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Brazil – Exchange Rate

Falling Interest Rate Differentials Leading to BRL Weakness

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- **The Brazilian *real* has been strongly underperforming other emerging market high-yield currencies, even during a period of U.S. dollar weakness against other major currencies and falling country risk (measured by CDS spreads).**
- **We attribute this underperformance mostly to falling overnight policy rates, which are leading interest rate differentials and hedging costs to the lowest levels in many years. The spread between BRL overnight rates and the average rate of seven high-yield currencies collapsed to -280 bps (as of February 28), from almost 600 bps only 12 months ago. These falling interest rate differentials make short-term investment in Brazil less attractive in both absolute and relative terms.**
- **We believe the combination of low hedging costs, domestic companies' balance sheets with large currency mismatches, and uncertainty about the presidential election to be held in October may be leading to high demand for USD hedges, also contributing to the BRL weakness.**
- **Those drivers are likely to remain active during the next few months, in our view, as interest rate differentials are likely to continue falling (as we expect the Brazil Central Bank to keep cutting until May, and the Federal Reserve and other central banks should remain in tightening mode) and electoral uncertainty should prevail until close to the voting date, October 7.**
- **We reaffirm our 2018 and 2019 year-end BRL/USD forecasts of 3.50 and 3.57, respectively.**

Figure 1. BRL/USD Interest Rate Differential and Hedging Cost Gauge

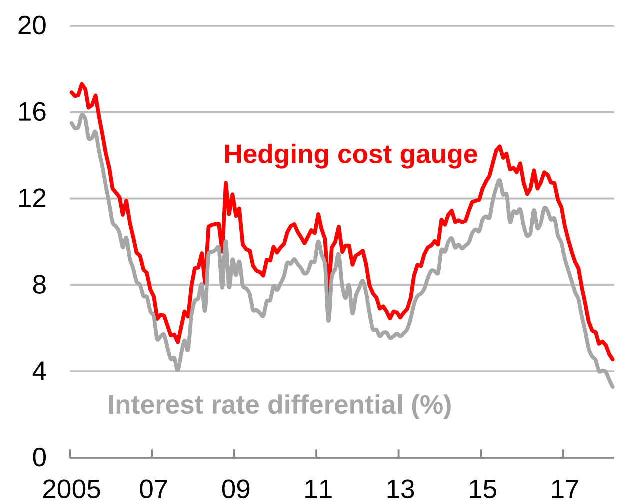
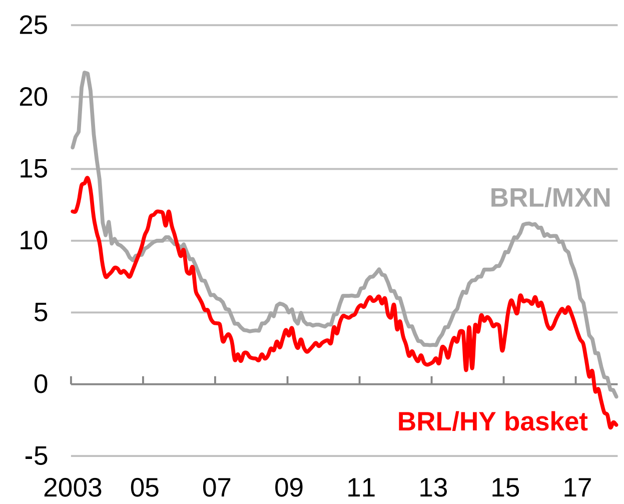


Figure 2. BRL/High Yield (HY) Basket and BRL/MXN Overnight Interest Rate Differentials (%)



Difference between six-month BRL and USD (*cupom cambial*) domestic rates. The hedging cost gauge adds six-month USD/BRL ATM volatility to that differential. High-yield basket includes MXN, IDR, INR, ZAR, TRY, COP, and ARS. Sources: Bloomberg and Santander estimates.

Underperforming BRL and a significant correlation breakdown

The Brazilian *real* has been strongly underperforming throughout the last year (see Figure 3). In a period when the U.S. dollar lost value relative to other major currencies (as measured by the DXY index), the BRL weakened even more, depreciating against the USD and underperforming a basket of other high-yield currencies (by our definition, major emerging market currencies whose domestic interest rates are currently higher than 4% – Mexican peso, Indonesian rupiah, Indian rupee, South African rand, Turkish lira, Colombian and Argentinian pesos). Furthermore, since the beginning of 2017, a long-standing correlation between the BRL/USD rate and Brazil five-year CDS has broken down: while the CDS spread practically halved, BRL/USD traded sideways (see Figure 4). Just for the sake of comparison: in October 2014, when the CDS was trading around current levels (174 bps), the BRL/USD rate was at 2.43, around 37% stronger than currently.

