COPOM PREVIEW: A real `dead´ one (policy meeting)

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- **On Wednesday (September 16), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. Sharing the (virtually unanimous) expectations, we see the Copom keeping the Selic policy rate on hold at 2.00%, a historical low.**
- **Even if there is little news in the Copom decision, the statement will be noteworthy. We believe the committee will maintain the forward guidance introduced at the previous meeting (basically meaning no hikes for the foreseeable future). Overall, we anticipate a neutral tone from the authority.**
- **In the absence of a fiscally led process of de-anchoring expectations, we see inflation fundamentals pointing toward below-target IPCA reading for 2021 (and increasingly likely for 2022), amid a slowly rebounding and highly slackened economy. We forecast that the Copom will stay put throughout 2021.**

Policy decision

On Wednesday, the BCB is scheduled to announce its monetary policy decision. Sharing the (virtually unanimous) expectations, we see the Copom keeping the Selic policy rate on hold at 2.00%, a historical low. While that would be the first time the Copom has kept the rate unchanged since June 2019, we believe the conditions around the meeting mean that it is likely to be a "dead" one.

Despite the natural uncertainty associated with estimating the neutral level of interest rates, the Selic rate is considerably expansionary as of now, consistent with the scenario of (current and expected) inflation far below the target and ample slacks in the economy. The (very) low interest rate has, on its own, a certain influence on the authority's cost-benefit analysis when it comes to considering the possibility of further additional stimulus.

Yet, the next monetary policy steps are restricted by macro prudential issues, financial stability concerns and, especially, mounting fiscal risks. Particularly now that markets are more alert to the possibility of upcoming budget decisions that could potentially imply significant changes in the current fiscal regime—specifically, a bending of the constitutional spending cap. Depending upon its nature and magnitude, such a regime change could increase difficulties in the fiscal consolidation process needed to avoid (expectations of) a divergent process of government debt in the long run. And that would also hurt the key pre-condition for the BCB to keep its recently inaugurated forward guidance (see details below).

Fiscal (and, to a lesser degree, regulatory) concerns continue to feed discussions about an effective lower bound for interest rates. It is widely accepted among economists that the latter fluctuates over time and that the current level of the Selic rate may now be close to that lower bound. If this is true, we believe that new interest rate stimuli at this juncture could likely prompt counterproductive consequences for the economy (i.e., do more harm than good).

Given the potentially adverse effects of a fiscal deterioration on the level of neutral interest rates and the anchoring of inflation expectations, we believe this is an appropriate time to monitor where fiscal policy is heading (amid ongoing discussions on the 2021 budget and government programs). The time is also ripe to watch the behavior of the broader economy in response to the strong (fiscal and monetary) stimuli implemented to fight the economic effects of the COVID-19 pandemic.

Forward guidance

Even if there is little news when it comes to the Copom decision, the statement will be noteworthy. Here, we believe that Copom will keep the forward guidance introduced at the previous meeting, whereby the authority signals the possibility of small rate cuts and, maybe more emphatically, no rate hikes for the foreseeable future if inflation expectations continue to run below the target (for the relevant policy horizon), and assuming that the fiscal regime remains unchanged and long-term expectations remain well-anchored.

It is possible, in our view, that the Copom will formally hint at a limited likelihood that new rate cuts will materialize in the short term. We think this is largely due to a recent increase in market tensions regarding the (perceptibly) rising execution risks for the fiscal adjustment process after the pandemic. Even if stemming from volatile items (e.g., food, energy), upward price pressures may also help induce a bit of caution on the part of the authority. The same goes for an apparently firmer recovery in economic activity—especially that signaled by preliminary data for 3Q20. That data is confirming the upside risks viewed by the BCB as per its own 2020 GDP forecast of -6.4%, presented in the 2Q inflation report. We believe that better activity probably contributes to reducing, at least for now, the sense of urgency to introduce additional stimulus, given the highly expansionary current stance.

Amid a short-term pickup in IPCA inflation, based on volatile items and limited FX pass-through, we believe that the Copom will continue to rule out the possibility of more persistent and widespread price pressures, given the muted underlying inflation figures and still comfortable inflation fundamentals (anchored inflation expectations, outsized labor slack). Thus, we do not expect a hawkish tone from the BCB in the communiqué.

