# PANORAMA

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## BRAZIL: A COUNTRY IN DEEP RECESSION LOOKS TENTATIVELY TOWARDS THE FIRST STEPS OF THE NEW GOVERNMENT.

COFACE ECONOMIC PUBLICATIONS

By Patricia Krause, Coface Latin America Economist

Brazil entered into a technical recession in the second quarter of 2015. Its economy contracted by 3.8 % in 2015, mainly driven by the free fall in investment and the collapse in consumption.

The current recession and the Carwash[1] corruption scandal have impacted the first of these variables, while the second has reacted to rising unemployment, negative growth in real wages and deteriorating credit conditions.

The government has also failed to contain the dangerous course of its expenses and a second year of primary fiscal deficit was reported in 2015– a clear sign of lack of fiscal discipline. After having already downgraded Brazil from A4 to B (see scale) in September 2015, Coface again downgraded the country in January 2016. Brazil's new C Coface assessment means that it is considered as high risk.

On May 12 2016, President Dilma Roussef was temporarily removed from office, after the Senate voted to begin an impeachment trial. The proceedings against her mandate concerned breaches of the Fiscal Responsibility Law and were particularly based on fiscal irregularities. Now that Vice President Michel Temer (PMDB party) has assumed the presidency, the Upper House will have 180 days to convene a trial to discuss the charges. Dilma will be impeached if two-thirds of the Upper House vote in favour. If this were to be the outcome, Temer will serve out the remainder of the presidential term, ending in 2018.

Confidence is expected to show signs of improvement in the short term, with the hopes that the new government brings. Nevertheless, Temer is taking office with only weak support from the population, as he was not voted for by direct election and as his party is also highly linked to the carwash corruption scandals. As the investigations are still ongoing, new scandals could erupt in the news over the coming months. He will not have much time to show improvements in terms of fiscal commitment and his ability to deal with Congress, in order to implement the measures required to support an economic rebound.

Activity will not rebound in 2016 and Coface expects a contraction of 3 % of GDP this year.The weak scenario has spilled over into the economy´s major sectors, leading to higher insolvency rates. Coface's sector barometer shows that the main segments of activity are at high risk. The scenario is even worse for the construction, automotive and steel industries, which are currently at very high risk. A reverse of this trend is not expected in the short term, as the deep recession is continuing to drag down profitability.

[1] Car Wash is an investigation being carried out by the Federal Police of Brazil. Initially a money laundering investigation, it has expanded to cover allegations of corruption at the state-controlled oil company Petrobras. It is alleged that executives and politicians have been involved with bribery in return for awarding contracts to construction firms at inflated prices.



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*"There is no easy way out of this crisis and the population is tired of corruption – which means that a rebound in confidence is unlikely in the short term"*

# 1 A COLLAPSING ECONOMY AWAITS THE RESOLUTIONS OF THE NEW GOVERNMENT

President Dilma Rousseff began her second 4-year mandate on January 1st 2015. She had many economic challenges to overcome, including artificially controlled inflation, subdued GDP growth and the precarious situation of the country's fiscal accounts. When President Rousseff took office for her second mandate, policy makers knew that Brazil was facing a serious risk of losing its investment grade status from the major credit agencies.

2015 ended with a GDP contraction of 3.8 % YoY – the worst result since 1990 - and none of the country's main difficulties had been resolved. The adjustment of artificially-low prices (such as energy tariffs and oil prices), the strong depreciation in exchange rates and the resilience of service prices, all contributed to driving inflation to 10.7 % a.y., up from the 6.4 % reported in 2014 and well above the target midpoint of 4.5 %. Fiscal adjustments also failed to show improvements. Pro-business Finance Minister, Joaquim Levy, resigned from his position at the end of 2015, due to the strong resistance from major leaders (such as Labour party members and Congressmen) to his plans to reduce fiscal deficit. The ongoing recession played against tax revenues, while the government´s weak support from Congress precluded improvements to public accounts. Fiscal deficit and public debt further deteriorated over the course of 2015 (see chart). This conjunction of factors led to the downgrade of Brazil's sovereign rating to junk by the three main credit rating agencies.

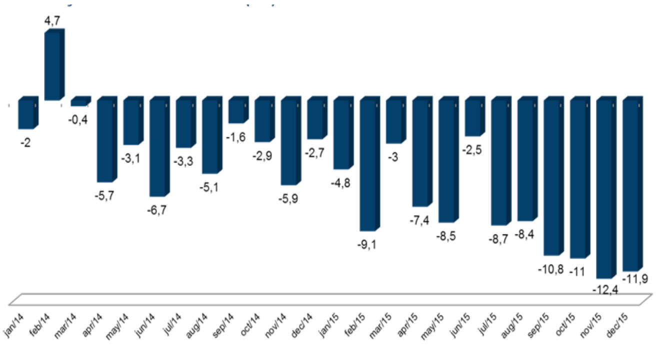
Corruption scandals and political uncertainty are preventing a rebound in business and consumer confidence, thus the economy´s recovery. Activity has been persistently weak, falling during four consecutive quarters. Investments are currently in free fall, having shrunk by 14 % YoY in 2015. Household consumption dropped by 4 % in 2015 YoY – the first negative result since 2003. Exports remained weak, despite the strong depreciation in exchange rates (47 % YoY). They grew by 6 % in 2015, but only when converted to Brazilian Real. On the supply side, industry remained the weakest arm of the economy, contracting by 8.3 % YoY (see sector barometer below for further details).

**Chart 1 - Government´s general deficit and gross debt**


Source: Central Bank

Industrial production has been slowing for 24 months in a row and idle capacity has reached 26.3 %. In the 12 months accumulated until February 2016, the sector contracted by 9 %. There are no signs of improvement and, in fact, the situation only worsened during the last months of the year (see chart). Industrial production fell by 9.8 % in February 2016, compared to February 2015. This poor outcome reflects the weak demand for durable goods (-20 % in the 12 months accumulated until Feb 2016) and the free-fall in investments (capital goods -27 % during the same period). The population is definitely not willing to consume, as the job market has been deteriorating and entrepreneurs are not investing due to the environment of high uncertainty. The new government will not lead to an automatic rebound.

