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Brazil Macro Compass

Recovery in Real Activity, Risks in Budget Outlook

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- **Notwithstanding being among the top performing emerging market currencies this week, the trajectory of the BRL has remained quite volatile these days, which led the Brazilian Central Bank (BCB) to intervene in the FX market for the first time since mid-May. Amid doubts about the fiscal outlook on the domestic front, we expect the Brazilian FX rate volatility to continue for a while.**

- **The nominal yield curve bear-steepened considerably this week, with the Jan-27 vs. Jan-22 gap moving back up north of 400 bps, reaching the highest levels since late May. The sell-off in U.S. Treasuries and another increase in fiscal jitters locally seem to have driven that movement. As we anticipate stable interest rates throughout 2021, we sense that the market is pricing in too many hikes (or premium) in the belly. But here, such an uncertain budget outlook could trigger a good deal of volatility, in our view.**

- **Retail sales activity is beginning to recover from the impact of the pandemic, and June's result surprised positively. The core retail index (ex auto and construction) posted a gain of 8.0% MoM s.a. (+0.6%) in June, virtually recovering all the points lost in the crisis. Broad retail sales rose 12.6% MoM s.a. (-0.9% YoY), which implies that 84% of the points lost in the crisis have already been recovered and that the index is still 4.7% below the reading for February. In July, our proprietary coincident index for retail sales (IGet) posted a gain of 8.1% MoM s.a. (-3.4% YoY), reinforcing the indications that April was the worst month for activity, with a gradual sequential recovery in place afterward. Regarding the services sector, the laggard in this recovery, the headline index rose 5.0% MoM s.a. (-12.0% YoY), which implies that total services have recovered only 20% of the points lost and that the index is still 14.5% below the reading for February.**

- **The BCB's monthly activity indicator capped the releases of activity indicators for June, posting a gain of 4.9% MoM s.a., virtually the same as the market consensus of 5.0%. The IBC-Br shows that activity has recovered 35.8% of the points lost in the crisis, but it is 9.6% below the reading for February. Regarding GDP projections, our tracking for 2Q20 – based on this index – is pointing to a sequential contraction ranging from 9.5% to 10.0%.**

- **Preliminary soft data released for July points to continued improvement in real activity. While we believe the numbers still suggest a gradual "normalization" in the economy, departing from a low comparison base after the sudden stop in March-April, the pace of gains in recent indicators imply upside risk to our projection of a 6.4% annual GDP contraction for 2020.**

- **In the Copom minutes, the BCB reaffirmed its forward guidance of interest rate at or below 2.00% for the foreseeable horizon. Explaining the conditionality (and boundaries) for the fulfillment of its policy intention, and by signaling and detailing the "additional gradualism", the BCB also buys as much flexibility as possible to (eventually) add stimulus without a pre-committed schedule, depending upon the scenario evolution. While for now this message keeps most upcoming Copom meetings (at least up to 1Q21) "asymmetrically alive", our baseline scenario contemplates a stable Selic rate at 2.00% all the way until early 2022.**

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Local markets—FX: The week is about to end with the BRL being among top performing emerging market currencies (up ~ 1% to ~5.39/USD). Yet we think one should not take that as a signal of tranquility in the Brazilian FX market. Doubts about the prospects of the fiscal policy (and the maintenance of the constitutional spending cap) on the domestic front and jitters on the international environment (with a rise in global interest rate this week) pushed the Brazilian currency close to USD/BRL5.50 at some point in recent days. That led the BCB to intervene in the FX market for the first time since mid-May (it auctioned USD1.0 billion in FX swaps last Wednesday).

After that intervention and on the heels of more constructive news regarding the Brazilian government's commitment to fiscal discipline, the BRL strengthened enough to post a gain from the end of last week. In any case, the volatility (and the uncertainty) remains pretty high. As discussions about the Brazilian budget for 2021 (and, implicitly, the future of the spending cap) are yet to heat up in the coming weeks—a draft bill is expected to be presented at the end of August—the fiscal theme should continue to weigh on the BRL. Thus, we think that the volatile pattern is going to prevail in the Brazilian FX market for a while.

