Economic outlook

Macroeconomic Research – Itaú Unibanco

March 2019

Roadmap

Global economy

- **Global growth to stabilize**
  - ✓ U.S.-China likely to reach a trade deal that could revert some of last year's tariff increase.
  - ✓ U.S. GDP to decelerate to 2.1% in 2019.
  - ✓ China activity will likely stabilize in 2Q19 with a trade deal and domestic stimulus.
  - ✓ Euro-area growth around potential puts ECB normalization under question.
  - ✓ Emerging markets: as global growth stabilizes, financial inflows will likely continue.

Brazil

- **New Central Bank governor assumes amidst an uncertain outlook**
  - ✓ We maintained our GDP growth forecasts at 2.0% in 2019 and 2.7% in 2020.
  - ✓ We revised our estimate for the primary deficit in 2019 to 1.4% of GDP, from 1.3%, but maintained our 0.8% deficit estimate for 2020. This scenario strictly depends on the approval of pension reform.
  - ✓ Our year-end forecasts for the exchange rate remained unchanged at BRL 3.80 per USD in 2019 and BRL 3.90 in 2020.
  - ✓ We expect the IPCA to rise 3.6% in both 2019 and 2020.
  - ✓ The Selic rate is expected to remain at 6.5% p.a. in upcoming policy meetings. However, the communication from the Monetary Policy Committee's (Copom), now under new leadership, and the news flow on pension reform will play a key role in determining the future trajectory for interest rates.

Global economy: our forecasts

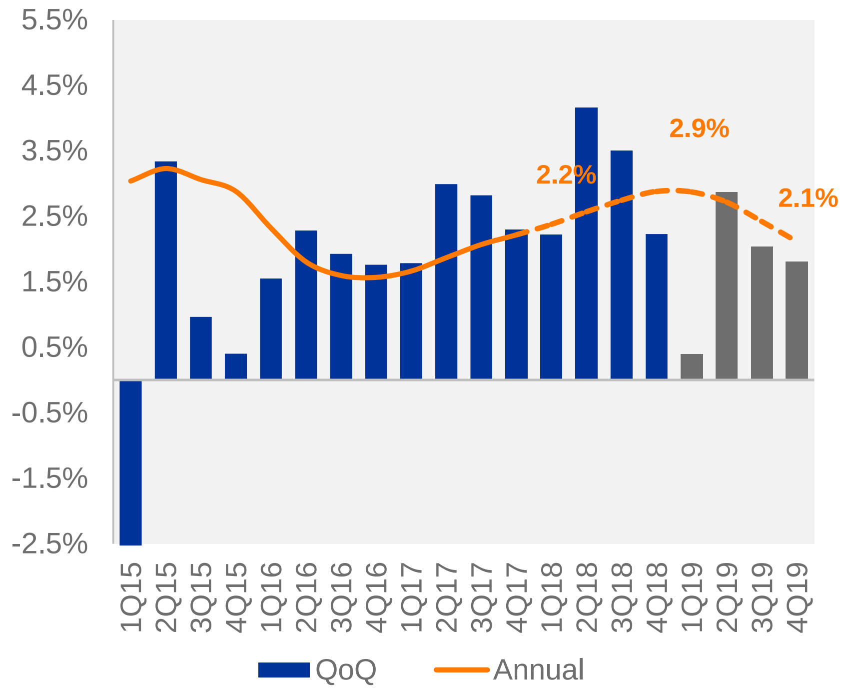
	2016	2017	2018	2019	2020
World	3.3	3.7	3.8	3.4	3.3
USA	1.6	2.2	2.9	2.1	1.7
Eurozone	1.9	2.5	1.8	1.2	1.2
Japan	1.0	1.4	0.7	0.9	0.9
China	6.7	6.9	6.6	6.2	6.0

Source: Itaú Unibanco, Haver Analytics

U.S. GDP to decelerate to 2.1% in 2019

- The U.S. activity slowdown at the turn of the year has further justified the Fed's patience in determining "further adjustments" to the Fed Funds Rate.
- GDP will likely rebound to 3% in 2Q19. Growth will be spurred by the reversal of the 1Q19 negative effects.
- Financial conditions suggest that GDP growth might stabilize close to 2% in 2H19. We lowered our 2019 U.S. GDP forecast to 2.1% (from 2.2%) due to softer base effects.

