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Brazil Macro Compass

Authorities Strike Back (…on the Virus's Effects)

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- **Brazil's rates markets calmed down this week, requiring less intervention from the National Treasury. However, the curve steepness keeps hitting new highs, with term premiums apparently indicating fiscal concerns, given the necessary budget expansion to combat the effects of Covid-19. The more discretionary and focused the stimulus, the better the economic conditions for a post-coronavirus recovery, in our view.**
- **Dynamics in Brazil's FX market also "improved" a bit, owing chiefly to a slightly lower risk aversion following the announcement of the U.S.'s fiscal package to support American households and the corporate sector. We expect market participants to remain focused on the unfolding pandemic (here and abroad), with the BRL still subject to a volatile environment despite the implementation of countercyclical measures (here and abroad).**
- **This week, The Brazilian Central Bank (BCB) strongly indicated its readiness to support the economy and financial system, as the impact from the Covid-19 outbreak manifest, likely in a deflationary fashion (in our view and the BCB's). On one front, the BCB (pre-emptively) took steps on regulatory and macro prudential fronts to maintain a well-functioning financial system and provide market liquidity (both credit and FX). On the monetary policy front, we expect the BCB to cautiously introduce a bit more stimulus, as it sees deflationary pressures on the one hand, with developments in transmission mechanisms (notably the yield curve) on the other. Our baseline continues to anticipate another rate cut of 25 bps, with our year-end Selic rate forecast kept at 3.50%. We still see the mounting fiscal risks in the medium term as a limiting factor for a much bolder action on the policy rate front.**
- **In the wake of the impacts of the Covid-19 on the Brazilian economy, further emergency relief measures were announced this week. On the fiscal side, the Lower House approved on Thursday a three-month aid to informal workers, entrepreneurs and low-income unemployed. According to preliminary estimates, this one-off measure will cost nearly BRL 50 billion to the central government for fiscal 2020.**
- **January economic activity (hard) data, released this week, were quite positive, confirming our expectation. However, these data are pre-coronavirus crisis and, therefore, do (almost) not help to assess the course of Brazilian GDP growth in 2020. Nonetheless, initial March indicators (soft data) were known and showed that the Brazilian economy is likely to be hard hit by the outbreak.**
- **March's mid-month inflation preview (IPCA-15) posted the lowest result for the month since the beginning of the *Real Plan*: +0.02%, consistent with +3.67% YoY. Core inflation keeps trending way below the target. 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 3.0% and 3.5%, respectively, face downside risks, assuming that the current fiscal framework will remain in place.**
- **Despite an increased annual current account deficit in February (to 2.9% of GDP, from 2.7%), we maintain our assessment that this topic will move off the market's radar this year after an anticipated slump in imports (as well as dividend remittances), owing to the impact of the coronavirus outbreak on domestic demand (particularly investments). We expect March's trade balance figures, slated to become public next Wednesday, to likely show a positive outcome (we forecast a USD3.6 billion surplus).**
- **Public sector accounts for February 2020, due out next week, will not be useful in evaluating the dynamics of Brazilian fiscal policy this year. We expect a large batch of emergency fiscal measures aimed at relieving the (potentially unprecedented) economic shock due to the rapidly spreading coronavirus, leading the government's primary deficit to increase much more than previously anticipated. It would be best, in our view, if this fiscal expansion is temporary, preserving the fiscal consolidation framework already in place.**

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Local market conditions - rates: Price action remains choppy in the local rates market, though less so than last week. The pressure from forced liquidations seems to have abated, with the National Treasury buying back only BRL2 billion in sovereign bonds (month-to-date intervention adds up to BRL33 billion). Long rates made new closing highs on March 23 (with Jan'27s hitting 9.87%), before collapsing throughout the week, though still underperforming the belly, resulting in a steeper curve. Week to the closing of March 26, Jan'22s, Jan'23s, and Jan'27s plunged, respectively, 141 bps, 149 bps, and 137 bps, respectively. The Jan'23s/Jan'27s spread skyrocketed to 208 bps, a new multi-year high. The short end of the DI curve remains pricing in a new rate cut (of around 30 bps) in May, but term premium remains relatively high beyond that. We keep favoring receivers shorter than the Jan'22s, given our scenario of low inflation, no rate hikes anytime soon, and high uncertainty about how the ongoing crisis may damage the current fiscal framework.

