# Major Country Risk Developments
# January 2024

By Byron Shoulton

## Overview

The U.S. and UK militaries stepped up strikes on Houthi forces in Yemen, attempting to repel repeated drone attacks by the Iran-backed Houthis on commercial shipping traveling through the Red Sea. This sea-lane accounts for 15% of the world's seaborne trade, including grain, oil, and liquid natural gas. Shipping companies have had to divert vessels to travel around the southern tip of Africa (the Cape of Good Hope) to avoid persistent drone attacks on global commercial shipping in the Red Sea.

The number of container ships at the mouth of the Red Sea on their way to or from the Suez Canal was down 90% in the first week of January compared with the start of 2023, due to the disruption from attacks by the Houthis. The Kiel Institute for the World Economy reports that container flows through the Red Sea fell below 70% of the usual level during December.

Forecasters had expected the wider impact of Israel's war on Hamas to be relatively contained. However, concerns are mounting over the likelihood of more significant knock-on effects for commodities, including oil, should U.S. forces get sucked deeper into the regional crisis raging since Hamas's October 7th attack on Israel. There is a consensus that the impact on global supply chains could become more severe if the crisis drags on beyond the first half of this year. Israel recently indicated that it is prepared to keep fighting for at least another year. Washington has sent hundreds more troops to the Middle East and struck Iran-backed militias in Iraq and Syria in retaliation for attacks on U.S. bases.

The International Association of Independent Tanker Owners, which represents 70% of all internationally traded oil, gas, and chemical tankers, has advised members to stay away from the Bab al-Mandab strait and for vessels travelling south via the Suez Canal to pause north of Yemen.

Global reinsurers have begun inserting cancellation provisions into policies to protect against a full-scale Middle East conflict, a move that threatens to further drive-up costs and risks for businesses operating in the region. The pullback by reinsurers, who share risks with primary insurers and play a crucial role in the global economy, reflect mounting concern in the financial sector over the direction of the war between Israel and Hamas. According to industry estimates, the global insurance sector has about $10 billion of exposure to Israel through political violence and terrorism policies. As industry participants move to reduce coverage for Israel and the region, considering the risks of a widening conflict, insiders believe this is feeding through to higher prices also for international and local interests seeking to protect infrastructure and property in the region. Reportedly, reinsurers are demanding significantly higher prices and have pushed primary insurers to cap the amount of coverage that they provide to clients in Israel and neighboring countries, e.g. Jordan, Lebanon.

The marine insurance market has reported a sharp rise in the cost of traveling through the Red Sea and Suez Canal because of the wave of Houthi attacks. Shipowners now pay additional premium for travelling through a designated portion of the Red Sea. These added charges have jumped by 10 to 15 times in recent months, contributing to decisions to reroute ships around Africa. Global reinsurers have between them approximately $600 billion in capital and have already been ratcheting up prices after years of losses from inflation, a series of natural catastrophes and Russia's full-scale invasion of Ukraine. The recent moves follow similar actions after the Ukraine war, where reinsurers responded more severely by excluding countries fully from contracts.

With the detour around Africa taking ships an extra seven to twenty days, freight rates for a standard container transported from China to Northern Europe went from about $1,500 in November to $5,000 today. Still, freight rates are far below the peaks of up to $14,000 reached during the pandemic.

Some economies are already feeling the effects. Egypt is one of them, given its reliance on shipping via the Suez Canal, which raised more than $9 billion in transit fees for the country during the last fiscal year.

Companies are also reporting strains. Tesla's German factory has halted production until February 11 because it is missing components due to the longer shipping times around the Cape of Good Hope. Some argue that inventory levels are sufficient to allow most companies to operate satisfactorily even with longer shipping times. Moreover, slower consumer demand following the spate of interest rate increases may limit companies' ability to raise prices and pass through higher shipping costs to customers. Oxford Economics estimates that if the Red Sea closed commercial traffic for several months, higher shipping rates could add 0.7 percentage points to annual CPI inflation rates by the end of 2024.