**Chart 2 - Indutrial production (YoY)**

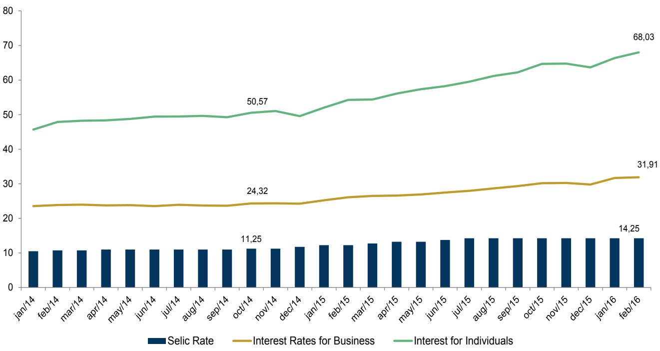



Source: IBGE

The hike in interest rates presents further difficulties for both companies and individuals. Since the reelection of President Dilma Rousseff in October 2014, the Selic reference interest rate has been raised by 3.25 percentage points, from 11% a.y to 14.25%, to try to tackle inflation. However, banks have not only passed on the hike in interest rates within their loan rates, but they have also increased their spreads (see chart below). Average annual interest rates for individuals, for non-earmarked loans, have risen from 50.57 % in October 2014 to 68.03 %.

The rate used for businesses has shown a similar trend, up from 24.32 % to 31.91 % during the same period. Highly leveraged companies have thus been facing strong headwinds and delinquency has increased. The next president to assume the management of the Central Bank is likely to continue targeting a reduction in inflation. Market agents are expecting the Selic rate to stand at 13% at the end of 2016.

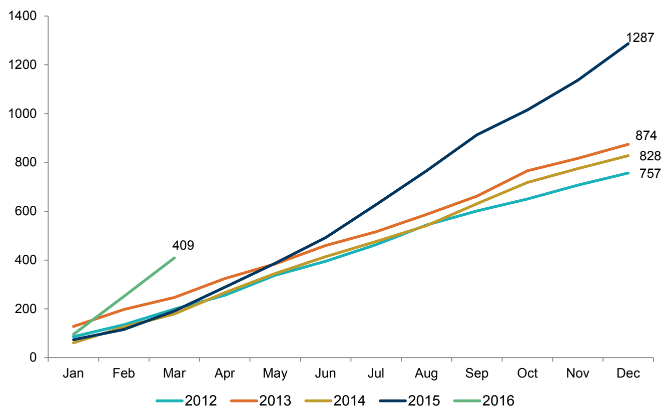
### Chart 3 - Selic vs average non-earmarked interested rate (a.y.)




Source: Central bank

Insolvency has reached a new record, impacted by the Car Wash operation and the ongoing recession. In 2015, 1,287 companies filed for chapter XI[2] in Brazil, a high of 55 % YoY (see chart). In the first quarter of 2016, 409 requests have already been filed (+114 % YoY). This figure indicates that the negative trend is likely to further intensify in 2016 and the country is expected to report a second year of contraction. Coface estimates that GDP will drop by 3 % in 2016. The Chapter XI requests are not concentrated within a specific industry. Risk is rather being spread across most of the domestic sectors. Small-sized companies accounted for 56 % of the requests filed in the first quarter, followed by medium-sized companies at 27 % and larger companies at 17 %. Chapter XI is designed as a tool for trying to avoid bankruptcy, but in Brazil, few companies are able to rebuild themselves. Experts believe that two years is a reasonable period for an enterprise to complete Chapter XI, but there are companies that remain in recovery for eight years. Use of the procedure has become more frequent, partly thanks to benevolence of the country's legislation, which grants long grace periods and large discounts for companies to pay its creditors.

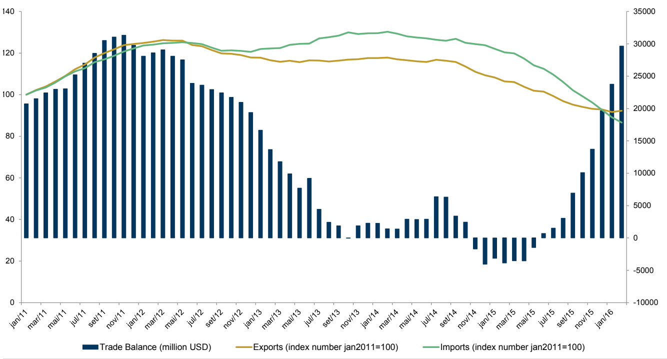
### Chart 4 - Number of Chapter XI requests (Acc. Along the year)




Source: SERASA

The economy is not expected to come out of recession before 2017. In the short-term, only two indicators are expected to improve: trade balances and inflation. As concerns foreign trade, both imports and exports had been decreasing in revenue terms. The balance has improved because the purchase of foreign goods declined at a higher pace than exports. In terms of volume, however, exports have begun to report improvements and they increased by 17 % YoY during the first quarter of 2016. The breakdown per aggregate value reveals that basic products remain the main drivers for foreign trade (+ 18 %), but manufactured (+ 14 %) and semi manufactured goods (+ 11 %) have also reported positive results. While the sharp depreciation in exchange rates last year finally seems to have led to the improved competitiveness of locally manufactured products, the weaker currency has reduced export prices in USD. Thus far, the higher exported volumes have not been sufficient to lead to higher revenues.

