Deutsche Bank

16 October 2009

Brazil Daily Update

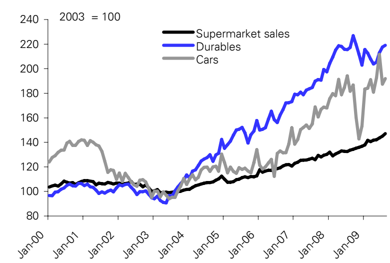
Faster growth, higher interest rates

Economics

Research Team

José Carlos de Faria
Economist
(+55) 11 2113-5185
jose.faria@db.com

Retail sales



Source: IBGE

Today: FGV is due to release two inflation indices: the weekly **IPC-S** and the October **IGP-10**. For the IPC-S, we forecast 0.20%, down from 0.25% in the previous period due to food price deflation. For the IGP-10, we project 0.15%, down from 0.35% in September due to deflation of wholesale agricultural prices led by milk and soybeans.

Retail sales grew 0.7% MoM and 4.7% YoY in August, in line with expectations (our forecasts were 0.6% MoM and 4.5% YoY). It was the fourth consecutive MoM increase in sales, which reflects the stimulus for consumption provided by high consumer confidence, low interest rates and buoyant labor income. In August, the 0.7% MoM rise was led by an increase of 1.4% in supermarket sales, which had already grown 1.0% MoM in July and in June. Sales of furniture and domestic appliances grew 0.6% MoM (after rising 2.2% MoM in July), probably still reflecting the lower IPI tax. Apparel sales declined 2.0% MoM after declining 4.1% MoM, still a payback to the strong 10.1% increase posted in June. Fuel sales dropped 0.7% MoM. In the first eight months of the year, retail sales climbed 4.7%, as supermarket sales jumped 7.4%, furniture and appliances fell 1.6%, apparel fell 6.2% and fuel sales climbed 0.4%. The “augmented index,” which also includes cars and construction materials, climbed 3.3% MoM in August after dropping 5.7% MoM in July. Car sales rose 2.5%, partially recovering from the 11.5% MoM drop registered in the previous month. In 8M09, the “augmented index” rose 3.7%, led by a 4.4% rise in car sales. In our opinion, the numbers show that consumption continues to lead the economy’s recovery. Although the gradual withdrawal of tax incentives by the government could act to slow down sales in the coming months, this effect will probably be offset by the ongoing recovery in credit. That said, we still believe that the steady pace of recovery allows the Central Bank to wait several months before starting a new tightening cycle.

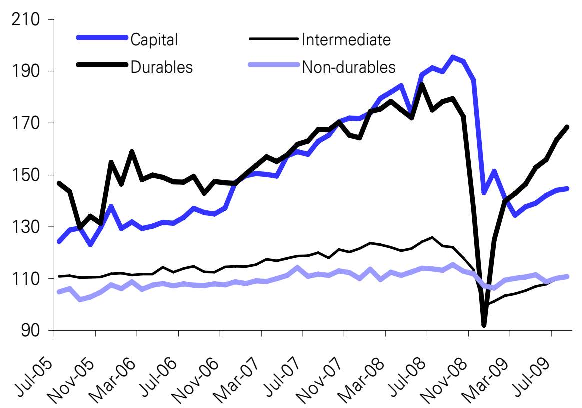
We have raised our forecasts for growth and interest rates. Since economic activity continues to accelerate, we have raised our GDP growth forecasts again to 0.3% from 0.0% for 2009 and to 5.2% from 4.8% for 2010. Although the Central Bank is on hold for now and the short-term inflation outlook remains benign, due to the speedy recovery we now expect the Central Bank to start hiking interest rates in June instead of October 2010. Despite aggressive Central Bank intervention in the FX market and expectations of a much larger current account deficit next year, we expect the BRL to appreciate further due to strong foreign capital flows, reaching BRL1.65/USD at the end of the year and BRL1.55/USD in 1Q09. We believe that the fiscal policy remains the main vulnerability: although relatively low interest rates provide leeway for the government to reduce the primary fiscal surplus without jeopardizing public debt sustainability, the strong fiscal expansion could put extra pressure on monetary policy **(more details on pages 2-6).**