Usually, the oil and gas market would take fright at the prospect of a much wider Middle East conflict. However, the price of oil declined throughout October, November, and December even as the Israel-Gaza conflict raged. But, a recent jump in oil prices in the wake of the U.S.-led strikes on the Houthis in January, lifted Brent crude to $80.50 per barrel, underscoring fears in financial markets that the U.S.-led response could herald more trouble ahead.

Falling energy costs have been a key driver behind declining inflation, so any interruption to that descent would present a setback to central banks' efforts to quell price growth.

## Energy outlook

In 2023, increased crude production from countries outside the Organization of Petroleum Exporters and its allies (OPEC+), was sufficient to cover the rise in global demand. This pushed OPEC+ to cut its output by 2.2 million barrels per day, an amount equivalent to 2% of global supply, in a bid to keep prices stable. Still, the oil market only just fell short of surplus in the final quarter of 2023.

The projection is for an average crude oversupply of 550,000 barrels per day during the first four months of 2024, which would be enough to replenish stocks by nearly as much as they declined during the heated summer months. New supplies this year will come from Brazil, Guyana and especially the U.S.

Abundant crude supplies suggest a stable first-half 2024 for energy. After that, surpluses could narrow. Non-OPEC oil could level off. Local protests shut down production at a crucial Libyan oilfield. Oil prices are just below $80 per barrel, down by 12% over the past quarter and well below 2022 levels. Price cuts announced for February by Saudi Aramco, Saudi Arabia's national oil company, were deeper than expected and is an indication of a weaker physical market. The lower revenue implied by the cuts is likely to test the Saudi's resolve in spearheading reduced crude production from OPEC+. One unknown is the extent to which new sources of oil will continue to influence prices. Analysts are split on whether oil prices will surge, slide or trade within a tight range over the coming months, highlighting how uncertain market participants have become about global growth and the potential for the war between Israel and Hamas to spiral into a broader, regional conflagration.

European gas prices are near their lowest levels in two years and prices for grains and metals also remain cheaper. The mined supply of lithium and nickel is also booming; that of cobalt, a by-product of copper and nickel production, remains robust, dampening green-metal prices.

## USA

The U.S. economy entered 2024 with a more positive outlook. Output in manufacturing, mining, agriculture, services, transportation, travel & leisure continues to recover and is currently above pre-pandemic levels. Mortgage rates have started to decline, while the construction sector is showing signs of a

mild increase in activity.

The Federal Reserve ("Fed") kept interest rates steady at a 22-year high of 5.25% to 5.5% in December, while providing forecasts showing U.S. officials believe rates will end this year at 4.5% to 4.75%. Rates are expected to fall even lower in 2025, with official forecasts at between 3.5% and 3.75%. The Fed's projections triggered a rally in U.S. stocks and a sharp fall in Treasury yields.

The U.S. jobs report for December showed an increase of 216,000 jobs. The results were stronger than forecasted and left the unemployment rate unchanged at a low of 3.7%. The indication is that the jobs market is not heating up but is maintaining a healthy tempo. There are jobs available for people looking.

With the October and November figures revised down, private payroll growth averaged 115,000 new jobs over the last three months. While healthcare, government, leisure, and hospitality again accounted for the lion's share of job growth, 59.6% of all private industries added workers, a relatively healthy breadth.

U.S. inflation declined sharply in 2023 from a high of 9.1% in 2022 to 3.7% in December 2023. According to a survey by the New York Federal Reserve Bank, consumers expect prices to rise by a modest 3% in 2024. That is still above the Fed's target of 2% but the downward trajectory has investors penciling in interest-rate cuts starting later this year. Despite ongoing global tensions and uncertainties, U.S. consumer spending remained brisk in the run-up to the holiday season and continued into the New Year. A survey of small-business owners found almost 25% of them still regard inflation as the single biggest problem, while nearly one-third of those companies planned to raise prices in the coming three months.

