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Brazil Macro Compass

To cut or not to cut (interest rate)?

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- **Global risk aversion and noisy fiscal developments strongly hit the local rates market, leading to an outsized bear-steepening of the curve. That movement led to very attractive valuations in the front end, considering our expected path for the Selic rate. Yet we believe the local markets remain in a "falling knife" period (i.e. with global and local risks far from fully dissipated), so that we recommend a huge amount of caution in positioning. Timing may still not be the best for now.**
- **This coming Wednesday, March 18, the Brazilian Central Bank (BCB) is set to announce its monetary policy decision. Amid a sea of uncertainties due to the economic impact and aftershocks from the coronavirus outbreak, as well as recent noise on the fiscal front, we expect the BCB to stay put, holding the Selic rate steady at 4.25%. But we recognize this is a (very) close call.**
- **Industrial production (IP) rose 0.9% MoM in January, in seasonally adjusted (s.a.) terms, topping our estimate (0.5% MoM s.a.) and market participant consensus view (0.6% MoM s.a.). Over a year ago, output fell 0.9%, better than our call (-1.4% YoY) and the Street estimate of -1.3% YoY. Despite the positive result for the month, the sequential trend keeps heading south. Importantly, January figures reflect the state of the industry before the coronavirus outbreak. With the risk of input shortages and activity stoppages on the rise, we remain cautious about future dynamics of economic activity.**
- **Albeit higher than expected, February's IPCA posted the lowest inflation print for that month in 20 years. Details underscore the lack of demand-led price pressures, as underlying figures point to an annualized pace of ~3.0%, compared with the midpoint target of 4.0% set for 2020. In the wake of the rising but still uncertain impact of the coronavirus on Brazil's economy, we increasingly believe that our 2020 and 2021 IPCA forecasts of 3.1% and 3.7%, respectively, could see downside, assuming that the current fiscal framework will remain in place (and unscathed).**
- **This week, Congress overrode a presidential veto on a bill that intended to increase spending with welfare payments — a fiscal setback to the federal government. Although the administration still could uphold its veto through judicial channels, lawmakers, nonetheless, sent a strong message to the executive branch. While maintaining the baseline scenario of continuity in the reformist agenda, we recognize the recent increase in the execution risks for the fiscal adjustment process.**

Market commentaries: The substantial deterioration in global risk appetite and increased noise on the fiscal front severely hit the local rates market this week. These events led to a (much) steeper curve, prompting an increased likelihood of a more cautious monetary policy stance, as priced in by short-term futures. At March 12 closing prices, DI futures were pricing in a flat Selic rate following next week's Copom meeting (in line with our call). The long end steepened strongly, with Jan'29s approximately 230 bps wider in the week to Thursday's close (at the time of writing, following the March 13 opening, a relief rally has offset about two-fifths of that move). A strong increase in country risk (5-year CDS spreads surged to 309 bps as of the March 12 close, from a 92-bp low three weeks earlier) and the equity markets' poor performance, leading to mandatory risk unwinding among funds and banks, helped exacerbate the move, in our view. The National Treasury's large (approximately BRL11 billion) repurchase auction, covering both linkers and fixed rate bonds, helped to ease market tension.

Looking ahead, under any assumption of calmer markets in the short term and our current scenario of a "low for long" policy rate, valuations look attractive, in our view, even at the front end. Jan'21/Jan'22 forward rate agreement (FRA) closed at 7.22% on March 12, implying a premium of more than 250 bps over our current expected carry path (with the Selic gradually raised to 5.50% by YE2021). We believe appetite for duration will remain subdued for a while, given that: (i) global risk sentiment seems far from healthy, as the economic effects of the coronavirus continue to spread; and (ii) caution about the fiscal outlook will remain in place until we see more clarity on the mending of the relationship between administration and Congress. Thus, we hold our view that the curve should remain quite steep for some time, until conditions are there for the BCB to start incorporating in its reaction function the virus scare-induced damage to economic activity and inflation (i.e., paving the way for more rate cuts).

Monetary policy: On Wednesday, March 18, the BCB is scheduled to announce its monetary policy decision. Amid a sea of uncertainties due to the economic impact and aftershocks from the coronavirus outbreak, as well as a recent local noise on the fiscal front, we expect the BCB to hold the policy rate steady at 4.25% (an all-time low). Yet we recognize this is a (very) close call.

On the back of a substantial increase in economic uncertainty and market volatility, the BCB policy guidance has vacillated in an attempt to keep pace with the fluid (global and local) circumstances. In an extraordinary, in-between-meetings communiqué published on March 3, the BCB revealed that they now believe the coronavirus is more likely to materialize as a deflationary shock. In the previous Copom statement (and policy minutes), the BCB had left the message that the coronavirus outbreak could have an ambiguous impact on inflation (conditions and) outlook. At that time (i.e., of the last policy meeting), the BCB was signaling that interest rates would likely remain on hold for some time, as the effects of previously added stimulus (i.e., rate cuts of 225 bps since mid-2019) would be under watch.

