Brazil 2006: Staying Afloat

Macroeconomic Research Group | August 2006

Staying Afloat

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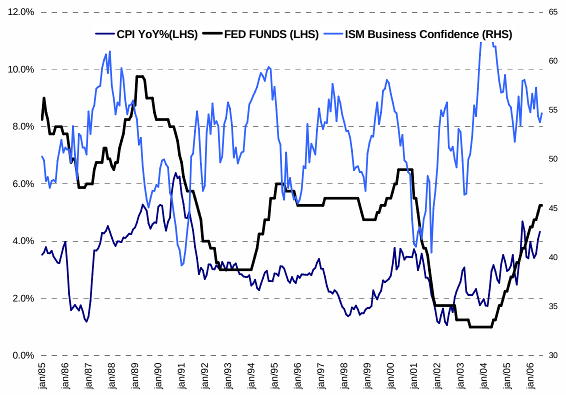
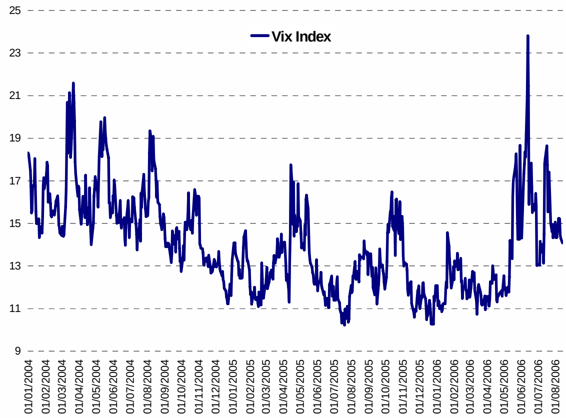
Fed-driven risk aversion and flight to quality movements lifted volatility significantly across global financial markets.

FED FUNDS, ISM and CPI



Source: Bloomberg

Implicit Volatility of the S&P500



Source: Bloomberg

Conditioning next monetary policy moves to upcoming economic events boosts both market and growth-expectation volatility.

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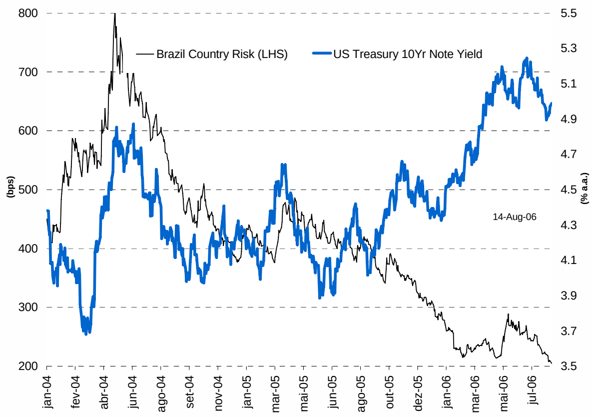
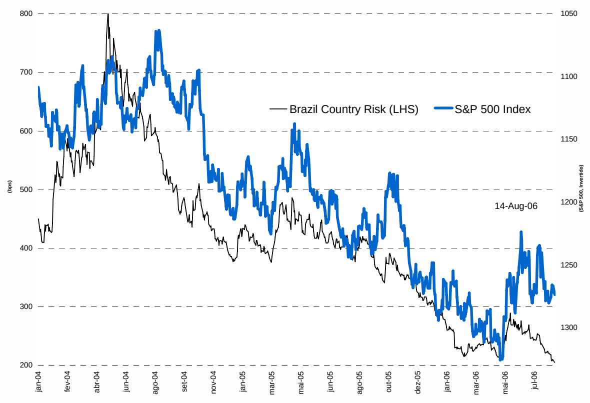
Risky Assets, including Brazil, suffered with the increase in volatility.

Treasury 10Yr Yield and Brazil Country Risk



Source: Bloomberg

S&P500 Inverted and Brazil Country Risk

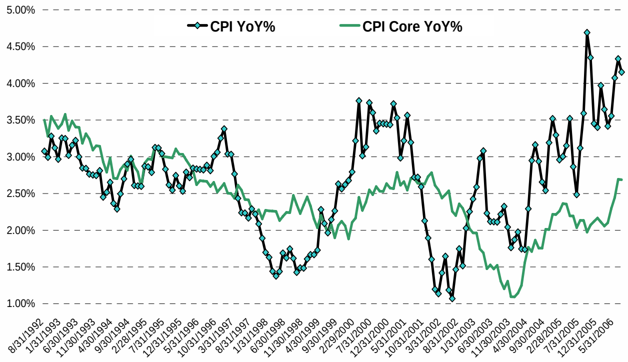


Source: Bloomberg

And while we expect uncertainty to remain high for a while, fundamentals should continue to drive valuation.

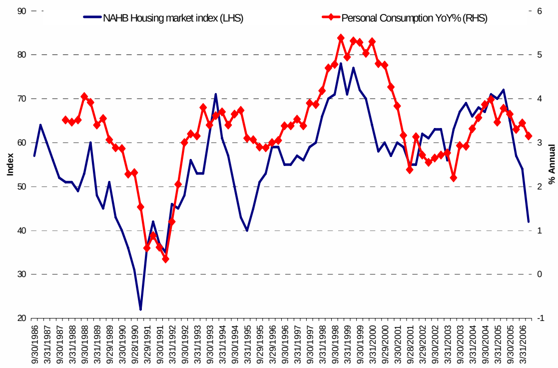
High inflation in the US (both core and headline numbers) …

US CPI—Headline and Core
(YoY%)



Source: Bloomberg

Housing and Consumption
(Index, GDP annualized QoQ% growth rates)

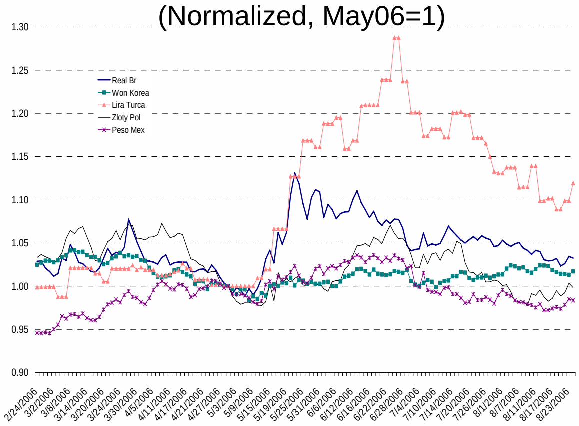


Source: Bloomberg

…are mitigated by the housing and consumption driven slowdown of economic growth in the country. Concerns about a US recession are beginning to rise.