Scenario assessment

Below, we summarize how the scenario has evolved since the previous Copom meeting. In Appendix 1 and 2, we present simplified datasets, seeking to summarize the key indicators the BCB will watch on the control panel as the authority contemplates its interest rate decision:

- **Current Inflation:** Consumer prices accelerated a bit on the margin, on the heels of volatile prices as food and energy. Still, headline inflation continues to run substantially below the target (as does the current speed of some key core IPCA gauges), still posting muted readings in the last few months (at a quarterly annualized rate of approximately 1.5%, versus an official mid-target of 3.75% for IPCA inflation 2021). Diffusion indexes also remain subdued, meaning no spreading in price hikes across the IPCA basket.

- **Inflation expectations:** Despite some localized concerns about food costs (as exogenous pressures are affecting the CPI with a little help from a temporary shopping spree supported by the government stimulus during the pandemic), analysts' consensus (according to Bloomberg) for IPCA inflation remained virtually stable, both for the relevant policy horizon (mostly 2021, but also 2022) and for the long run. This trend naturally reduces the likelihood of a more significant dissemination of these scattered price pressures, for now still more likely to be a change in relative prices. Inflation breakeven rates have increased, though, in our view, probably reflecting some perceived risks that PPI pressures will make their way to consumers (front end). Also, higher concerns about execution risks for the fiscal adjustment process post the COVID-19 pandemic contributed to building an inflation premium (back end).

- **Real activity:** While still showing an asymmetric pace of recovery (sector- and region-wise), activity has seen broad-based sequential improvement, following April's sudden stop. The numbers reflect the gradual reopening of businesses and easing of social distancing measures, as well as massive (yet temporary) government stimulus. No wonder that consumer spending on goods is the best-performing sector, and the only one now running at levels just above those seen in February. In fact, the large pool of government transfers are more than offsetting the decline in the real wage bill. All in all, incoming data for 3Q20 is implying upside risks to our forecast for full-year 2020 (currently at -6.4%), which confirms the BCB's perception of upside risk, as per its own forecast (similar to ours) as published in the last quarterly inflation report (June 2020).

- **Selic expectations:** Although expectations have stabilized for YE2020, at 2.00%, with markets taking the cue from recent BCB communications and no longer expecting rate cuts for the cycle, analysts are apparently moving closer to our call of low interest rate for long (i.e., no hikes until 2022) and very slow normalization (with no neutral policy stance until 2023). In fact, median Selic rate projections have declined by 0.5 p.p. for intervals from 2021 to 2023.

- **Financial conditions:** With the notable exception of stability in the real ex-ante (1-year) interest rate and the slight decline in the sovereign (5-year) CDS, market conditions have been a bit less favorable since the recent meeting. The FX rate has weakened, commodity prices and Brazilian stocks have fallen, and nominal yields have risen in recent weeks. Still, both the monetary policy stance and financial markets conditions remain fairly supportive, providing an additional push for domestic demand as the economy (gradually) reopens.

What to expect

Despite rising execution risks for the fiscal adjustment process in the medium term (as discussions on budget 2021 and government policies take shape), our scenario continues to look for the maintenance of the current fiscal regime (meaning no change in the effectiveness of the spending cap from 2021 onward).This is the main hypothesis behind our scenario of low interest rates for long.

In the absence of a fiscally led process of de-anchoring expectations, we see CPI volatility and noise generated by the (rather asymmetric) effects of the pandemic as temporary developments. In other words, we continue to anticipate a lack of generalized or persistent demand-led price pressures for the foreseeable horizon. In our view, key inflation fundamentals indicate below-target IPCA reading for 2021 (and increasingly likely for 2022), amid a slowly rebounding and highly slackened economy. Thus, we continue to believe that the Copom is likely to stay put throughout 2021.