In this recent announcement, the Copom seemed to indicate that it will continue to monitor the impact of the coronavirus on the inflation outlook in a phrasing that buys the authority a few degrees of freedom. A few days after that communication, BCB officials also clarified that the current stage of the cycle warrants “caution”. At that moment, the authority seemed to have reopened the door for a little more interest-rate stimulus.

Life is complicated, especially in turbulent periods such as this one. A turnaround (at least in sentiment, perceptions) came after a recent Congressional decision to override a presidential veto for an expenditure-generating bill. That Congressional decision entails a potential increase in mandatory expenses (entitlements), possibly creating ample difficulty for compliance with the constitutional spending cap ahead (see fiscal policy commentary below). This new event triggered greater risk perception about the execution of the (still incomplete) fiscal adjustment process, further fueling an ongoing sell-off of local assets (already in the making on the back of global developments). In our view, such a spike in macroeconomic risk premium (fueled by this risky fiscal step) does make the case for some BCB parsimony.

With the extent and size of the recent global and local shocks being a big unknown at this juncture, conditions around this monetary policy meeting remain quite fluid, and things could change rapidly of course. For now, we sense that the worsening macroeconomic risk locally will tend to dominate the (for now, mostly globally led) downside risks for the economy. That picture could change, depending upon how the executive and legislative branches will join forces to (signal and) keep the country on the path of fiscal reforms, with no back-tracking. If that is the case (maybe within a couple of months, in our view), then a tranquil outlook for inflation would likely prevail in the BCB’s mindset, in our view, amid hefty capacity slacks, slow-moving activity, anchored expectations and lower commodity prices (the latter could offset the pass-through from the USD/BRL spike to CPI).

Owing to the coronavirus-related shocks, we believe that activity and inflation expectations are poised to move south in coming weeks. In our view, that would impart downside risks for interest rates, especially for 2021, but that would be true only if fiscal consolidation becomes, once again, a priority for politicians and policymakers. In other words, we see a government-parliament agreement (to keep the fiscal adjustment in place) as a pre-condition for a few rate cuts of minimal speed (i.e., 25 bps per meeting) to materialize in coming months. That scenario would probably also lead to interest rate at even lower levels and for even longer, in our view.

Economic activity: Industrial production (IP) rose 0.9% MoM sa in January, topping our estimate (0.5% MoM s.a.) and consensus (0.6% MoM s.a.). Over a year ago, output fell 0.9%, better than our call (-1.4% YoY) and the Street’s (-1.3% YoY). Despite the positive result for that month, the sequential trend continues heading south.

The breakdown points to tepid growth among industrial sectors for January, as the diffusion index (measured as the percentage of industrial categories that posted monthly seasonally-adjusted expansion compared with December 2019) stood at 50.3%, near its historical average. Among categories, the highlight was the recovery in the production of capital and durable goods, which increased 12.6% and 3.7%, respectively, in MoM seasonally adjusted terms. These results reversed the 12.3% MoM s.a. and 4.4% MoM s.a. drops observed last December. Details also showed that mining segment continued to contract, despite the record-high oil production in January, owing to the decline observed in iron ore quarrying. As a result, the output of mining activities as a whole fell 3.1% MoM s.a. in that period, thus totaling a 5.0% QoQ s.a. drop in the three-month moving average ended in January.

Although January's industrial production did surprise positively, the output remains on a downward trend. On top of that, we still need to monitor local effects of the coronavirus outbreak to have more color on the size of downside risks for economic activity ahead. In sum, with the risk of input shortages and activity stoppages on the rise, we remain cautious about future dynamics of economic activity.

Inflation: The Brazil's official inflation index—dubbed IPCA—posted a 0.25% MoM gain in February, the slowest change for such a month since 2000. In seasonally adjusted terms, we calculate a 0.17% MoM move, fairly below the mid-target for 2020 translated into a monthly change (0.33%). This figure takes the annual change down to 4.00% from 4.19% in the previous reading, which is exactly the BCB's mid-target set for the end of this year. The headline result surprised analysts—including ourselves—to the upside, as both our estimate and market participants' consensual one pointed to 0.15% MoM, mainly on the heels of hygiene products—a segment that has been showing some atypical price volatility of late.

The monthly headline was pressured downward by volatile groups, such as foodstuff and fuel. The change in the electricity tariff flag—from yellow to green (meaning a full removal of additional charge collected usually in dry periods) also dragged energy costs down. All of these effects helped offset the (seasonal) February spike in school tuition costs.