Local market conditions - FX: The dynamics of the Brazilian FX market also "improved" a little, focused on the international news flow and chiefly the sizeable U.S. fiscal package to support American households and the corporate sector. After initial setbacks—the package was rejected twice by Democratic senators—U.S. lawmakers finally approved the US$2.0 trillion support to the U.S. economy, which in tandem with a bold announcement made by the Fed—the US monetary authority decided to launch an open-ended purchase program of financial assets that will include even corporate debt—and signals conveyed by officials of main advanced economies/blocs ensuring the provision of further liquidity support to their regions led the BRL to recede from its highs. As a result, the Brazilian FX rate traded below the USD/BRL5.00 symbolic threshold, notwithstanding the downbeat flow of news related to the Covid-19 outbreak on economies in general—Brazilian confidence indices have plummeted and U.S. labor market data have unveiled dismal numbers. At the time of writing, the BRL was back at ~BRL5.10/USD. In our view, market participants should remain focused on the unfolding of the pandemic and, consequently, the Brazilian currency continues to be subject to a volatile environment — notwithstanding the launch of countercyclical measures by authorities both here and abroad.

Monetary policy: Early this week, the BCB published the minutes from last week's Copom policy meeting, occasion where the authority cut the Selic policy rate by 50bps to 3.75%, a new historical low. On the scenario assessment, the BCB continues to see underlying inflation "running at levels compatible with meeting the inflation target at the relevant horizon for monetary policy." Activity was seen on a gradual recovery path, as expected, before the novel coronavirus outbreak. The incoming data before this massive shock (e.g., for January) is seen bearing "little relevance to prospective analysis." The output gap was also believed to be gradually closing before the crisis, according to the BCB. But that has since changed: in the authority´s view, "measures of economic slack have become dated" (par. #11 and #12). The BCB also provides a detailed assessment of the global context and the impact of Covid-19 on Brazil (par. #13), seeing a rapid change in the international environment for EMs from "favorable to challenging", on the heels of a higher risk aversion and "substantial tightening of financial conditions." According to the BCB, "fiscal and monetary measures adopted by the key economies tend to mitigate only a small share of these effects."

The minutes also reveal internal discussions on potential effects of the pandemic on the Brazilian economy and inflation outlook (par. #14 and #15). The committee refers to three channels of transmission: (i) a supply shock, owing to "interrupted production chains", seen with "small quantitative importance" given the closeness of the Brazilian economy and, consequently, the minor interconnection with global production chains; (ii) a shock in production costs, on the heels of lower commodity prices and a weaker exchange rate, seeming to imply "a strong disinflationary impact in the short term" and to "be put into perspective" for longer horizons, given the volatility of raw material costs measures in local currency; and (iii) demand shortage, caused by "uncertainty and the restrictions imposed by the pandemic", which could be substantial and "quite significant at the relevant horizon for monetary policy", according to the Copom. This underscores the assessment that the Covid-19 shock will be of a disinflationary nature in Brazil.

In terms of policy guidance, the BCB highlights that "(…) According to simulations presented at the Copom meeting, (…) it would be necessary to reduce the policy rate by more than 0.50 percentage point" to offset the aforementioned demand impact from the Covid-19 outbreak. This naturally raises the question: why then has the BCB not acted more aggressively? In the committee's view, a bolder move (i.e., cutting more than 50 bps) could "become counterproductive and (…) result in tighter financial conditions, thus leading to the opposite desired effect" (par. #17). In fact, the BCB believes that a scenario with "deterioration of the external scenario, the frustrations regarding the continuity of the reforms and the possible permanent changes in the public accounts adjustment process, may threaten the fall in structural interest rates observed in recent years" (par. #16). In other words, the risks of fiscal deterioration amid such a turbulent global backdrop could put upward pressure in neutral rates, according to the BCB´s view, worsening the balance of risks and reducing the theoretical space for even bolder rate moves.