Local markets—rates: Based on prices from Friday morning (time of writing), the nominal yield curve bear-steepened considerably this week. In the front end, the Jan-22 DI future was about to close the week at 2.81% (+16 bps from last Friday). In the back end, the Jan-27 DI future was trading at 6.86% (+51 bps from last Friday), pushing the steepness in this segment (i.e., 2027s vs. 2022s) to nearly 405 bps, compared to 370 bps in the previous week and ~150 bps early this year. In fact, the steepness of the curve in this section is the highest since the latter half of May.

This movement seems to have been influenced by the swings in U.S. Treasuries, in our view, as well as mounting concerns about fiscal reforms in Brazil. Those fears intensified after the resignation of two undersecretaries at the Ministry of Economy, which was subsequently followed by authorities' efforts to calm down the markets. Leaders of the Executive and Legislative branches verbally reaffirmed their commitment to the constitutional spending cap and macro reforms, with proposals to curb mandatory expenses still being discussed by the economic team. We expect the market to increasingly monitor the development and evolution of concrete measures to reign in mandatory spending.

The market is pricing in a small probability (of less than 10%) for a rate cut in the September Copom meeting, which seems fair enough given the asymmetry reaffirmed by the minutes (see our comment below) on the one hand and our baseline projection (in line with consensus) of no more moves for a considerable time on the other. Yet we sense that the market is pricing in too many hikes (or premia) in the belly, so that we see value in receiving rates at this segment. But here, one has to withstand potential volatility that could follow noise on the budget outlook in coming weeks, as Budget 2021 discussions draw near.

Economic activity: Retail activity is beginning to recover from the impact of the pandemic amid a gradual easing of the social-distancing measures implemented to avoid a larger outbreak of COVID-19. Headline broad retail sales rose 12.6% MoM s.a. (-0.9 % YoY) in June, a gain considerably better than our forecast of 7.2% and consensus of 6.7%. Core retail index (ex auto and construction) had a gain of 8.0% MoM s.a. (+0.6 % YoY), considerably better than our forecast of 4.9% MoM and consensus of 5.1%. Core and broad retail sales have already recovered 100% and 84% of the points lost between March and April. Broad retail sales are still 4.7% below the reading of February (pre-crisis).

After the sharp and widespread drop registered in March and April, June's positive result was largely driven by segments such as 'Vehicles' (35.2% MoM),'Furniture and Home Appliances' (31.0% MoM) and 'Books' (69.1% MoM). 'Clothing', which posted a gain of 96.3% MoM last month, was up 53.2% MoM. 'Supermarkets' and 'Pharmaceuticals', which saw some resilience in recent months, as they were able to continue operating since they are essential goods, registered a gain of 0.8% and a decline of -2.7%, respectively. Regarding the diffusion index, 9 of the 10 sectors of the broad retail sales category posted positive variations. Yet these gains were registered against very depressed levels. In quarterly terms, the broad index registered a sharp decline of -7.8% QoQ s.a., after reaching an all-time negative variation in the previous month, and the three-month moving average posted the first positive result since February, with a gain of 3.9%.

Credit-sensitive segments are suffering a much higher impact from the crisis than the income-sensitive, especially due to the temporary income preservation program provided by the government's massive transfer programs to households. The six-month (annualized rate) moving average of the credit-led segment registered its fourth negative result since March, down -33.3%, while the income-led segment was virtually stable, posting a decline of -0.1%.

In July, our proprietary coincident index for retail sales (IGet) posted a gain of 8.1% MoM s.a. (-3.4 % YoY), while the indexes weighted according to core (IGetp) and broad (IGetpa) retail sales survey methodology registered monthly gains of 8.0% (-6.6% YoY) and 5.2% (-21.8 YoY), respectively. Regarding the accumulated drop, IGet has already recovered 75% of the points lost between March and April, but is still 8% below the reading seen in February (pre-crisis). The

weighted indexes have already recovered 68% and 41% of the points lost in the crisis, but are still 9% and 23% below the level seen in February, respectively. In our view, this result reinforces the signal provided in the previously released indexes for economic activity: April was the worst month for activity, with a gradual and sequential resumption, but with the economy still operating at levels below that observed before the crisis. Our preliminary tracking for the retail sales survey (core and broad) for July is 4.3% MoM (-0.2% YoY) and 4.5% MoM (-3.8% YoY), respectively.