Separately, a pile-up of bad debt threatens to sour investors' growing optimism about the prospects for the largest U.S. banks.  Non-performing loans — debt tied to borrowers who have not made a payment in at least the past 90 days — are expected to have risen to a combined $24.4bn in the last three months of 2023 at the four largest U.S. lenders — JPMorgan Chase, Bank of America, Wells Fargo and Citigroup, according to a Bloomberg analysts' consensus. That is up nearly $6bn since the end of 2022.

The big banks have indicated they expect the rise in unpaid debts to slow soon. Several banks have reduced the amount of money they put away for future bad loans, so-called provisions, in the third quarter. Provisions were expected to have shrunk again in the final three months of last year. But, if the money that banks are putting away for bad loans unexpectedly jumps, that could raise alarms for investors. The big banks believe U.S. consumers have weathered the Fed's interest rate rises in good shape and stressed that overall consumer activity remains resilient. However, the banks noted that savers had less money in their bank accounts than they did 12 months ago (due to a jump in spending), while defaults started to climb.

Credit remains a wild card. Commercial property, and in particular mortgages on less-full office buildings, had been one of the biggest factors pushing up problem debts. More recently though, delinquencies have been rising on consumer loans, particularly credit cards and car debt. This has made some analysts nervous, especially because what the banks are putting away for loan-loss reserves now is much smaller than what they set aside when bad loans were rising at the start of the pandemic. Bank reserves are considered adequate right now.  Bankers warn that keeping U.S. unemployment rate low -about 3.7%- will be crucial to ensuring loan losses remain at marginal levels over the 18 months. In a sign of a worsening credit environment, the big four banks reported that the net charge-off rate- the portion of loans with losses that are marked as unrecoverable- rose in the fourth quarter 2023 to the highest level since the pandemic.

Collectively, the banks set aside more than $8 billion in reserves to cover potential losses during the final three months of 2023, up from $6.2 billion a year earlier.

The upcoming presidential election is shaping to be a strong indicator of how Americans feel about the economic outlook.

U.S. crude production soared last year as a boom in shale helped drive output growth of about two million barrels per day in 2023, the most since the U.S. lifted curbs on exports. This helped to push prices down by around 10% in 2023, the first annual fall since 2020. The U.S. has become the world's largest natural gas producer, but the benefits of that drilling boom remain unevenly distributed. Swaths of the country have access to cheaper gas, and export facilities are now selling excess production overseas. Other areas, including the New England states, are bereft of sufficient supplies and must pay more for energy. The threat of closure of a Massachusetts import facility has sparked fresh concerns over the reliability of the Northeast U.S.'s energy supplies.

## Israel

Israel mobilized about 360,000 soldiers in response to Hamas's surprise attack on October 7th, during which militants killed 1,200 people and took another 240 hostages. After initially bombarding Gaza for three weeks, Israel launched a devastating ground offensive in the territory. The assault has killed more than 23,000 people, left hundreds of thousands homeless, and reduced huge swaths of the enclave to rubble.

For three months Israel has waged its offensive against Hamas in Gaza. Since the October 7th attacks, Israel has had to rethink its long-standing security doctrine. That doctrine involved relying less on negotiating for peace with the Palestinians, strengthening military defenses, building walls, and using technology to repel missile attacks and infiltrations. In the interim, Palestinians have become radicalized, and the walls failed to stop the atrocities of October 7th. Catching Israel and much of the wider world completely off guard, Hamas's October 7th attack exposed enormous flaws in Israel's previous assumptions. Indeed, the war has now reset the entire Palestinian question, putting Gaza and its people squarely at the center of any future Israeli-Palestinian negotiation.