While the Copom continued to indicate a flight plan with no imminent cuts (by judging that "the maintenance of the Selic rate at its new level as appropriate"), the authority continues to grant itself freedom to change its mind, claiming that "new information on economic conditions will be essential to determine its next step". Amid market discussions on the effectiveness of interest-rate cuts amid spreading news of lockdowns in the Brazilian economy, the BCB also states that

additional stimulus is indeed effective, as it could help prompt "accelerating economic recovery when the restrictions imposed by the pandemic start to be lifted" (paragraph #18). Importantly, the Copom clarifies that "the greater variance in the balance of risks does not necessarily imply gradualism in the conduct of monetary policy, but that the magnitude of forthcoming monetary policy decisions is subject to greater uncertainty" (paragraph #19). This paragraph seems as emphatic as could be on the possibility of new cuts ahead. But those may probably hinge on soothing local market conditions and a less noisy fiscal outlook for the medium term. Combined, these claims seem to convey a message that new cuts are still a near-term possibility.

Monday´s announcement of the Copom minutes was complemented with a press conference by Governor Roberto Campos Neto. At the occasion, the authority announced, listed and quantified regulatory and macro prudential measures undertaken to maintain the smooth functioning of financial markets and the financial system. This robust and effective BCB response to the local (economic, financial) impacts of the coronavirus outbreak includes many initiatives that aim to provide market liquidity, which the BCB estimates at an effect of about BRL1.2 trillion. These efforts should be seen as complementary actions to the standard monetary policy tools already being used to attenuate the effects of the virus on the Brazilian economy.

Later on the BCB also published its 1Q20 inflation report, completing the set of formal communications. Amid (what the BCB considers) greater than usual uncertainty following the macro effects of Covid-19. One of the key attractions of the report – the BCB's inflation simulations – ended up on the back burner this time. In the press conference, BCB officials emphasized the greater role of the balance of risks (i.e., the distribution of probability of inflation outcomes) vis-à-vis the baseline scenarios tested (i.e., the point-estimates for each simulation) for the key policy horizons, in the determination of the next policy steps. Having made this important caveat, the BCB numbers point to inflation figures below the center target for this year and next (the focal policy horizons). In the scenarios now considered more carefully by the authority (as mentioned in the press conference) - with a stable exchange rate at BRL4.75/USD all the way up to YE2022 - the BCB simulates IPCA at 3.0% (2020), 3.6% (2021) and 3.8% (2022), when assuming a stable Selic rate all the way at 4.25%. Assuming a Selic rate path according to median economists' forecasts (3.75% for YE2020, 5.25% for YE2021 and 6.00% for YE2022), the BCB simulates IPCA at 3.0% (2020), 3.6% (2021) and 3.5% (2022). In sum, the cold numbers say that there could be limited space for the BCB to cut rate in a baseline scenario with flat BRL and GDP level. Especially given that the authority that will continue to see a moving policy horizon toward YE2021 (a horizon for which the inflation is seen narrower). However, the fact that we expect GDP forecasts to be further revised downward and that the balance of risks will continue to evolve in a disinflationary pattern—as the crisis' epicenter and aftershocks unfolds—mean that the theoretical (i.e., demand-supply driven) space for rate cuts will probably increase down the road.

Another usual attraction of the inflation report is the BCB studies on relevant themes for the moment. No wonder, one of the key boxes dealt with the Covid-19 outbreak, showing the fast deterioration and larger dispersion of GDP forecasts in the wake of the outbreak, amid great uncertainty about its impacts. In a box focused on inflation, BCB calculations show that supply shocks—notably in protein prices—added 1.2 p.p. to the annual IPCA headline (4.31%, vs target of 4.25%). A complementary box to that one points to a faster and large pass through than usual of higher meat prices at wholesale, which took place in only a month, and implying a partial anticipation to 2019 of inflationary pressures expected for 2020. There is also a couple of noteworthy boxes on monetary policy: one deals with a new index of financial conditions developed by the BCB, which improves forecasts for economic activity: the recent deterioration trend in this index clearly ill for upcoming growth trends, in our view. Another box discusses and provides evidence of the increased power of monetary policy, both through econometric evidence, pointing to greater sensitivity of non-earmarked lending to changes in the policy rate, as well as a semi-structural model, indicating a greater effect of Selic changes on inflation. Yet the discussion on the power of monetary policy – which previously meant how strong the economy would react to previous stimulus – is to be put on hold for some time (i.e. at least until the health crisis is over).