Services activity, the laggard in the recovery, also started to leave behind the impacts from the pandemic. Headline service sector activity rose 5.0 % MoM s.a. (-12.0 % YoY) in June, a gain slightly better than the market consensus (-12.7 % YoY). Regarding the accumulated drop, Total Services has recovered only 20% of the points lost between March and April, and the index is still 14.5% below the reading of February (pre-crisis).

After the sharp and widespread drop registered in March and April, June's positive result was highly driven by categories such as Families (14.2 % MoM), Transportation (6.9 % MoM) and Others (6.4 % MoM). Yet these gains apply over very depressed levels. In terms of trends, the headline index registered a sharp drop of 15.4 % QoQ s.a., an all-time negative variation, and the three-month moving average fell a fourth straight month by registering -2.9 %, after posting its worst result in the previous month.

The BCB's monthly activity indicator ended the sequence of releases of the main activity indicators for the month of June. The IBC-Br posted a gain of 4.9% MoM s.a. (-7.1% YoY), virtually the same as the market consensus of 5.0% MoM s.a. (-7.0% YoY). This result implies that 35.8% of the points lost between March and April have already been recovered, but the index is still -9.6% below the reading for February. In terms of trends, the quarterly rolling result points to a contraction of -10.9%, affected by April's slump in activity, while the three-month moving average registered a fall of -1.3%, after reaching an all-time low in the previous month. Regarding GDP projections, our tracking for 2Q20 – based on this index – is 9.9% QoQ s.a.

This result is consistent with the sequential resumption in activity seen for other key sector-based indicators in June (e.g., industrial production, retail sales, services sector). With the opening and return to full operation of businesses, we expect a gradual resumption of economic activity to reverse the trend observed from the beginning of the pandemic up to now. Preliminary soft data released for July points to continued improvement in real activity. While we believe the numbers still suggest a gradual "normalization" in the economy, departing from a low comparison base after the sudden stop in March-April, the pace of gains in recent indicators imply upside risk to our projection of a 6.4% annual GDP contraction for 2020.

Monetary policy: This past Tuesday (August 11), BCB published minutes from the August 4-5 Copom policy meeting, when the authority cut the Selic rate by 25 bps, to 2.00% (another historical low). In general, we sense that the BCB took the opportunity to explain the rationale behind its forward guidance of interest rates at or below 2.00% for a considerable amount of time, conditional upon a few factors.

In the scenario assessment, the BCB highlights the partial recovery of economic activity and the asymmetry between the durables segment (from both consumption and investment standpoints) and the services sector. The former is seen as being driven by government transfer programs, while the latter is seen as being still affected by social-distancing measures. The Copom is dealing with a good deal of uncertainty about the pace of an economic recovery, given "the evolution of the pandemic and the necessary decline in emergency aid by the end of 2020" (paragraph 12), which could lead to an even more gradual recovery, according to the BCB.

The Copom also sees asymmetry in the level of slacks, which we expect will be even greater for the services sector. Given the nature of the shock generated by the pandemic, the BCB believes that "the disinflationary pressures from reduced demand may last longer than in previous recessions" (paragraph 13).

On the policy front, the BCB explains that the decision to "increase residually the degree of monetary stimulus" follows the authority's view that the expected value for future inflation for the relevant policy horizon still runs below the mid-target. This means that the deflationary impact from economic slacks and anchored expectations are dominating the upwardly skewed inflationary risks "related to fiscal issues" (paragraph 14).

As in the previous policy meeting, the BCB also kept the discussions on the effective lower bound for interest rate, seen as dynamic over time but significantly higher for EM economies facing fiscal fragilities and uncertainties (clearly the case of Brazil). The Copom keeps the indication that "we would already be close to the level from which further interest rate reductions could be accompanied by asset price instability" (paragraph 15). The committee also refer to the "prudential and financial stability issues" related to the level of interest rate and policy transmission. While the BCB sees stress test results indicating that the Brazilian financial system is resilient to the higher credit risk brought by the pandemic, the

committee ponders that “an unprecedentedly low interest rate environment may generate increased asset price volatility”. That could damage the “proper functioning” of the financial system and capital markets without a necessary time of transition, according to the authority (paragraph 16).

