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Brazil Macro Compass

Eyeing the GDP Tumble in Q2

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- **The local yield curve has bear-steepened (a bit further), partly tracking the movement in U.S. Treasuries, but largely influenced by a local news cycle that feeds perceptions of execution risk for the fiscal adjustment process after the pandemic. We continue to envision persistent volatility and premia for Brazilian assets in the next few weeks and months, at least until we have greater clarity on the ability and willingness to keep the constitutional spending cap viable for the coming years.**

- **Despite the absence of the Brazilian Central Bank (BCB) in the local FX market and the strengthening (and outperformance) of the BRL as compared with last Friday's closing level, the trajectory of the Brazilian FX rate has continued to be extremely volatile, as market participants remain wary of the prospects for domestic fiscal policy.**

- **The government announced the intended extension of the Emergency Aid (corona voucher) until the end of year — as a possible transition to a new welfare program (to be christened *Renda Brasil*). If approved in Congress, this extension will add BRL100 billion to this year's consolidated primary fiscal deficit, which we have been estimating at BRL845 billion.**

- **This week, FGV has released sector-based surveys for August, basically confirming last week's preview that already indicated positive numbers. The survey highlights the distinct speeds of recovery faced by each sector. While Industry and Retail Sales confidence have already virtually recovered from April's tumble, Services and Consumer Confidence are presenting slower paths of recovery, and are still far from the pre-crisis reading.**

- **The BCB has released credit statistics for July. Total outstanding credit reached BRL3.7 trillion, an increase of 11.3% YoY and the highest rate since August 2012. These figures confirm the importance of credit support measures announced during the pandemic.**

- **August's IPCA-15 registered a 0.23% MoM change (2.28% YoY). The result was in line with market expectations, but slightly above our estimate of 0.20% MoM. Despite the small upside surprise, the number reaffirms our view of a benign scenario for inflation. In particular, we continue to see a muted dynamic for core prices. We forecast 2020 IPCA inflation at 1.5%, but we see upside risks, with our high-frequency tracking hovering around 1.8%. For 2021, we continue to forecast 2.7% for IPCA inflation.**

- **As we expected, changes in external sector data stemming from the review carried out by the BCB have not altered substantially the improving trend that the current account balance has registered recently. Thus, we are keeping our forecast of a USD1.4 billion annual surplus for 2020, the strongest reading since 2007.**

- **Next week, IBGE will release the 2Q20 GDP report. We are forecasting a year-over-year headline decline of 10.0% (YoY), consistent with a quarterly decline of -8.2% (QoQ s.a.). This result means significant upside risk to our projection for the annual GDP this year (for now we pencil in -6.4%). Next week, IBGE will release the Industrial Production data for July, and we expect another sequential gain after the sharp drop seen in April. Our monthly projection is at 5.5 % MoM (s.a.), which means that the headline index will be 8.5 % below the reading of February (pre-crisis).**

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Local markets—rates: By the time of writing (Friday around noon), nominal yields looked poised to post a slight bear-steepening on a week-over-week basis. In the front end, the Jan-22 DI future was standing at 2.83% (+3 bps from last Friday). In the back end, the Jan-27 DI future was trading at 6.86% (+7 bps from last Friday). The steepness in this segment (i.e., 2027s vs. 2022s) was heading to end the week at 403 bps, compared to 399 bps in the previous week. This gap reached the widest level since mid-May on Thursday, but pared a good deal of this rise after a bull-flattening session on Friday.

There is a good deal of risk and inflationary premium in the back end of the local yield curve, and this is clearer when we compare asset prices with survey estimates. Our numbers have it that the 5-year breakeven inflation rate (BEIR) has averaged near 4.20% in recent days, meaning a premium (vis-à-vis consensus estimates) just above 150 bps. This compares with an average premium of ~25 bps seen from July 2019 to February 2020 and of ~75bp for the last 10 years. In nominal rates, a comparison between traded yields and analysts´ consensus implies an average premium of nearly 190 bps in recent days for the 5-year rate. This premium compares with an average of ~45 bps from July 2019 to February 2020 and ~160 bps for the last 10 years.

The recent upshift and steepening of the local yield curve seems to track the movement in global rates, given this week´s bear steepening in U.S. Treasuries after Fed Chairman Powell announced a dovish forward guidance in the Fed's new policy framework (the Fed committed to accommodating inflation moderately above 2% for some time).

Local factors also played a key role in the yield curve's bearishness of late, amid difficult negotiations between the economic team and other members of the executive branch over the terms of a new welfare program and the room for more government investment. The Ministry of Economy is struggling to find a balance between mounting pressures for budget spending (especially in social policies) and the necessity to keep the constitutional spending viable for the next few years. Given the tight leeway to execute the budget within the constitutional cap – already for 2021 but especially for 2022 – the market is starting to price in greater execution risks for the fiscal adjustment process after COVID-19.