Government policy: In the wake of the impacts of the Covid-19 on the Brazilian economy, further emergency relief measures were announced this week. On the fiscal side, the Lower House approved last Thursday a three-month aid to informal and autonomous workers, entrepreneurs and low-income unemployed. The voucher value was raised from BRL200 (original proposal sent by the federal administration) to BRL600, limited to two installments per family. Women who are breadwinners in their families will receive BRL1,200 per month. According to preliminary estimates, this one-off measure will cost the central government nearly BRL 50 billion for fiscal 2020. The Senate should pass the bill quickly (by the beginning of next week, in our view). The government's economic team continues to formulate new measures aimed at relieving the economic impact of the coronavirus outbreak, particularly focused on the maintenance of jobs and provision of liquidity to businesses. For instance, the federal administration will likely announce a package for easing labor relations, combined with compensation payments for: (i) workers who have their work hours and wages reduced by companies (up to 50% in most cases, possibly up to 65% for the sectors most severely hit by the crisis); and (ii) workers affected by the temporary suspension of job contracts (up to two months). Moreover, the government is poised to massively use state-owned banks to expand credit supply along with government-backed loans to corporates.

Economic activity: This week, several economic activity data for January 2020 were released. On Tuesday (March 24), the IBGE's Monthly Retail Survey (PMC) reported weak sales in January, confirming the expectation of maintenance of the slowdown trend observed since November 2019. Core retail sales drop 1.0% MoM in seasonally adjusted terms (sa), in line with our forecast (-1.0% MoM sa) and below market consensus (-0.4% YoY). Compared with January 2020, there was a 1.4% YoY growth.

Still regarding the core retail sales, we highlight that the QoQ sa growth dropped to 0.0% in January, down from 0.8%. This slowdown in the retail sales noticed in January was, in our view, largely expected once the temporary stimulus increase in income owing to withdrawals from FGTS (private workers' mandatory savings fund) has being concentrated in the 4Q19 and therefore are no longer stimulating Brazilian economy. Hence, among categories, we point out "Furniture and Appliances" and "Office Equipment and Supplies",- registered a 1.9% MoM sa and 1.6% MoM sa fall respectively, possibly, in our view, suggesting a payback from previous gains led by the release of FGTS funds.

As for the broader picture, which includes sales of building materials, vehicles, and auto parts, the 0.6% MoM sa growth was well above our forecast (-1.8%MoM) and market consensus (-0.5% MoM sa). In comparison with January 2019, the broad retail gauge 3.5% YoY growth and in the quarterly comparison there was a 0.2% QoQ sa fall. This positive figure was a big surprise that can be explained mainly by the sharp 8.5% MoM sa increase registered by "Vehicles & auto-parts," while we expected a large contraction of this categories due to the coincident indicators released before.

On Wednesday (March 25), the IBGE's Monthly Service Survey (PMS) revealed that (part of) the services sector grew 0.6% MoM sa in January 2020, which was below our forecast (1.0% MoM) and in line with market consensus (0.5% MoM sa). Compared with January 2019, the sector grew 1.7% y/y; as per the quarterly dynamics, there also a slowdown in the pace of growth to 0.7% q/q sa down from 1.4% q/q sa in December. Similar to the trend of retail sales in the period, the slowdown is directly related to end of stimulus fostered by withdrawals from FGTS. Among categories, only the "Information and Communication Services," fell in the month (0.9% m/m sa). Therefore, all other categories registered monthly growth in January.