Monthly Review

We expect GDP to grow 5.2% next year

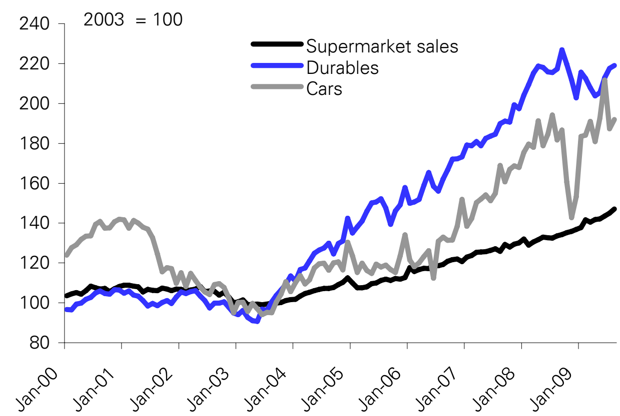
We have raised our GDP growth forecasts again to 0.3% from 0.0% for 2009 and to 5.2% from 4.8% for 2010. We believe that growth will accelerate next year due to the global economic recovery and powerful monetary and fiscal stimuli. After growing 1.9% QoQ in 2Q09, there is evidence that GDP maintained strong momentum in 3Q09, led by consumption. Preliminary numbers suggest that GDP will grow between 1.5% and 2.0% QoQ in 3Q09.

Figure 1: Industrial production



Source: IBGE

Figure 2: Retail sales



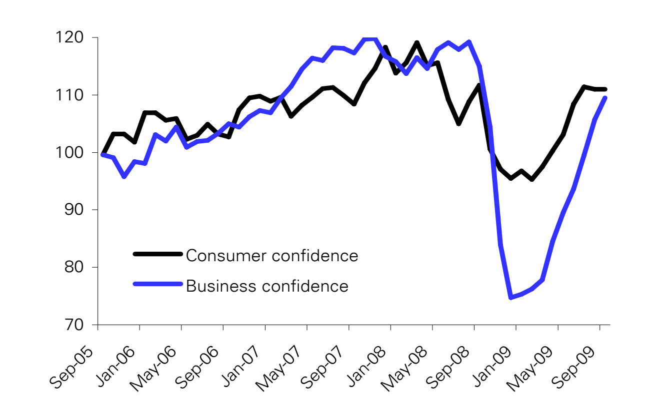
Source: IBGE

Industrial production posted a hefty increase of 2.2% MoM in July followed by 1.1% MoM in August, led by durable consumer goods, which grew by a combined 8.0% in the two months and were down just 3.7% YoY in August. While durable goods will probably slow down in the coming months as a payback to the strong rebound displayed so far and because of the gradual withdrawal of tax incentives by the government (especially in the car sector), other industries are picking up. Although production of intermediate goods (the largest industrial sector) was still down 8.1% YoY in August – reflecting to a large extent the large drop in exports of manufactured goods – it is recovering steadily, having posted positive growth for eight consecutive months. Non-durable consumer goods have performed relatively well this year – they were down by only 1.3% YoY in August – because they do not rely so much on credit and have benefited from buoyant labor income. On the other hand, reflecting the overall decline in investments, capital goods continued to under-perform and posted the sharpest YoY decline among all the sectors: -22.3% YoY in August. Nevertheless, since business confidence has rebounded strongly, capacity utilization is rising gradually and credit is thawing, we expect investment – and consequently the production of capital goods – to stabilize and recover in the coming quarters.

