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Brazil Macro Compass

Under Pressure

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- **The local curve continues to steepen, with short rates making new lows (on the back of mild inflation and downward revisions to growth) and the long end widening. This movement is not set for a reversal in the short term, in our view.**
- **The February 2020 IPCA-15, which is the mid-month preview of the officially targeted inflation index, printed a 0.22% MoM change, thus below market consensus but above our forecast (0.24% and 0.17%, respectively). In YoY terms, inflation receded to 4.21% from 4.34% in January, thus getting closer to the level targeted by the Brazilian Central Bank (BCB) for 2020 (4.00%).**
- **Although the largest deficit of the historical series for the month of January, the negative imbalance of USD11.9 billion registered by the current account balance last month came in line with our expectation, owing to the concentration of interest payments and the remittance of profits and dividends. For 2020, we keep our assessment of a gradual deterioration that should lead the current account deficit to reach USD56.7 billion from USD49.5 billion in 2019.**
- **We estimate that the unemployment rate is likely to continue on a gradual downward trend throughout this year, gaining momentum especially in the second half. For January 2020 figures, we estimate a fall to 11.5% from 11.6%—after seasonal adjustment—which should have meant an increase to 11.3% from 11.0%, considering the original series.**
- **We expect the public sector January 2020 fiscal accounts to show a primary result significantly higher than that observed in the same month of the last few years, due to both the strong federal tax collection and a slow pace of expenditure execution. Despite this, the 2020 public sector primary deficit tends to be larger than that recorded in 2019, underlining that the fiscal adjustment is incomplete. To contain the unsustainable growth in mandatory expenditures and ensure compliance with the constitutional spending cap, Congress needs to approve further fiscal reforms.**

This week we highlight two developments in the local rates market: the continuing rally in short term rates (tenors up to Jan. 23) and the steepening in the long end of the curve. In the first case, DI contracts made fresh historical lows, with DIs Jan. 21, Jan. 22, and Jan. 23 narrowing, respectively, by 4 bps, 7 bps, and 5 bps. The market now prices in a Selic rate virtually flat until the end of this year, with hikes from 1Q21 until 5.75% by YE2021. Since we expect a less aggressive (to 5.5% at YE2021) and delayed (starting in 2Q21) hiking cycle, we still see residual value in receivers up to Jan. 22, especially in contracts maturing from Jul. 21. At current prices, further compression in the very front end (Jan. 21) seems conditioned to the market expecting the BCB to resume cuts still this year, which is not compatible with our inflation/growth expectations or with the recent Copom speech. On the other hand, the inflation outlook remains comfortable enough for the market to keep postponing the expected beginning of a new hiking cycle.

As for the curve slope, the Jan.23/Jan. 27 spread hit a new high since September 2018, at 120 bps (14 bps up this week). Despite the apparent stretched level, we do not see any short-term triggers for a reversal of the recent trend, with the potential for more compression in the short end still not exhausted, a new hiking cycle still too far in the future, challenges in the continuation of the fiscal consolidation agenda, lack of interest from foreign investors and locals rotating portfolios into equities. Therefore, we still see more potential in outright receivers in the short end than in flatteners.

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Inflation: The IPCA-15—which is the mid-month preview of the officially targeted inflation index—printed a 0.22% MoM change in February 2020. At last, the IPCA-15 was based upon the new weighting structure for its components and, consequently, bore a bearish bias. Nonetheless, we witnessed some negative surprises such as gas prices, which showed an acceleration in the period, notwithstanding the several downward adjustments in fuel costs announced in January. On the other hand, we continue to see a drop in prices of animal proteins, health and personal care items and foodstuff products. These groups had a downward impact of 13 bps, 7 bps and 4 bps, respectively, on the headline change.

Overall, the February index unveiled a quite favorable composition, which led its underlying gages (core and dispersion indices) to print lower readings than the average historical data. The three-month moving average of the IPCA EX-3 (the core inflation gauge most sensitive to the economic cycle) in seasonally adjusted annualized terms receded to 2.8% from 3.0% in the previous reading, while services also retreated to 3.5% from 3.7% in the same comparison, thus suggesting the absence of demand pressures on inflation dynamics for 2020.

As some items of this mid-month preview will be repeated for the February IPCA, we expect the officially targeted index to increase 0.14% MoM, which would mean a 3.89% YoY change if our estimate proves right (the IPCA for February will be released on March 11). We forecast lower prices for animal proteins and, especially, administered items—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"). All in all, inflation continues to hint at a quite comfortable backdrop for the current year.

External sector data: The current account balance registered a USD11.9 billion deficit in February 2020, which was in line with our estimate of a USD11.7 billion deficit. The result led the current account deficit to USD52.3 billion in 12-month-to-date terms (or 2.9% of GDP). The outcome is compatible with our forecast for a USD56.7 billion deficit in fiscal 2020 (3.0% of GDP), thus underpinning our expectation for a slower deterioration of the current account balance than the trajectory suggested in the aftermath of the reviews that the BCB carried out in 2019.

