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Brazil Macro Compass

Central Bank Decisions

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- **Despite continuing uncertainties on the international front—the inconclusive Democratic Party primaries in the U.S. presidential elections and unusual changes in Chinese data related to the coronavirus epidemic, among others—the highlight of the week was the Brazilian Central Bank's release of the Copom meeting minutes and its intervention in the FX market. Owing to downside risks to economic activity, we continue to see a downward trend between the short-end and the belly of the domestic yield curve, which still seems us quite steep.**
- **Amid weakening pressures on the FX rate resulting from both external (news related to the coronavirus) and domestic factors (low interest rate differential, distinct opinions about FX policy), at the end of the week the Brazilian Central Bank announced that it would sell USD2.0 billion via FX swaps. This intervention was aimed at curbing dysfunctionalities in the FX market and reinforced the view that the choice of the tool to do so depends on the profile of the flows. As a result of the BCB's action, the FX rate fell below USD/BRL4.30 after breaching the USD/BRL4.38 level earlier this week—thus matching the average of changes registered by peers during the week. We continue to believe that the monetary authority will not attempt to change the FX rate trend. Incidentally, we project some strengthening of the currency in 2H20 due to the prospect of better economic performance, the likely (in our view) approval of an important fiscal initiative (the so-called "Emergency Fiscal Package"), and the dilution of the impact from the coronavirus.**
- **The Central Bank published the minutes of the Copom policy meeting of February 4-5, where the authority justified the "interruption" of the easing cycle due to "multiple uncertainties" around the transmission of the stimulus already implemented. According to Copom, a "better understanding" of these effects on the economy is "essential" for deciding on the next policy steps. We continue to expect the policy rate to remain stable (at 4.25%) throughout 2020, given our expectation of a (gradual) GDP acceleration this year. Nevertheless, the pace of an eventual normalization of monetary policy in 2021 may prove slower than currently expected by the market (we project the Selic rate at 5.50% at the end of next year).**
- **The stream of weak activity data for December released this week led us to lower our GDP growth forecasts. As noted in our February 14 report, *Still on Track, but More Gradually*, we revised our GDP growth forecast for 4Q19 to 0.4% q/q sa from 0.8% q/q sa, which translates into 1.1% full year growth if our estimate proves correct .**
- **Next Thursday (February 20) the IBGE will release its mid-month inflation preview for February 2020—the IPCA-15—and we expect deceleration in that index for January to 0.17%, or 4.16% y/y. The main factor that explains this benign behavior, in our opinion, is the drop in the "Regulated Price" group.**
- **We expect the current account balance to have registered a sizeable deficit in January—we estimate a USD11.7 billion shortfall last month—which we believe is likely to keep market participants wary about the dynamics of the Brazilian balance of payments. However, we think this result will need to be taken with a grain of salt, because we see it as mostly the result of an unfavorable mix of seasonal and *ad hoc* factors.**

The dynamics of the yield curve for the week were especially influenced by the minutes of the last Copom meeting. From our viewpoint, the market's interpretation seems to have been that the Selic rate will remain at the current level for a long period, which favors the carry in the middle part of the curve (for example: the DIs Jan-22 and Jan-23 registered

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some of the biggest declines in the week, around 20-25 bps). The rally of the curve was especially intense in the one- to four-year segment.

Another highlight was the foreign exchange intervention carried out by the Central Bank at the end of this week—through the sale of USD2 billion in foreign exchange swaps between Thursday and Friday—which also seems to have influenced the yield market, in our view, confirming a positive correlation in the short term between the FX rate and short rates. This is due, in our opinion, to the positioning of many local funds receiving rates and selling BRL. For our part, we believe that, in view of well-anchored inflation expectations and resource slack, the exchange rate pass-through to inflation is quite limited. Thus, we expect recent movements in the exchange rate to have little influence on the next steps in monetary policy.

The BCB's action in the FX market and signs of less impact from the news related to coronavirus on the global risk appetite helped bring the exchange rate to a level below 4.30 at the end of this week, after having tested levels above 4.38 (a record high, in nominal terms). During the week, the national currency appreciated by about 0.5% against the USD, in a median performance compared to some of the world's most liquid currencies.

Next week, the main points of attention in the market should be the IPCA-15 for February and the CAGED for January. Below-expected data, indicating well-behaved inflation and still very gradual activity recovery, could lead to new historical lows in the short and intermediate sections of the local yield curve. As for the FX rate, it will be important to monitor the BCB's stance in the coming days, although we continue to believe that the authority will only act when it sees signs of a dysfunctional market..

Monetary policy: The Brazilian Central Bank (BCB) published the minutes of last week's Copom policy meeting, where the monetary authority cut the Selic rate by a quarter of a point to 4.25%, the lowest level since the implementation of the inflation-targeting regime (1999). At the same time, the Committee pre-announced the "interruption" of the easing cycle, in the wake of rate cuts totaling 225 bps since mid-2019.