### Chart 5 - Trade Balance (12 months accumulated)




Source: MDIC

### Table 1 - Export Breakdown per aggregate value (Main Goods)

In terms of main markets China is still the leader, as the destination of 17 % of exports during the first quarter of 2016 (+ 13 % YoY). This robust performance was led by a sharp increase in soya and pulp shipments. Exports to the United States, the second largest destination for Brazilian products, decreased during the same period (-13 % YoY). Iron and steel, semi-manufactured goods, coffee grains and crude oil were the main negative surprises.

| Jan-March 2016<br>Jan-March 2015 | Million USD | % change YoY in USD | % change YoY in volume |
|---|---|---|---|
| **Total** | **40573** | **-5** | **17** |
| **Basic Products** | **17379** | **-5** | **18** |
| Soya | 3788 | 46 | 65 |
| Iron ore and its concentrates | 2118 | -45 | 8 |
| Corn grains | 1965 | 111 | 138 |
| Crude oil | 1835 | -32 | 19 |
| **Semi-manufactured goods** | **6248** | **-9** | **11** |
| Pulp | 1470 | 13 | 13 |
| Raw cane sugar | 1463 | -3 | 15 |
| Ferroalloy | 534 | -18 | 78 |
| Leather and fur | 533 | -16 | 10 |
| **Manufactured Goods** | **16043** | **-2** | **14** |
| Passenger cars | 1022 | 56 | 69 |
| Aeroplanes | 897 | 32 | 14 |
| Aluminum oxide and hydroxide | 589 | -11 | 12 |
| Polymers of ethylene , propylene and styrene | 478 | 31 | 60 |
| Auto and tractor parts | 440 | -22 | -11 |
| Refined sugar | 398 | -15 | - |

Source: MDIC

[2] Chapter XI: (Chapter XI was established in Brazil in 2005 under the new Bankruptcies Law

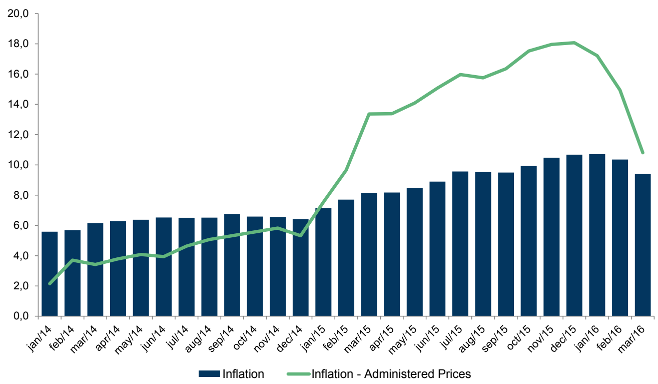
**Table 2 - Export main consumers (Jan-Mar/16 vs Jan-Mar/15)**

| Country | Million USD | % Change YoY | % of total exports |
|---|---|---|---|
| 1. China | 6.966 | 13 | 17 |
| 2. United States | 5.055 | -13 | 12 |
| 3. Argentina | 3.060 | - | 8 |
| 4. Netherlands | 2.223 | -1 | 5 |
| 5. Japan | 1.283 | 7 | 3 |

Source: MDIC

Inflation has peaked. In 2015 the index accelerated significantly, due to the strong depreciation in exchange rates and adjustments in fixed prices (see chart). In 2014, oil prices and energy tariffs were kept at low levels, in order to artificially maintain inflation within the target range. Following the presidential elections of October 2014, controlled prices (24.3 % of the index) began to be rebalanced, driving inflation to 10.7 % for the full year of 2015, up from 6.4 % in 2014. In late 2015, inflation began to decompress, as the rise in regulated prices slowed, the effects of the exchange rate lost strength and service prices lowered in response to the recession. This tendency is expected to persist over the coming months, thus steering inflation to 7.5 % a.y. by December 2016.

**Chart 6 - Inflation (12 months accumulates)**




Source: IBGE

## 2 IMPEACHMENT GAINED STRENGTH

Brazil is facing its second impeachment process since the end of the military dictatorship that ruled from 1964 to 1985. Fernando Collor de Mello took office in 1990 and was the first directly elected president following the reestablishment of democracy. Accusations by the president's brother, of condoning an influence-peddling scheme, led to the opening of impeachment proceedings in Congress. On September 29, 1992 over two-thirds of Lower House members voted in favour of Collor´s impeachment. He was then taken out of office to await the decision of the Upper House. Three months later, almost certain that the Senate would vote against the continuation of his mandate, Collor resigned just a few hours before the Upper House gave its decision. Vice president Itamar Franco took office and Collor´s political rights were suspended for eight years. In 1992, 500,000 people took to the streets of 17 cities protesting against the government. In 2015, the same number was recorded in Paulista alone (one of São Paulo's main avenues).

Rousseff´s battle in Congress began in December 2015, when the Lower House speaker (Eduardo Cunha of the PMDB and one of the president´s main opponents) accepted a request to begin impeachment proceedings against her. The request was submitted by three lawyers and backed by the left-wing PSDB party, along with 45 other organisations and parties. The request concerned breaches of the Fiscal Responsibility Law and was particularly based on two violations: i) postponement of transfers of subsidies from the Treasury to public banks (known as "fiscal paddling") and ii) authorisation of expenses through presidential decrees (without formal budget allocations from Congress).

The Carwash scandal was the main reason for the uprising against Dilma´s government. During the investigation it was suggested that Petrobras´ money might have been used to pay for political campaigns, to buy political support in the fragmented Congress and for personal enrichment. Petrobras did a write-down of 6.2 billion reals (roughly 2.3 billion USD or 0.1 % of GDP) in its 2014 balance sheet, which referred to the additional costs improperly capitalised in the corruption scheme uncovered by Carwash.

The Brazilian Supreme Court set out the impeachment process. First an impeachment committee was formed in the Lower House comprised of members from all parties. President Dilma was then given 10 sessions to present her case before this committee. The latter had after five sessions to prepare a report either in favour or opposed to impeachment. The committee's opinion was then presented to the full chamber, 48 hours after the publication of the report.

The impeachment process was formally opened as two-thirds (342 members) of the Lower House voted in favour. The process thus moved to the Senate and on May 12th, by a large majority (55 votes in favour and 22 against), Dilma Rousseff was temporarily removed from office. Vice President Michel Temer (PMDB party) has now taken office. The Upper House now has 180 days to convene a trial to discuss the charges. Dilma will be impeached if two-thirds of the Upper House vote in favour. If this were to be the outcome, Temer will serve out the remainder of the presidential term, ending in 2018. As the initial in the Upper House already attained two-thirds of the votes, it will be very difficult for Dilma to defeat this process. Temer, on the other hand, is faced withmajor challenges and will not be able to wait too long to show his first positive results. The economy is paralysed and urgently needs a quick solution for its political framework.