Israel's air defenses now face an increasingly sophisticated arsenal of missiles aimed at it by Iran-backed militants in Lebanon, Yemen and elsewhere. Israel has stepped up its attacks on Hezbollah in Lebanon, killing leaders of both Hamas and Hezbollah in the country, and setting the stage for the widening of the war. Israel is suspected of killing a top Iranian commander in Syria and explosions have killed almost one hundred people in Iran. War could break out between Israel and Hezbollah, the Iran-backed militia in Lebanon. Fears of regional escalation have grown as global diplomacy appears stalled.

A dynamic private sector, robust economy and institutions have helped Israel cope with highly unstable governments and most external shocks, but the war in Gaza will stretch security and economic resources and may precipitate a short, sharp recession. Political volatility has heightened because of the war and internal dissatisfaction with Prime Minister Netanyahu's leadership.

In Gaza, two million civilians are at risk of famine while attacks by Houthis in Yemen threaten world trade. Israel's northern border is tense after the assassination of a Hamas leader in Lebanon. Three months after the Hamas attack triggered the war, the Israel Defense Forces say 12 Hamas battalions based in North Gaza are no longer functioning as coherent fighting units. Israeli intelligence estimates that Hamas has two dozen battalions in total and about 25,000 to 30,000 fighters. The Israel Defense Force ("IDF") reports that about 8,000 Hamas fighters have been killed, including key field commanders. The focus now is the dismantling of Hamas in the central and southern Gaza Strip and eliminating its leadership wherever they can be found.

A consensus supports removing Hamas from power in Gaza: it has oppressed and impoverished the people there. While Hamas is certainly an impediment to peace, Israel should make clear its fight is with the terrorists. That means using force judiciously and letting in more aid. This is not happening. Some are searching for a plan that could be implemented after the war. Some wish to create a path to a moderate Palestinian state. Such an approach would help maintain support for Israel in the U.S. and elsewhere. The U.S. acts as a deterrent to Iran and backs detente between Israel and Gulf states which also oppose Iran's influence. Most importantly, the U.S. underwrites the security of Israel. Yet, Israel cannot succumb to what the U.S. dictates on the timetable for the war's end.

In Gaza, the concern is that Israel's tactics exemplifies reckless disregard for civilian lives. The Hamas-run authorities say over 23,000 civilians and fighters have died. The UN says another 7,000 may lie under rubble. Israel says it has killed 8,000 terrorists. Meanwhile, not enough water, food or medicine is reaching Gaza and there are no true safe zones for civilians. No one seems to have a post-war plan ready. Israel has excluded rule by the Palestinian Authority in Gaza. Furthermore, extremists in Israel's coalition government talk of permanently displacing Palestinians from the enclave. It is not surprising that Israeli public opinion shows little sympathy for the Palestinians. A majority believe that the obliteration of Gaza may help restore Israel's deterrent power. Prime Minister Netanyahu's desperation to cling to power means pandering to the most extremists' elements, testing U.S. patience, and that of its allies, while isolating Arab states.

The threat of a Hezbollah invasion or missile strikes means that one strip of northern Israel is now uninhabited. Israel's options are few. A pre-emptive invasion of Lebanon could lead to a military quagmire, trigger collapse of the weak Lebanese state and could damage relations with the U.S. Diplomacy, which might create a buffer zone between Hezbollah and Israel's border, but a regional plan is needed to contain and deter Iran. This requires U.S. support, that of other Western allies, and the Gulf Arab states. Netanyahu may not care about alienating outsiders, but his popularity at home has plummeted. Israel's Supreme Court has also just struck down his government's controversial judicial overhaul. Given the trauma of October 7th, any successor to Netanyahu will not be soft on security. Still, another Israeli leader might understand that famine in Gaza, anarchy, open-ended occupation, and the erosion of U.S.

backing will not make Israel safer.

The Israeli economy will be affected by the war, but no one can, at this stage, predict by how much.

The IDF has indicated that five brigades — amounting to a few thousand troops — will soon be taken out of Gaza for training and recuperation. While the U.S. has been urging Israel to move to a more targeted, lower-intensity phase of its war against Hamas, the IDF cast the troop reductions as part a practical step to manage forces through what it expects to be several more months of fighting.