U.S.: GDP growth

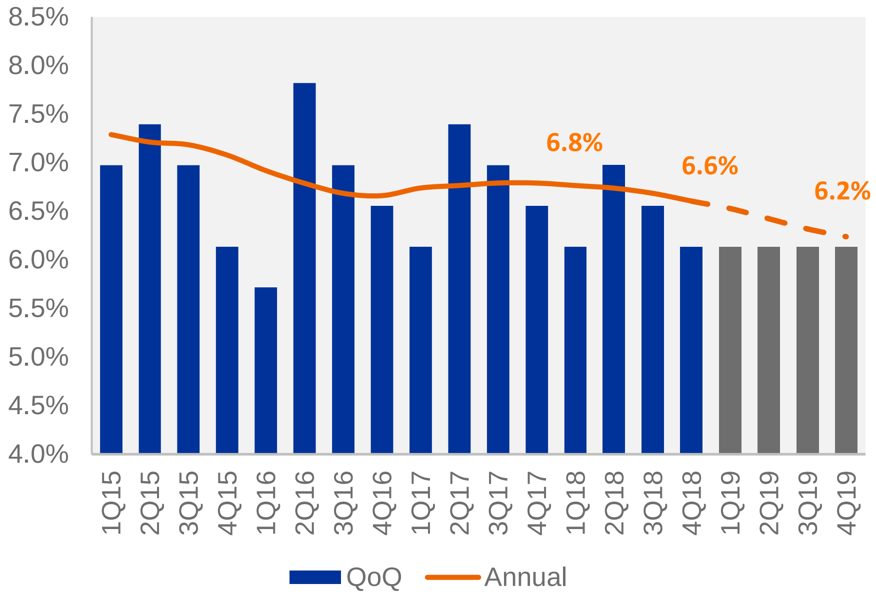


Source: Haver Analytics, Itaú

China activity will likely stabilize in 2Q19 with a trade deal and domestic stimulus

- Policymakers seek to stabilize activity with modest stimulus, focused on tax cuts and improving credit conditions for SMEs. Some green shoots are already starting to appear in activity.
- However, if the trade war escalates, the economy will decelerate, even with more stimuli. In a full-fledged trade war, China's GDP growth could be trimmed by another 0.9 pp in 2019.
- We revise our GDP forecast to 6.2% (prior: 6.1%) and 6.0% (prior: 5.9%) in 2019 and 2020, respectively.