Temer is taking up office with only weak support from the population, as he was not voted for by direct elections and as his party it is also highly linked to the carwash corruption scandals. As the investigation is still ongoing, new scandals could erupt in the news over the coming months. He will have little time to show improvements in terms of fiscal commitment and his ability to deal with Congress, in order to implement the measures needed to support an economic rebound.

Temer is an experienced politician with good communication skills, which will help him to deal with Congress. The PMDB party is the biggest in Brazil and holds the highest number of seats in both houses (67 seats in the Lower House and 17 seats in the Senate). It is expected that he will work with a political base of between 250-300 deputies. This would be enough to approve supplementary laws and interim measures, but Temer will need to build a larger coalition in order to promote changes in the Constitution (such as the much-needed social security reforms).

The first challenge will be the fiscal results for 2016. Dilma´s government sent Congress reviewed primary fiscal results for this year, changing the estimated value from a surplus of 24 billion reals (0.4 % of GDP) to a deficit of 96.6 reals (roughly 1.6 %) of GDP. The new government will have only until May 22 to make adjustments to this estimation. Currently the 12 months accumulated deficit until March 2016 stands at 2.28 %, thus the new proposal already seems unrealistic. The new government will probably work with higher deficit, as it would be impossible to obtain fiscal balance improvements before the end of the year.

The economic team is expected to be composed of pro-business names with strong reputations - but there is no easy way out of the crisis. Families are already leveraged and the rising unemployment rate and economic instability will prevent a strong rebound in consumption. Moreover the population is tired of corruption. It is estimated that 3 million people took to the streets to protest against the government on March 13. This is the largest demonstration in the country´s history. This movement also revealed that people are not only displeased with the incumbent president, but in general with all the politicians under investigation. This was shown when Senator Aécio Neves, from the center right PSDB party, tried to join the demonstration and was met with great hostility from the public. Neves achieved second place in the 2014 Presidential elections, but his name has also been involved in corruption scandals.

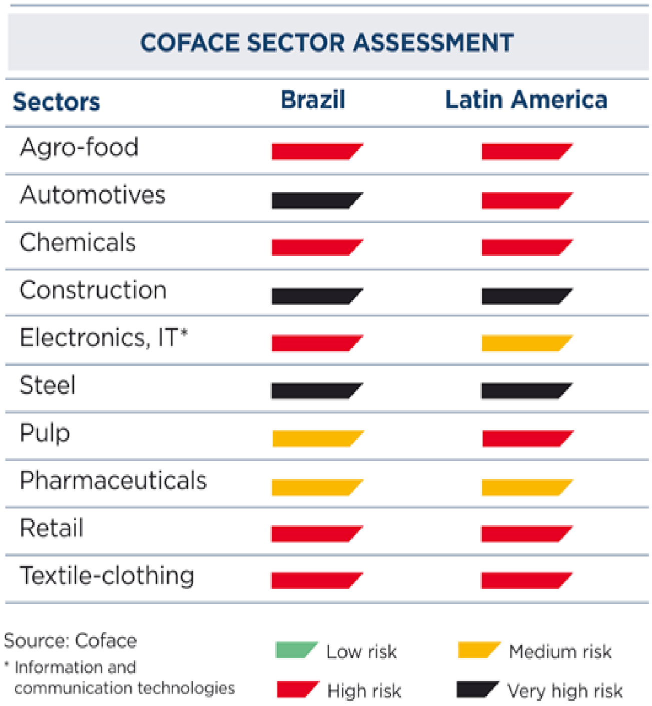
As yet, no date can be forecast for the completion of the Car Wash operation. During the two years of investigations already carried out, 500 search warrants have been executed by the Federal Police, 180 people accused and 70 convicted.

There were 40 plea-bargain testimonies and almost 3 billion reals (roughly 900 million USD) recovered. It is the biggest success of any corruption investigation in the country´s history - and this can certainly be seen as a positive evolution for the country. Nevertheless, the counter effects on the country's economy are bitter and will continue to cause instability in the shorter-term.

Electoral law was changed in 2015 and campaign donations from corporate institutions are no longer permitted. This could force political parties to merge, in order to gain strength – resulting in a less fragmented Congress. Nevertheless, the eventual benefits of this new legislation will only be seen after the elections of October 2018.

## 3 SECTOR BAROMETER

Against this backdrop of deep recession and political crisis, sector risk is comparatively high. Coface´s sector barometer analyses the financial performance of companies in different industries, combined with its payment experiences. Brazilian risk has further deteriorated since the last Panorama published in October 2015. One segment has been reviewed downwards. Pharmaceuticals have descended from low risk to medium risk. Overall, most sectors are classified as high risk.




### Agro-food: redord crop, but margins squeezed

Brazil has benefitted from record crops over recent years and, according to a survey by the National Supply Company (Conab), 2015/16 crops should be just as positive. Production is estimated at 209 million tons (+ 0.6 % compared to 2014/15), while productivity should report a marginal decline of 0.2 %. Soya will remain the main contributor to growth.

**Table 3**

| Production Forecast - Crop 2015/16 | | | |
|---|---|---|---|
| Culture | Million tonnes | % compared with 2014/2015 | Productivity |
| Soya | 98982 | 2.9 | -0.4 |
| Corn | 84660 | - | 1.4 |
| Rice | 11168 | -10.2 | 1.8 |
| Wheat | 5535 | - | - |
| Cotton | 3706 | -5.3 | 4.2 |
| Bean | 3309 | 6.2 | 6 |
| Total | 209011 | 0.6 | -0.2 |

Source: CONAB

Brazil´s agriculture activity grew by 1.8 % in 2015, reaching 263.6 billion reals (79 billion USD, or 4.5 % of GDP). This outcome is relatively good when compared to the general GDP contraction of 3.8 %. However, the segment has been facing some challenges in terms of profitability. The context of increasing interest rates in Brazil poses a particular challenge for the segment, which traditionally works with long payment terms. The strong deterioration in exchange rates (-47% YoY in 2015, compared with 2014) is not helping either, as the agricultural sector has a high dependency on imported fertilisers.

International agricultural prices are not expected to improve, as the main producing countries are also expected to harvest good crops, with no serious weather issues. Moreover, the end of export tariffs in Argentina[3] will have a positive effect on its production in 2016, thus increasing the world supply of soya, corn and wheat and reducing Brazil´s potential markets. Within this backdrop, the sector assessment is expected to remain at high risk.