Over the decades U.S.-Israeli cooperation has been turbulent at times, but it has maintained a steady upward trajectory. U.S. security, diplomatic, and economic assistance has bolstered Israel's position in a volatile region. Having the U.S. as its defender has enabled Israel to punch above is demographic weight and geographic size, projecting strength well beyond its borders. Furthermore, the U.S. commitment to Israel has endured through both Democratic and Republican presidents.

What is now abundantly clear, is that Israel's latitude to pursue its stated war objectives would be constrained were it not for the support of the U.S. As fighting persists and gaps emerge between the U.S. and Israeli positions, Israel has strong reasons to invest in keeping its primary alliance intact. To ensure that its bond with the U.S. survives this war, Israel will need to manage its military campaign more judiciously, as well as tackle its domestic political problems; and it must determine conclusively how it will settle its conflict with the Palestinians. Regional security, stability and continued global trade flows all depend on finding a lasting solution here.

## China

China's auto exports surged to a record last year, overtaking Japan as the world's largest auto exporter, marking a significant shift for the global auto industry. While China has been acknowledged as a world leader in electric vehicles, traditional gas-powered autos were the main driver of the increase, with demand surging especially in Russia. Chinese carmakers seized the void left in Russia by the departure of Western carmakers following the invasion of Ukraine.


BYD, the Chinese automaker, surpassed Tesla as the world's largest manufacturer of battery-powered electric vehicles, selling 526,000 compared to Tesla's 484,000. The Chinese government has provided large subsidies to the EV industry. Besides, China dominates the manufacture of electric cars' most critical component, batteries. China's vast domestic market allows local firms to benefit from economies of scale.

China's leadership is focused on future technologies: lithium-ion batteries, electric vehicles, and solar panels, are seen as "pillars of the economy." The ambition is that in years to come, China's advancement in these key sectors will be felt across the world. A manufacturing export boom is expected to challenge all of China's leading competitors. This focus is further reinforced by the need to offset China's current real-estate slump, which is dragging on economic growth. Sales by the country's 100 largest real-estate developers fell by 17% in 2023, and overall investment in residential buildings fell 8%. After a decade in which capital spending on property outstripped economic growth, officials now hope that manufacturing can pick up the slack.

State-owned banks – corporate China's main source of financing - are funneling cash to industrial firms. In return for an extension of pandemic-era tax breaks and carve-outs for green industries, exporters in powerhouse provinces have been told to expand production. During the first 11 months of 2023, capital spending on smelting metals, manufacturing vehicles, and making electrical equipment rose 10%, 18%, and 34%, respectively, compared with the similar period in 2022.

Nevertheless, Chinese consumer prices remained in deflationary territory for a third straight month in December, adding to several challenges policymakers face. Yet even in the face of falling prices, tepid trade, and continuing real estate market woes, a median of forecasts points to expectations of year-on-year GDP growth of 5.2% in the fourth quarter 2023. That is an improvement on growth of 4.9% during the previous three months. However, forecasters warn that maintaining the same growth target will be tough in 2024 because there is less tailwind and China's structural deceleration continues.

## Europe

Mildly improving confidence in the eurozone economy suggests any recession this year is likely to be short and shallow. The region's sentiment indicator showed a third straight improvement in December, with rising confidence both among consumers and in industry, providing a bright spot amid sliding retail sales. The post-pandemic drag on net trade from high inventories is ending, as is the squeeze on disposable incomes from high inflation. This is pointing to a gradual recovery in the months ahead. Both the European Central Bank ("ECB") and the Bank of England ("BoE") refused to declare victory over inflation. Policymakers have signaled that regional interest rates would need to remain higher for longer, diverging from the U.S. Federal Reserve.