GDP growth

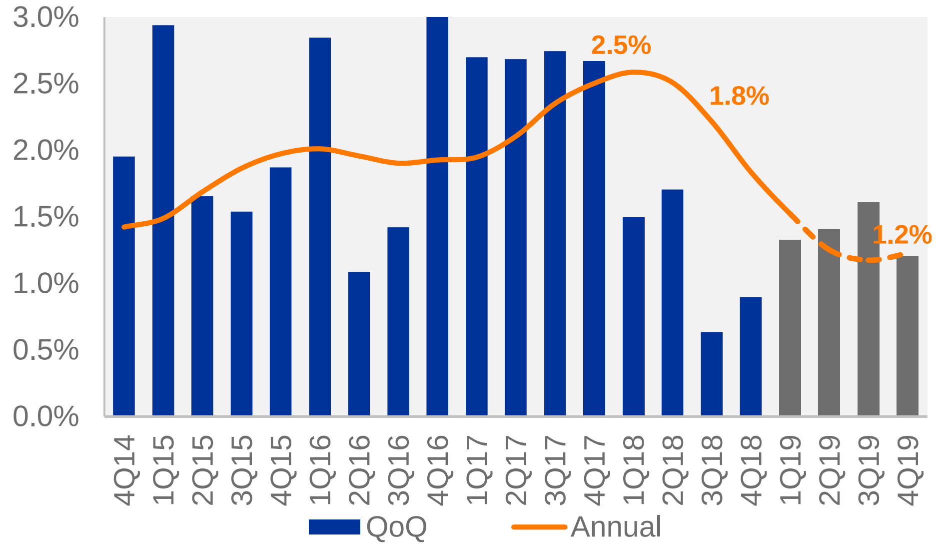


Source: Haver Analytics, Itaú

Euro-area growth around potential puts ECB normalization under question

- We expect euro-area growth to be only slightly above potential in 2019. After growing 1.8% in 2018, we expect the euro-area economy to decelerate to 1.2% this year, just a bit above the potential estimates of around 1.0%. Growth is still limited by weak external demand and high economic-policy uncertainty.
- Lower growth and delayed inflation convergence put ECB normalization under question.

Eurozone: GDP growth
% annualized

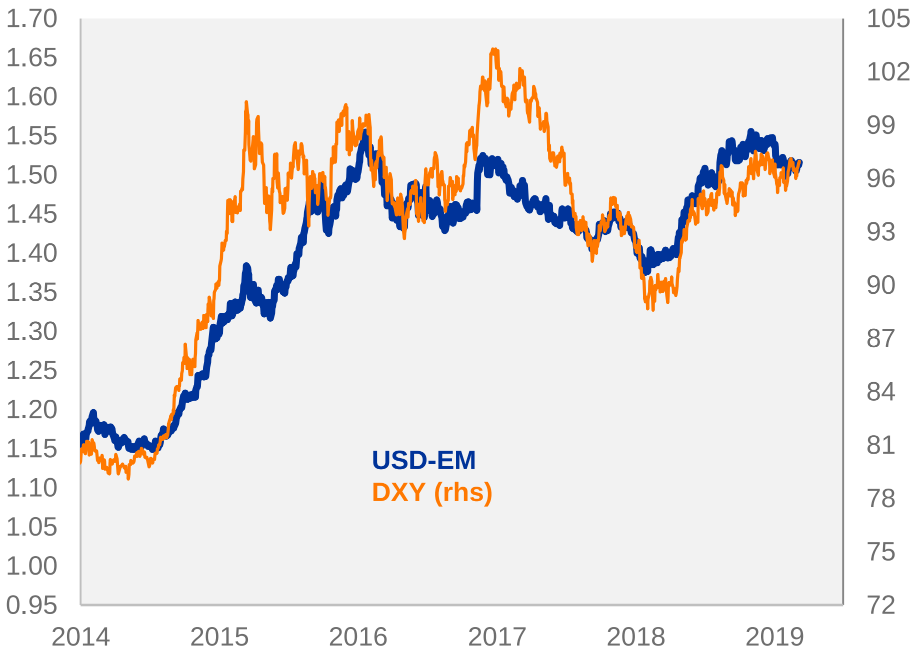


Source: Haver Analytics, Itaú

Emerging markets: as global growth stabilizes, financial inflows will likely continue

- EMFX has benefited from Fed patience.
- As a consequence, EM central banks felt less pressure to raise rates and some could enter an easing cycle this year.
- The risk to EM is lower global growth at the moment.
- But as we expect China to stabilize in 2Q19, we also see financial inflows into EM continuing ahead.

EMFX and DXY



Source: Itaú

LatAm: sluggish activity

- With poor economic growth in the core economies, activity in the region has been disappointing. For 2019, we reduced our growth forecasts for Argentina and Mexico, while the downside risks to our GDP projections for Brazil are increasing.
- With sluggish growth and well-behaved exchange rates, there is a comfortable inflation outlook for most countries in the region. We now expect rate cuts in Mexico by the end of this year and see a more gradual tightening cycle in Chile and Colombia relative to our previous scenario.