## Chemicals: lower trade deficit helped by depreciation exchange rates

As a major part of the chemical sector concerns chemical products for industrial use, it has been impacted by the negative performance of industry (-8.3 % in 2015 YoY). In 2015, the production of chemical products reported a marginal increase of 0.5 %, while domestic sales dropped by 5.4 %. Capacity utilisation ended the year at 78 %, one percentage point below the level recorded in the previous year.

The trade deficit declined by 18.5 % in 2015, down to 25.4 billion USD - the lowest value since 2011. The sharp deterioration in exchange rates and weak domestic demand explain the contraction of 16 % YoY in imports (both in terms of value and volume). The weaker Brazilian Real and the consequent gain in competitiveness have led to an increase of 10 % in exports, however only in terms of volume. In terms of total revenues, they decreased by 12 %, as average prices were down by 14 %.

Industry´s main costs remain under pressure. Brazil imports roughly 50 % of its natural gas and the strong depreciation in exchange rates in 2015 (-47 % YoY) have exceeded the positive effects of lower international gas prices (-44 %). In addition, energy prices had increased by 34.4 %, year on year, by February 2016. These are clearly negative factors for the local industry, especially at a time when chemical companies in many parts of the world have benefited from lower energy prices.

Investment projects have been falling. The Brazilian Chemical Industry Association (Abiquim) forecasts that disbursements will decline successively over the next four years, to reach the lowest level registered since 1995. This downwards trend began in 2014, when investments totaled 1.8 billion USD, down from 2.1 billion USD one year earlier. In 2015, investments were estimated at 1.7 billion USD, but are only expected to reach 200 million USD in 2016. Faced with the lack of competitiveness, the ongoing political crisis and weak local demand, risks for the sector remain high.

## Electronics, IT: not imunne to the deep recession

The ongoing recession and the depreciation of the Real against the USD, caused a collapse in consumer electronics spending in 2015. Retail sales of electronics dropped by 5.4 % in the previous year. Segments that used to outperform, such as smartphones and tablets, contracted by 13.4 % and 10 %, respectively, YoY.

Currency depreciation also put pressure on vendor margins, as the segment has a high import coefficient. As a response to weak domestic demand in 2015, suppliers absorbed part of the increase in costs. In 2016 there will be reduced space for this trend to continue, as margins are already squeezed.

In 2016, conditions will remain challenging. With the backdrop of the deteriorating economic scenario, the segment is expected to report a second year of contraction. In this context consumers are also likely to select cheaper models when making purchases. Thus the drop in value will be even greater than the reduction in volume. Risks will therefore remain high, with increasing pressure on profit margins. The credit scenario, marked by more selective credit disbursements and higher interest rates, is also creating problems.

## Pulp: a favorable environment

Brazil's pulp sector is favoured by natural advantages, such as its short wood production and harvesting cycle. The segment has a high export bias and has thus benefited from the strong depreciation in exchange rates.

In 2015, exports reached 5.6 billion USD, a high of 5.6 % in terms of revenue, YoY. This positive performance was driven by volumes that rose by 8.5 % YoY, while prices reported a drop of 2.7 % YoY. Sales to the Chinese market accounted for the largest share, with a high of 15 % YoY.

The market will continue to stand out from other economic sectors in 2016. Prices may be negatively pressured by the high global supply, but the maturation of domestic investments in production capacity expansion together with higher exports will sustain the sector´s production. According to the Brazilian Economic Consultancy, LCA, production should increase by an annual average of 4.5 % over the years from 2016 to 2020.

## Pharmaceuticals: helped by aging population and lower income elasticity

Brazil´s pharmaceutical market is the sixth largest in the world and the second among emerging countries (only behind China). Sales doubled in size between 2010 and 2015, to reach 75.4 billion reals in 2015 (roughly 22.6 billion USD). This strong performance can be linked to the gains in real income reported over the last fifteen years and the country's aging population.

The segment is continuing to demonstrate a more resilient performance. Despite the period of deep recession, pharmaceuticals have benefited from the lower income elasticity of its segment. People are not going to stop the consumption of a vital medicine because their wages have deteriorated, or due to fear of losing their jobs.

Pharmaceutical retail sales are currently the only one of the eight retail subcategories to show a positive performance. Pharmaceutical sales increased by 2.6 % year on year in January 2016, while retail dropped by 5.2 % in the same period. The results also reveal that despite the relatively good performance, the segment's sales are not as robust as they were in previous years. This loss in strength has impacted delinquency, which has shown a high in recent months. In this context, the sector has been downgraded, from low to medium risk.

## Retail: slumping sales in the backdrop of weak fundamentals

Between 2005 and 2014, retail grew by an annual average rate of 6.8 %. For many years, the sector was one of the main

[3] Export tariffs in Argentina were removed by its new president, Mauricio Macri, in December 2015. Soya is the only crop for which tariffs will be gradually reduced. These tariffs have already dropped from 35 % to 30 %.

drivers for growth. These days are now over and retail has been declining for 10 consecutive months. Taking into account a year on year comparison, retail sales declined by 5.3 % in the months accumulated until February 2016.

Retail's main fundamentals have been deteriorating very rapidly. The unemployment rate reached 8.2 % in February 2016, the highest rate for the month since 2009 and an increase of 2.4 percentage points compared to the same month of the previous year. Average real income also decreased, by 3.7 % in 2015 YoY - the first negative result since 2003. In addition, banks have been increasing their spreads.

Consumption of durable goods has been particularly impacted. Faced with the weak current scenario, people are definitely not inclined to purchase or finance expensive products. When retail is broken down into its 10 sub-categories, it can be seen that vehicles, along with furniture and household appliances, have been the most impacted segments so far. They contracted by 17 % and 16 %, respectively, YoY in the 12 months accumulated until February 2016.