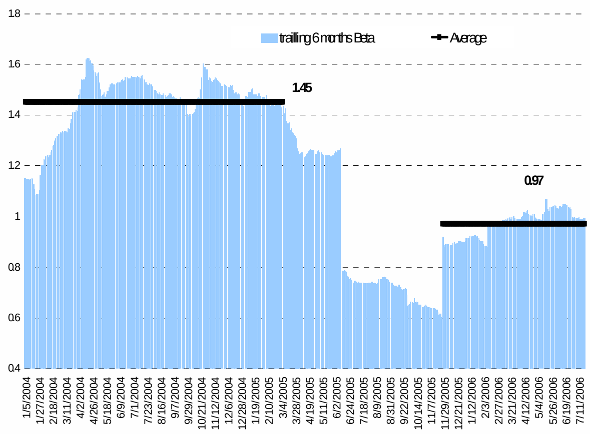
Despite the uncertain global backdrop, fundamentals should prevail...

Emerging Market Currencies – Selected Countries
(Normalized, May06=1)



Source: UBB, Bloomberg

Brazilian "Beta" – EMBI
(Trailing 6 months)



Source: UBB, Bloomberg

…hence helping explain why Brazilian assets are over-performing other EMKTs.

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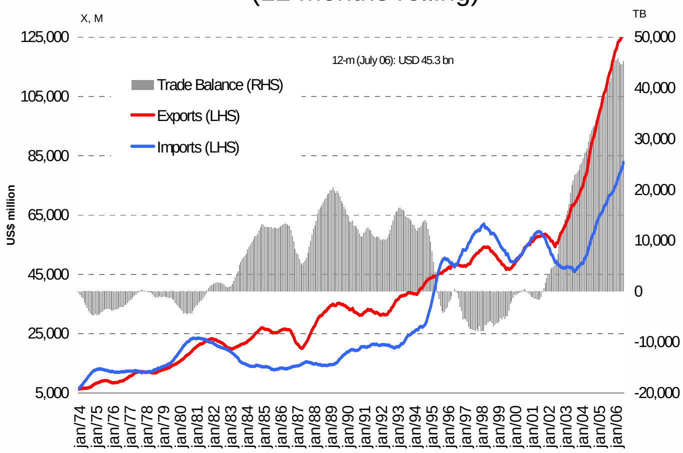
Strong fundamentals and improved external solvency are helping shield the Brazilian economy from the waves of global uncertainty.

Trade Balance, Exports and Imports
(12 months rolling)



Source: Ministry of Commerce

Emerging market selected countries

Country	Current Account US$bn 12-month Rolling	International Reserves $bn, Latest
Brazil	13.3	59.2
Turkey	-25.5	55.9
South Africa	-10.1	21.3
Colombia	-1.9	14.9
Indonesia	3	38.3
Mexico	-5.7	76
Chile	0.7	17.5
Philippines	2.4	17.9
Thailand	-0.7	53.7
India	-13.3	153.6

Source:The Economist, Bloomberg

Robust trade surplus, shrinking external indebtedness and improving stock of international reserves should keep asset price volatility smaller than in the past.

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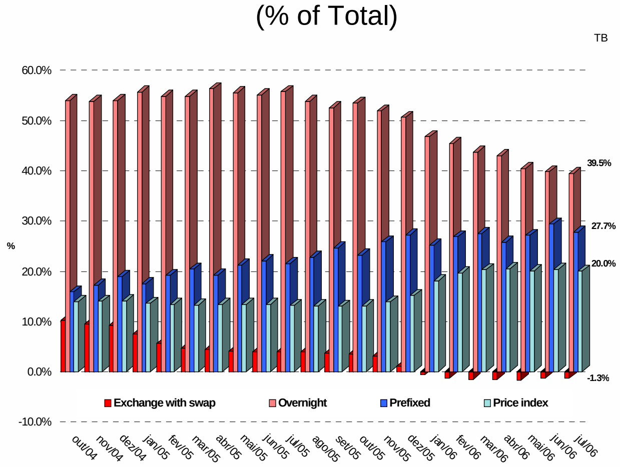
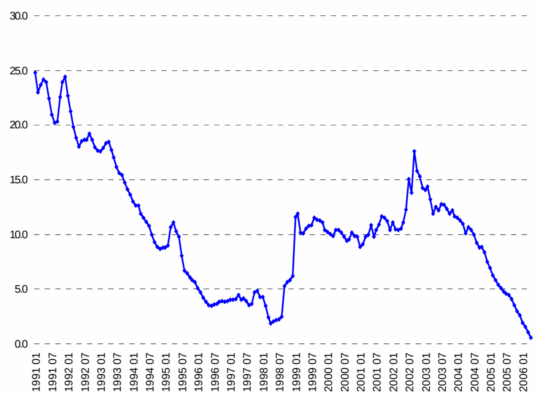
Improving domestic debt profile and vanishing net external indebtedness helps consolidate the perception of solvency.

Domestic Debt Composition
(% of Total)



Source: BCB

Net Government External Debt/ GDP
(% of GDP)



Source: BCB, UBB

The government's exposure to the USD shifted signs, implying that BRL weakness dampens the debt-to-GDP ratio. A very different picture from 2002, when the overshooting of the USD contaminated fiscal fundamentals.

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High trade surpluses combined with external inflows allowed the Central Bank to replenish international reserves.