In the minutes, the Copom pointed out that "given the multiple uncertainties regarding the current size of economic slack, the speed of economic recovery, and the increase in the power of monetary policy, which acts with lags in the economy, the Copom considers that it is important to observe the effects of the monetary stimulus cycle" (paragraph 18). The BCB also recognized that "a better understanding of these effects is essential to determine the next steps in monetary policy."

Based on these comments, we think the authority associates a more cautious approach with "uncertainties regarding the lag and the magnitude of the effects of the stimulus already granted." The committee assesses that "it is essential to observe the evolution of economic activity and inflation projections and expectations over the next months, with increasing weight for 2021" (paragraph 19).

Although some analysts may see this communication as a sign that a range of monetary policy options is open to policymakers in the months to come, we conclude that the primary factor driving interest rates will be the consistency of the economic recovery. We see that as the decisive factor for inflation projections for 2021—increasingly the focal horizon for BCB policy.

In the scenario assessment, the Copom highlights a dichotomy between the labor market and the production of goods. In the minutes, the BCB board points out that "the labor market continues to recover gradually," while "recent industrial production data and preliminary investment indicators have performed worse than expected" (paragraph 10).

As for the size of economic slack, we noted apparent differences of opinion within the committee. Some members "assessed that the exhaustion of the centralized capital allocation model and the long duration of the recession may have produced supply constraints" (paragraph 11), which suggests less idleness than usually estimated via "traditional methods." In contrast, other members believe that "the dynamics of the core inflation, despite the recent effects of the protein price shock, signals that the economic slack is still large" (paragraph 12).

In the minutes, the Central Bank also discussed the possible effects of the coronavirus, concluding that "the consequence of these effects to monetary policy conduct will depend on the relative magnitude of the global economic slowdown versus the reaction of financial assets" (paragraph 15). In sum, we believe the authority is seeing ambiguous possibilities for the inflationary impact of the coronavirus, should this shock prove persistent.

All in all, we continue to believe that the Copom has ended the easing cycle. A possible revision of its strategy—leading to a hypothetical implementation of additional stimuli—will fundamentally hinge on the eventuality of reasonable disappointment with the pace of economic recovery, in our view. In a context of anchored inflation expectations and relatively stabilized assets (despite a structurally weaker BRL), the path of GDP growth will be crucial for inflation in

2021. With our expectation that GDP growth will head toward c.2% in coming years, from c.1% in recent years, we continue to think the next BCB action will be a hike, in a normalization cycle that we see starting in 2Q21. However, for intervals seen as “reasonable” today (i.e., below but not too far from current projections), the slower than expected pace of recovery may push the normalization cycle further out in time, reducing its speed and intensity.

Economic activity: This week, several economic activity data for December 2019 were released. On Wednesday (February 12), the IBGE’s Monthly Retail Survey (PMC) reported weak sales in December 2019. Core retail sales grew 2.6% y/y, below our forecast (3.6% y/y) and market consensus (3.4% y/y). Compared with November, there was a 0.1% m/m fall in seasonally adjusted terms (sa).

As a result, core retail sales grew 1.2% q/q sa in 4Q19 and 1.8% in 2019 as a whole. The solid growth in 4Q19 can be directly attributed to the temporary increase in income owing to withdrawals from FGTS (private workers’ mandatory savings fund). Among categories, we highlight “Furniture and Appliances,” which registered a 3.4% m/m sa increase and a 6.1% q/q sa rise in 4Q19.

As for the broader picture, which includes sales of building materials, vehicles, and auto parts, the 3.9% y/y growth was roughly in line with our forecast (4.3% y/y), but below market consensus (5.4% y/y). In comparison with November, the broad retail gauge fell 0.8% m/m sa. This negative result can be explained mainly by the sharp 4.0% m/m sa drop registered by “Vehicles & auto-parts,” which was in line with our expectation. Compared to 3Q19, broad retail sales grew 0.7% q/q sa, while for 2019 as whole there was a 3.9% expansion.

On Thursday (February 13), the IBGE's Monthly Service Survey (PMS) revealed that the services sector grew 1.6% y/y in December 2019, which was above our forecast (0.7% y/y) and in line with market consensus (1.5% y/y). Compared with November, the sector fell 0.4% m/m sa.

As a result, services expanded 1.4% q/q sa in 4Q19 and recorded a 1.0% full year increase in 2019. Similar to the performance of retail sales in the period, the growth is directly related to the increase in income fostered by withdrawals from FGTS.

Among categories, we highlight “Administrative and Professional Services,” which grew 1.2% q/q sa in 4Q19 despite the 1.3% m/m sa drop, confirming a steady and gradual recovery. Another category worth mentioning is “Other Services,” which registered strong growth in comparison with November (3.4% m/m sa), also directly affected by the temporary income stimulus.