Appendix 1: Copom Dataset – Part 1

		THIS TIME	*LAST MEETING*	*1y AGO*
INFLATION				
Forecasts (% p.a.) - BCB's Focus report				
Forecast for a year ahead	↑	3.14	2.92	3.44
Forecast for 2020 (Focus) - target: 4.00%	↑	1.94	1.63	3.80
Forecast for 2021 (Focus) - target: 3.75%	↑	3.01	3.00	3.75
Forecast for 2022 (Focus) - target: 3.50%	→	3.50	3.50	3.50
Forecast for 2023 (Focus) - target: 3.25%	→	3.25	3.25	3.50
Forecast for 2024 (Focus) - target: ??????	→	3.25	3.25	-
Breakeven inflation rates (% p.a.)				
1-year	↑	4.2	2.9	3.5
2-year	↑	4.2	3.3	3.8
5-year	↑	4.3	4.0	3.9
10-year	↑	4.2	4.0	4.0
Actual CPI data				
Headline (% YoY)	↑	2.4	2.3	3.4
Headline (% QoQ, saar)	↑	3.9	1.5	1.7
Core IPCA X3 (% YoY)	↓	1.5	1.7	2.7
Core IPCA X3 (% QoQ, saar)	↑	0.6	-0.2	2.1
New cores average (% YoY)	↓	2.0	2.1	3.2
New cores average (% QoQ, saar)	↑	1.6	1.0	2.6
Diffusion index (sa)	↓	59%	61%	58%
Diffusion in services (sa)	↓	45%	45%	62%
MONETARY POLICY				
Selic rate (% p.a.)				
Actual	↓	2.00	2.25	6.00
Forecast for 2020 (Focus)	→	2.00	2.00	5.00
Forecast for 2021 (Focus)	↓	2.50	3.00	7.00
Forecast for 2022 (Focus)	↓	4.50	5.00	7.00
Forecast for 2023 (Focus)	↓	5.50	6.00	7.00
Forecast for 2024 (Focus)	→	6.00	6.00	-
Yield curve (% p.a.)				
1-year OIS swaps (pré-DI)	↑	2.5	2.4	5.1
2-year OIS swaps (pré-DI)	↑	3.8	3.4	5.6
Ex-ante real interest rate (% p.a.)				
1-year (OIS swaps vs. inflation forecast)	↓	-0.6	-0.6	1.6

Source: Santander, IBGE, Brazilian Central Bank, Bloomberg, Anbima
Last update: September 11, 2020

Appendix 2: Copom Dataset – Part 2

		THIS TIME	LAST MEETING	1y AGO
REAL ACTIVITY				
GDP forecasts (% p.a.) - BCB's Focus report				
Forecast for 2020 (Focus)	↑	-5.11	-5.63	2.00
Forecast for 2021 (Focus)	→	3.50	3.50	2.50
Forecast for 2022 (Focus)	→	2.50	2.50	2.50
Forecast for 2023 (Focus)	→	2.50	2.50	2.50
Forecast for 2024 (Focus)	→	2.50	2.50	-
Actual activity data				
IBC-Br (% QoQ, saar)	↑	-10.4	-35.0	2.1
Industrial production (% QoQ, saar)	↑	-4.9	-53.4	-1.2
Retail sales (% QoQ, saar)	↑	26.0	-45.2	5.1
Services volume (% QoQ, saar)	↑	-27.7	-49.2	1.0
Unemployment rate (% 3m, SA)	↑	13.1	12.8	12.0
Real average wage (% YoY, 3m)	↑	6.9	5.0	-0.3
Real wage bill (% YoY, 3m)	↓	-4.4	-2.8	2.4
Caged payrolls (thousands, SA, 3m)	↑	-91	-453	45
Economic confidence (2011=100)	↑	80.2	76.0	86.9
EXTERNAL SECTOR				
FX rate (USD/BRL)				
Actual	↑	5.32	5.22	4.11
Actual (rounded 5-day average)	↑	5.30	5.15	4.10
Forecast for 2020 (Focus)	↑	5.25	5.20	3.90
Forecast for 2021 (Focus)	→	5.00	5.00	3.90
Forecast for 2022 (Focus)	↑	4.90	4.80	3.95
Forecast for 2023 (Focus)	↑	4.90	4.80	4.00
Forecast for 2024 (Focus)	↑	4.90	4.80	-
Current account balance (USD Billions, 12m)				
Actual	↑	-29.7	-43.2	-46.5
Forecast for 2020 (Focus)	↓	-6.5	-5.9	-45.0
Forecast for 2021 (Focus)	↑	-15.7	-16.0	-45.0
Forecast for 2022 (Focus)	↑	-24.2	-25.5	-40.0
Forecast for 2023 (Focus)	↑	-33.5	-34.9	-23.0
Forecast for 2024 (Focus)	↑	-40.4	-40.5	-
ASSET PRICES				
CRB Commodity Index	↓	146	149	178
IC-Br (% YoY)	↑	38.9	27.3	-9.6
Brazil 5-year CDS (basis-points)	↓	203	219	120
Ibovespa stock index (points)	↓	98,363	102,802	104,532
DI Jan-21 (% p.a.)	↑	1.97	1.96	5.22
DI Jan-22 (% p.a.)	↑	2.85	2.77	5.81
NTN-F 2023 (% p.a.)	↑	4.19	3.85	6.19
NTN-F 2027 (% p.a.)	↑	6.69	6.04	6.96
NTN-B 2035 (% p.a.)	↑	3.52	3.23	3.46

Source: Santander, IBGE, Brazilian Central Bank, Bloomberg
Last update: September 11, 2020

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