Central Bank BRL Interventions

(USD Millions)

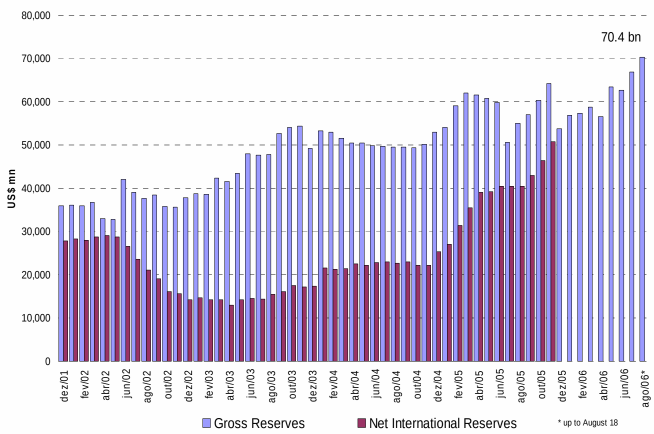
US$ million	Total	Auctions average	Daily average intervention
October	**3,579**	**199**	**179**
Reverse swap	-	-	-
Spot	3,579	199	179
November	**6,793**	**731**	**340**
Reverse swap	2,610	522	131
Spot	4,183	209	209
December	**13,303**	**665**	**605**
Reverse swap	9,640	482	438
Spot	3,663	183	166
January	**9,979**	**454**	**454**
Reverse swap	7,449	339	339
Spot	2,530	115	115
February	**6,919**	**384**	**384**
Reverse swap	4,060	226	226
Spot	2,859	159	159
March	**2,536**	**159**	**110**
Reverse swap	848	212	37
Spot	2,536	159	110
April	**2,470**	**137**	**137**
Reverse swap	-	-	-
Spot	2,470	137	137
May	**4,009**	**445**	**182**
Reverse swap /1	-	-	-
Spot	4,009	445	182
June	**0**	**0**	**0**
Reverse swap	-	-	-
Spot	0	0	0
July	**5,101**	**255**	**243**
Reverse swap	-	-	-
Spot	5,101	255	243
August	**3,295**	**300**	**300**
Reverse swap	-	-	-
Spot /2	3,295	300	300
Total	**57,983**	**-**	**-**

1/ Withought the US$ 643 mn rollover of the US$ 920 mn reverse sw ap matured on May, 2.
2/ Up to August 15

Source : Bloomberg, Unibanco

International Reserves

(in USD mn)



Source : BCB

While the BCB plays according to the textbook (replenishing reserves and buying back external debt), the benefits of adding another USD in the stock of reserves has to consider the fiscal cost of sterilization.

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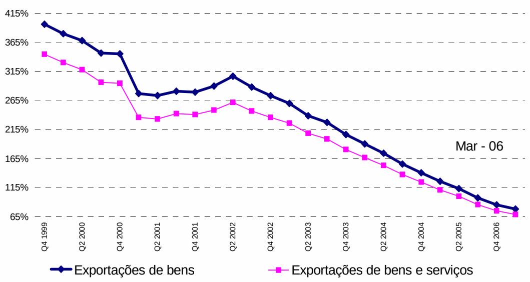
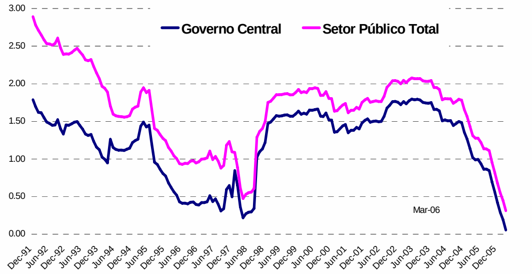
External solvency indicators keep improving

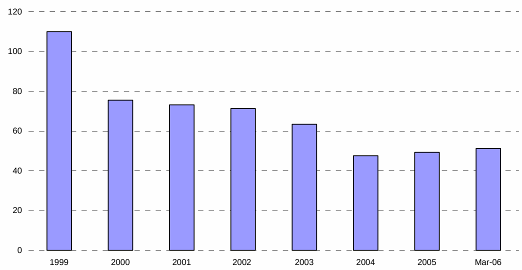
Net External Debt / Exports



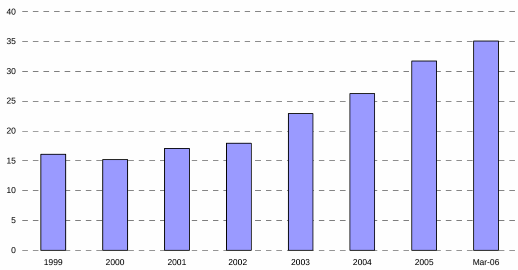
Net External Government Debt / Exports



External Debt-Service / Exports



International Reserves / External Debt



Source: BCB

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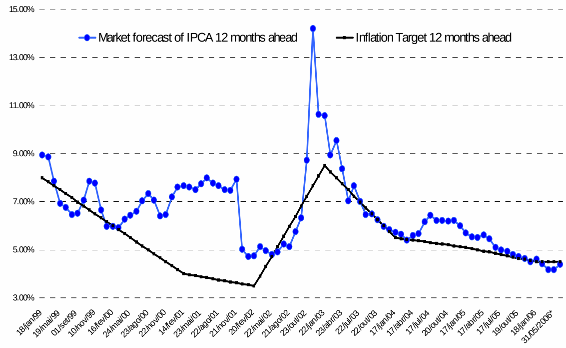
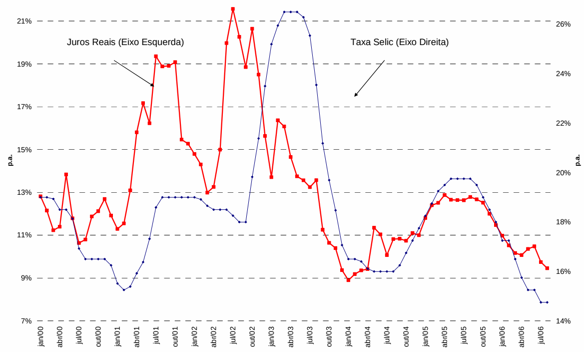
Low inflation, high real interest rates, contained capacity utilization and well anchored 07 inflation expectations are paving the way for more monetary easing.

Market Forecasts
(BCB's Target vs. 12m Ahead Consensus)



Source: BCB, IBGE, Unibanco

Interest Rates
(real ex-ante and nominal Selic rates)



Source: BCB, IBGE

And the easing should roll on in Brazil, despite the global moneatry policy tightening cycle.