We anticipate difficulties in reaching an intermediate solution, potentially feeding a good deal of zigzagging in perceived economic fundamentals and volatility in Brazilian asset prices. Thus, we continue to recommend caution when dealing with local assets for the next few weeks and months, at least until we have greater clarity on the ability and willingness to keep the constitutional spending cap viable for the coming years.

Local markets—FX: Considering just the fact that the BRL strengthened and outperformed this week (at the time of writing, around noon on Friday, the USDBRL pair was quoted at 5.45 against 5.62 last Friday, standing among the week´s top performers versus the USD, among major currencies) and the BCB did not intervene in the Brazilian FX market, one might think that the trajectory of the currency would have been smooth recently, but that would have been a reasonable mistake. As the prospects for domestic fiscal policy remain unclear, market participants have been cautious with their exposure to Brazilian financial assets. That's been true especially for the FX market, as in contrast with what happens in the fixed-income market, there is no clear "forward guidance" to anchor short-term moves (i.e. no commitment to the level of the FX rate, in a flexible exchange rate regime), and the BCB's interventions usually occur at times when a substantial weakening has already materialized, and with a view to reduce volatility. Consequently, the trajectory of the BRL has continued to be quite volatile and, until there is a clearer outlook on the fiscal horizon, we believe it is likely to continue to do so.

Fiscal policy: On Thursday (August 27), the National Monetary Council (CMN in Portuguese acronym) approved the transfer of part of the BCB's 1H20 currency-related profits on FX reserves to the National Treasury (NT), totaling BRL503 billion. The BCB transfer to the NT will add to BRL325 billion, which will boost the Treasury´s liquidity buffer and maybe help servicing the public debt, amid strains to refinance debt, especially in terms of costs. This transaction is allowed under a new 2019 law, which allows these transfers in times of "conditions of severe liquidity difficulties", which have arisen due to the pandemic and the necessity to implement large fiscal stimuli.

Another key discussion regarding fiscal policy this week was the challenging trade-offs in relation to the creation of a new welfare program called *Renda Brasil*, which could potentially add to a mounting (and economically suffocating) level of mandatory expenses for the coming years, putting pressure on the execution of the constitutional spending cap in the near future (read 2021 and 2022). The initial plan was to launch the program this week, but the lack of funding sources has stood in the way, as the extinction of other social welfare programs, such as the annual bonuses for low-income workers (*Abono Salarial*) was rejected by the president. The economic team will now work in a new proposal to establish this new welfare program without damaging the credibility of the fiscal regime.

In the meanwhile, the government announced the intention of extending the Emergency Aid (nicknamed corona voucher) until the end of the year as part of a transition to the new welfare program. The extension should be with a BRL300 monthly stipend, less than the BRL600 average paychecks given to households in recent months. The proposal would still require Congressional approval and, if approved, would prompt an impact of BRL100 billion (BRL25 billion per month) on this year's primary fiscal deficit. This extension of the Emergency Aid has not been included in our fiscal scenario forecasts, as we have been looking for a public sector primary fiscal deficit of BRL845 billion for 2020.

Economic activity: This week, FGV has released all the components of soft data for August, confirming last week's preview that already indicated positive numbers.

From the household standpoint, the consumer confidence index rose 1.8 % MoM (s.a.), reaching 80.2 points, a result considerably better than in the preview (75.8). The index has shown its fourth gain in a row after the sharp drop seen in April. The headline number is down -8.7% since February (marking the pre-crisis level), meaning that 74% of the points lost between March and April have already been recovered. This August result was mainly driven by the expectation component, up 2.4%, while the current component pointed to modest growth of 0.7%. In terms of trends, the three-month average (of the headline) posted a gain of 8.5 %, which was the second gain in a row since February, after reaching the all-time low in April. In the details, the survey shows that the intention to purchase durable goods points to growth of 1.8%, the fourth positive result after the sharp tumble in April. The labor differential (i.e. percentage of respondents viewing jobs as hard to get minus respondents viewing jobs as easy to get) was slightly down, to 93.4 (from 93.9), but still standing at high levels. This number highlights some existing headwinds in the job market.

