

February, 2011

Brazil: quarterly outlook

Commodity price hike is a major concern but local responsible policies are bound to control inflation.

Our base hypothesis is that a better consensus on the global economic performance may reduce market's volatility. In addition, responsible economic policies are likely to reinforce country's attractiveness, which may anchor expectations and help local government to control inflation.

This Quarterly Outlook brings our year's story and its related forecasts. We analyse global and local drivers for our calls, which act as control variables for our quarterly reviews.

WestLB's outlook is based on a lower volatility story. While throughout 2010 we saw investors moving from a strong rebound view to the double-dip call and again to an optimistic scenario, this year's rationale is based on a better consensus on the economic environment. Developed countries may deliver a mild but sustainable recovery. Local environment may also calm markets down: responsible policies and close-to-potential growth are likely to help to anchor expectations.

Global factors

To build an outlook for Brazil we assume hypotheses on risk aversion, global dollar and commodity prices. These variables are drivers for our local forecasts: balance of payments, FX rate, inflation, interest rates and growth.

In our view, risk aversion may fall, global dollar is likely to have a slight recovery and commodity prices will probably sustain part of their recent hikes.

We believe this year's information set is better, which means asset prices can be less volatile. Differently from last year, we don't see investors swaying that often from euphoria to depression. We use SP500 volatility (VIX) as a proxy for global risk aversion: after the historical highs reached in 2008, we see volatility falling to more normal levels.

Our call is far from implying a favorable scenario for global economy, and hints at the likelihood of a better understanding of the recovery process. We work with neither a double dip in the US, nor a downturn in China nor even a rupture in Europe. Difficulties in the US, Europe and Japan are likely to linger on, but our main call is that overall performance may keep improving slowly but progressively.

In the US, labor market and credit conditions are constraints for a faster rebound. But on the other hand, policy stimuli are on track and labor market may deliver a lagged rebound, since confidence in recovery is likely to increase. In the Eurozone, fiscal adjustments, together with multilateral support, will probably finance European governments. In the emerging markets, even if we move from a cyclical rebound to sustainable growth close to potential, trend remains favorable.

In such a scenario, dollar may slightly recover lost ground. On one hand, fundamentals – lower global volatility and higher US growth (current account deficit) – suggest a weaker dollar. However, uncertainties on Europe have been a key short-term driver for global dollar. Since the European currency is likely to mirror solvency, fiscal and coordination issues, the Euro situation - rather than other fundamentals - is a call for a mild upward trend for global dollar. Moreover, we don't rule out a scenario in which markets start to price in a change in the US monetary policy.

Finally, since last year the US monetary policy stimuli have started to move commodity prices up. On top of that,

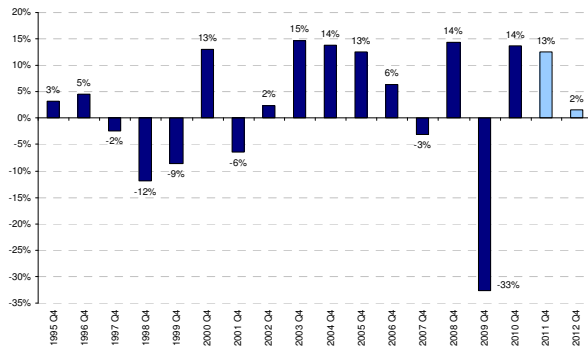
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new fiscal impulses in the US, China’s sustained growth and poor weather conditions have moved prices to higher levels.

Current prices suggest a carry-over close to 18% for this year. According to our scenario, commodity prices may increase 13% in 2011, after a 14% hike last year (figure 01). That said, our rationale based on a dollar rebound implies that prices may move back to the 3Q10 level.

Figure 01: Commodities prices (CRB % yoy)



Source: Bloomberg, WestLB Brazil.

This global outlook for risk aversion, global dollar and commodity prices is likely to reinforce Brazil’s favorable performance. Liquidity conditions sustain capital inflows and local growth. But commodity prices emerge as a global and local challenge.

Local factors

Responsible economic policy may reinforce country’s attractiveness and keep external accounts and FX rate under control. Due to commodity price shock, inflationary risk is the main issue and asks for tighter fiscal and monetary policies. At the end of the day, we see growth moving toward potential and inflation plotting a longer convergence to targets.