**Table 4**

| Physical Sales Volume Index - % in YoY terms (12 months acc. until February 2016) | |
|---|---|
| **Restricted Retail Trade** | **-5.3 %** |
| Fuels and lubrificants | -6.8 % |
| Supermarkets | -3.0 % |
| Textiles, clothing and footwear | -9.7 % |
| Furniture and household appliances | -16 % |
| Pharmaceutical articles and similar products | 2.9 % |
| Books, newspaper, magazines and office products | -12.3 % |
| Office, computer and comm. equipment and material | -7.5 % |
| Other articles | -3.9 % |
| **Extended Retail Trade** | **-9.1 %** |
| Vehicles, motorcycles and auto parts | -17 % |
| Construction material | -9.5 % |

Source: IBGE

Retail sales will show the second year of contraction in a row. The fragile economic scenario and the perspectives of still-higher unemployment over the upcoming months will prevent a rebound in sales. Risks will remain high, as weak demand and the greater competitiveness of the retail segment hamper the transfer of higher production costs to the prices paid by end-consumers.

## Textile - Clothing: remains vulnerable

The strong depreciation in exchange rates has reduced the import coefficient. The textile sector is subject to high exposure from imports. Over the last fifteen years, local producers have been losing out to cheap Asian imports, mainly from China. This movement has been contained by the strong deterioration in exchange rates, which have reduced the attractiveness of imported materiel. The import coefficient dropped to 18.3 % in the 12 months accumulated until January 2016, down from 24.3 % reported in the same month of 2015.

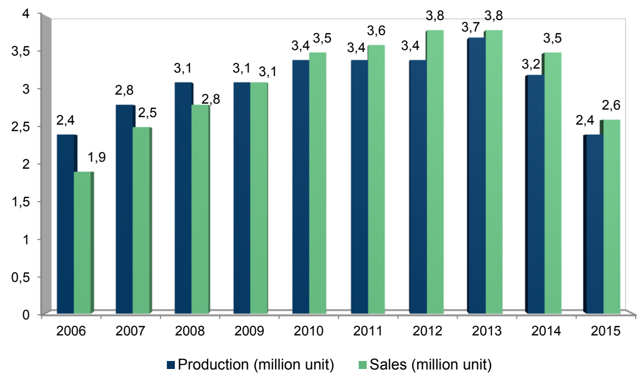
Imports fell by 31.7 %, year on year, in February. This strong contraction can also attributed to the weaker domestic market. Production of textiles shrunk by 15 %, year on year, in January 2016, while internal consumption dropped by 19 % during the same period. The weak domestic market has resulted in adjustments to apparel prices and margins therefore remain tight. Apparel prices increased by 5.8 % in the 12 months until February 2016, while general inflation stood at 10.4 %. As a consequence of the negative conjuncture, the textile industry saw a 13.3 % fall in employment in the 12 months until January 2016.

The scenario will remain challenging but exports are expected to bring some relief to the industry. In 2015, exports reported a hike of 8 % in terms of volume. Export revenues, however, contracted by 6 %, due to the sharp deterioration in exchange rates. So far, in 2016, export sales have shown brighter results. In the first two months of the year, revenues and exported volumes respectively increased by 35 % and 59 %, year on year. It is worth noting, however, that exports represent only 2.6 % of domestic production.

## Automotive sector: receding to the levels of a decade ago

The Brazilian automotive market observed a second year of contraction in 2015. Auto production dropped by 23 % in the year (2.4 million units), while sales shrunk by 27 % (2.6 million units). The industry has thus been set back to the levels of 2007 (see chart) and is well below the peak reported in 2013. 2015 saw the closure of 1,047 of the country's car dealers.

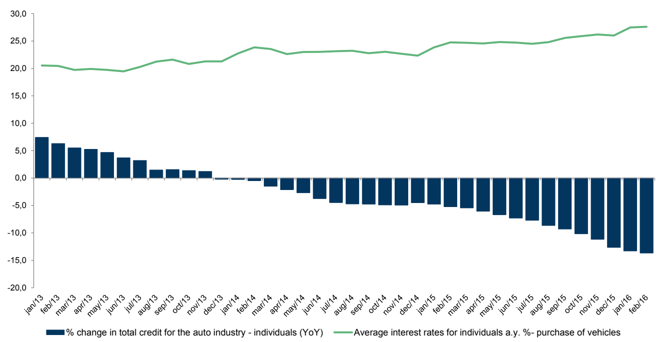
**Chart 7 - Production vs sales**




Source: ANFAVEA

Domestic fundamentals are very weak and Brazilians are definitely not motivated to consume durable goods. Since November 2014, the country´s labour market has severely deteriorated. The unemployment rate has risen from 4.6 % in November 2014, to 8.2 % in February 2016. Following 11 years of growth, real income contracted by 3.7 % in 2015, partly due to rising inflation (10.7 % in 2015). Credit conditions have not helped the situation (see chart). Interest rates have been following the hikes in the benchmark Selic rate and consumers are wary of assuming new debts. The total volume of credit used for the purchase of vehicles reached 157 million reals in February 2016 (roughly 44.5 billion USD), down by 14 % YoY and 19 % less than the record achieved in July 2013. Moreover, the annual average interest rate for vehicle financing stood at 27.6 % in February 2016, up by 8 percentage points from the historical minimum recorded in June 2013.

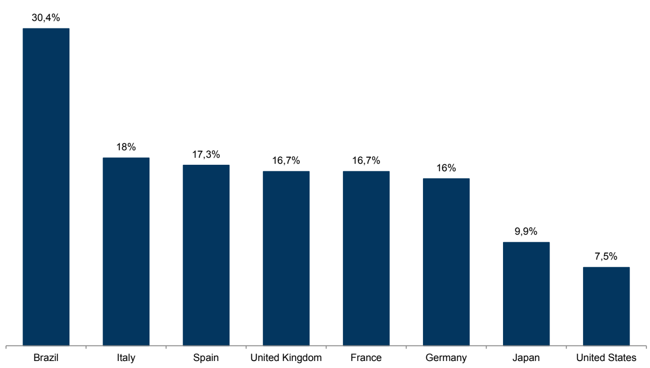
**Chart 8 - Credit conditions for the purchase of vehicles**




Source: Central Bank

The IPI tax on industrialised products was reset in January 2015. This raised prices in a context of subdued demand. During the world economic crisis of 2008, the Brazilian government decided to provide temporary tax breaks for the automotive industry. This palliative measure was extended many times, but in late 2014 it was decided to fully reestablish the IPI due to the deteriorating situation of the country's public accounts. The tax burden on cars in Brazil is extremely high when compared with other major producers (see chart).