In manufacturing, FGV's industrial survey showed that headline business confidence rose 9.9 % MoM (s.a.). This result follows an increase both in the current situation component (9.8%) and in the expectations index (10.1%). Regard the accumulated drop in the recent months, 93.8% of the points lost between March and April have already been recovered, and the index is now only 2.7% below the level seen before the COVID-19 crisis. In terms of trends, the three-month average registered a gain of 16.3%, the second positive reading since February. The details show current and expected demand gained 5.2% and 6.1%, respectively. For the second time since January, expected demand stands above the current demand, which is a better sign of industrial activity ahead. Expected production also showed a positive result (8.9%) for a fourth straight month, after recovering last month all the points lost in the crisis. Industrial capacity utilization rose to 75.3% (72.3% in the previous month), a much better result than the all-time low reached in April (57.3%), but still well below the historical average of 80%. Low capacity use is to remain an important headwind for investment spending this year. The inventories surplus (i.e. percentage of respondents viewing inventories as excessive minus respondents viewing inventories as insufficient) points to a decline, reaching 4.2 points (previously 8.1), after registering in April its highest value since 2016.

Regarding Retail and Construction sectors, FGV's survey showed that confidence apparently continued to increase in August. The retail sales headline index rose 12.2% MoM (s.a.), reaching 96.6 points and posting its fourth gain in a row after April's tumble. This result implies confidence is down by -3.2 % since February (marking the pre-crisis level), meaning that 92% of the points lost between March and April have already been recovered. In the survey details, the expected sales index points to growth (of 9.6%) for a fourth month running. Construction has also continued to recover, with the headline index posting a gain of 4.9%, reaching 87.8 points and posting its fourth gain in a row after April's sharp drop. This result implies confidence is down by -5.4 % since February (marking the pre-crisis level), meaning that 82% of the points lost between March and April have already been recovered.

In Services, the survey showed that the headline index pointed to growth of 7.6%, reaching 85 points. The index has shown its fourth gain in a row after April's sharp drop. This figure follows an increase both in the current situation component (8.2 %) and the expectations component (7.1 %). In the survey details, expected demand and expected employment pointed to growth for a fourth month running (3.8% and 4.8%, respectively). Regard the accumulated drop in the recent months, 78.3 % of the points lost between March and April have already been recovered, but the confidence index is still 10% below the reading seen in February.

Inflation: August's IPCA-15 registered a 0.23% MoM change (2.28% YoY). The result was in line with market expectations, but slightly above our estimate of 0.20% MoM.

The upside surprises were concentrated in free prices. Industrial goods rose 0.50% MoM, vs. our expectation of 0.33%, contributing +4 bps to our headline forecast error. After a sharp fall in April and May, the group has been recovering as a result of some specific demand pressures (mostly computers and TV, which are related to home-office activities), allowing for some exchange rate pass-through. Services were also an upside surprise, contributing +3 bps to the forecast

error, but unlike industrial goods, prices in this group fell 0.50% this month – the group has been a major driver of the low inflation environment. Food-at-home was a downside surprise, rising 0.61%, whereas we expected 0.74%, a difference of -2 bps for the headline forecast. Finally, administered prices also surprised to the downside, contributing -2 bps to the forecast error.

The new average of core measures (EX0, E3, DP, MS, and P55) registered a 0.14% MoM change, with the annualized (and seasonally adjusted) three-month moving average reaching a muted 1.4%, vs. the target for 2020 at 4.0%. In particular, the trend for the IPCA EX3 core gauge — a measure highly correlated with the output gap —is hovering around 0.2% MM3saar. Additionally, the diffusion index stood at 52.8% on a seasonally adjusted basis, still close to the lowest historical levels.

Despite the small upside surprise, the number reaffirms our view of a benign scenario for inflation. In particular, we continue to see a muted dynamic for core prices, as economic slack should remain high for a considerable period of time, despite the cushioning of demand generated by government stimulus programs and the reopening of a number of regional economies. We believe the well-anchored inflation expectations should also play an important role in price dynamics in Brazil. We forecast 2020 IPCA inflation at 1.5%, but we see considerable upside risks, with our high-frequency tracking hovering around 1.9%. For 2021, we continue to forecast 2.7% for IPCA inflation.

Credit markets: The BCB released data on credit statistics for July. Total outstanding credit reached BRL3.7 trillion, an increase of 11.3% YoY and the highest rate since August 2012. These figures confirm the importance of credit support measures announced by the BCB during the pandemic.

Breaking down the numbers, non-earmarked outstanding credit rose by 13.4% YoY and earmarked outstanding credit by +2.7% YoY. Total household new loans registered +5.9% MoM s.a., the third consecutive monthly increase since April, suggesting a recovery in household consumption. Total non-financial corporations new loans reading was +13.3% MoM s.a., of which earmarked credit expansion accounted for BRL28 billion in total, on the back of the PRONAMPE disbursement program (for small firms).

Average interest rate in new loans continued to drop, in general: for non-earmarked loans, household average interest rate was 39.9% (-1.5 p.p. MoM), and at 12.3% (-0.7 p.p. MoM) for non-financial corporations. For earmarked loans, household average interest rate was 7.1% (-0.2 p.p. MoM) and 7.1% (+0.6 p.p. MoM) for non-financial corporations.