Additionally, underlying inflation figures remain fairly tame, confirming the lack of demand-led price pressures. The IPCA EX3 (a core gage, including cyclical goods and services more sensitive to monetary policy swings) rose 0.25% MoM, with our calculations pointing to a 0.27% MoM gain in seasonally adjusted terms. These results keep the reading below 3% in YoY terms (to be precise, at 2.8%) and the quarterly sequential trend at similar level (2.9% QoQ—seasonally adjusted annual rate [saar]). The average of key core gages paints a similar picture: 3.0% YoY and 3.3% QoQ (saar).

Diffusion indices underscore our perception that there is a lack of widespread price increases across the (newly) revised IPCA basket: the all-item diffusion index stood at 49.3% (50.8% s.a., according to our calculation) and our own ex-food diffusion meter printed 47.4% (meaning 49.6% s.a.). The seasonally adjusted three-month averages for these indices stood at 51.8% (lowest since April 2018) for the headline and at 50.6% for the ex-food index (lowest level in our series that started in 2000). These readings are far below their historical averages (~62%).

All in all, data continue to herald a tranquil inflation scenario, amid a below-potential and slow-moving economic activity in tandem with anchored inflation expectations. Despite a conceivable pass-through from the significant BRL weakening seen in recent weeks (assuming these levels remain in place for some time) to CPI indices, the decline in commodity prices and downside risks to economic activity continue to feed expectations of net disinflationary pressures to come down the line. We do see a downward bias as per our IPCA forecasts for 2020 (3.1%) and 2021 (3.7%), assuming that the current fiscal framework will remain in place (and unscathed).

Fiscal policy and politics: Last Wednesday, Brazil's Congress overrode a presidential veto to bill PLS 55/96, which proposed raising the monthly household income limit required for granting welfare payments under the Continued Cash Benefit Program (BPC, acronym in Portuguese). This program focuses on low-income seniors and disabled citizens not eligible for regular retirement benefits. The threshold went to BRL523 from BRL261 (i.e., to half of the minimum wage instead of a quarter of its value). While 45 senators voted to override the veto in the Senate (41 were needed), 302 federal representatives voted to override it in the Lower House (257 were needed).

According to the government's economic team estimates, the decision to override the presidential veto should increase central government's primary expenses by BRL217 billion in 10 years (BRL20 billion already in 2021). That means a little less than a fifth of the total savings expected with the new pension system legislation (i.e., a constitutional amendment and anti-fraud measures). Our calculations indicate that the economic impact from the law approved may be slightly lower (around BRL17 billion per year). If implemented, that measure would pose high risks for the government to comply with the spending cap rule next year.

We see the refusal as a clear political setback for the federal administration in the midst of tensions between the executive and legislative branches regarding the execution of the budget. Importantly, the federal administration can still hold back implementation, since the expansion in mandatory expenditures arising from the new law was not accompanied by a compensation measure (neither a revenue-funding source nor the reduction of other public outlay). Hence, the government counts on some alternatives to question lawmakers' decision. Firstly, the government could challenge the legitimacy of the expenditure increase via an injunction to the Supreme Federal Court, arguing that lawmakers' decision did not abide by the Annual Budgetary Law (LOA, acronym in Portuguese), the Fiscal Responsibility Law (LRF, acronym in Portuguese) and/or that it violates the Constitution (Article 195, paragraph 5). Secondly, the government can send a new proposal to parliament's assessment aiming at changing again the income criterion for receiving the social benefit. The latter seems to be significantly more difficult given the current state of the relationship between the executive and legislative branches.

In our view, the most likely scenario is that the government's economic team will resort to a decision carried out by the federal audit court (TCU, acronym in Portuguese) that defined that any further public spending approved by lawmakers without an specific source of revenue cannot become effective. In this case, the government would buy some time—until the end of this year, when the 2021 budgetary law is due to be approved—to find a source of revenue to cover the extra spending or to negotiate a deal with lawmakers to mitigate or even eliminate the expenditure increase.

Our baseline scenario indicates that the difference between the expected primary spending and the constitutional spending cap is around BRL15 billion next year. Combined with the budgetary rigidity (especially from 2020 onward, because of the lower executive discretion power over the public budget), which could lead to a significant reduction of discretionary spending in order to comply with the cap. Consequently, higher risks of a shutdown in some public services could be the political pressure that leads to some leeway regarding to the spending cap rule, which would damage the economic sentiment about the Brazilian fiscal adjustment, in our view.

In our opinion, congressional representatives sent a strong message to the executive branch this week and the reaction from the presidency is likely to play a major role in the assessment of political and budgetary risks going forward. We continue to expect a convergence of the agendas, leading to approval (still in 2020) of an "emergency package bill" aimed at curbing mandatory expenditures. That would "guarantee" compliance with the spending cap rule until (at least) 2024 and provide some room for higher public investment. Nonetheless, we acknowledge that the balance of risks for the execution of the government's reform agenda has worsened in the short term.

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)
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