Figure 3. Currencies' Performance (%)

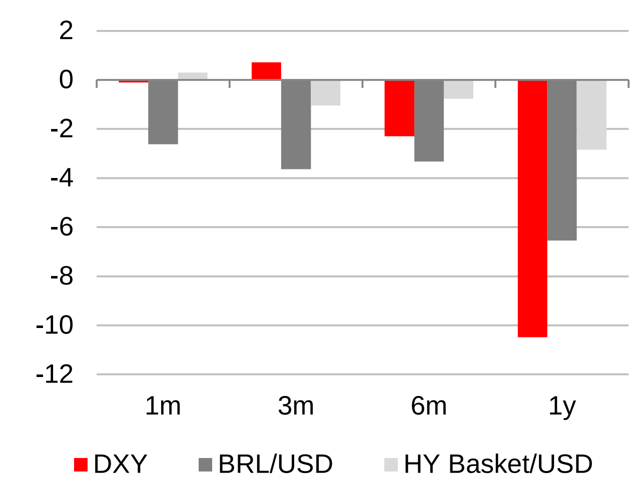
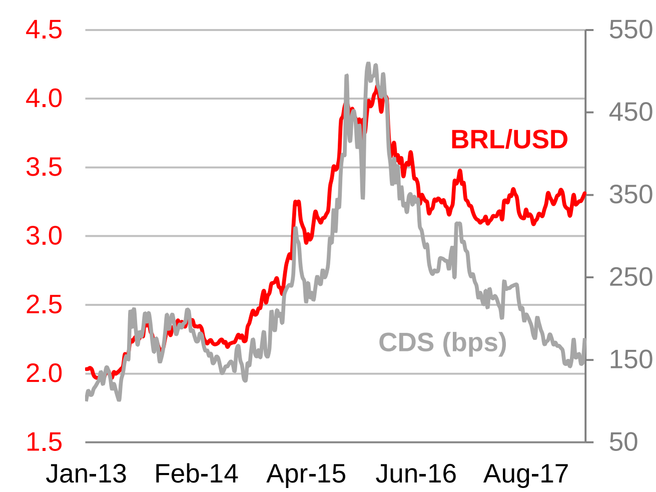


Figure 4. BRL/USD Rate and Brazil Five-Year CDS



Negative changes mean underlying currency/index losing value. High-yield basket includes MXN, IDR, INR, ZAR, TRY, COP, and ARS. Sources: Bloomberg and Santander estimates.

In our report *Why Has the BRL Weakened in 2017?* (January 8, 2018), we argued that the aggressive monetary easing over the last 18 months was the main factor behind the BRL depreciation, and that interest rate differentials are playing a larger role in the currency price. Here we extend that analysis, looking at different types of interest rate differentials and at a metric for hard currency hedging costs.

Lowest interest rate differentials and cheapest hedging cost in years

The Brazil Central Bank's aggressive cycle of monetary easing, following strong disinflation led by food prices and high levels of economic slack, brought the benchmark overnight rate to its lowest level in 60 years (see *Coming – The Lowest Interest Rates Ever?* October 10, 2017). Meanwhile, many central banks around the world have been following the Federal Reserve and hiking rates. As a result, interest rate differentials between Brazil and the U.S. and Brazil and other high-yield countries are also at multiyear lows (see Figure 2).

That conjuncture reduces both the absolute and relative attractiveness of the BRL in the so-called "carry trade": (i) using the USD as a funding currency, expected returns from holding BRL longs are the lowest in many years; and (ii) BRL returns are now, also for the first time in decades, lower than those of a basket of other high-yield currencies (defined above) and of the Mexican peso, the other highly liquid currency in Latin America. In theory, this should reduce hot-money flows to Brazil, and this is suggested by balance of payments data. Although this is hard to measure, since most of the trades are done in over-the-counter derivatives markets, Brazil Central Bank data shows that foreign currency inflows more sensitive to domestic interest rates (intercompany loans, bonds, mutual funds, and short-term loans) have been diminishing, despite the local economic recovery and the recent good performance of domestic assets (see Figure 5).

This narrowing interest rate differential, coupled with relatively low market volatility, suggests to us that hedging costs are also falling strongly. We built a simple gauge for these costs by adding the interest rate differential between local BRL and USD (*cupom cambial*) six-month rates to the USD/BRL six-month ATM implied volatility (calculated by Bloomberg) – hence, hedging costs could actually become more expensive if interest rate differentials led to higher implied volatility. This indicator shows that hedging costs more than halved over the past 12 months and are now also at the lowest level in the past 13 years (see Figure 1).