After dropping sharply in 4Q08 and 1Q09, business and consumer confidence have rebounded sharply and are already close to pre-crisis levels. Consumer confidence did not fall as much as business confidence during the crisis, reflecting the surprising resilience of the labor market. The unemployment rate stood at 8.1% in August, not significantly higher than the 7.6% recorded in August 2008. Consequently, labor income declined very little during the crisis, providing an important support for private consumption. The lower-than-expected increase in unemployment was explained not only by a decline in the participation rate (as workers became more pessimistic about their prospects of obtaining employment and quit the job market), but also by the firms' decision to adjust production mainly by reducing working hours rather than firing workers because of high firing costs and perhaps also due to expectations that the downturn would be temporary. The latest employment numbers show that the industrial sector – where the layoffs were heavily concentrated – is starting to hire again, which will most likely offset a possible increase in the labor supply triggered by growing optimism about the economy.

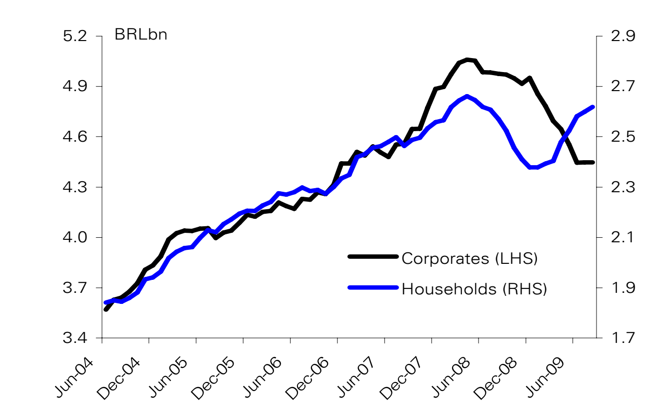
In addition to supporting consumption, labor market stability has also restrained credit delinquency, helping bank loans to recover relatively fast. Although non-performing consumer loans climbed to 8.4% from 7.6% in October 2008, credit origination grew 8.3% YoY in August. Corporate credit remains more sluggish (origination fell down 8.8% YoY in August) and non-performing loans continue to grow in this sector. However, we believe that delinquency among corporate loans is peaking and will likely start declining in the coming months due to the overall economic recovery.

Figure 3: Consumer and business confidence



Source: FGV

Figure 4: Credit origination



Source: BCB

Although the short-term inflation outlook remains benign, the strong fiscal expansion does not bode well for inflation in 2011

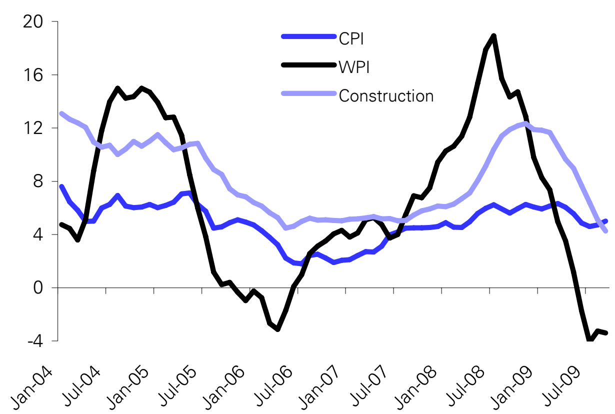
The IPCA consumer index decelerated further to 4.3% YoY in September, the lowest YoY increase since November 2007. We expect the IPCA to rise 4.2% in 2009, thus remaining below the official inflation target of 4.5%. In 2010, inflation should benefit from subdued pressure on administered prices, which are strongly influenced by past inflation (especially by wholesale price indices). While we expect administered prices – which account for 30% of the IPCA – to rise 4.0% in 2009, they will likely climb approximately 3.5% in 2010. Despite the strong GDP growth projected for 2010, services – which have been an important source of inflation this year – will hardly grow faster in 2010, given the lower 2009 IPCA and smaller minimum wage increase expected for 2010 (8.8%, compared to 12.0% this year). Therefore, unless commodity prices rebound faster than we expect, we believe that the IPCA will not surpass the 4.5% target in 2010.