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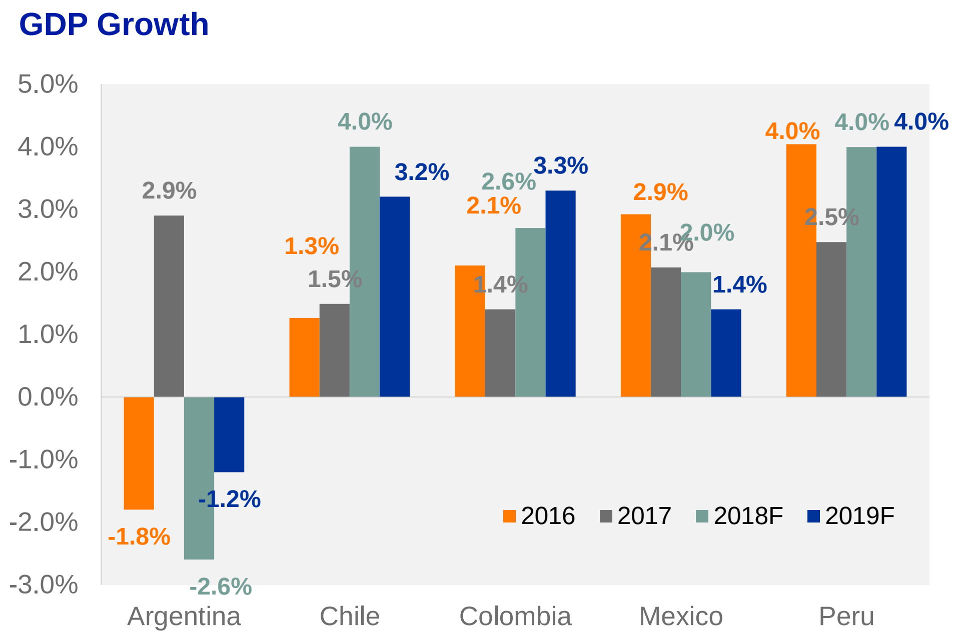


Source: Itaú

LatAm: our forecasts

Peru	2017	2018	2019F	2020F
GDP - %	2.5	4.0	**4.0**	**4.0**
PEN / USD (Dec)	3.24	3.37	**3.35**	**3.31**
Reference rate (Dec) - %	3.25	2.75	**3.25**	**4.25**
CPI	1.4	2.2	**2.6**	**2.5**

Mexico	2017	2018	2019F	2020F
GDP - %	2.1	2.0	**1.4**	**1.7**
MXN / USD (Dec)	19.70	19.70	**20.00**	**19.80**
Reference rate (Dec) - %	7.25	8.25	**7.75**	**6.75**
CPI	6.8	4.8	**3.6**	**3.4**

Colombia	2017	2018	2019F	2020F
GDP - %	1.4	2.7	**3.3**	**3.6**
COP / USD (Dec)	2932	3254	**3180**	**3180**
Reference rate (Dec) - %	4.75	4.25	**4.50**	**4.50**
CPI	4.1	3.2	**3.0**	**3.0**

Chile	2017	2018	2019F	2020F
GDP - %	1.5	**4.0**	**3.2**	**4.0**
CLP / USD (Dec)	615	694	**645**	**635**
Reference rate (Dec) - %	2.50	2.75	**3.25**	**4.00**
CPI	2.3	2.6	**2.6**	**2.9**

Argentina	2017	2018	2019F	2020F
GDP - %	2.9	**-2.6**	**-1.2**	**3.0**
ARS / USD (dec)	18.8	37.8	**50.0**	**60.0**
Reference rate (Dec) - %	28.75	59.25	**37.00**	**27.00**
CPI - % (Buenos Aires)	24.8	47.6	**35.0**	**27.0**