Balance of payments: The current account balance registered a USD1.6 billion surplus in July, which was above our estimate of a USD1.1 billion positive outcome, and twice as high as the median market estimate (USD0.8 billion). Direct investment in the country tallied USD2.7 billion last month and also overcame both our expectation (USD2.5 billion) and the median market estimate (USD2.2 billion). On the heels of these results the current account deficit receded to USD31.7 billion in 12-month-to-date terms (or 2.0% of GDP) from USD50.9 billion in December 2019 (2.8% of GDP), while direct investment in the country declined to USD62.6 billion (3.9% of GDP) from USD73.5 billion (4.0% of GDP) in the same comparison.

It is important to keep in mind that the BCB reviewed historical data for 2019 and 1H20, which explains the bulk of the difference to our estimates of a USD27.3 billion current account deficit and a USD65.6 billion inflow of direct investment in the country in the last 12 months ended in July. However, as stated in our August 21 weekly report, And the Fiscal Jitters Take Main Stage, the long-term trajectories of both variables have not been dramatically changed as they were last year, when the BCB carried out the first review in the historical data. Hence, the prospects for a significant adjustment in the current account deficit remain in place, in our opinion. Incidentally, the average current account balance of the last 3 months in seasonally-adjusted annualized terms suggests a USD17.4 billion surplus. While we expect the full reactivation of the economy in the coming months to reduce that speed of improvement in the wake of higher imports and services outlays, and some increase in the remittance of profits and dividends, the gradual recovery we anticipate for the Brazilian economy indicates a relatively balanced situation for the current account in the medium term.

On top of that, we remain comfortable with our forecast for a USD40.0-billion net inflow in direct investment in the country for 2020, which should be more than enough to finance even an eventual small current account balance. For the coming years, given our expectation of progress on the reformist agenda and better activity readings, we believe that direct investment in the country is likely to grow, thus preventing external financing needs from becoming an issue for the country in the medium term. That is, the Brazilian current account balance should not be a fundamental reason for any pressure over the BRL.

Next week: On Tuesday (Sept. 1), the IBGE will release 2Q20 GDP. We are forecasting a year-over-year decline of 10.0% (YoY), consistent with a quarterly decline of 8.2% (QoQ s.a.). This result means considerable upside risk to our projection of an annual contraction of -6.4% in 2020.

On the same day, the Brazilian Foreign Trade Secretariat (dubbed SECEX in the Portuguese acronym) is due to release the trade balance figures for August, for which we expect a USD6.4-billion monthly surplus stemming from USD18.2 billion in export revenue and USD11.8 billion of import outlays. Factoring out oil platforms deals that are related to tax issues rather than with genuine trade business, and adjusting both exports and imports by the number of business days and by their respective seasonal factors, we project both to have expanded as compared with the previous reading. Incidentally, this would be the first increase in imports after a five-month streak of declines in those terms, which would reinforce our perception that the Brazilian economy has already begun to recover (albeit at a gradual pace). That's the reason why we think the annual surplus as indicated by the 3-month-moving average of adjusted exports and imports (USD84.5 billion) should dwindle as we approach the end of the year (we project a USD60.5-billion trade surplus for 2020).

On Thursday (Sept. 3), the IBGE will release the Industrial Production data for July, and we expect another gain in a row after the sharp drop seen in April. Our monthly projection is at 5.5 % MoM (s.a.), which means that the headline index will be 8.5 % below the reading of February (pre-crisis).

MACRO AGENDA

Indicator	Date	Estimate	Prior
Net Debt Jul (% GDP)	Mon, 31-Aug	-	58.10
Primary Budget Balance Jul	Mon, 31-Aug	-	-188.07
GDP 2Q (% YoY)	Tue, 01-Sep	-10.0	-0.30
GDP 2Q (% QoQ)	Tue, 01-Sep	-8.2	-1.5
Trade Balance Monthly Aug/20 (USD billion)	Tue, 01-Sep	6.4	8.1
Exports Total Aug/20 (USD billion)	Tue, 01-Sep	18.2	19.6
Imports Total Aug/20 (USD billion)	Tue, 01-Sep	11.8	11.5
Vehicle Sales Fenabrave Aug/20	Tue, 01-Sep	-	174k
Industrial Production Jul (% MoM)	Thu, 03-Sep	5.5	8.9
Industrial Production Jul (% YoY)	Thu, 03-Sep	- 6.3	-9.0
Vehicle Production Anfavea	Fri, 04-Sep	-	170k

Sources: Bloomberg and Santander.

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