The ECB and BoE announcements dampened expectations sparked by the Fed, which indicated it would cut rates next year. Instead, the ECB warned that there is still work to be done to tame price pressures after leaving interest rates unchanged, and it pushed back against market expectations for the central bank to cut rates as early as March 2024. The ECB will not lower its guards against inflationary pressures, even as it cut its inflation forecast for 2024.

Europe's manic buying of gas supplies since the start of Russia's war and a mild winter have helped keep gas-storage levels at around 90% of capacity, well above the five-year average. Assuming normal weather and no major disruptions, storage should remain close to 70% of capacity by March, according to Rystad Energy consultancy, easily beating the European Commission's target of 45% by February 1st. Ample stocks should hold gas prices down, not

only in Europe but also in Asia, in turn incentivizing more coal-to-gas switching in power generation everywhere. This should help lower coal prices already dulled by a huge ramp-up in production in India and China. Tankers carried a record haul of U.S. oil to Europe in December, solidifying the U.S. role as the continent's energy backstop. The European Union and the UK imported nearly 2.3 million barrels of crude a day in December, according to ship tracking firm Kpler, nearly double the amount in the months before Russia's invasion of Ukraine whipsawed oil markets.

Eurozone inflation rose to 2.9% in December, reversing six months of consecutive falls and raising questions over how soon the European Central Bank would start cutting interest rates. The annual rise of consumer prices in the 20 countries that share the euro in December was up from a more than two-year low of 2.4% the previous month. The reduction of government subsidies on gas, electricity and food that began last year has triggered a re-acceleration of annual inflation in much of Europe. This has led investors to scale back their bets that the ECB will start rate cuts as early as March, putting a dent in a recent rally in bond markets. Most economists believe eurozone inflation will soon start to fall again. December's pick-up in price pressures was deemed a blip, that may be reversed in January due to further declines in food and core inflation.

The ECB, which is due to meet to discuss monetary policy in late January, has pushed back against investor expectations of imminent rate cuts, saying it wanted to see signs of wage pressures cooling to be sure inflation was on track to hit 2%.

German factory output fell for six consecutive months – with few signs of a rebound. Truck traffic of German roadways – usually a strong indicator of the strength of economic activity- also fell. The layoff rate in Germany has started to increase a bit, but from a very low level. There is the sentiment that we started to see the delayed effects of the 2022 energy price shock. Several German companies outlined plans to cut jobs late in 2023, including the country's biggest lender, Deutsche Bank, and chemicals producers, BASF and Lanxess. According to the ECB, there are signs that the labor market is struggling to remain a bright spot for the eurozone economy. Fewer new jobs are being created, including services, which suggests that the cooling of the economy is gradually feeding through to employment. Many German companies are still suffering from labor shortages and the economy minister has called for an increase in skilled immigrants to bolster its aging workforce. While eurozone unemployment is expected to stay at a record low of 6.4%, forecasts for both the Germany and the eurozone, unemployment rates indicate a rise of half a percentage point in 2024 as key sectors lay off workers.

The decline of the German economy in 2023 compounds what has been a gloomy start of 2024 for the country. Germany has been hit by nationwide train strikes over working hours, and disruptive protests by farmers against cuts to fuel subsidies.

Germany was the worst-performing major economy in 2023, according to the International Monetary Fund, which recently forecasted that advanced economies grew 1.5% in 2023, while emerging market and developing economies expanded 4%. German retail sales, exports and industrial production all fell in 2023. Households were hit by the biggest surge in the cost of living for a generation while the country's sprawling manufacturing sector suffered from high energy costs, weak global demand (e.g. China) and rising financing costs.

Germany's growth is projected to pick up to 0.6% in 2024 according to the OECD, which would still make it one of the world's weakest large economies. Since the government slashed spending plans to address the 60 billion euros budget deficit, analysts have cut their forecast for 2024 growth. Economists expect consumer spending to rally in Germany in 2024, as household purchasing power recovers, thanks to continued strong growth in wages and slower rates of inflation. Inflation fell from above 11% in late 2022 to as low as 2.3% last November. However, consumer prices are still more than 20% higher than they were before the pandemic and inflation picked up to 3.8% in December after the government phased out energy subsidies.