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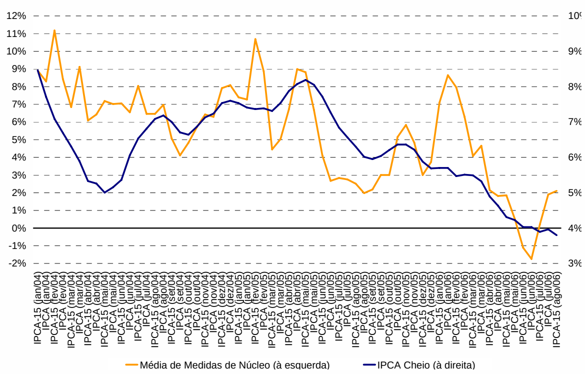
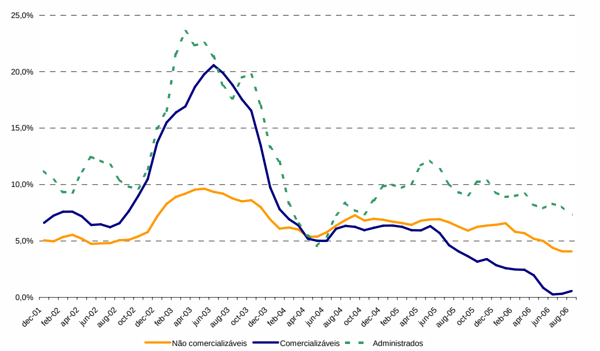
Inflation continues to surprise on the downside and the outlook remains very benign.

IPCA Headline and Ann AVG of cores
(12M %; trimmed, market and exclusion cores)



Source: Fipe, Unibanco

Tradable, Non-tradable and Regulated Inflation
(trailling 12 months %)



Source: IBGE, Unibanco

Besides the effects of a stronger BRL, non-tradable inflation is also moving south, reaching the lowest levels in more than 5 years .

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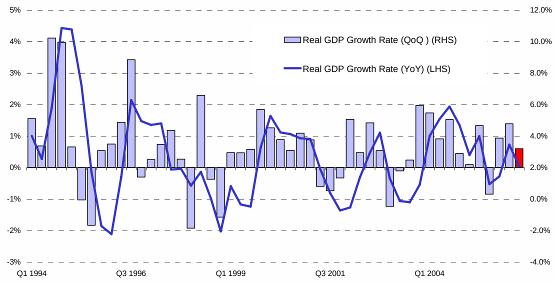
Domestic absorption should be the main driver of growth this year…

Real GDP Growth

(QoQ %)



Source: IBGE, Unibanco

Demand Components

(YoY%)

	QoQ Seasonally Adjusted					Annual
	1Q06	4Q05	3Q05	2Q05	1Q05	Growth rate
			Aggregate Demand			
GDP	**1.4%**	**0.9%**	**-0.8%**	**1.3%**	**0.1%**	**2.4%**
Consumption	0.6%	1.2%	1.0%	1.2%	-0.1%	3.3%
Government	1.0%	0.1%	-0.5%	1.0%	0.2%	1.7%
Investment	3.7%	1.7%	-0.9%	4.7%	-3.0%	3.2%
Exports	3.9%	0.7%	1.8%	2.6%	3.3%	10.7%
Imports	11.6%	-0.9%	1.9%	2.1%	1.1%	10.4%

Source: IBGE, Unibanco

…lead by private consumption, investments and strong fiscal stimulus.

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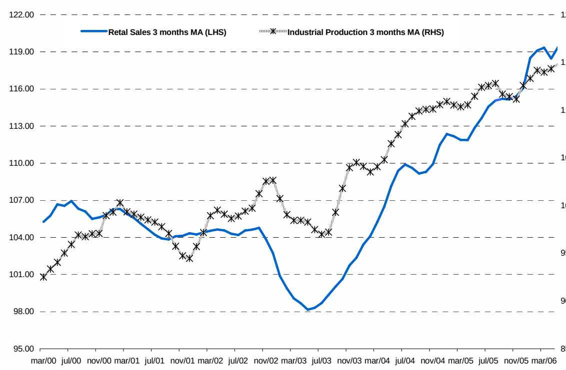
And the effect of stronger primary consumption is already popping up.

Production and Demand

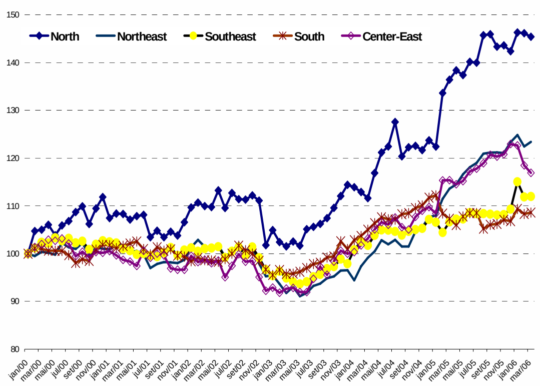
(IP and Retail Sales Index SA,
3 Month Moving Average)



Fonte: IBGE / Unibanco

Retail Sales by Region

(Real Sales Deflated by IPCA)



Fonte: IBGE, Unibanco

Especially in less developed regions. Retail activity in the North and in the Northeast are being pushed by income transfer programs.

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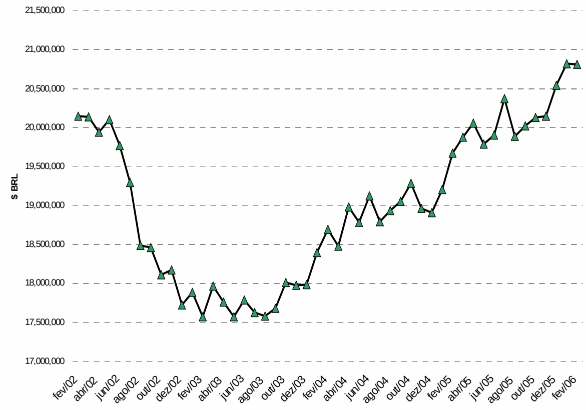
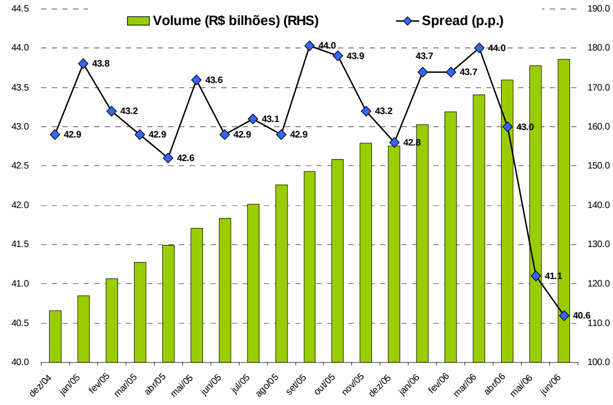
Improvements in the labor market, especially real income, should also help keep consumption afloat.