**Chart 9 - Tax burden on cars - Share of consumer prices - 2015**




Source: ANFAVEA

The industry has been operating at roughly 44 % of installed capacity. This percentage is based on the annualised daily auto production observed in March 2016.

According to data released by Anfavea, Brazil's National Association of Motor Vehicle Manufacturers, the scenario is even worse for truck producers, whose idle capacity stands at an impressive 80 %. This last figure is in line with the drop of 14 % in investments in the previous year. Inventory levels at factories and resellers stood at 43 days of sales at the end of March 2016 (against the standard of 30-35 days). This weak scenario has also impacted the industry´s workforce, which contracted by 11.4 % in 2015.
Improvements in the export market are expected to bring marginal relief. In 2015, 417,000 units were exported, a rise of 25 % YoY. This result does, however, come after the sharp decline observed in 2014 (- 40 % YoY), when exports were highly impacted by Argentian import barriers. Exports in 2016 should be positively impacted by the end of these barriers, which took effect in December 2015, after the pro-business president Mauricio Macri took office. Sales are also expected to be boosted by trade agreements with Mexico, Colombia and Uruguay. Nevertheless, it is worth noting that exports only represent 17 % of the industry´s production.

The automotive industry is set to endure a third year of contraction in 2016 and the first signs of a rebound are not expected before 2017. The results accumulated in the first quarter of 2016 corroborate this analysis. Production and sales have dropped, by respectively 28 % and 29 %, YoY. In October 2015, Coface reviewed the risk assessment for the automotive industry in Brazil from high to very high. As no improvement has been reported since then, it remains at very high risk. Domestic fundamentals will remain weak due to the current recession and the country's deep confidence crisis. The main factors influencing car sales, such as employment and real income, are expected to continue deteriorating.

## Construction: 2015, a year to be forgotten

Construction represents 5.5 % of the country´s GDP, or 325 billion reals (roughly 97.6 billion USD). The segment was highly impacted in 2015 by the deepening of the Car Wash operation , the economic crisis and cuts in public investments. It contracted by 7.6 % YoY, marking the second negative outcome in a row (see chart).

**Chart 10 - Construction's GDP versus Brazil's GDP**


Source: IBGE

Since the Car Wash Operation began two years ago, in March 2014, many construction groups have filed for Chapter XI protection. Some of the companies accused were already under financial strain and they then started to face stronger credit restrictions as their names were raised during the investigation. This also prompted cuts in investment plans, affecting infrastructure projects.

The country´s attempts to promote fiscal adjustment have reduced investments in infrastructure. In 2015, PAC - Growth Acceleration Program3 expenses were down 17 % YoY, totaling 47.3 billion reals (roughly 14.2 billion USD or 0.8 % of GDP). Moreover, in late February 2016, the government announced new cuts of 4.2 billion reals (or 0.1 % GDP) for this year. Within this context of budgetary stringency, the Union and states did not conclude any contracts with Brazil´s largest civil construction companies in 2015. A study carried out by Brazilian newspaper Valor, which examined the balance sheets of the country's seven major construction groups, showed that revenues from public works account for at least 31 % of each company's total revenues. In some cases, the dependency on public works is as much as two-thirds of revenues.

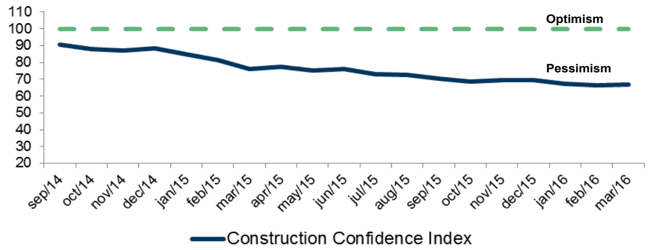
The ongoing economic crisis has curbed real estate, a market which enjoyed a golden age between 2009 and 2011. In former years, high prices prevailed, driven by the increase in credit supply following the subprime crisis and improvements in financing terms - which brought many people into the market. However, with the surge of the economic crisis in 2015, prices began to decline and the average supply price dropped by 9 %, in real terms, YoY.

The real estate segment ended 2015 with 109,000 units sold, a drop of 15 % year on year. New releases also contracted by 19 %, signaling that the market is adjusting to lower demand associated with the deterioration in the job market, lower real wages and worsening credit conditions. The rise in unemployment also brings more credit delinquency, especially among those with credit financing for real estate that is still under construction. The Brazilian Consumer Protection Code guarantees that buyers can withdraw from purchases, leaving the builder with almost the entire burden.

Weak activity in the construction sector has led to the systematic elimination of jobs. The balance between hires and layoffs has been negative since July 2014. According to the General Registry of the Employed and Unemployed (Caged), the civil works industry slashed 405,600 jobs in the 12 months accumulated until February 2016, equal to 13.3 % of the industry´s workforce.

The construction confidence index is currently at its historical minimum, indicating that the sector will continue to shrink over the coming months. The index stood at 66.8 points in March 2016, well below the 100 points which separates optimism from pessimism (see chart). The uncertainties on the political and macroeconomic fronts, including the Car Wash operation, are the main barriers to a rebound in activity.

**Chart 11 - Constrution Confidence Index**




Source: FGV

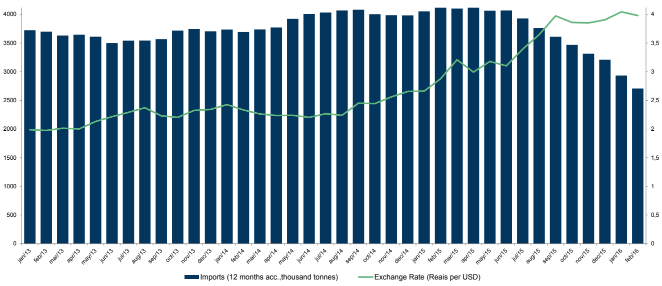
During the first quarter of 2016, the absence of new public works continued to cause fear in the market. Until now, civil construction firms have been relying on revenues from ongoing projects. When these works are completed, revenues will wane if there are no replacement projects. Companies which are not able to migrate to the private construction market, or to focus on projects in other countries, could face high risks of insolvency. The real estate market is likely to remain weak, due to rising unemployment, lower real wages and high interest rates.