European consumers reined in their spending in the run-up to Christmas causing retail sales to fall 0.3% across the region. Expectations of a rate cut by the ECB in March are likely too optimistic, as the central bank will want to have solid evidence of a moderation in wages before making the crucial decision. Eurozone energy prices fell 6.7% in the year to December, compared with an annual decline of 11.5% in the previous month, according to an index of consumer prices published by Eurostat. Fresh food prices accelerated in December, rising 6.7% compared with 6.3% in the previous month.

The recent signs of a pick-up in eurozone inflation reflects the comparison with a year earlier when several governments — including those in Germany and France — heavily subsidized gas, electricity, and food costs, which drove down the cost of household bills temporarily. Core inflation, which excludes volatile energy and food prices to give a better picture of underlying price pressures, slowed from 3.6% in November to 3.4% in December. Services inflation, which is closely tracked by the ECB to see the impact of rising wages, was flat at 4%.

The news from the eurozone trade front showed exports from the bloc rose 1% at year-end, while imports dipped 0.6%. However, compared to a year earlier, eurozone exports were still down 4.7%, while imports fell 16.7%, reflecting the fall in prices of energy and food imports.

Meanwhile, the BoE voted to hold rates at 5.25%, as the Monetary Policy Committee warned it was confronting a more stubborn problem with inflation than its counterparts across the Atlantic.

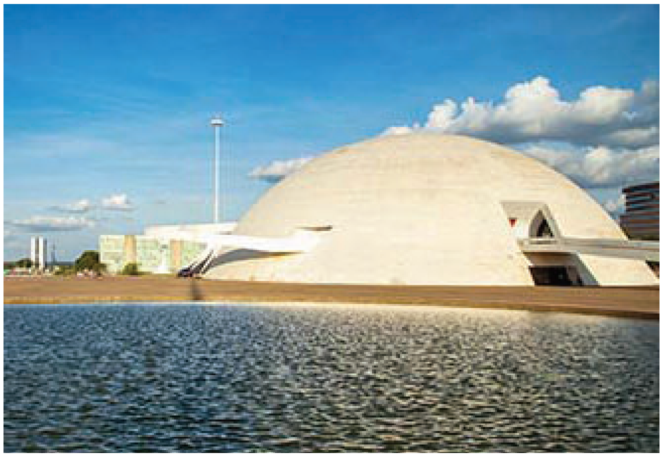
UK industry data showed retailers had a disappointing December, with consumers holding back from big purchases. The UK cost of living crisis has been PR challenge for big retailers, which over the past year have been accused of “greedflation”-raising prices faster than costs warrant-and squeezing supplies of the items on their shelves.

## Brazil

Dampened by restrained global growth, the expectation is for Brazil’s economic activity to slow in 2024, with full-year GDP growth easing to 1.7% from an estimated 3% in 2023.

Despite the restoration of institutional stability by President Lula’s government following the post-election riots a year ago, political polarization has not gone away. President Luiz Inácio Lula da Silva and his predecessor Jair Bolsonaro traded accusations about the violence that followed Lula’s inauguration a year ago, in a sign of persistent divisions in Latin America’s largest democracy. Lula, a 78-year-old former trade unionist who previously ruled Brazil between 2003 and 2010, accused the far-right Bolsonaro of being behind the attacks on government buildings by his supporters. The commemoration of the events perpetuates memories of the episode, which is contrary to the government of unity that Lula proposed in 2023. Many Brazilians believe that the Lula-versus-Bolsonaro dynamic will probably continue to be played out in municipal elections later this year. Lula remains a divisive figure. He was previously jailed for almost two years on corruption convictions that were later overturned, paving the way for his political comeback.