Total Payroll
(Employment * Real wages; BRL)



Source: IBGE

Household Total Credit and Spreads



Source: BCB, Unibanco

The highlight goes to improving real wage mass and stronger supply of credit.

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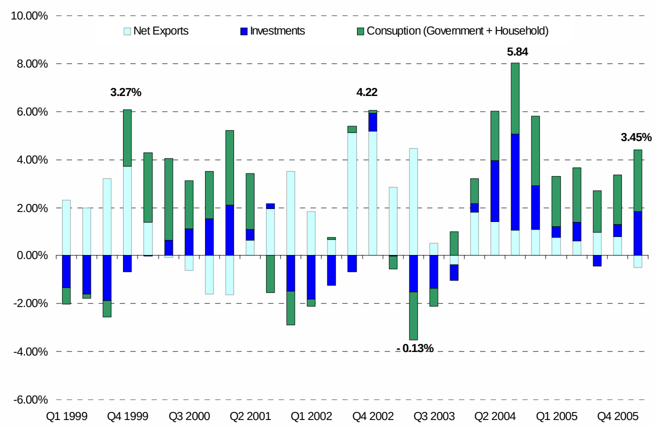
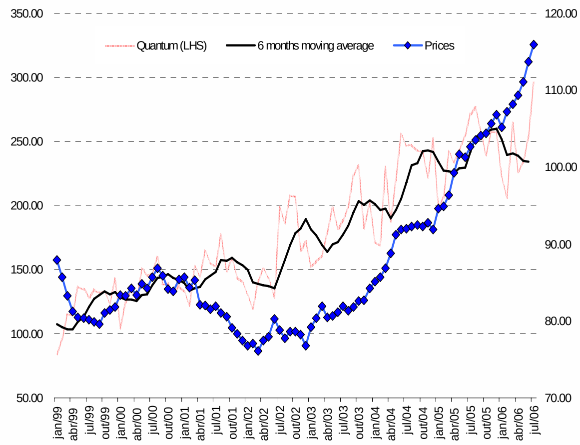
When compared to 04, domestic absorption shouldn't pressure inflation. This time, net exports are pitching in negative contributions.

Contributions to Growth
(GDP YoY %)



Source: IBGE

Exports Quantum
(Index, 1996=100)

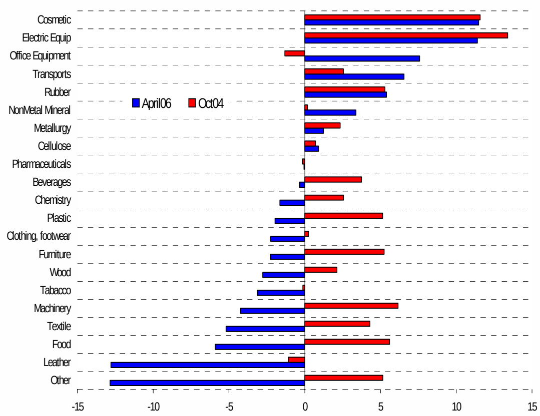


Source: Secex

External demand is falling – at least in volumes – allowing domestic consumption and investments to growth without pushing capacity utilization rates up.

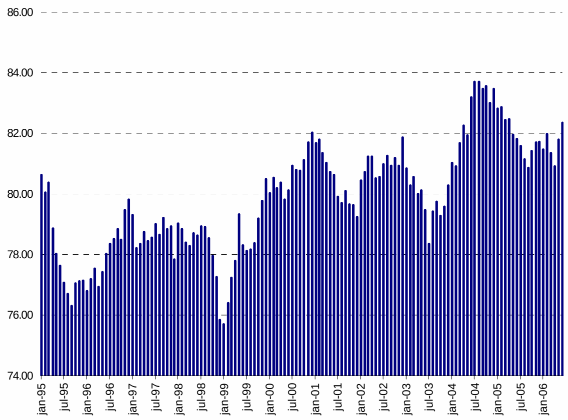
Capacity utilization rates are lower than in previous expansion cycles…

Utilization rates by Industry Segment
(FGV, %)



Source: FGV

Capacity Utilization
(CNI, %)

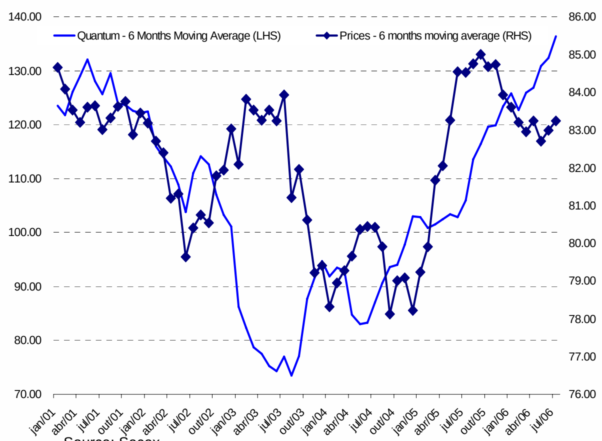


Source: CNI

.. Especially in the consumption goods segments.