Finally, the IBC-Br (Central Bank economic activity index, viewed as a monthly GDP proxy) consolidated the economic activity data in January, as the indicator raised 0.2% m/m sa, somewhat below our forecast and market consensus. In comparison with January 19 the IBC-Br grew 0.7% and stayed stable in the quarterly comparison after registering 0.5% q/q sa growth in 4Q19.

However, these January data are pre-coronavirus crisis and, therefore, it does (almost) not help to analyze the course of Brazilian GDP growth in 2020, once again we reinforce that the magnitude and duration of the outbreak remains quite uncertain hence the situation requires continued monitoring. Nonetheless some March confidence indicators were released this week and could show what we might face in the next (few) month(s). First the Consumer Confidence Indicator drop 8.7% MoM sa reaching the lowest level since January 2017, among the components both Actual (-5.9% MoM sa) and Expectation (-6.9% MoM sa) fell sharply and the details shows that the medium income consumers are the most worried about the outlook. Second the Retail Confidence Indicator hit the wires and also showed a 11.7% MoM sa fall but, differently from the Consumer Confidence Indicator, the Actual component grew 1.4% m/m sa which can might be explained by a run to essential goods the days before the lockdown, while the Expectation component slumped 22.7%-lowest level since April 2016. Third the Construction Confidence Indicator registered a more gradual decrease of 2.2% MoM sa and last but not least, the Industry Confidence Indicator fell 3.8% MoM sa, the Actual component dropped 2.1% m/m sa and the Expectation component fell 5.5% MoM sa. These March confidence indicators got just some days of the Brazilian lockdown due to the coronavirus hence we expect to see worst figures for April. However, although it indicates a negative impact on economic growth, the hard data likely will not suffer as much as these soft data, in our view. Therefore, it is important to keep monitoring every data to be released.

Inflation: The Brazil's mid-month inflation preview—dubbed IPCA-15—posted a +0.02% MoM gain in March, the slowest change for such a month since the Real Plan (1994). In seasonally adjusted terms, we calculate a 0.05% MoM move, fairly below the mid-target for 2020 translated into a monthly change (0.33%). This figure takes the annual change down to 3.67% from 4.21% in the previous reading, lower than BCB's mid-target set for the end of this year (+4.0%).

Volatile groups, such as foodstuff and fuels, pressured the monthly headline downward. Additionally, underlying inflation figures remain 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 0.28% MoM gain in seasonally adjusted terms. These results keep the reading below 3% in YoY terms (at 2.8%) and the quarterly sequential trend at similar level (2.9% QoQ—seasonally adjusted annual rate [saar]). Core Services drop 0.01% MoM; 0.06% MoM gain in seasonally adjusted terms. The all-item diffusion index stood at 46.7% (54.0% s.a.,

according to our calculation) and our own (ex. food) diffusion meter printed 43.5% (meaning 49.9% s.a.). These readings are far below their historical averages (~62%).

All in all, the data continue to point to 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 per our IPCA forecasts for 2020 (3.0%) and 2021 (3.5%), assuming that the current fiscal framework will remain in place (and unscathed).

Balance of payments: The Brazilian February's current account deficit (CAD) came in slightly higher than our forecast (USD3.9 billion vs our forecast of USD3.5 billion) owing to larger payments of interests on external debt than we anticipated. As a result, the CAD climbed to USD52.9 billion in 12-month-to-date terms (2.9% of GDP) as compared with the USD49.5 billion level (2.7% of GDP) observed at YE2019. We keep our assessment that the CAD will soon cease to be a source of concern for market participants, as it will become clear that its deterioration pace would not be as fast as some players were previously thinking of. In our view, CAD components did not show any influence related to the coronavirus pandemic yet, which means signals of the contraction we now expect the CAD to show in 2020 as compared with 2019 (to USD36.0 billion from USD49.5 billion, respectively) are yet to materialize. However, the review of external sector data displayed by the BCB in its quarterly inflation report indicates that we are not the only ones assuming that the coronavirus should lead the CAD to shrink this year (the BCB estimates the CAD to reach USD41.0 billion in 2020 or 2.5% of GDP). On top of the likely decline that we—and a mounting number of pundits—expect the CAD to show this year, it is also consensual that, albeit lower, foreign direct investments should continue to be more than sufficient to finance that gap (we concur with the BCB's forecast of a net inflow of USD60 billion for this year), which should ease market participants' minds regarding the robustness of the Brazilian balance of payments.