The right-winger, Bolsonaro, a former army captain who has exalted Brazil’s 21-year military dictatorship that ended in 1985, was not present in the country at the time of the attacks, having travelled to Florida to avoid Lula’s swearing-in. Bolsonaro has since been barred from running for office until 2030 due to campaign violations and faces a host of other legal probes from his time in office. Bolsonaro hit back saying he regretted the events of January 8, 2023, but denied that they amounted to a coup attempt and alleged a “trap by the left.” Some within Bolsonaro’s conservative movement have claimed there was infiltration by leftwing activists. Bolsonaro described prison sentences of up to 17 years given to those already found guilty as absurd. The disturbances carried echoes of the Capitol invasion in Washington D.C., two years earlier.



Local elections in October will dominate Brazilian politics in 2024, narrowing the scope for reforms. The local elections are shaping up to be another contest that reflects the country's highly polarized society. Forces aligned with Lula will compete fiercely with those that support his influential right-wing predecessor.

Brazil's turn to lead the Group of Twenty (G20) countries will give President Lula da Silva, the opportunity to elevate the country's standing and to trumpet his own development and sustainability ambitions.

The Brazilian congress will focus on passing complementary laws to regulate a landmark sales tax simplification reform, which was approved in late 2023. The expectation is that legislators will dilute Lula's progressive income tax reform. A likely revenue shortfall will cause the government to miss its goal of bringing the primary fiscal account into balance.

Monetary easing will support a pick-up in manufacturing and services later this year, but agriculture is projected to weaken relative to 2023, when El Nino weather effects led to bumper crops. A close eye will be kept on investments in energy and infrastructure in Brazil. New oil exploration in the Equatorial Margin will sit awkwardly, with Lula's international environmental narrative.

As part of its spending ambitions, the government's new political action committee involves investments of $340 billion, (or 17% of GDP) until 2030, with a focus on sustainability projects in areas including transport, energy, and education. This year, the government intends to focus on finishing current projects. One highlight will be the expansion and modernization of five road networks to strengthen Brazil's connections with ports in other countries that lie on the Pacific Ocean and the Caribbean Sea, facilitating trade with South American neighbors and with Asia. The project will also improve access to Brazil's substantial reserves of nickel and rare earth elements, reducing a previous obstacle to inserting the country into the supply chain of the critical minerals that will power the global green energy transition. Multilateral banks and the Banco Nacional de Desenvolvimento Economico e Social (BNDES the state-owned development bank) have already committed $10 billion to the project.

A severe drought in the Amazon risks hampering corn shipments from Brazil, the world's largest exporter of the grain. Still, increased planting of grains and soybeans (outside Ukraine) and better weather conditions elsewhere have prompted forecasters to project improved harvests in 2024-25.

The forecast for Brazil's oil production has been revised upwards amid progress on new pre-salt projects. The medium-term outlook has become increasingly upbeat, now projections are for average liquid natural gas production to surpass 4 million barrels per day in 2026, an increase from the previously anticipated 3.7 million barrels per day.

2023 GDP growth settled at 3%, a slowdown from growth of 3.5% in Q3 2023. The economy was propped up in 2023 by a strong labor market, industrial and robust exports of agricultural goods. We expect growth to be slower in 2024 but a robust labor market, a rise in real minimum wages, steady disinflation and a recently implemented household debt restructuring program for up to 30 million people, will support private consumption and most service sectors.

The central bank's monetary-easing cycle will also take some pressure off sectors that have been struggling with elevated rates (a product of the bank's aggressive tightening in 2021-23). Moreover, industrial production is set to pick up following months of stagnation as lower borrowing costs spur investment and domestic demand growth. Against this backdrop, sectors that are more exposed to local credit dynamics (such as capital goods, automotive and real estate) are likely to receive a boost from stronger business and consumer confidence as interest rates fall. Some industrial sectors are also expected to benefit from Lula's "new industrial policy," the details of which are to be announced over the coming months and will likely involve more subsidized credit from state banks.

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