Source: Itaú

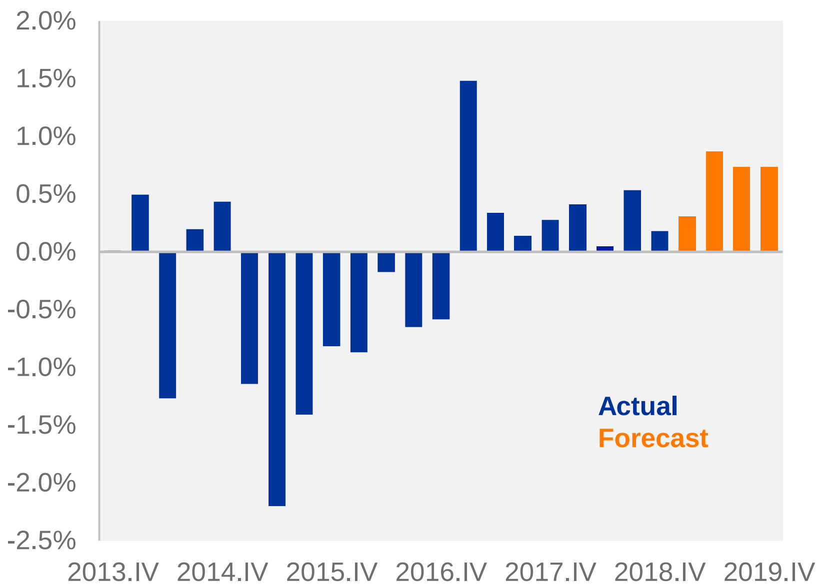
Brazil: our forecasts

	2016	2017	2018	2019	2020
Economic Activity					
GDP (%)	-3.3	1.0	1.1	2.0	2.7
Unemployment (%) – December (PNAD cont.)	12.7	12.5	12.3	11.8	11.5
Inflation					
CPI (%)	6.3	2.9	3.7	3.6	3.6
Monetary Policy					
Selic Rate (%)	13.75	7.00	6.50	6.50	6.50
Fiscal					
Primary Surplus (% GDP)	-2.5	-1.7	-1.6	-1.4	-0.8
Balance of Payments					
Exchange Rate (eop)	3.26	3.31	3.88	3.80	3.90
Current Account (% GDP)	-1.3	-0.3	-0.8	-0.9	-1.8

Slow recovery in economic activity

- Weak data in early 1Q19. The industrial sector maintained its sluggish pace in the start of the year, with industrial production falling 0.8% in January.
- We anticipate GDP growth of 0.3% qoq in 1Q19, leading to an annualized rate of 1.2%. For the full year and next year, our forecasts remain at 2.0% and 2.7%, respectively. Importantly, we assume a pickup in the pace of economic activity at the margin, but still at a moderate level. However, weak 1Q19 activity figures brought downside bias to our estimates.
- This scenario assumes that the recent improvement in financial conditions will continue and drive an acceleration of activity, with better performance from the industrial sector in particular. Continued improvement, however, depends on reforms moving forward, particularly the pension reform.

GDP growth (qoq)

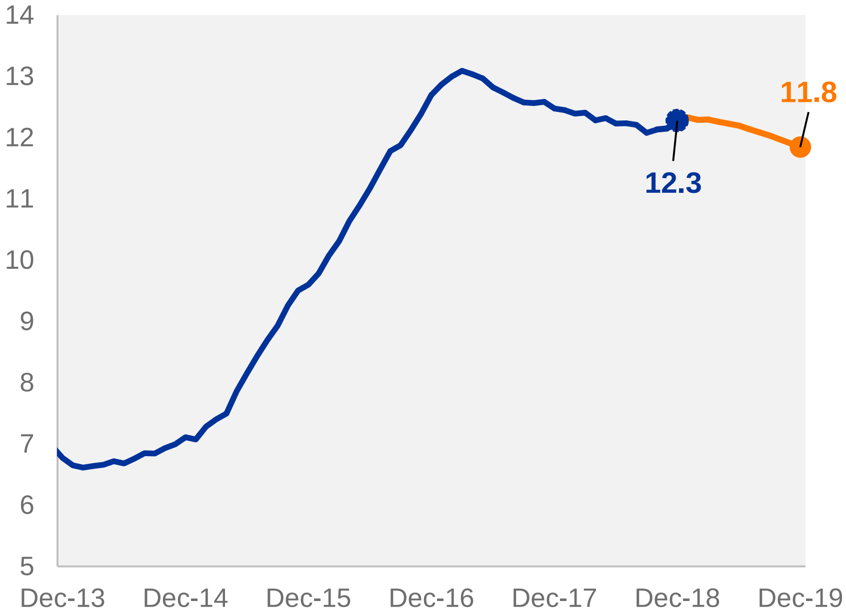


Source: IBGE, Itaú

The labor market has also faced a slow-paced recovery

- The nationwide unemployment rate, measured by the PNAD Contínua survey, was stable at 12.3% in the quarter ended in January, according to our seasonal adjustment. The formal labor market, which had been showing a stronger recovery, slowed down once again in January, with 26,000 new formal jobs created in net terms, adjusted for seasonality, pushing the quarterly moving average down to 50,000, from 58,000 per month.