For 2011, however, we believe that the Central Bank (CB) will not be able to maintain inflation below the 4.5% target unless it reduces the monetary stimulus in 2010. In the Inflation Report published at the end of September, CB officials expressed concerns about the inflationary effects of the ongoing fiscal expansion. The CB expects consumer prices to rise by 4.4% in 2010 but forecasts that inflation will accelerate to 4.6% in 1Q11 and 2Q11, mainly due to the "fiscal impulses expected for 2H09 and 1H10." The CB expects inflation to recede to 4.5% in 3Q11, assuming that "at least part of the fiscal stimulus will be reduced in 2H10" – an optimistic assumption, in our opinion.

The faster-than-expected recovery has prompted us to revise our interest rate scenario

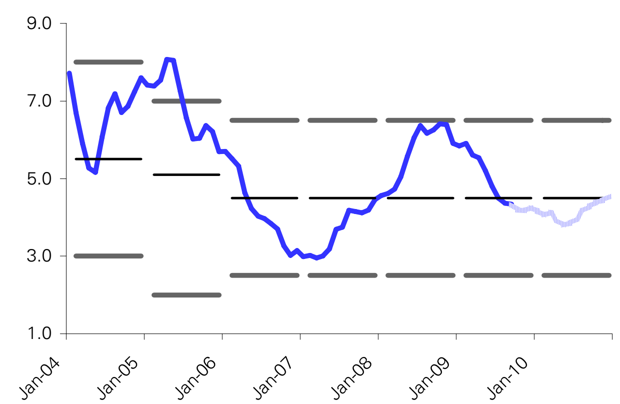
We now expect the CB to start hiking interest rates in June rather than October 2010 and have therefore raised our Selic rate forecast for the end of 2010 to 11.00% from 9.75%. Our revised scenario of faster growth for 2010 suggests that the output gap will be close to zero as early as 1Q10, which will probably have an adverse effect on inflation expectations and prompt the CB to act preemptively to prevent inflation from deviating from the target in 2011. While we still believe that political factors will complicate matters for the CB, two mitigating factors could make it easier for authorities to hike rates before the October elections. First, interest rates have never been so low and, by acting sooner, the CB could reduce the magnitude of the total tightening cycle. Second, the positive growth environment and declining unemployment could help offset the negative political consequences of the rate hike. That said, we still believe that the benign inflation outlook reduces the likelihood of a rate hike in 1Q10 (we expect YoY inflation to bottom at 3.8% in May and gradually rise to 4.8% in 1Q11). The BRL appreciation – which will likely deepen in 1H10 – will probably play against an early rate hike as well. Furthermore, authorities could try to buy some time raising reserve requirements on bank deposits – which were reduced aggressively after the 2008 financial shock – before raising rates.

Figure 5: IGP-DI breakdown



Source: FGV

Figure 6: IPCA and inflation targets



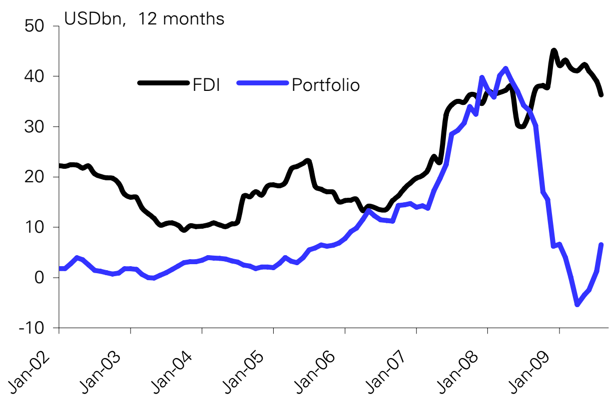
Source: IBGE, Deutsche Bank forecasts

While we expect the economic recovery to fuel the current account deficit, we believe that the BRL will appreciate further due to strong capital inflows

The faster-than-expected BRL appreciation has led us to revise our year-end BRL forecast again to 1.65/USD from 1.75/USD. We expect the currency to eventually reach 1.55/USD in 1Q10. Since we are projecting faster growth, we have raised our 2010 current account deficit forecast to USD40bn (2.1% of GDP) from USD32bn. We expect imports to increase significantly next year, reducing the trade surplus to USD15bn from an estimated USD28bn in 2009. We also forecast that profit remittances will grow strongly in 2010 due to the economic recovery and BRL appreciation. Nevertheless, we believe that foreign investment will continue financing the current account deficit and force the Central Bank to further accumulate international reserves.