The segment will therefore remain at very high risk over the coming months.

## Steel: Weak domestic market exacerbated by world steel overcapacity.

The challenging environment faced by the Brazilian steel industry is not new, but it has worsened since 2015 as the country entered into recession. All of the three main steel consumers are now contracting: the automotive industry, capital goods and construction. Steel production thus contracted by 1.9 % in 2015 YoY, mainly driven by the strong decline in long (-13.5 % YoY) and flat (-5.9 % YoY) steel. Internal sales also disappointed and shrunk by 26.1 % YoY.

**Chart 12 - Steel production**

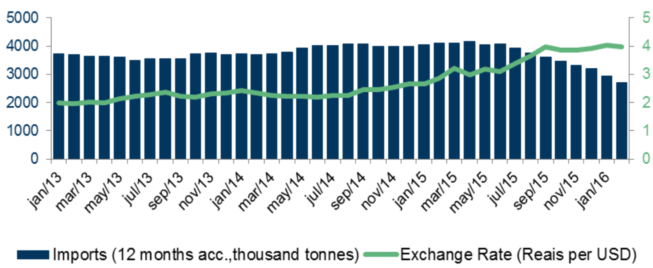


Source: Brazilian Steel Institute

Global fundamentals have not changed much and steel overcapacity remains a key challenge. According to the World Steel Association (WSA), global steel demand contracted by 1.7 % in 2015. This fall is mainly associated with China, which remains by far the world´s largest steel producer and consumer (roughly 50 % of global market). A further slowdown in real estate investments led to a drop of 3.5 % in steel consumption in 2015. On the supply side, global steel production decreased by 2.9 % in volume terms and the world´s capacity utilisation rate ended 2015 at a new historical low of 64.6 %. The drop of 2.3 % in China´s output in 2015 was taken by the market as an initial adjustment to the world´s steel oversupply, for which the country is mainly responsible. According to China's steel association, over half of the country´s steel producers have been sustaining losses.

The strong depreciation of the Brazilian real reduced steel imports. In recent years Brazil had been invaded by cheap steel, mainly from China. The government implemented anti-dumping measures to try to protect local industry – but these measures had no real effect. Now, however, the tendency seems to have been contained, thanks to the strong depreciation of the Brazilian Real (see chart). According to Brazil's National Steel Distributors Institute (Inda), imports contracted by 86.3 % in February 2016, YoY. The share of imported steel stood at roughly 4.2 % in February 2016, the lowest rate observed since 2008.

**Chart 13 - Steel imports vs exchange rates**




Source: Brazilian Steel Institute and Central Bank

As local demand remains very weak, steel producers have been unable to adjust their prices. According to Inda, imported steel is currently 5 % more expensive than Brazilian steel. Inda's president has commented that a rise of 10 % in domestic prices seems plausible. Steel mills are, however, finding it difficult to implement this increase, due to subdued demand and high competition in the market. For instance, in the first two months of 2016, purchases of steel by distributors dropped by 22.5 % YoY and inventory levels stood at 3.7 months (2.5 months is considered a reference level).

National steel producers have been tackling the external market. This tendency can be explained by the recent gains in competitiveness, due to currency depreciation and the recession in Brazil. In terms of volume, steel exports increased by an impressive 40.3 % in 2015. Profitability was, however, contained by the lower international prices for commodities.

Hikes in delinquency and insolvencies have been observed. Steel distributors with dependence on foreign steel suppliers were heavily impacted by the strong depreciation in exchange rates (-47 % YoY in 2015). These companies do not usually have a natural hedge (as they do not export) and financial hedging is often seen as a very expensive solution. They have thus been facing headwinds, as sales in the country have considerably decreased. Hikes in bank interest rates have not helped. According to INDA, client delinquency within the distribution network increased by 50 % in 2015. Many distributors filed for Chapter XI, or bankruptcy. The distribution segment's workforce has been reduced by 22 % over the last two years.

Coface expects the steel sector to remain at very high risk in the short term. The main fundamentals, which contributed to the downgrade from high risk to very high risk in October 2015, have not improved. The country is expected to report a second year of contraction, exchange rates will remain volatile due to the political scenario and interest rates will remain high.

## 4 CONCLUSION

It is clear that Brazil's economic rebound will not be immediate. There should be slight improve ments in confidence indexes and possibly mild GDP growth rates starting in 2017. However some agents are already forecasting that the current decade will be a lost one, in terms of economic activity. The country could contract by almost 7 % in two years.

The frightening trajectory of public accounts needs to be contai ned by urgent and long-awaited reforms. Social security reforms are one of the most important. Social security deficit reached 85 billion reals in 2015 (25 billion USD or 1.4 % of GDP) and will continue to deteriorate rapidly if nothing is done.

Brazil still holds a favorable demographic pyramid, but this has been changing as life expectancy has been increasing and people are having fewer children. Another important reform involves eliminating indexing rules (such as the minimum wage rule) that make public spending overly rigid and difficult to manage during periods of difficulty. Politicians usually avoid these types of measures due to their unpopularity with voters - however they can no longer be postponed. These actions would also be very important in regaining credibility with investors.

The strong deterioration in exchange rates is good news for exports – but they are faced with obstacles, such as poor infras tructure and lack of trade agreements. Clearly improving infras tructure is a difficult task in the current climate of corruption scandals which involve names close to the government and the country's largest economic conglomerates. Once again, success in implementing the much needed fiscal needed reforms would be a good starting point. As to trade agreements, the country is still very closed and limited by the Mercosul. New trade relations need to be established.

Household consumption, the main component of GDP, is likely to take longer to rebound. During the subprime crisis in 2008 – 2009, the government decided on a strong injection of credit into the economy, in order to maintain activity. At that time, this formula was a success – but it would not work in the current context. People are already leveraged - as opposed to eight years ago, when there was pent-up demand for credit. They are also worried by rising unemployment and lower real wages.



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