ECONOMICS **21 August 2020**

Brazil Macro Compass

And the Fiscal Jitters Take Main Stage

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- **In a rather volatile week for the yield curve (and Brazilian assets in general), nominal yields managed to tighten a bit (5-10 bps) on a week-over-week basis. In the end, the movement seems to follow both a respite in global rates as well as the relief following the Lower House decision (as opposed to a previous Senate vote) to keep the broad-based freeze in public sector wages until year-end 2021. This week's developments are a reminder of the difficult path for fiscal consolidation reforms ahead, amid increasing pressures for spending, on one end, and the need to keep the constitutional spending cap feasible, on the other. We anticipate high volatility and premia for the coming weeks and months, until we have greater clarity on the way forward for budget policies.**

- **On that note, we think the significant BRL weakening seen this week illustrates how sensitive market participants currently are to (potential) setbacks on the fiscal front, which led the Brazilian Central Bank (BCB) to carry out multiple interventions in the FX market in the last couple of days.**

- **According to FGV's industrial survey preview for August, headline business confidence rose 9.4 % MoM s.a. (reaching 98.2 points). This positive result implies that 92.6% of the points lost between March and April have already been recovered and that the index is only 3.1% below the reading seen in February.**

- **According to the Caged (establishment) survey, formal job creation continued to show a slower deterioration trend in July. The net (unadjusted) job creation stood at +131k; adjusted for seasonality, the number recorded was +140k, according to our own calculation. The three-month moving average now points to a payroll contraction of 76k jobs per month, a much better result than in April (an all-time low of almost -500k). The numbers herald a negative trend in formal job creation, but maybe less intense than previously thought—at least for now.**

- **Federal tax collection totaled BRL116.0 billion in July, beating market forecasts (BRL112.0 billion). Real core revenue fell 15.3% YoY, meaning a much slower pace of decline compared to Q2 (-30.1%). This "improvement" comes on the heels of a gradual recovery (or normalization) of economic activities and the end of temporary tax deferrals. While the faster-than-expected rebound in the economy prompts upside risks for tax collection, the likely extension of government stimulus to households implies significant downside risks to our consolidated primary deficit forecast for this year (we currently pencil in 12.2% of GDP).**

- **On Tuesday, IBGE releases the IPCA-15 inflation for August. We expect a reading of +0.20% MoM (+2.25% YoY). We continue to see a muted pace for core prices, as economic slacks are expected to remain high for a considerable period. Our forecast for 2020 IPCA inflation is 1.5%, but we are envisioning upside risks and our high-frequency tracking is hovering around 1.9%. For 2021, we continue to forecast 2.7% of IPCA inflation.**

- **On the same day, we expect July 2020 Brazilian external sector data to continue hinting at a swift adjustment in the current account balance, which we estimate to have registered the fifth monthly surplus in a row (USD1.1 billion). However, we note the BCB will present the outcome of its first semi-annual review, which may affect previously-reported figures and the shape of their trajectories—although not the trajectories themselves, in our view.**

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Local markets—rates: Based on prices from Friday morning (time of writing), nominal yields tightened a bit this week. In the front end, the Jan-22 DI future was about to close the week at 2.76% (-4 bps from last Friday). In the back end, the Jan-27 DI future was trading at 6.76% (-7 bps from last Friday). The steepness in this segment (i.e., 2027s vs. 2022s) edged down to 400 bps, compared to 403 bps in the previous week. That is far from the ~150 bps seen early this year and relatively close to the peak of ~450 bps seen late in April.

An apparent respite in global rates (probably reflected in the slight decline in U.S. Treasury yields this week) could have created a better external backdrop for the local yield curve. That meant one less source of pressure, at least compared to the previous week. Yet local news flow was the key driver of volatility for most Brazilian asset classes, and the yield curve certainly reflected that. A sell-off followed Wednesday's rejection by the Senate of a presidential veto that barred wage increases for certain categories of public sector workers (applied to all of its entities). A relief rally took place in the wake of a Lower House vote to keep such wage freezing in place (until the year-end 2021).

That episode is a reminder of the difficult upcoming negotiations ahead between the Ministry of Economy and other members of the administration (both in the Executive and Legislative branches) on the shaping of fiscal policy trends for the coming years. In the wake of the overwhelming impact of the pandemic, the economic team needs to accommodate, on one hand, an increasing pressure for spending (in both investment and social policies) and, on the other hand, the necessity to keep the constitutional spending cap feasible at least for the next few years. The latter is key to signaling to the market a path of fiscal sustainability for the long run.