Finally, the IBC-Br (Central Bank economic activity index, viewed as a monthly GDP proxy) consolidated the sequence of weak monthly activity data in December, as the indicator fell 0.3% m/m (+1.3% y/y). In 4Q19, the IBC-Br grew only 0.5%, pointing to a moderate GDP increase in the period. As pointed out in our report published today, *Brazil – Macroeconomic Scenario: Still on Track, but More Gradually*, we revised our GDP growth forecast for the quarter from 0.8% q/q sa to 0.4% q/q sa, which translates into 1.1% full year growth if our estimate proves correct.

Inflation: The Brazilian official statistics bureau—IBGE in the Portuguese acronym—will release the mid-month preview of the officially targeted index for February (IPCA-15) next week. Unlike the report for January, this time the IPCA-15 will assume the new weighting structure for its components. Our calculations indicate a slowdown compared with the January reading, when the IPCA-15 registered a 0.71% m/m increase that meant a 4.34% y/y change. We expect the index to have increased 0.17% m/m, which would mean a 4.16% y/y change if our estimate proves right. In addition to the downward effect resulting from the new weighting structure, we estimate lower animal protein prices and, mainly, lower administered prices—e.g., for gasoline, due to downward adjustments in January and February, and for electricity, due to the lack of additional fee usually charged in dry periods (the so-called “green flag”).

With respect to core measures, we anticipate a constructive backdrop, with the underlying services core receding to 0.16% m/m in February from 0.45% m/m in January, which would translate into a retreat to 3.54% from 3.73% in y/y terms—in line with the average level observed in recent years. Regarding the IPCA-EX3 index (the core inflation gauge most sensitive to the economic cycle), we expect it to return to the 3% level, thus suggesting the absence of demand pressures on inflation dynamics.

External sector data: Although the Brazilian economy has managed to lure a sizeable amount of foreign direct investment (FDI) for the last three years—net monthly inflows averaged USD6.3 billion in the period—which have exceeded its current account deficit (CAD) by far, the Brazilian economy has faced market participants’ suspicion regarding the dynamics of its balance of payments (BoP) because of the rising trend of the CAD, notwithstanding the lack of robust economic growth rates. Incidentally, market participants have included this skepticism in the list of reasons for the devaluation of the BRL in 2020—although the theme did not prevent the currency from strengthening in December. As a result, we believe the release of external sector data for January 2019 next Friday (February 21) is

likely to leave market participants warier at first, as we estimate the CAD to have reached as high as USD11.7 billion in the period—the largest shortfall since January 2015, when the CAD printed a USD12.0 billion reading, and twice as high as the previous figure. If our estimate proves right, CAD would have climbed to USD53.5 billion in 12-month-to-date terms, thus reaching the psychological threshold of 3.0% of GDP that usually raises a yellow flag. However, we think the outcome must be taken with a grain of salt, as an unfavorable mix of seasonal and *ad hoc* factors likely contributed to the substantial imbalance.

We remind readers that, when the Brazilian Central Bank (BCB) released external sector data for December 2019 on January 27, the institution provided some preliminary figures for the BoP in January 2020, including its forecast for the CAD in the period, which was USD8.7 billion. At that juncture, trade balance preliminary readings were indicating that exports and imports were about to match each other in the period, but the final outcome was a trade deficit that amounted to approximately USD1.7 billion due to the import of two oil platforms in the last week of last month. Given that result, if it were possible for the BCB to announce a revision of its January CAD estimate, we believe the institution would do so and move the estimate upward to USD10.4 billion at least. Therefore, part of the blame for the large CAD in January is associated with this *ad hoc* factor that has nothing to do with economic activity but rather is related to changes in previous tax rules that incentivized the return of oil platforms that were once exported by the same companies that are now bringing them back.

However, one may consider that, even factoring out the negative surprise provided by the trade balance last month, the USD8.7 billion CAD estimate from the BCB reflected a large imbalance in the month. In our opinion, it did. That's where the seasonal pattern plays its role. Taking a look at the current account balance time series, it is easy to identify three months in which sizeable deficits usually occur: January, July, and December. The reason for this pattern is the concentration of interest payments in January and July—especially those related to domestic bonds held by foreigners—and the remittances of profits and dividends in December. Therefore, although we think the January CAD is likely to add to market participants' concern at first, we do not think it is prudent to extrapolate the result for the rest of the year. We expect smaller imbalances to materialize in the coming months, which are likely to underpin our forecast of a gradual deterioration in the CAD in 2020, as discussed in our February 14 report, *Still on Track, but More Gradually.*

Recent Publications (Available on Our Website)

- Macroeconomic Scenario: Still on Track, but More Gradually (February 14, 2020)
- *FX Compass – BRL: We hope they'd got it* (January 23, 2020)
- *Brazil Macro Propositions for 2020* (January 13, 2020)
- *Macroeconomic Scenario: A Better Outlook* (December 13, 2019)
- *Macroeconomic Scenario: Better Days Ahead* (October 31, 2019)
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