Figure 5. 12-Month Cumulative Flows, Items More Sensitive to Domestic Interest Rates (USD billion)

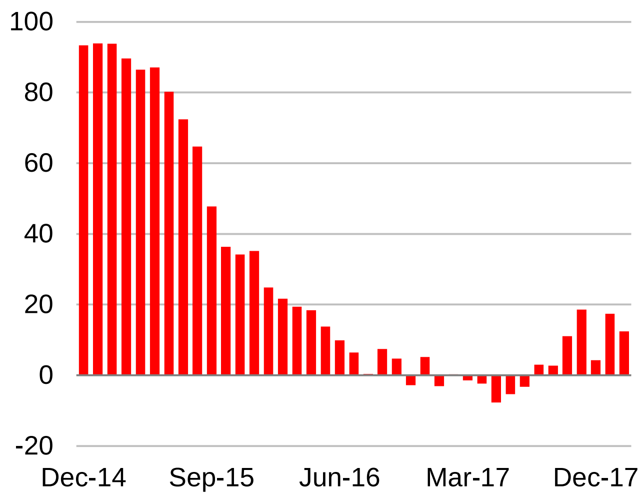
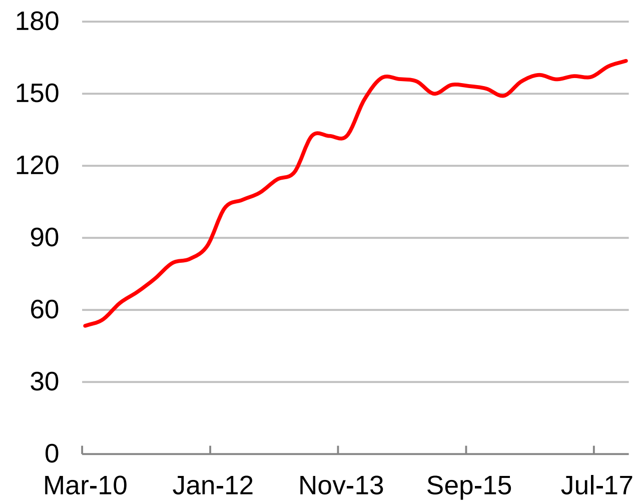


Figure 6. Outstanding Foreign Debt, Non-Financial Corporations (USD billion)



Items more sensitive to domestic interest rates include intercompany loans, bonds, mutual funds, and short-term loans. Sources: Brazil Central Bank, BIS, and Santander.

Considering that large Brazilian companies carry substantial currency mismatches in their balance sheets (since domestic capital markets are expensive and not deep enough for large debt issuances – see Figure 6), and given the high political/policy risk associated with October presidential elections, demand for hedging has been increasing substantially, according to our observations. Similarly, probably for the first time in many years, it makes sense, in our opinion, for foreign institutional investors to hedge currency exposure in their bond and equity portfolios, whose expected returns are now considerably higher than short-term BRL rates. This increased demand for hard currency has been, in our view, the main culprit behind the recent BRL weakness.

Looking ahead: expect more weakness to come

The Brazil Central Bank has been signaling that the monetary easing cycle will be extended at least until May (see *Brazil Macro Compass: A Surprisingly Dovish Central Bank*, March 23, 2018), while we believe the Federal Reserve is likely to keep hiking for the next year or more. This will lead the interest rate differential to further narrow over the next few months, reducing BRL attractiveness and cheapening hedging costs. Electoral angst is unlikely to dissipate in the short term, in our view, as the number of presidential pre-candidates points to an open and fragmented race, which will narrow down to fewer choices only closer to the deadline for candidacy registration, on August 15. Unless commodity prices, historically the main driver for the BRL's value, start to rally strongly, the BRL is set for further weakness, in our view. We maintain our forecast at BRL/USD 3.50 for the year-end rate. An increase in hedging costs led by higher currency volatility is unlikely to decrease domestic demand for hard currency, in our view – we think the opposite is more likely to happen, if the BRL weakening trend starts to accelerate.

Looking at a longer time horizon (from 4Q18 on), the results of the October presidential election are likely to be a key variable, in our opinion. If a market-friendly candidate prevails, and assuming a gradual normalization of U.S. rates, we believe those currency hedges will likely start to be unwound, and Brazil's growth potential may attract a large flow of foreign investments, turning the BRL into an outperformer. For 2019 year-end, we maintain our forecast of a BRL/USD rate at 3.57, as we believe even a good relative performance should lead to additional weakening in a perceived more challenging environment for emerging countries.

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