We expect difficulties in reaching a deal and the resulting execution risks to likely continue prompting some zigzagging in projected economic fundamentals, and therefore asset prices. A few weeks from now, we anticipate that the market will put increased focus on discussions related to the Budget 2021 and the initiatives to create a legal framework to curb mandatory expenses and execute the constitutional spending cap. Thus, one should brace for a good deal of volatility (and risk premia) in Brazilian market for the coming weeks and months, until we have greater clarity on the way forward for budget policies.

Local markets—FX: Along with worries about the prospects for fiscal policy and given the overturn of a presidential veto in the Senate that would have opened room for a substantial increase in public mandatory expenditures (via wages) in the coming years, the BRL breached the USDBRL5.50 level and traded as high as USDBRL5.65 intraday on Thursday. This move led the BCB to intervene in the FX market with different tools (USD swaps at first, and then spot sales) that amounted to USD1.6 billion in the last couple of days.

On the heels of these interventions and the failure to overturn the presidential veto in the Lower House—in order to revoke the freezing of public sector wages, both congressional houses needed to agree—the BRL reversed some of the weakening, but is still on track to end the week among the worst performers of its peers (at the time of writing, the BRL was trading at USDBRL5.59, or ~3.1 weaker than a week ago). In our view, this behavior hints at the heightened sensitivity among market participants to any threats to the already besieged spending-cap rule. Given that there are yet other vetoes to be voted in the coming weeks, with potential to damage the current fiscal regime, we think some nervousness should continue to prevail in the Brazilian FX market.

Economic activity: According to FGV's industrial survey preview for August, headline business confidence rose 9.4 % MoM s.a. (reaching 98.2 points), following an increase both in the current situation component (9.1%) and in the expectation component (9.7%). This positive result implies that 92.6% of the points lost between March and April have already been recovered and that the index is only 3.1% below the reading seen in February. The industrial capacity utilization posted a gain of 3.1 p.p., reaching 75.4%, a result considerably better than the all-time low reached in April (57.3%) and 0.8 p.p below the reading in February (76.2%), but still well below the historical average of 80%. We expect low capacity use to remain an important headwind for investment spending this year. Next week (August 27), FGV will release the final industrial survey for August.

According to the Caged (establishment) survey, formal job creation continued to show a slower deterioration trend in July. The net (unadjusted) job creation stood at +131k; controlling for seasonality, the headline was +140k, according to our own estimates. This result is much better than the historical average for the month (net job creation of 58k); the year-to-date reading stands at -1,100k. The three-month moving average now points to a payroll contraction of 76k jobs per month, a much better result than the one seen in April (all-time low of almost -500k). All in all, the Caged numbers still signal a deterioration in labor market conditions, but maybe less intensely than previously thought. At least for now.

Fiscal accounts: As published on Thursday (August 20) by the Brazilian Revenue Service (RFB in Portuguese acronym), federal tax collection totaled BRL116.0 billion in July, beating market forecasts (BRL112.0 billion). In our calculations, real core revenues fell 15.3% YoY, which means a much slower pace of decline compared to the previous three months – as Q2 saw apace of year-on-year decline –of 30.1%.

That "improvement" follows the gradual normalization of real activity (as regional economies reopen), as well as the end of temporary deferrals of tax payments. The amount of deferred taxes was BRL81.4 billion in H1 (a monthly average of BRL28 billion in recent months), but totaled just BRL0.5 billion in July. In the opposite direction, the use of tax credits by Brazilian firms nearly doubled from last year, totaling BRL18.7 billion for the month. Based on official calculations, federal proceeds would have fallen by 7.9% YoY excluding these atypical factors.

The details show a notable improvement in value-added taxes (representing 41% of core tax receipts in the last 12 months), down 16.0% YoY in real terms in July, which compares to a tumble of 43.1% in Q2. Taxes on income and property (representing 52% of core tax receipts in the last 12 months) slid by an inflation-adjusted rate of 13.1% YoY on the same criterion, slightly "better" than the -19.6% clip seen in Q2. Taxes on financial activities (2% of core revenues) remain under pressure, slumping at a pace of 73.9% YoY in real terms, on the heels of temporary tax breaks.

We continue to expect total federal tax collection to plunge 11.5% in real terms this year, which is equivalent to tax losses of ~BRL180 billion compared to 2019. This estimate already takes into account the likely creation of a new tax amnesty program, allowing taxes to be paid in installments over the next few years. We estimate this measure widens the 2020 central government's primary deficit by a full BRL80 billion. In any case, given the faster-than-expected recovery in economic indicators in recent months, there is slight upside risk to our government revenue forecasts for this year.