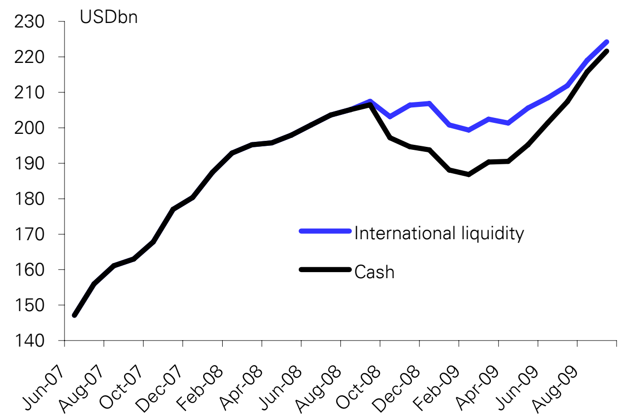
The improvement in market confidence (reinforced by Moody's decision to upgrade Brazil to investment grade in September) and resurgence of IPOs in the local stock market has attracted an estimated USD25bn in foreign portfolio investment into Brazil since May. The CB has been quite aggressive in mopping up the excess dollar inflows, which has taken international reserves to an all-time high of USD231bn. Even so, given the fast BRL appreciation, the government is once again considering creating a special sovereign wealth fund to purchase dollars and avoid further currency strengthening. The Treasury would issue long-term bonds in the local market to fund dollar purchases. Although such a fund could increase FX volatility by reducing the transparency of government intervention, we do not believe that it would be able to stop further appreciation should the global economic outlook continue to improve. That said, we think that the government would probably take more aggressive measures – such as taxing capital inflows – should the BRL reach the 1.50/USD level.

Figure 7: Foreign investment



Source: BCB

Figure 8: International reserves

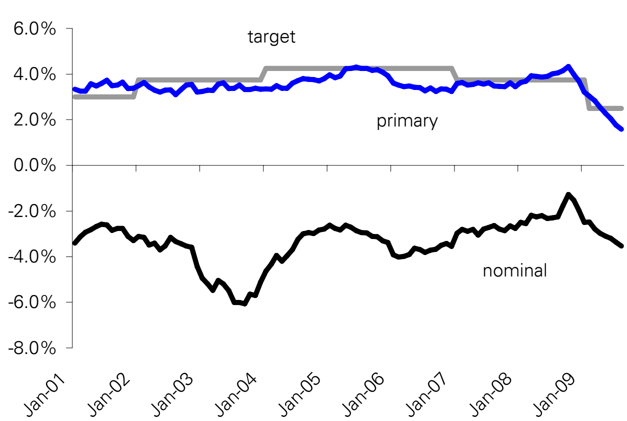


Source: Deutsche Bank

Despite widespread concerns about the aggressive fiscal expansion, the government reduced its primary surplus target again

