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Brazil Macro Compass

A (bit) less nerve-wrecking week.

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- **After reaching a new historical high a week ago, the BRL showed decent strengthening in the last few days, owing mostly to developments on the international front, such as the minutes of the last FOMC meeting and expectations of a positive outcome in the OPEC+ gathering on Thursday afternoon. As a result, the USD/BRL cross is currently trading below USD/BRL5.10, far stronger than the USD/BRL5.35 close level of last Friday.**

- **A pro-risk sentiment abroad determined the movements in local yields this week, as a bull-flattening took place even amid signs of parliamentary initiatives that could bring risks to Brazil's fiscal consolidation process. We continue to see fluid global conditions (amid uncertainties related to the coronavirus pandemic, both in the realm of health and economics) and risks to the fiscal policy and macro reform outlook. Thus, we expect the local yield curve to remain considerably steep for some time.**

- **February activity data, released this week confirmed the gradual recovery that we were expecting for this year. However, retail sales and service sector figures referred to the pre-coronavirus and, therefore, they barely help us assess the actual course of Brazilian GDP growth in 2020.**

- **March's IPCA posted a weak 0.07% MoM change (our projection: 0.14%), and its breakdown underscored our assessment that Brazil's economy was already running under conditions that indicated a lack of demand-led price pressures. Additionally, the release also brought incipient signs of (what we believe will be) a deflationary impact of the coronavirus on the economy.**

- **This week's legislative agenda has been marked by intense discussions on the so-called "war-time budget" and emergency measures for states public finances. Regarding the former, the lack of consensus led senators to postpone until the next week the analysis of a constitutional amendment proposal that creates a temporary separate fiscal budget, suspends fiscal constraints (imposed by the Fiscal Responsibility Law) and allows Brazil's Central Bank (BCB) to purchase public bonds and private financial assets (during calamity situations).**

- **By the same token, owing to dissent among representatives, political party leaders decided to assess the so-called Mansueto Plan following decisions on measures related to the crisis, since its original structural approach clashed with the emergency provisions intended to grant more fiscal relief for states and municipalities in the short-term. We estimate a fiscal impact of ~BRL175 billion (2.4% of GDP) if this new bill successfully passes through Congress in its current form. In our view, fiscal risk perception could rise significantly if these short-term relief measures are not accompanied by transparent and credible counterweights. The Lower House is expected to debate (and maybe vote) on this matter next week.**

Local market conditions — FX: In our opinion, market participants have taken recent news with a pinch of optimism that led global financial asset prices to improve in recent few days. The BRL was no exception. After having breached the USD/BRL5.30 threshold, reaching a new historical high of USD/BRL5.35 last Friday, the pair receded to ~USD/BRL4.07 at the time of this writing. Abroad, the minutes of the last FOMC meeting confirmed member wariness of the disruption that the pandemic could inflict on the U.S. economy, thus justifying the prompt responses carried out in two unscheduled meetings. Moreover, it reinforced general perception that the U.S. monetary authority will resort to a myriad of instruments to support financial markets, even if that means creating new ones. Moreover, sanguine commentaries by Algerian authorities regarding the likely result of the OPEC+ meeting this afternoon helped oil prices improve somewhat, thus bringing some respite to the global energy sector and, consequently, to the corporate sector as a whole. Last but not least, on the international front, this week also U.S. Senator Bernie Sanders suspend his presidential campaign, thus paving the way for former U.S. Vice President Joe Biden to be the presumptive Democratic presidential nominee, challenging President Trump's reelection bid. The suspension reduced—at least for now, in our view—fears about the outcome of US presidential election, as the platforms of both likely candidates could be perceived as less disruptive to financial market than a Sanders' candidacy.

Adding to these external developments, statements by BCB Governor Campos Neto also helped the BRL strengthen owing to his relatively hawkish tone regarding next moves on the monetary policy front (more details in the following section), as well as to his avowal to intervene heavily in the FX market, if necessary, as he believes the country has a comfortable cushion of international reserves among other instruments. As it has become clear lately—at least, it should have already been so, in our opinion—market participants should not take the statement as a BCB's attempt to defend a preset level for the BRL but rather as a commitment to ensure the well-functioning of the FX market. That is, the Brazilian monetary authority will forestall dysfunctionalities from arising but will not prevent the BRL from following its trajectory according to financial conditions and Brazilian economic fundamentals. Then, for the coming weeks, as we expect the COVID-19 uncertainties to (unfortunately) remain in place for while more, financial conditions should also continue to be wobbly, in our view, which means the FX rate could remain volatile.