Unemployment rate
%, seasonally adjusted



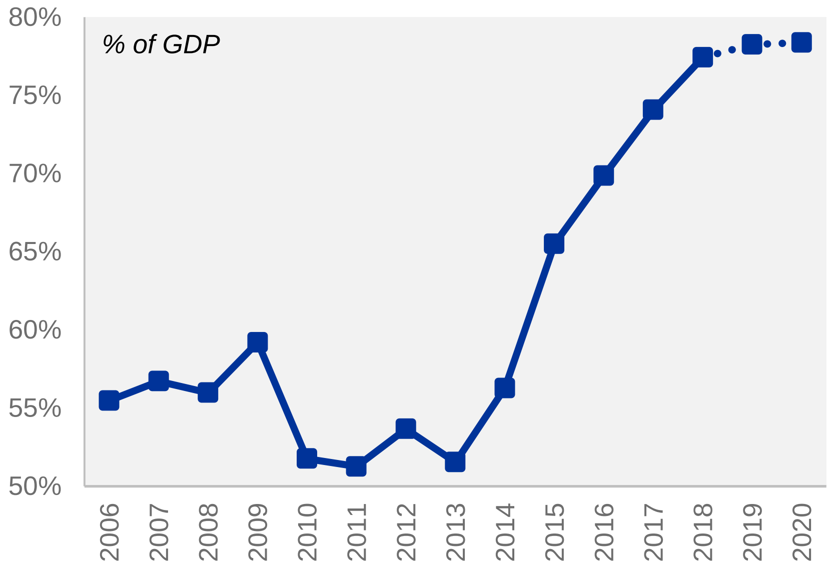
Net Formal Job Creation (CAGED)
3mma, thousands

Source: IBGE, Itaú, FGV

Fiscal sustainability depends on reforms

- We revised our estimate for the primary deficit in 2019 to -1.4% of GDP (BRL 101 billion) from -1.3% of GDP (BRL 96 billion). The revision was driven by a delay in the Eletrobrás capitalization process (which would generate BRL 12 billion for the government), partially offset by expectations for lower mandatory and discretionary expenses. The downward revision of our estimate does not change our view that complying with the spending cap rule and the primary deficit target (-1.8% of GDP or BRL 132 billion) is not greatly challenging.
- For 2020, we continue to forecast a primary deficit of 0.8% of GDP (BRL 59 billion). Without reforms, meeting the spending cap will hardly be feasible from 2020 onward, putting fiscal rebalancing in jeopardy.
- In particular, we expect the pension reform will be approved in 2019. In our view, the version approved by the Congress will have a fiscal impact equivalent to 50% to 75% of the text presented by the government, i.e., a primary balance increase equal to 1.4 p.p. to 2.1 p.p. of GDP in 2027.