Next week: The firsts February (still pre-coronavirus crisis) activity indicators will be published. First the National Households Survey will be released on Tuesday, and we expect the unemployment rate to remain stable at 11.5% in seasonally adjusted terms (11.7% up from 11.2% in the original series). Second, on Wednesday, we expect the Monthly Industry Survey to present negative figures with a 0.2% MoM sa drop (-2.0% YoY).

As per the external accounts, barring for operations related to either import or export of oil platforms—nobody knows when those will happen—March's trade balance is likely to register a USD3.6 billion surplus, which is an outcome that is compatible with our forecast for the USD29.8 billion positive imbalance we project for the year as a whole–as compared with the USD48.0 billion in 2019. If our forecast proves true, trade balance will have amassed a USD5.0 billion surplus in 1Q20, which is nearly half of the USD10.5 billion in 1Q19. Though, it is important to note that when one factors out oil platforms from both sides, this year-on-year discrepancy in Q1 is much smaller (USD8.2 billion vs USD10.3 billion in the same comparison). Trade surpluses should get larger in the coming months as Brazilian crops—especially of soybeans—are going to be dispatched abroad.

On Monday (March 30), The National Treasury Secretariat (STN, in Portuguese acronym) will unveil the central government's primary result for February 2020. We estimate a monthly deficit of BRL 25.2bn, following the remarkable primary surplus of BRL 44.1 billion registered in January, which was mostly explained by atypical and temporary factors (e.g. sharp expansion in income tax and contribution on net profits in the wake of asset sales carried out by state-owned companies, in addition to the low pace of expenditure execution). The absence of meaningful non-recurring revenues combined with larger transfers to regional governments (influenced by the aforementioned unusual revenues in the previous month) are the main reasons behind the more pronounced central government's primary deficit in February 2020 compared to the same month last year (-BRL18.2 billion). Regarding the expenditure side, we believe that the pace of execution of primary spending remained low in February, reflecting uncertainties related to the public budget management in a context of greater control by Congress.

Furthermore, the Central Bank of Brazil will release the consolidated public sector's fiscal accounts for February – it includes the federal government, regional governments and state-owned companies – next Tuesday (March 31). We expect a monthly primary deficit of BRL23.2 billion, with the following breakdown: -BRL 25.9 billion for the federal government; BRL 2.6 billion for states and municipalities; and BRL 0.1 billion for state-owned companies.

We acknowledge that February data are not useful for assessing the dynamics of Brazilian fiscal accounts in 2020, since we expect a large bunch of emergency fiscal measures to relieve the (potentially unprecedented) economic shock and mitigate systemic risks due to the rapidly spreading coronavirus, leading to a sharp expansion of the primary fiscal deficit in the coming months. On this matter, we believe it would be best if this year's fiscal expansion focuses on the core of the problem, maintaining the fiscal consolidation framework in place. On the bright side, the economic team has emphasized the need to preserve the constitutional spending cap, which is currently the most important anchor for fiscal

policy and the Brazilian economy, in our view. The more intact the fiscal framework, the stronger the economy when a recovery (from the coronavirus outbreak) takes place.

HIGHLIGHTS

Indicator	Estimate	Consensus	Prior
Central Govt's primary fiscal balance Feb20	-BRL25.2bn	- -	BRL44.1bn
Public Sector's primary fiscal balance Feb20	-BRL25.9bn	- -	BRL56.3bn
Jobless rate Feb20 (nsa)	11.7%	- -	11.2%
Trade balance Mar20	USD3.6bn	- -	USD3.1bn

Recent Publications (Available on Our Website)

- *FX Compass – BRL: It's more than solely the Covid-19* (March 26, 2020)
- *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)

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