Macroeconomic Scenario

18 February 2020

Revision of 2020 Scenario

Summary

The macroeconomic scenario changed with the outbreak of the coronavirus, the weaker-than-expected economic activity and the more favorable inflation conditions. Under this new environment, we revised our macroeconomic scenario. One of the major movements was on GDP growth, which we are revising to 2.2% this year from our previous call of 2.8%. We keep our USDBRL forecast in the end of this year at 4.10, but we did some revision of BRL to weaker levels in the short-run, the average USDBRL moved slightly to 4.14 from 4.09. The forecast for IPCA inflation reduced to 3.1% from 4.0% influenced by the scenario of weaker economic activity and some unexpected positive events like heavy rainfall keeping green flag on electricity tariffs for longer. At last, now we expect Selic policy rate constant at 4.25% until the end of this year. See the changes summarized in the table I:

TABLE I --- CHANGES IN 2020 SCENARIO

	OLD	NEW	CHANGE
real GDP growth (%)	2.8	2.2	-0.6
exchange rate (USDBRL -- yearend)	4.10	4.10	0.00
exchange rate (USDBRL -- year average)	4.09	4.14	0.05
IPCA inflation rate (%)	4.0	3.1	-0.9
Selic interest rate (% -- yearend)	5.25	4.25	-1.00

Source: Banco MUFG Brasil S.A., a member of MUFG

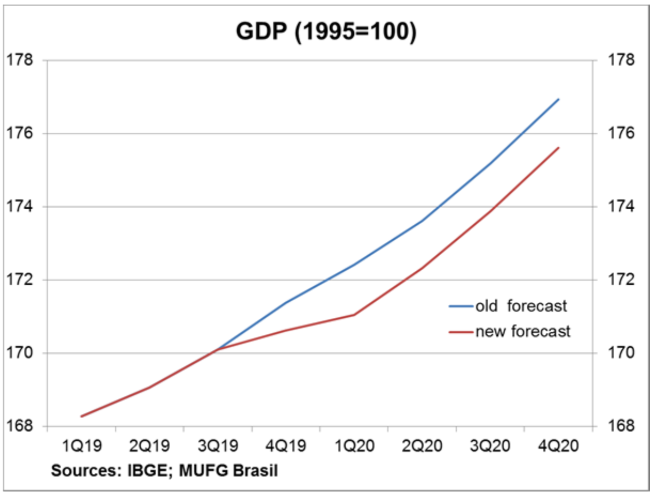
GDP revision

The revision of GDP figures were driven by the disappointment of coincident indicators of the economic activity, the weak leading indicators and the impact of coronavirus on the global economy. Under this scenario, we revised our figures for the 4Q19 and 1Q20, leading to changes in the annual growth to 1.1% from 1.2% in 2019 and to 2.2% from 2.8% in 2020. The changes of quarterly figures are:

- **4Q19** --- the economic activity index released by the Central Bank posted a growth of 0.46% in the 4Q19 over the 3Q19, seasonally adjusted, but it was lower-than-previously expected as November and December figures disappointed, coming very weak. So, we change our call for 4Q19 GDP growth (to be released on March 04th) to 0.30% from 0.75%. Only this revision means that the carry-over for 2020 GDP was reduced by 0.35 percentage points, from 1.00% to 0.65%. Only this mathematical adjustment accounts for more than half of the 2020 GDP revision;

- **1Q20** --- the revision of these figures were motivated by the weak leading indicators and a first assessment of the impact of the coronavirus on the economy. Indeed, we can observe the deterioration on consumer and business confidence shown in January 2020 mainly with regards to the assessment on current situation. Regarding the coronavirus, the impact would be through several channels: i) lower exports not only to China, but to the world in general as global economy would be affected as a whole; ii) drop of income from the exporting sector as of lower commodity prices and iii) some bottleneck in sectors that rely on imported components as of difficulties in importing them from China. Regarding the impact on Brazil, it is estimated that for every cut on GDP growth in China by 1 percentage point (pp) leads to an impact of around -0.2 pp in Brazilian GDP. Our economist in China estimates a reduction of Chinese GDP between 1 and 2 pp, which would mean a negative impact on Brazil between 0.2 and 0.4 pp. As a result, 1Q20 GDP growth was revised to 0.25% from 0.60% over 4Q19, seasonally adjusted.