Gross Public Debt

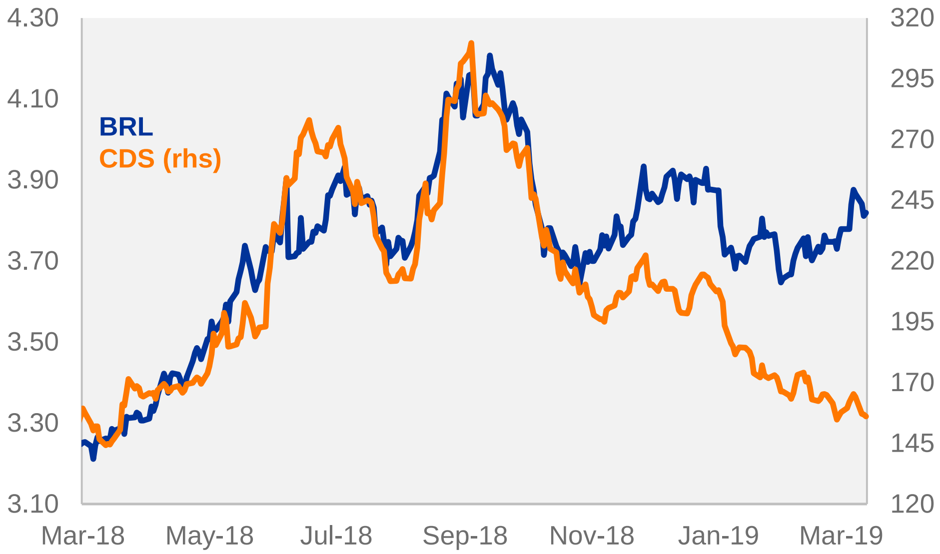


Source: Central Bank, Itaú

BRL under greater pressure

- After slight relief early in the year, the real weakened in early March. However, data showing strong growth in the U.S. – in contrast with sluggish or moderate growth in the rest of the world – led to an appreciation of the U.S. dollar in early March, pressuring the BRL and other emerging market currencies.
- We maintained our year-end forecasts for the exchange rate at BRL 3.80 per USD in 2019 and BRL 3.90 in 2020.
- Expectations for deterioration in 2020 are based on a mild deterioration in global financial conditions, due to the withdrawal of stimuli by central banks in developed economies.

Exchange rate (BRL) and Country Risk Premium (CDS)