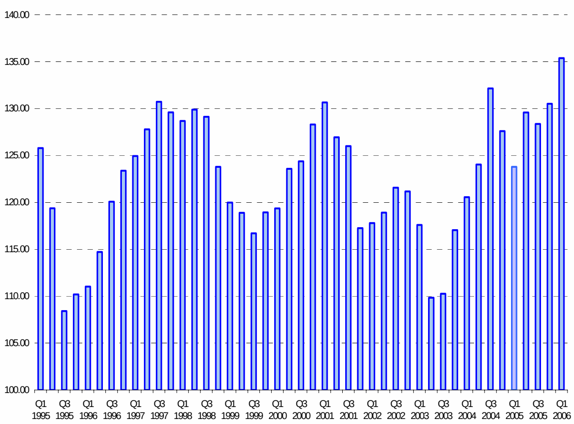
Investments are on the rise, favored by a stronger BRL, lower interest rates and international capital goods prices…

Capital Goods Imports
(Quantum and Prices)



Source: Secex

Investments Evolution
(Index, SA)



Source: IBGE

.. Increasing the country's potential GDP growth rate.

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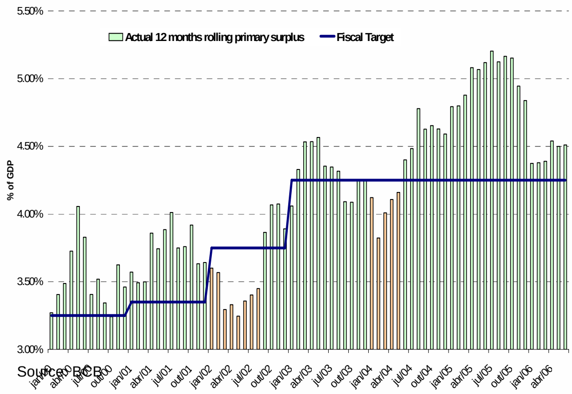
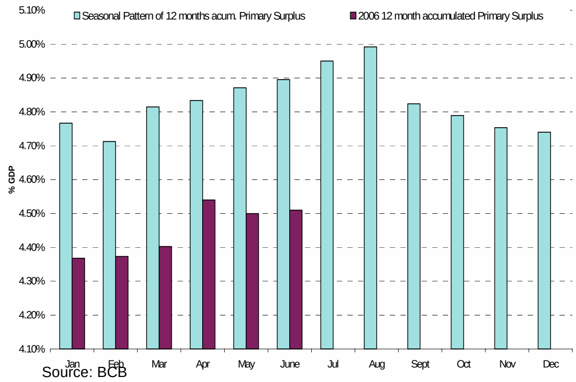
Fiscal austerity, one of the pillars of macro stability, could be at risk in the longer-run.

Primary Budget Surplus
(% GDP)



Source: BCB

Seasonal Pattern of Primary Surplus
(Seasonality vs 06, % GDP)



Source: BCB

However, short-term risks eased with the better than expected primary surplus in the second quarter of the year.

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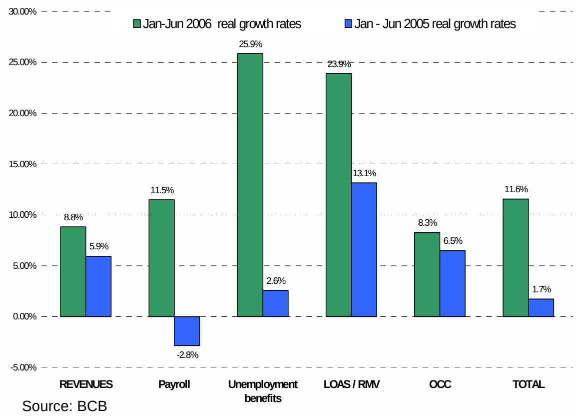
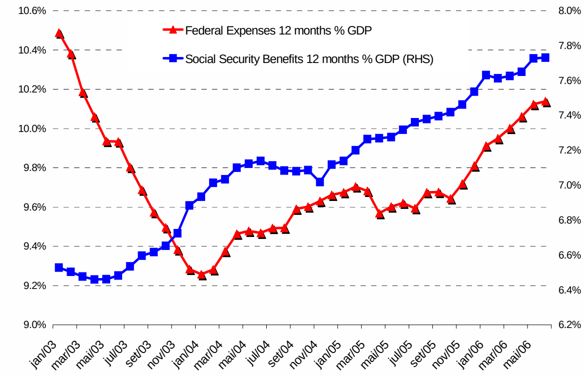
Higher current expenses and social security benefits are compromising the sustainability of the fiscal adjustment…

Current Expenses Real Growth
(% Year to Date)



Source: BCB

Central Government Expenses
(% GDP)

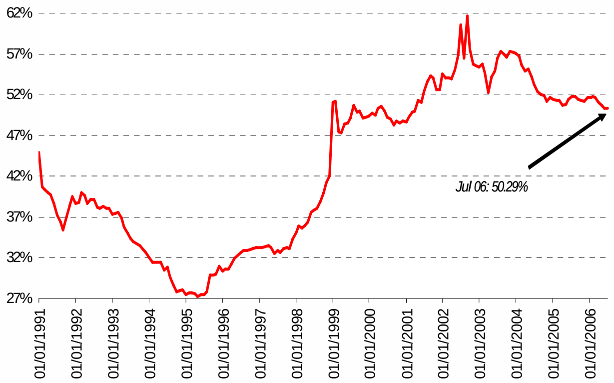


Source: BCB

…and the outlook of even higher spending (minimum wage increase and stronger electoral outlays) should add to this pressures in the course of the year.

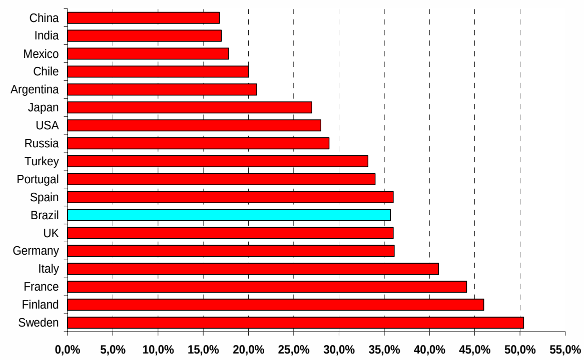
High primary fiscal surplus remains necessary to stabilize/reduce the debt to GDP ratio.