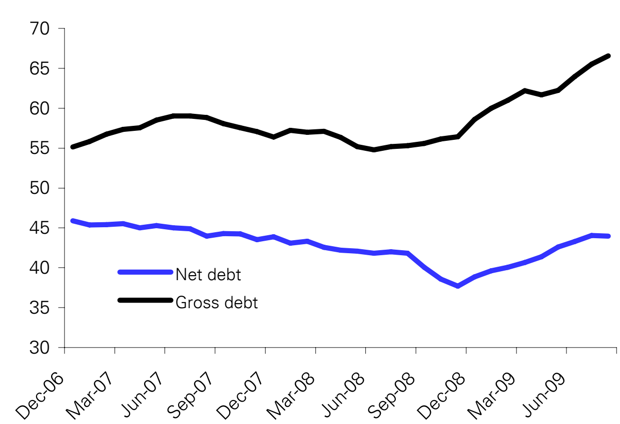
The public sector's primary fiscal surplus totaled BRL43.5bn in 8M09, sharply down from BRL102.9bn in 8M08. The central government's surplus plunged to BRL26.5bn from BRL75.7bn, as federal revenues fell 0.8% YoY and expenditures jumped 16.1% YoY, led by personnel spending. In the September Inflation Report, the Central Bank implicitly criticized the fiscal policy by stressing that the share of welfare programs in total federal spending has been declining since 2007 and that expenditure growth has been dominated by personnel and other current spending. The 12-month primary surplus dropped to 1.59% of GDP in August, the lowest level since June 1999. Although the 2009 surplus target is 2.5% of GDP, the government is allowed to deduct investments in infrastructure conducted through the so-called Pilot Investment Program (PPI) from the target.

Figure 9: PSBR



Source: BCB

Figure 10: Public debt



Source: BCB

Given the sharp drop in the primary surplus, the government has asked Congress to modify the 2009 Budget Guideline Law (LDO) so as to raise the PPI to 0.94% from 0.50% of GDP, thus reducing the 2009 effective surplus target (i.e. the target adjusted by the PPI) to 1.56% from 2.00% of GDP. For 2010, according to the LDO, the consolidated target is 3.3% of GDP and the PPI amounts to 0.65% of GDP, so the effective target is equivalent to 2.65% of GDP. However, the government could modify the LDO at any time and the congressman in charge of reviewing the 2010 federal budget has recently stated that he is considering reducing the consolidated target to 2.5% or even 2.0% of GDP even though the government will count on the Sovereign Wealth Fund (0.5% of GDP) to finance expenditures next year as well. Therefore, there is a considerable risk that the fiscal moderation that the Central Bank is expecting for 2H10 will not materialize.

José Carlos de Faria, São Paulo, (5511) 2113-5185

Data and Events Calendar

Monday	Tuesday	Wednesday	Thursday	Friday
19-October	**20-October**	**21-October**	**22-October**	**23-October**
Focus Survey Trade balance, weekly Tax collection (Sep)	IGP-M, 2nd preview	**COPOM meeting**	**Unemployment rate (Sep)**	IPCA-15 (Oct) Consumer confidence (Oct) IPC-S
26-October	**27-October**	**28-October**	**29-October**	**30-October**
Focus Survey Trade balance, weekly **Balance of Payments (Sep)**	**Total outstanding loans (Sep)** Central govt. fiscal balance (Sep)	**PSBR (Sep)**	**IGP-M (Oct)** **COPOM minutes**	
2-November	**3-November**	**4-November**	**5-November**	**6-November**
Focus Survey **Trade Balance (Oct)**	**Industrial Production (Sep)** IPC-S	FIPE CPI (Oct)	CNI Capacity Utilization (Sep)	
9-November	**10-November**	**11-November**	**12-November**	**13-November**
Focus Survey **IGP-DI (Oct)** IPC-S Trade balance, weekly	FIPE CPI weekly	**IPCA (Oct)** INPC (Oct) IGP-M, 1st preview		**Retail Sales (Sep)**
16-November	**17-November**	**18-November**	**19-November**	**20-November**
Focus Survey IPC-S Trade balance, weekly	FIPE CPI weekly IGP-10 (Nov)		IGP-M, 2nd preview	Tax Collection (Oct)

