on the currency has increased the likelihood of another rate hike in April. The COPOM minutes to be published next Thursday could indicate whether the authorities are contemplating further tightening or not.

Political crisis jeopardizes fiscal adjustment

On Tuesday, Attorney General Rodrigo Janot submitted a request for the Supreme Court (STF) to indict 54 people, including congressmen and former congressmen, who allegedly benefitted from the Petrobras bribery scheme. The names were brought up by defendants who testified in exchange for plea-bargain agreements. The Supreme Court must decide on the indictments because congressmen have a privileged legal status. While the names have not been revealed yet (the STF may decide to lift the secrecy on the process and publish the names), newspaper Estado de São Paulo yesterday reported that Lower House Speaker Eduardo Cunha and Senate Speaker Renan Calheiros, both of the PMDB party, were among the 54 names.

Less than two hours after the press reported the inclusion of Cunha and Calheiros in the list, Calheiros rejected Provisional Decree 669, which aimed at reducing the payroll tax rebates and save BRL5.3bn this year, an important component of Finance Minister Joaquim Levy's fiscal adjustment plan. Calheiros argued that the

provisional decree was unconstitutional because it modified another provisional decree approved a few months ago. He also claimed that the government had to submit its proposal through an ordinary bill instead of a provisional decree.

The government reacted by issuing an ordinary bill with constitutional urgency introducing the same measures as the rejected provisional decree. The urgency means that each house in Congress will have 45 days to vote on it, or it will block the entire voting schedule. Consequently, in the best-case scenario, it will take more time for the measures to become effective (tax changes require a 90-day period – which starts at the date of publication of a provisional decree, but only after the approval of an ordinary bill by Congress). Moreover, the risk that Congress will not pass these measures has increased. The risk to the other provisional decrees changing the rules on pensions and unemployment benefits has increased as well.

According to newspaper Valor Economico, Calheiros' unexpected decision to reject the provisional decree was a reaction to the inclusion of his name in the Petrobras bribery list. There has been enormous political speculation about this list and behind-the-scenes moves by government officials (especially Justice Minister Eduardo Cardozo) lately, and, according to newspaper O Globo, Calheiros believes that the government worked to include their names in the list in order to neutralize their growing political influence in Congress. Regardless of the motivations that led Calheiros to refuse the government's provisional decree, the resulting political crisis certainly increases the risk of political rejection of Levy's fiscal adjustment plan. Consequently, the Finance Minister may be forced to rely more on spending cuts than on tax hikes to meet the fiscal target.

Increase in industrial production in January does not indicate recovery

Industrial production rose 2.0% MoM in January, in line with market expectations. The increase in January was mainly a payback to the sharp decline registered in the previous two months (-3.2% MoM in December, revised from -2.8%, and -1.1% MoM in November) and does not signal any recovery in our view. At this point, although the weaker FX tends to help the industrial sector, high interest rates, depressed business confidence, and the risk of energy rationing continue to hurt manufacturing activity. The increase in industrial output in January was led by a 9.1% MoM jump in the production of capital goods, following three consecutive monthly declines (including an 11.5% MoM plunge in December). Intermediate goods rose 0.7% MoM, after falling 0.6% in December and 0.3% in November. Durable goods fell 1.4% MoM (car production fell 0.6% MoM), and non-durable consumer goods declined 0.3% MoM. On a year-on-year comparison, industrial production fell 5.2%, as capital goods plunged 16.4% YoY, durables plummeted 13.9% YoY, non-durable consumer goods declined 5.3% YoY, and intermediate goods fell 2.4% YoY.

The FX market posted a deficit of USD1.1bn in February

The last week of the month registered a large net outflow of USD3.3bn, mainly due to an increase in financial outflows. In February, the commercial market posted a net inflow of USD0.6bn (as daily import outflows fell more than export inflows) and the financial market posted a deficit of USD1.7bn (as financial inflows fell 17% from January and outflows declined 6%). Although the net FX flow shifted from a USD0.3bn deficit in 2M14 to a USD2.8bn surplus in 2M15, there is a risk of further deterioration this year due to the negative economic outlook and increasing political turbulence.

Thursday highlights:

FIPE will release São Paulo's inflation index for February, and we expect 1.20%. The ANFAVEA carmaker association could release data on car sales and production for February.

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