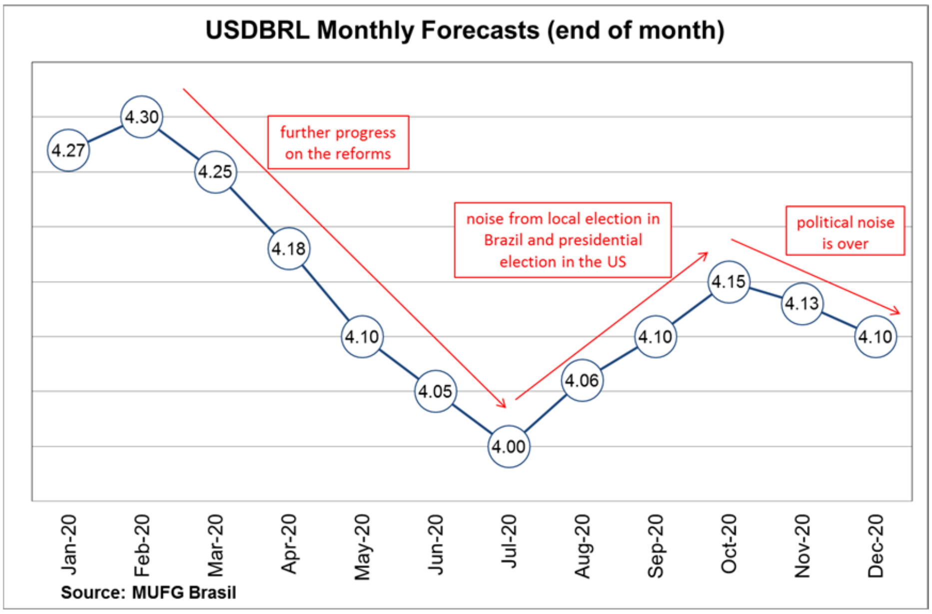
All in all, we revised our GDP growth forecast to 2.2% from 2.8%. For next year, we keep our confidence at a sharper GDP growth of 3.5% assuming that the economic reforms will be in good progress this year thus restoring confidence by businessmen, and therefore resulting in sharper job creation in the formal labor market, which would boost household consumption. Furthermore, the scenario abroad might improve with the reduction of the uncertainties, considering that Coronavirus will



be already controlled

FX rate

BRL has been under pressure amid the current high level of uncertainty abroad as of the concerns on the potential impact of the new coronavirus on the global economy, and therefore reflecting on the risk-off mood against EM currencies such as BRL. And, BRL has been among the worst EM currencies so far this year because of the low carry-trade compared to our peers and the reduction of funding abroad, once domestic funding became more competitive with the sharp cut of the Selic policy rate. However, although the scenario abroad is still quite gloomy, we assume that the coronavirus will be controlled during this year, and therefore those tensions abroad tends to ease and BRL might gradually appreciate back to 4.10 in the end of this year. Such strengthening might also be driven by the progress of the reforms and the faster economic growth.



Inflation

Inflation readings are coming better-than-expected, what made us revise down our call due to:

- Lower-than-previously expected inflation figures for the 1st quarter influenced by the low food inflation, mainly benefitted by some deflation of meat prices. In the last quarter 2019, these prices soared 29.9% in the wake of the swine disease in China. Previous assumption was the maintenance of some hike in the beginning of 2020, but January reading for meat posted deflation, which continued now in February. Given its weight of almost 3% in the headline inflation, this item will push inflation down;

- Also lower-than-previously expected inflation coming from monitored prices amid the significant rainfall in the latest months that contribute to increase reservoir levels and leading to lower pressure on electric energy and water & sewage. Thus, the energy supply through more expensive electricity price from thermoelectric plants might be lower this year, what means less additional cost for consumers. Additionally, the increase of bus tariffs is much lower than previous years because of local elections when there is no political incentive to adjust public transport tariffs. And the reduction of oil prices abroad as a consequence of the coronavirus dragging global growth;
- Downward revision of our GDP forecasts for this year leading to the maintenance of idle capacity at excessive levels for a longer time, and therefore lowering pressure on inflation through the consumption channel. In such scenario, the FX pass-through to inflation is quite limited, so the current weak currency is not a concern in terms of meeting the 4.0% inflation target this year.

All these items might produce a significant downward pressure on the headline, making us to revise our call to 3.1% from 4.0% for this year.

Selic Policy Rate

The Central Bank has cut the Selic policy rate to current 4.25% from 14.25% in September 2016. In the last minutes released by the monetary authority, the Central Bank indicated the interruption of the easing cycle given some uncertainties regarding the global economy, the progress of the reforms and the impact of the policy rate cuts already done in the economy. There is the possibility of the Central Bank resuming the policy rate cuts ahead, but in the middle of this year the focus of the Central Bank will be moving to achieve the 2021 target and the current scenario of market forecast is at the 2021 target of 3.75%. In such inflation and economic activity scenarios, Central Bank tends to keep Selic policy rate at 4.25% until the end of this year. However, as soon as we keep our scenario of stronger GDP growth next year

(3.5%) and therefore a sharper reduction of idle capacity, Central Bank might start removing the monetary stimuli during the first semester of 2021.

Medium Term Scenario

Our changes were concentrated in the 2020 figures, what means that our assumptions for the medium term scenario are still valid. We consider a global environment improving from the current uncertainties. In the domestic front, the government will be able to progress on the reforms that coupled with the favorable financial conditions, low inflation and improved labor market will foster stronger economic growth driven by household consumption and investments. In such condition, BRL would be somewhat stable after the appreciation expected until the end of 2020.

TABLE II --- MACROECONOMIC DATA FORECAST

	2020	2021	2022	2023
real GDP growth (%)	2.2	3.5	3.5	3.5
exchange rate (USDBRL -- yearend)	4.10	4.05	4.10	4.15
exchange rate (USDBRL -- year average)	4.14	4.08	4.08	4.13
IPCA inflation rate (%)	3.1	3.8	3.5	3.5
Selic interest rate (% -- yearend)	4.25	6.50	6.50	6.50

Source: Banco MUFG Brasil S.A., a member of MUFG

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