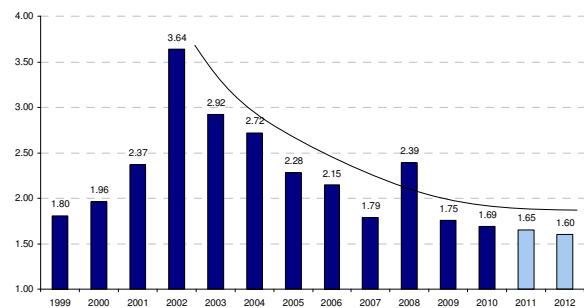
The new government has given better-than-expected signs on the macroeconomic side. Even with political transitions, we have learned that Brazil does have political and economic incentives to stick to responsible policies. Also, local political speech has been favorable in terms of building up a better regulatory environment, which is

critical for attracting private investments and increasing potential growth.

Sovereign risk premium (EMBI) mirrors global liquidity and local institutional improvements and will probably sustain a very smooth downward trend. Also, we don’t take external accounts as a relevant issue. In spite of uncertainties on the current account deficit trend, global recovery, commodity prices and local economic slowdown point to a better performance. Trade surplus is likely to remain favorable and we see a controlled current account deficit, running around 2.5% of GDP. We see no room for an explosive trend.

Differently from past years’ trend, BRL may run stable (figure 02). On one hand, lower global risk aversion is likely to move capitals toward emerging markets. But on the other hand, stronger global dollar, relatively stable risk premium – Brazil is expensive now - and falling commodity prices may avoid local currency to present a further appreciation. Moreover, investors’ doubts on current account deficit and government’s market intervention increase market’s risk aversion.

Figure 02: BRL (yearend)



Source: Bloomberg, WestLB Brazil.

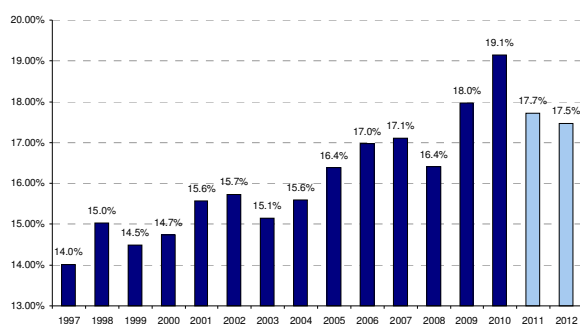
Recent commodity price hike is moving global and local inflation up. This supply shock adds risks to the inflationary dynamics, since we still have a local heated economy.

The supply shock requires tighter fiscal and monetary policies. In our call, a 150 bps hike may be enough to control inflationary expectations. Also we estimate that macroprudential measures (reserves requirement increase)

may be equivalent to a 100 bps rate raise. Note that we don't share the view that Brazil's Central Bank has adopted an inflationary bias, or developed a higher tolerance to inflation. When shocks hit the economy, central bankers have to focus on the second-round effects on inflation rather than on the impacts caused to headline inflation. As a result, flexible inflation targeting implies the use of escape clauses: longer convergence periods and target ranges.

Fiscal policy may help to anchor inflation expectations. We work with a slash in expenditure close to BRL 40 billion in this year's budget. Expenditures may reach 18% of GDP (figure 03), which explains a primary result close to – but still below – the target. In our estimates, fiscal effort is equivalent to a 50 bps rate raise and, most importantly, reinforces new government's commitment to responsible policies, which is relevant to help Central Bank anchor expectations.

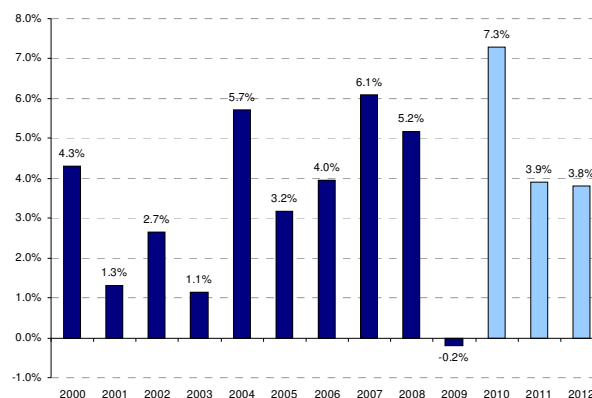
Figure 03: Central Government expenditures (% GDP)



Source: Central Bank, WestLB Brazil.