The aforementioned discussion on the effectiveness of the policy transmission via financial system and capital markets is the reason behind the need for “caution and additional gradualism” when it comes to considering possible new rate cuts ahead. Importantly, the BCB claims that eventual rate cuts “would require greater clarity about prospective inflation and activity” and “could be spaced over time” (paragraph 16). In other words, eventual new stimulus could happen at a pace of 25 bps once in every two or more meetings ahead. In our view, this “additional gradualism” buys the BCB a great amount of flexibility to refrain from completely closing the door on possible additional stimulus amid a sea of uncertainty. For now, this expression keeps “alive” a number of Copom meetings ahead, especially from 4Q20 onward.

In paragraphs 17 to 19, the Copom provided more information on its new outcome-based forward guidance for the medium term. The latter was considered by the committee as an additional policy tool to balance the need to stimulate the economy for target-achievement purposes with the need to keep a good deal of caution in the stimulus for prudential reasons. While the authority recognizes limitations in the use of the forward guidance as a policy instrument in emerging economies (which are more vulnerable to shocks), that strategy is dominant from a cost-benefit standpoint, as it influences expectations shaping the intermediate part of the yield curve. In other words, we believe that the use of the forward guidance could be considered as a tool to maximize the transmission of policy by pressuring downward the one-year ex-ante interest rate – the most important benchmark in terms of local financial costs.

The Copom minutes also confirm the asymmetry in the forward guidance, as the committee explicitly mention “an asymmetric policy intention”. The BCB claims “if the necessary conditions were met, the Copom would not raise the interest rate but could reduce it”. To maximize the effectiveness of the forward guidance, the conditions for this policy intention to be fulfilled follow:

1. Inflation projections (both by analysts and the BCB) standing below the target for 2021 (but to a lesser extent for 2022 as well)
2. The maintenance of the fiscal regime
3. The anchoring of long-term inflation expectations

The breaching of condition #2 (e.g., via legal changes significantly reducing the effectiveness of the constitutional spending cap) changes the structural level of interest rate (and indirectly, the level of policy stimulus). The breaching of condition item #3 (e.g., the divergence of long-term inflation forecasts) could worsen the cost-benefit ratio for the implementation and transmission of policy stimulus.

All in all, our interpretation of the Copom minutes is that the BCB reaffirmed its forward guidance of interest rate at or below 2.00% for the foreseeable horizon. Explaining the conditionality (and boundaries) for the fulfillment of its policy intention, the BCB also buys maximum flexibility to (eventually) add stimulus without a pre-committed schedule, depending on the scenario evolution.

Our baseline scenario contemplates a stable Selic rate at 2.00% all the way until early 2022, when we envision the start of a gradual removal of stimuli and normalization of the policy stance. On one hand, we sense that the BCB forward guidance keeps our level of conviction (with regards our own forecast) relatively low for the short term. We recognize that a hypothetical combination of better financial conditions, further declines in inflation expectations and, if the case, an unchanged fiscal regime could encourage the authority to test even greater levels of stimulus sometime in 4Q20 or 1Q21. On other hand, the second part of the forward guidance strengthens our confidence in our medium-term scenario of even lower interest rate for even longer, given our expectation of a gradual economic recovery and slow erosion of economic slacks.

Next week: On macro agenda, FGV will release next Thursday (20-Aug) the preview of Industrial Business Confidence for August. Based on the extraordinary preview released on Friday (with data collected until 13-Aug), we expect an increase of 8.8 points in the industry confidence, reaching to 98.6 points. This result implies that 94% of the points lost between March and April will be recovered.

MACRO AGENDA

Indicator	Date	Estimate	Prior
IGP-M Inflation 2nd Preview Aug/20 (% MoM)	Tue,18-Aug	-	2.02
CNI Industrial Confidence Aug/20 (% nsa)	Thu, 20-Aug	-	47.6
Preview Industrial Confidence Index FGV Aug/20 (points)	Thu, 20-Aug	-	89.8
Federal Tax Collection Jul/20 (BRL billion)	20/26-Aug	-	86.3

Sources: Brazilian IRS, CNI, FGV, and Santander.

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