Regarding the components of the current account balance, we learnt the trade balance posted a USD2.6 billion deficit last month, while services account registered a USD2.7 billion shortage—net tourism outlays reached as high as USD0.9 billion and equipment rental net payments amounted to USD1.3 billion in the period—and the primary income account recorded a USD6.8 billion negative imbalance—net interest payments totaled USD4.0 billion and the remittance of profits and dividends tallied USD2.8 billion. The USD0.1 billion surplus that the secondary income account showed in February 2020 concluded the list of contributors to the result of the current account balance last month. In 12-month-to-date terms, trade balance surplus shrank to USD37.2 billion from USD40.8 billion in the previous reading, while services shortage reached USD35.0 billion (USD35.1 billion in the previous month) and the primary income negative imbalance totaled USD55.6 billion (USD56.1 billion a month ago). As compared with the levels observed in December 2019—trade surplus of USD40.8 billion, services shortage of USD35.1 billion, primary income negative imbalance of USD56.1 billion—January 2020 figures underpin our assessment that dynamics of current account balance are likely to be set by the trajectory of the trade balance rather than other items.

Regarding the financial account, the net inflow of foreign direct investment reached USD5.6 billion last month—we projected a USD6.0 billion net inflow—which translated into a USD78.3 billion contribution in 12-month-to-date terms. Hence, the most important external funding source shows that is more than sufficient to finance the gap observed in the current account balance, a backdrop that reinforces our perception that the Brazilian balance of payments is not likely to turn into a thorny issue in the coming months.

Economic activity: Next week, the first labor market data for 2020 will hit the wires. We expect the net creation of formal jobs to continue improving and estimate that 70,000 posts were created in January 2020. Regarding the national unemployment rate, we forecast a fall to 11.5% from 11.6%—after seasonal adjustment—which should have meant an increase in the original series to 11.3% from 11.0%. We believe that the unemployment rate will continue to decline gradually over the course of this year, gaining momentum especially in the second half in the wake of laggard effects of recent monetary incentives granted by the BCB.

Fiscal policy: Important publications on Brazilian fiscal policy will hit the wires next week. On Thursday (February 02), The National Treasury Secretariat (STN, acronym in Portuguese) will release the central government's primary result for January 2020. We estimate a monthly surplus of BRL41.5 billion, significantly above the balance registered in the same month of last year (BRL30.0 billion). This expectation is due both to the strong performance of tax revenue and low execution of expenditure earlier this year. With regard to revenue, we highlight the significant expansion in income tax (from companies and individuals) and contribution on net profits in January—as published yesterday by The Federal

Revenue of Brazil—in the wake of corporate reorganizations carried out by state-owned companies and net individual gains from trading on the stock markets in the recent period. Concerning the expenditure side, the pace of execution of discretionary spending in January 2020 was well below that observed in the same month of the last few years, mainly reflecting the changes related to the public budget management in a context of greater control by Congress: 2020 will be the year of implementation of the so-called "imposing budget", in which the Legislative Branch (in the form of parliamentary amendments) has greater control over the pace and priorities of the primary expenses execution. Remaining doubts about the actual amount of budgetary resources to be made available through amendments (mainly amendments defined by the Budgetary Law's Rapporteur, which are expected to be resolved only in early March), added to the adaptation of the Executive and Legislative branches to the new budget management framework, explain the slow pace of expenditure execution earlier this year, in our opinion.

Hence, the strong primary result to be presented by the central government next week should be taken with a grain of salt, in our view. Although we expect higher growth in tax revenues this year, in line with the ongoing recovery in domestic activity, we expect the central government's 2020 primary deficit to be worse than that observed in 2019. We project a negative balance of BRL107.5 billion (-1.4% of GDP) in the current year (budget target: -BRL124.1 billion, or -1.6% of GDP); last year, the large amount of non-recurring revenue, especially from oil auctions (for example, BRL23.7 billion from the Transfer of Oil Rights [ToR] auction), meaningfully contributed to the reduction of the primary deficit (actual primary result: -BRL95.5 billion, or -1.3% of GDP; budget target: -BRL139 billion, or -1.9% of GDP).

STN will also publish next week (on Friday, February 28) its Four-Month Public Debt Projections Report, which we expect will unveil more favorable expectations for Brazilian government debt. We have emphasized in our reports (for details, see *Still on Track, but More Gradually*, February 14, 2020) that the downward trend in gross public debt started last year: the indicator ended 2019 at 75.8% of GDP, below the level 76.5% of GDP registered at YE2018. However, this movement is also partially related to non-recurring factors, such as the advance payments of state-owned banks (notably BNDES) to the National Treasury and the sale of international reserves in the spot FX market carried out by the BCB in 2H19; hence, unlike the gross debt, the gauge of net debt (it excludes credits from the non-financial public sector) has not yet started to fall. Another reason behind the more benign trajectory of the gross public debt-to-GDP ratio, nevertheless, corresponds to the adoption of fiscal adjustment measures in recent years, which has reduced the perception of sovereign risk and has contributed to the decline in the cost to roll over the debt. In other words, Brazilian government's willingness to seek the sustainability of public accounts has been effective, though it is always important to point out that the fiscal adjustment is incomplete, which requires further advances in the reformist agenda.

Finally, the BCB is set release (also next Friday, on February 28) the consolidated public sector's fiscal accounts for January; it includes the federal government, regional governments and state-owned companies. We expect a monthly primary surplus of BRL55.7 billion, with the following breakdown: BRL45.8 billion for the federal government; BRL9.7 billion for states and municipalities; and BRL0.2 billion for state-owned companies. As already mentioned, the magnitude of the improvement in fiscal accounts in January should not be extrapolated for the rest of the year. We forecast a negative primary balance of BRL98.5 billion (-1.2% of GDP) for the public sector in 2020, following the primary deficit of BRL61.9 billion (-0.9% of GDP) recorded in 2019.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: They Have Not Got It (Yet)* (February 20, 2020)
- *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)

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