If we assume the whole economic policy efforts – fiscal and monetary – in interest rates equivalence, we estimate a hike close to 500 bps. With such restrictive policies in place, growth and inflation may move down. Retail sales and, especially, industrial production may run at a milder pace, with impacts on labor market: unemployment rate may keep falling, but at a slower pace. Also, monetary policy and macroprudential measures are expected to move total outstanding loans toward their long-term trend. As a result, we forecast GDP running at 3.9% this year (figure 04), slightly lower than the estimated potential growth.

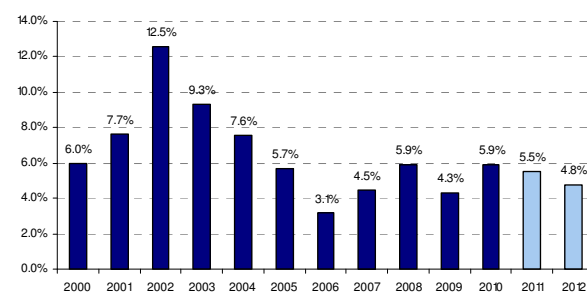
Figure 04: GDP (% yoy)



Source: IBGE, WestLB Brazil.

All in, fiscal and monetary policies may partially offset the commodity shock impacts on inflation. Consumer price indexes will probably print a convergence trend. We assume three main hypotheses for inflation: (a) GDP may run close to the long-term trend; (b) commodity prices may fall from current levels; and (c) economic policies are likely to anchor expectations. As a result, IPCA may run at 5.5% this year and 4.8% in 2012 (figure 05).

Figure 05: Inflation (IPCA - % yoy)



Source: IBGE, WestLB Brasil.

Final remarks

Given our call for lower risk aversion, we see no pressures on the external accounts and BRL may run stable. However, recent commodity price hike is an issue for local inflation, which requires more restrictive policies. As a result, growth may converge toward long-term trend, producing lower pressures on inflation (table).

Table: 1Q11 WestLB outlook

	2008	2009	2010	2011P	2012P
Real GDP (% yoy)	5.1	-0.2	7.3	3.9	3.8
Total outstanding loans (% GDP)	42.5	46.9	51.4	56.2	62.5
Retail sales (% yoy)	9.1	5.9	10.8	5.9	6.2
Industrial production (% yoy)	3.1	-7.4	10.4	3.5	3.8
Unemployment rate (% yearly average)	7.9	8.1	6.7	6.1	6.1
Consumer prices (IPCA, % yoy)	5.9	4.3	5.9	5.5	4.8
Consumer prices (INPC, % yoy)	6.5	4.3	6.5	5.7	4.8
Wholesale prices (IGP-M, % yoy)	9.8	-1.0	11.3	8.5	9.0
Short-term interest rate (% yearend)	13.75	8.75	10.75	12.25	12.25
Public Sector primary surplus (% GDP)	4.07	2.10	2.90	2.80	2.30
Public Sector nominal deficit (% GDP)	2.00	3.30	2.40	2.50	2.90
Net public sector debt (% GDP)	38.5	42.8	40.4	40.1	40.4
Gross public sector debt (% GDP)	57.4	62.0	55.0	59.1	60.3
Exchange rate units/US\$ (end-yr, monthly average)	2.39	1.75	1.69	1.65	1.60
Exchange rate units/eur (end-yr, monthly average)	3.24	2.46	2.24	2.15	2.10
Trade balance (US\$ bn)	24.8	24.7	25.1	26.5	23.0
Current account balance (US\$ bn)	-28.3	-24.3	-47.5	-50.7	-63.2
Current account balance (% GDP)	-1.8	-1.5	-2.3	-2.2	-2.7
Risk premium, CDS 5 years (bps)	345	110	112	100	85
Risk premium, EMBI (bps)	474	210	175	165	150
Net foreign direct investment (US\$ bn)	45.1	21.6	48.5	55.0	60.0
International reserves (US\$ bn)	207	235	289	325	370
US real GDP (%)	0.0	-2.6	2.9	3.3	2.5
Fed funds rate target (%)	0.25	0.25	0.25	0.25	1.50

Source: Central Bank, WestLB Brazil.

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