Source: Bloomberg, IBGE, Banco Central do Brasil

Economic Indicators and Forecasts

	2005	2006	2007	2008	2009F	2010F
Economic Activity						
Real GDP (%YoY)	3.2	4.0	5.7	5.1	0.3	5.2
Nominal GDP (R$bn)	2,147.2	2,369.8	2,597.6	2,889.7	3,014.7	3,288.9
Nominal GDP (USDbn)	882.4	1,088.9	1,333.8	1,573.3	1,525.1	1,934.7
GDP per capita (USD)	4,791.1	5,833.3	7,050.1	8,205.3	7,847.9	9,822.8
Industrial production(%YoY)	3.1	2.8	6.0	3.1	-7.0	8.0
Unemployment Rate (%)	9.8	10.0	9.3	7.9	8.2	7.9
Prices						
IPCA (%)	5.7	3.1	4.5	5.9	4.3	4.5
IGP-M (%)	1.2	3.8	7.7	9.8	-0.6	4.5
Fiscal Accounts						
Primary balance (% of GDP)	3.9	3.3	3.5	3.7	1.6	2.5
Nominal balance (% of GDP)	-3.4	-3.5	-2.8	-2.0	-3.0	-2.0
Net government debt (% of GDP) year end	48.0	45.9	43.9	38.8	44.3	42.8
External Accounts						
Merchandise exports (USDbn)	118.3	137.8	160.6	197.9	151.0	172.0
Merchandise imports (USDbn)	73.6	91.4	120.6	173.1	123.0	157.0
Trade balance (USDbn)	44.7	46.5	40.0	24.8	28.0	15.0
Current account balance (USDbn)	14.0	13.6	1.6	-28.2	-15.0	-40.0
Current account balance (% of GDP)	1.6	1.3	0.1	-1.8	-1.0	-2.1
Foreign direct investment (USDbn, ex-loans)	15.0	15.4	26.1	30.1	15.0	23.0
Foreign exchange reserves (USDbn)	53.8	85.8	180.3	206.8	239.8	245.8
Reserves (months of next year's imports)	7.1	8.5	12.5	20.2	18.3	17.1
Debt Indicators						
Gross external debt (USDbn)	188.0	199.4	240.5	262.9	269.9	278.9
Gross external debt (% of GDP)	21.3	18.3	18.0	16.7	17.7	14.4
Gross external debt (% of exports)	158.9	144.7	149.7	132.8	178.7	162.2
Total debt service (USDbn)	48.5	60.5	55.2	39.8	42.0	45.0
Total debt service (% of GDP)	5.5	5.6	4.1	2.5	2.8	2.3
Interest and exchange rates						
Overnight interest rate (%, eop)	18.0	13.3	11.3	13.8	8.8	11.0
Overnight interest rate (%, average)	19.1	15.1	12.0	12.5	9.9	9.5
Exchange rate (BRL/USD, eop)	2.34	2.14	1.77	2.34	1.65	1.70
Exchange rate (BRL/USD, average)	2.44	2.18	1.95	1.83	1.98	1.68

Source: Deutsche Bank estimates, National Statistics

Acronyms

BCB	*Banco Central do Brasil*
BNDES	*Banco Nacional de Desenvolvimento*
CNI	*Confederação Nacional da Indústria*
FGV	*Fundação Getúlio Vargas*
FIESP	*Federação das Indústrias do Estado de São Paulo*
FIPE	*Fundação Instituto de Pesquisas Econômicas da Universidade de São Paulo*
IBGE	*Instituto Brasileiro de Geografia e Estatística*
SECEX	*Secretaria de Comércio Exterior (Ministério da Indústria e Comércio)*
STN	*Secretaria do Tesouro Nacional (Ministério da Fazenda)*

Source: Deutsche Bank

Appendix 1

Important Disclosures

Additional information available upon request

For disclosures pertaining to recommendations or estimates made on a security mentioned in this report, please see the most recently published company report or visit our global disclosure look-up page on our website at http://gm.db.com/ger/disclosure/DisclosureDirectory.eqsr.