Debt / GDP Ratio
(%GDP)



Source: BCB, Unibanco

Tax Burden
(% GDP - 2004)

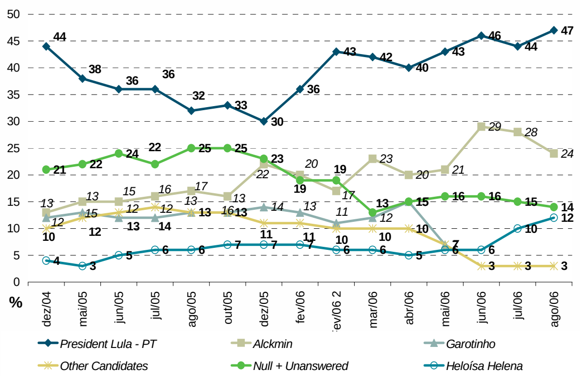


Source: BCB

The limited space of inflation and debt financing of the government implies that either cuts in current expenditure are implemented, freeing space for infrastructure investment, or the tax burden will have to continue rising.

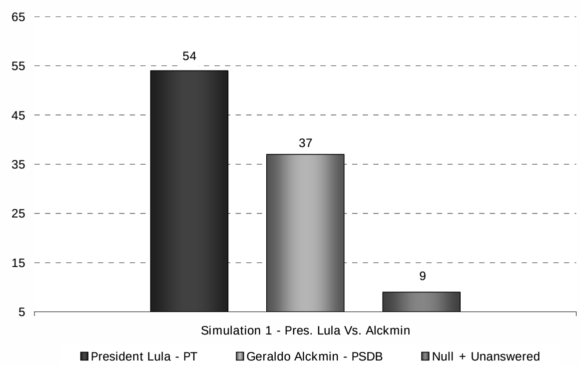
Latest pools indicate that President Lula remains a very strong candidate in next October elections.

Vote Intention
(First Round)



Source: Datafolha

Vote Intention
(Second Ballot)



Source: Datafolha

Rising vote intentions and popularity increases the chance of a first round victory of president Lula.

Forecasts

	2002	2003	2004	2005	2006	2007 E
Crescimento do PIB (%)	2.0	0.5	4.9	*2.3*	*3.5*	*3.5*
. Agricultura	5.5	4.5	5.3	*0.8*	*2.0*	*3.0*
. Indústria	2.8	-0.1	6.2	*2.5*	*4.5*	*4.0*
. Serviços	1.7	0.6	3.3	*2.0*	*3.0*	*3.0*
Inflação (IGP-DI) %	26.4	7.7	12.1	*1.2*	*3.2*	*4.5*
Inflação (IGP-M) %	25.3	8.7	12.4	*1.2*	*3.4*	*4.5*
Inflação (IPCA) %	12.5	9.3	*7.6*	*5.7*	*3.8*	*4.5*
Balança Comercial (US$ B)	13.1	24.8	33.7	*44.8*	*39.0*	*36.0*
Exportações	60.3	73.1	96.4	*118.3*	*138.0*	*151.8*
Importações	47.2	48.3	62.8	*73.5*	*99.0*	*115.8*
Conta Corrente (US$ B)	-7.6	4.0	*11.7*	*14.2*	*9.7*	*-2.1*
Conta Corrente (% PIB)	-1.7%	0.8%	*1.9%*	*1.8%*	*1.1%*	*-0.2%*
FDI (US$ B)	16.6	10.1	*18.2*	*15.2*	*18.0*	*18.0*
FDI (% GDP)	3.6%	2.1%	*3.0%*	*1.9%*	*2.5%*	*2.6%*
Taxa de Juros (SELIC) % - final	25.00	16.50	17.75	*18.00*	*14.00*	*13.00*
Taxa de Juros (SELIC) %- médio	19.2	23.3	16.2	*19.0*	*15.2*	*13.5*
Taxa de Juros (SELIC/US$) %	(21.7)	50.8	26.5	*35.0*	*22.6*	*11.8*
Taxa de Juros Reais (SELIC/IPCA) %	5.9	12.8	8.0	*12.6*	*11.0*	*8.6*
Taxa de Juros Reais (SELIC/IGP) %	(5.7)	14.5	3.7	*17.6*	*11.6*	*8.6*
Taxa de Juro Real Ex-Ante (Swap 360/IPCA proj.) media %	17.1	13.0	10.3	*12.4*	-	-
Taxa de Câmbio (R$/US$) - final	3.53	2.89	2.65	*2.34*	*2.20*	*2.23*
Risco Brasil (Embi) - final	1439	463	383	*305*	*220*	*220*
Desvalorização Real do Câmbio (IPCA/CPI)	52.3%	-18.2%	-8.1%	*-11.8%*	*-6.0%*	*1.5%*
Superávit Primário (%do PIB)	3.89	4.25	*4.58*	*4.81*	*4.25*	*4.25*
Dívida Líquida (% PIB)	55.5	57.2	*51.7*	*51.6*	*49.1*	*46.9*

E - Estimativa Unibanco

Risks

External

- **Reversal of global economic growth trend**
  - **Swift steepening of the US yield curve**
  - **US recession**
- **Burst in commodity-price bubble**
- **Oil prices**

Domestic

- **2006 elections**
- **Faltering economic growth**
- **Quality of fiscal adjustment and procyclical fiscal policy**

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Appendix 1B: Simulating Flows to FX Market in 2006

2006 Trade Balance Forecast

World Export Growth

Average Nominal FX Rate	5.0%	7.4%	9.5%	11.0%
2.00	23.7	25.9	27.8	29.1
2.10	28.5	30.7	32.7	34.1
2.28	36.6	39.0*	40.9	42.3
2.40	41.5	43.9	46.0	47.5

** Unibanco Forecast*

(1) Domestic real GDP growth in 2006: 3.5%

(2) 2005 IPCA inflation: 4.5%

(3) Export Price YoY Change: 8.6%

Source: Unibanco

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Appendix 2A: Debt-Ratio Forecast Elasticities

	Change in Parameter	Change in Debt/GDP *(% GDP)*
12-month primary surplus	1,0%	1,0%
Average interest rate (Selic)	1,0%	0,3%
Year-end FX rate (BRL/USD)	R$ 0,10	0,4%
Annual real GDP growth	1,0%	0,5%