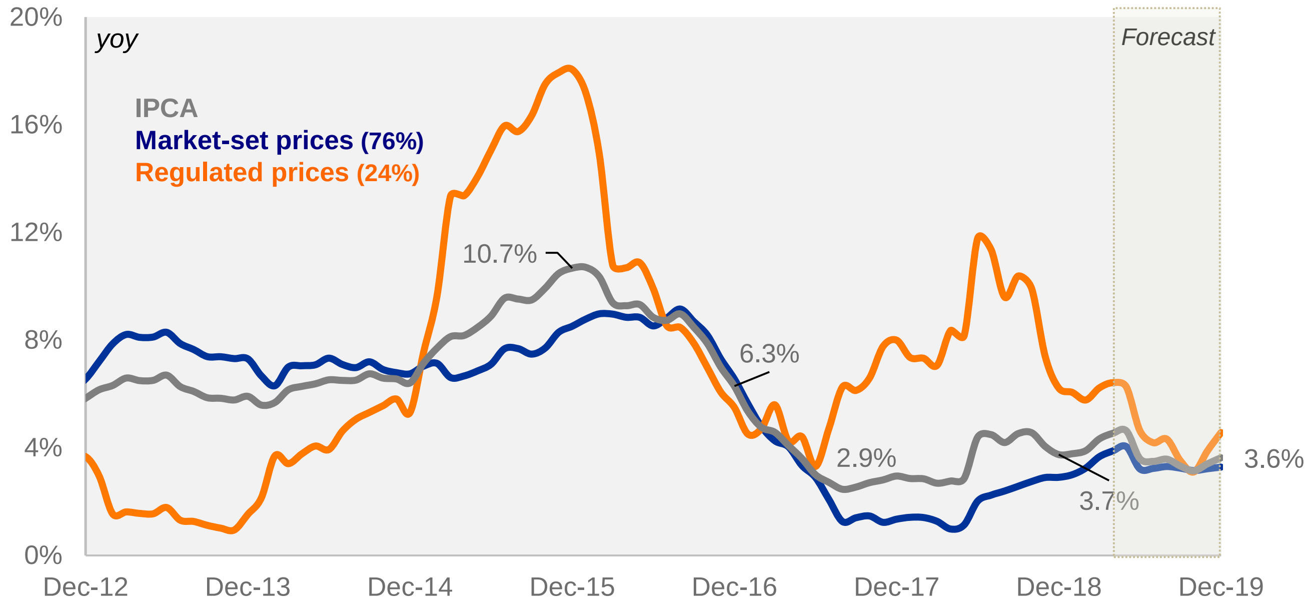


Source: Itaú, BCB, Bloomberg

Our IPCA forecasts remain at 3.6% for 2019 and 2020

- We maintained our year-end forecasts for the exchange rate at BRL 3.80 per USD in 2019 and BRL 3.90 in 2020. No evidence of inflationary pressures. Inertia and inflation expectations remain well behaved. Additionally, the economy continues to run with a large slack, putting downward pressure on inflation.
- For 2020, our inflation forecast is unchanged at 3.6%. In particular, we see low risk of demand-pull inflation in the relevant monetary policy horizon (i.e., this year and next year), even with upside surprises from a recovery in economic activity.

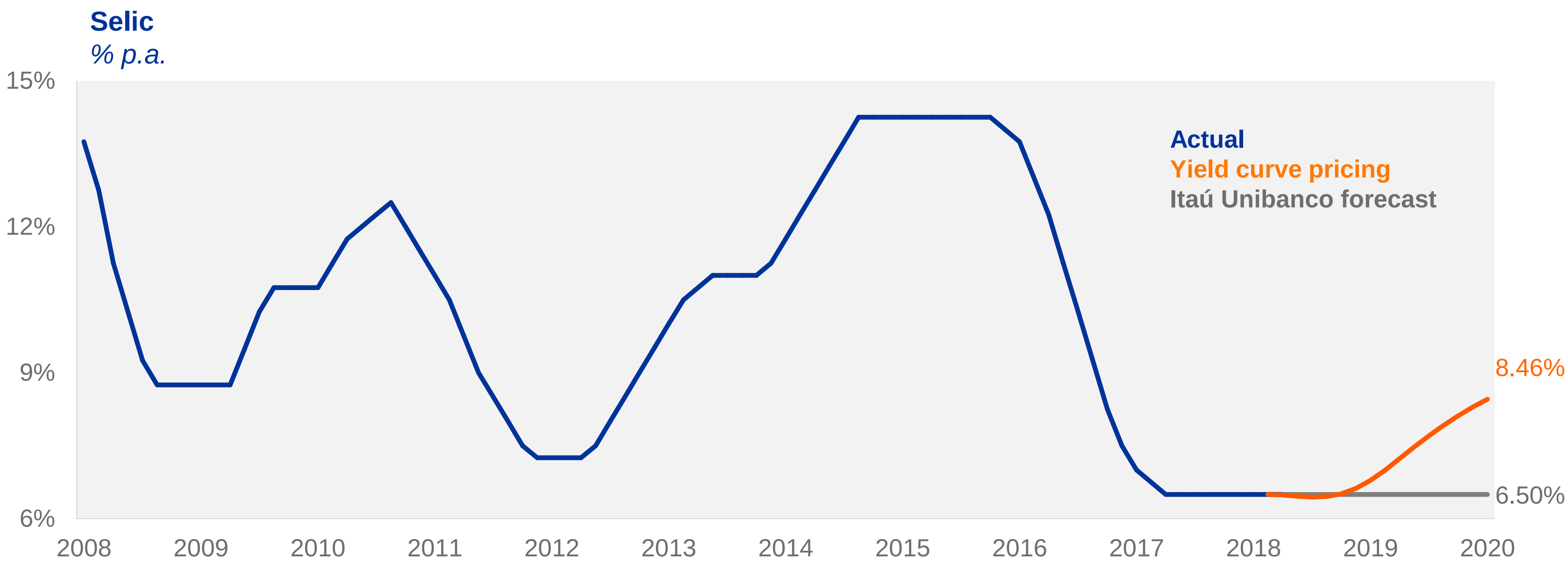
IPCA Breakdown



Source: Itaú, IBGE

Central Bank: New leadership

- In his confirmation hearing in the Senate, new Central Bank Chairman Roberto Campos Neto indicated continuity in monetary policy and microeconomic policies.
- For the time being, we expect the Copom to keep the Selic rate unchanged at 6.5% p.a. in coming meetings, but there is more uncertainty than usual surrounding this call.



Source: Itaú, Bloomberg

Conclusion

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