Analyst Certification

The views expressed in this report accurately reflect the personal views of the undersigned lead analyst(s). In addition, the undersigned lead analyst(s) has not and will not receive any compensation for providing a specific recommendation or view in this report. Jose Carlos Faria

Regulatory Disclosures

1. Important Additional Conflict Disclosures

Aside from within this report, important conflict disclosures can also be found at https://gm.db.com/equities under the "Disclosures Lookup" and "Legal" tabs. Investors are strongly encouraged to review this information before investing.

2. Short-Term Trade Ideas

Deutsche Bank equity research analysts sometimes have shorter-term trade ideas (known as SOLAR ideas) that are consistent or inconsistent with Deutsche Bank's existing longer term ratings. These trade ideas can be found at the SOLAR link at http://gm.db.com.

3. Country-Specific Disclosures

Australia: This research, and any access to it, is intended only for "wholesale clients" within the meaning of the Australian Corporations Act.

EU countries: Disclosures relating to our obligations under MiFiD can be found at http://globalmarkets.db.com/riskdisclosures.

Japan: Disclosures under the Financial Instruments and Exchange Law: Company name – Deutsche Securities Inc. Registration number – Registered as a financial instruments dealer by the Head of the Kanto Local Finance Bureau (Kinsho) No. 117. Member of associations: JSDA, The Financial Futures Association of Japan. This report is not meant to solicit the purchase of specific financial instruments or related services. We may charge commissions and fees for certain categories of investment advice, products and services. Recommended investment strategies, products and services carry the risk of losses to principal and other losses as a result of changes in market and/or economic trends, and/or fluctuations in market value. Before deciding on the purchase of financial products and/or services, customers should carefully read the relevant disclosures, prospectuses and other documentation.

Malaysia: Deutsche Bank AG and/or its affiliate(s) may maintain positions in the securities referred to herein and may from time to time offer those securities for purchase or may have an interest to purchase such securities. Deutsche Bank may engage in transactions in a manner inconsistent with the views discussed herein.

New Zealand: This research is not intended for, and should not be given to, "members of the public" within the meaning of the New Zealand Securities Market Act 1988.

Russia: This information, interpretation and opinions submitted herein are not in the context of, and do not constitute, any appraisal or evaluation activity requiring a license in the Russian Federation.

David Folkerts-Landau
Managing Director
Global Head of Research

Stuart Parkinson
Chief Operating Officer

Guy Ashton
Global Head
Company Research

Marcel Cassard
Global Head
Fixed Income Strategies and Economics

Germany
Andreas Neubauer
Regional Head

Asia-Pacific
Michael Spencer
Regional Head

Americas
Steve Pollard
Regional Head

Principal Locations

Deutsche Bank AG
London
1 Great Winchester Street
London EC2N 2EQ
Tel: (44) 20 7545 8000

Deutsche Bank AG
New York
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250-2500

Deutsche Bank AG
Hong Kong
Cheung Kong Center,
2 Queen's Road Central
Hong Kong
Tel: (52) 2203 8888

Deutsche Bank AG
Japan
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Tel: (81) 3 5156 6701

Deutsche Bank AG
Frankfurt
Große Gallusstraße 10-14
60272 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Aurora business park
82 bld.2 Sadovnicheskaya street
Moscow, 115035
Russia
Tel: (7) 495 797-5000

Deutsche Bank AG
Singapore
One Raffles Quay
South Tower
Singapore 048583
Tel: (65) 6423 8001

Deutsche Bank AG
Australia
Deutsche Bank Place, Level 16
Corner of Hunter & Phillip Streets
Sydney NSW 2000
Tel: (61) 2 8258 1234

Deutsche Bank Dubai
Dubai International Financial Centre
The Gate, West Wing, Level 3
P.O. Box 504 902
Dubai City
Tel: (971) 4 3611 700

Subscribers to research via email receive their electronic publication on average 1-2 working days earlier than the printed version.

If you would like to receive this or any other product via email please contact your usual Deutsche Bank representative.

Publication Address:
Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
(1) 212 250 2500

Internet:
http://gmr.db.com
Ask your usual contact for a username and password.

Global Disclaimer