For now, we see the 2020 central government's primary fiscal deficit totaling BRL820 billion (11.9% of GDP), whereas the consolidated public sector is expected to record a primary fiscal deficit of BRL845 billion (12.2% of GDP). However, this estimate does not take into account a likely extension of the emergency aid to households, which would likely add another BRL100 billion in additional spending for 2020. (For details, please see our June 25 report, *Updating Our Inflation, FX and Interest Rate Forecasts.*)

Inflation: On Tuesday, IBGE releases the IPCA-15 inflation for August. We expect a reading of +0.20% MoM (+2.25% YoY).

This reading will be pressured, again, by administered prices, although less than in previous readings. This group should go up 0.94% MoM, per our projections, driven by gasoline's recovery and the concentration of electrical energy tariff adjustments that had been postponed since the beginning of COVID-19 crisis. Conversely, free prices will be slightly negative, -0.06%. We forecast that the main driver of free prices will be services, with a -0.59% MoM variation. We further forecast that food-at-home will face upward pressure, rising 0.74%. Finally, industrial goods should rise 0.33%, per our projections.

We continue to see a muted pace for core prices, as we expect economic slacks to remain high for a considerable period, despite the cushioning of demand generated by government stimulus and the reopening of a number of regional economies. Well-anchored inflation expectations also should play a big role: we forecast 2020 IPCA inflation at 1.5%, but we are envisioning considerable upside risks, with our high-frequency tracking is hovering around 1.9%. For 2021, we continue to forecast 2.7% of IPCA inflation.

Balance of payments: Chiefly due to the decline observed in outlays related to goods and services imports and lower remittances of profits and dividends than in recent years—clearly stemming from the isolation measures during the pandemic and the ensuing economic contraction—we estimate that the Brazilian current account balance registered its fifth consecutive monthly surplus in July 2020 (USD1.1 billion). If accurate, the country will have nearly halved the annual imbalance observed last year (USD27.3 billion in 12-month-to-date terms last month vs. USD49.5 billion in December 2019). This would represent a significant improvement over a short period of time, and we expect this trajectory to continue (we forecast a USD1.4 billion annual surplus in 2020). However, it is important to note the BCB will unveil the result of its first semi-annual review of the year, which may bring changes to previously-reported figures and, hence, to the shape of their trajectories–although, in our opinion, not to their trajectories themselves as occurred in 2019, when the BCB carried out the first review of its data after a long period of time.

The review process is also expected to result in updated financial figures, but once again we do not anticipate any changes in the long-term trends. Based upon current figures, we estimate direct onshore investment to have recorded a net monthly inflow of USD2.5 billion in July 2020, which would translate into a retreat in 12-month-to-date terms, to USD68.1 billion in July 2020 from USD78.6 billion in December 2019. Given the lack of growth in tandem with a still complex business environment and the postponement of structural reforms, investors' appetites have dwindled recently, and we project the net inflow of direct onshore investment to tally USD40.0 billion in 2020 (the lowest level since mid-2010 in 12-month-to-date terms). While foreign direct investment will remain at levels high enough to meet the Brazilian economy´s external financing needs, the lower level of FDI illustrates why we think it will be crucial to resume discussions about structural reforms in order to lure more foreign investment to the country in the near future.

Next week: On the macro agenda, throughout the week, the FGV will release key sector-based surveys for August; we will pay particular attention to the details of the Industrial Survey on Thursday (August 27), especially the data on inventories and expected output. According to the preview published recently, we expect all the confidence indexes to post monthly gains, except for the consumer index.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Consumer Confidence Index FGV Aug/20 (points)	Mon, 24-Aug	-	78.8
Retail Confidence Index FGV Aug/20 (points)	Tue, 25-Aug	-	86.1
IPCA-15 Aug/20 (% MoM)	Tue, 25-Aug	0.20	0.30
IPCA-15 Aug/20 (% YoY)	Tue, 25-Aug	2.25	2.13
Current Account Balance Jul/20 (USD billion)	Tue, 25-Aug	1.1	2.2
Direct Onshore Investment Jul/20 (USD billion)	Tue, 25-Aug	2.5	4.8
Construction Confidence Index FGV Aug/20 (points)	Wed, 26-Aug	-	83.7
Industrial Confidence Index FGV Aug/20 (points)	Thu, 27-Aug	-	89.8

Sources: Bloomberg and Santander.

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