Source: Unibanco

Appendix 2B: Trade Balance Forecast Elasticities

Trade Elasticities	EXPORTS		IMPORTS	
	Short Term	Long Term	Short Term	Long Term
Nominal FX rate	**0,46***	**0,69**	**-0,40**	**-0,73**
Export (Import) Price	**1,74**	**2,58**	**-**	**-**
Domestic Income	**-1,39****	**-2,07**	**2,17**	**3,97**
International Income	**2,34***	**3,48**	**-**	**-**

* 1 Quarter Lag

** 2 Quarters Lag

Source: Unibanco

Appendix 3A: Main Brazilian Exports Products

	2005		
	US$ million	Change %	Share %
Primary	**34,722**	**21.8%**	**29.3%**
Soya products	8,210	-5.3%	6.9%
Iron ore	7,297	53.3%	6.2%
Meats	7,035	29.9%	5.9%
Oil	4,164	64.8%	3.5%
Semimanufactured	**15,961**	**18.8%**	**13.5%**
Sugar	2,382	57.7%	2.0%
Semimanufactured iron and steel products	2,277	7.7%	1.9%
Pulp	2,034	18.1%	1.7%
Manufactured	**65,144**	**23.0%**	**55.1%**
Automobile	4,395	31.1%	3.7%
Flat steel	3,899	34.2%	3.3%
Car & tractor parts	3,238	25.7%	2.7%
Planes	3,168	-3.1%	2.7%
Special operations	**2,482**	**57.2%**	**2.1%**
Total	**118,308**	**22.6%**	**100%**

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Appendix 3A: Brazilian Imports

	$USD		2006*	
	2006*	**2005**	**% Change**	**% Share**
Total	41,348	34,001	21.6%	100%
Crude and intermediate goods	20,349	7,974	13.2%	49.2%
Fuel	6,881	5,168	33.1%	16.6%
Capital goods	8,864	7,042	25.9%	21.4%
Consumption	5,215	3,817	36.6%	12.6%
Durable goods	2,577	1,705	51.1%	6.2%
Non-Durable	2,638	2,112	24.9%	6.4%

* Jan-Jun/06

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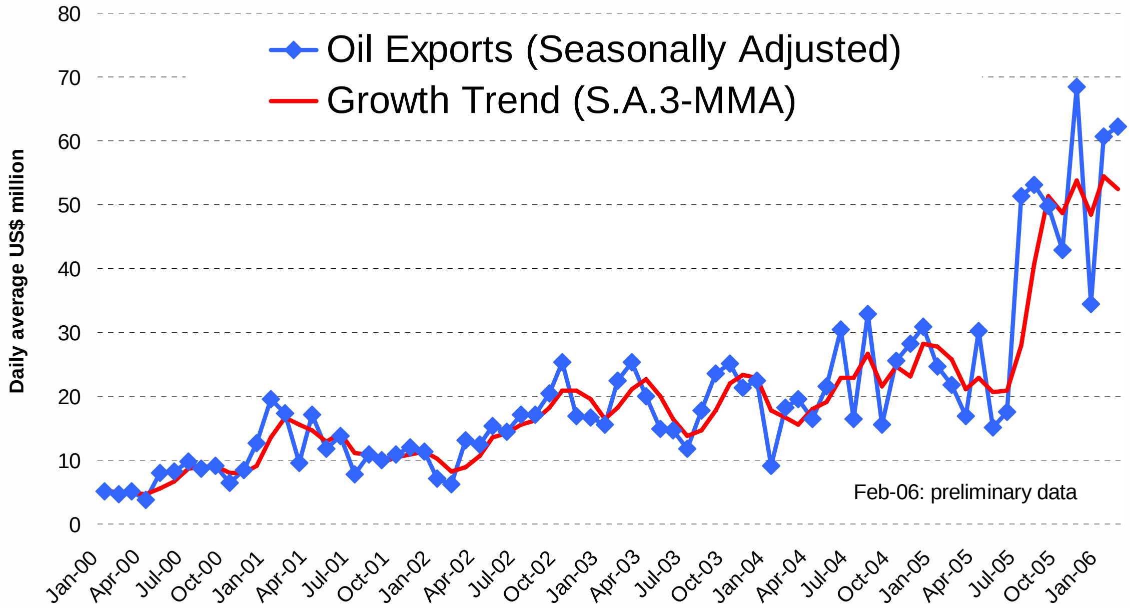
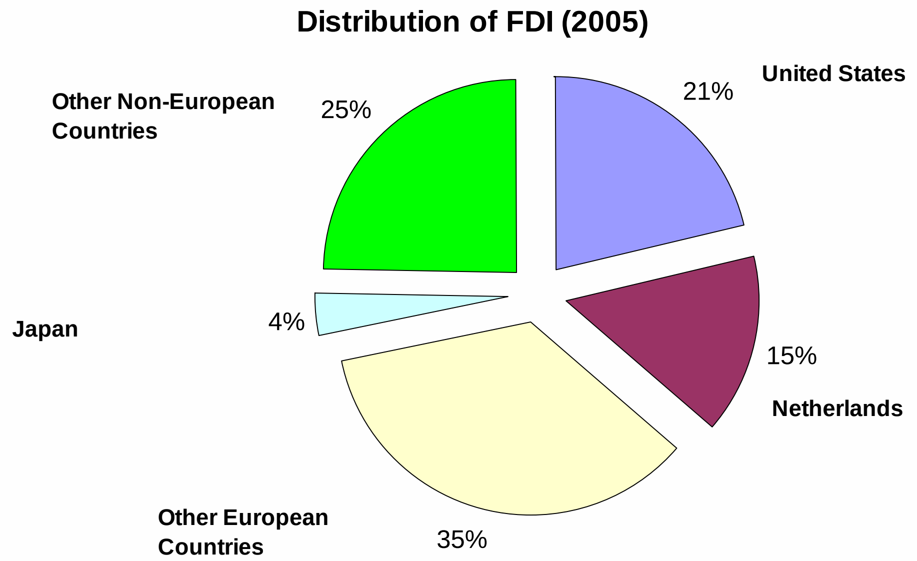
Appendix 3B: The Structural Change in Oil Exports



Source: Secex, Unibanco

Appendix 4: Brazil's Largest Investors



Source: BCB