Local market conditions — rates: The pro-risk sentiment abroad also determined the movements in the local yields this week, as a bull-flattening took place even amid parliamentary initiatives that could bring risks to Brazil's fiscal consolidation process (see our fiscal policy section below). In our view, macro and fiscal reforms will be even more necessary in the aftermath of the COVID-19 crisis. In the short end of the yield curve, market participants continue to count on a 50-bp policy rate cut in the next Copom meeting, with a probability around 80% already priced in. The Jan-21 DI future has been roughly stable for the week (~3.15% by at the time of writing), as the March IPCA release confirmed a deflationary shock in place and added to an already favorable inflation backdrop. In the back end, the Jan-25 DI future fell 60 bps for the week (trading around 6.60%, at the time of writing), probably, in our view, on the heels of same drivers that caused a rally in Brazil's country risk (as 5-year CDS tightened by 80 bps, to 274bps). Despite this constructive movement in recent days, we continue to see fluid global conditions (amid uncertainties related to the coronavirus outbreak, both in the realm of health and economics), as well as higher risks for the fiscal policy and macro reforms outlook. In other words, although probable BCB rate cuts may continue to support the short end, the back end will probably remain under pressure on the heels of persistent uncertainties, in our view. Thus, we expect the local yield curve to remain pretty steep for some time.

Economic activity: This week we had the release of some activity data for February 2020. Last Tuesday (April 7), the IBGE's Monthly Retail Survey (dubbed PMC) reported growth in both concepts of retail sales, as core retail sales grew 1.0% MoM in seasonally adjusted terms (sa), above our forecast (0.6% MoM sa) and its broader gauge—which factor in the contribution of building material stores and vehicles and auto-parts' dealers—expanded 0.7% MoM sa (in line with our forecast of 0.5% MoM sa increase). Compared with February 2019, core retail sales recorded a 4.7% YoY growth and its broader expanded 3.3% YoY.

Taking a more thorough look at the core retail sales, we highlight that the moving QoQ sa growth dropped to -0.6% in February, down from 0.0% observed in the quarter ended in January. This slowdown trend in retail sales noticed in February was, in our view, largely expected once the temporary stimulus granted to income owing to withdrawals from FGTS (a private workers' mandatory savings fund) was concentrated in 4Q19; therefore, it is no longer stimulating the Brazilian economy. Nonetheless, February figures were above our expectation regarding the level of growth and composition. Among categories, we point out that "Hypermarkets", "Fabrics and Clothing", "Furniture and Appliances" and "Other items", registered a combined expansion of 1.5% MoM sa. Those categories represent almost 80% of core retail sales and possibly, in our view, suggest a payback from the drop observed in January.

As for the broader picture, the positive monthly reading was somewhat expected because there was an expectation (confirmed) of increase in the core retail sales and also in "Vehicles & auto-parts". Nevertheless, the virtual stability of "Building Materials" disappointed, as we forecasted growth in this category. Despite the high volatility of this segment, the 0.9% QoQ sa fall in February frustrate our expectation once it indicates that the building sector did not start 2020 at a strong pace of expansion.

Then, on Wednesday (April 8) the IBGE's Monthly Service Survey (PMS) showed that the service sector dropped 1.0% MoM sa in February 2020, which was well below our forecast (0.1% MoM sa). Compared with a year ago, the sector grew 0.7% YoY and, as per the moving QoQ sa dynamics, there was a 1.4% contraction in February as compared with a 1.4% QoQ sa growth in December 2019. Among the categories, the main surprise was the 0.9% MoM sa drop of "Professional and Administrative Services", which led it to one of the lowest levels of its historical series. Still regarding this category, the moving QoQ sa dynamics also showed a strong deceleration process (a 2.3% QoQ sa contraction in the quarter ended in February). On the other hand, the category "Transportation Services" showed a 0.4% MoM sa increase, which indicates that the record grain harvest the country yielded this year has begun to flow to ports, in our view.

Although presenting mixed signs when we look at their monthly performances, those results confirm the gradual recovery trend that we had expected for 2020. However, these data are related to a pre-coronavirus environment and, therefore, they should barely help us to assess the course of Brazilian GDP growth in 2020.

Inflation: Brazil's official inflation index (IPCA) posted a 0.07% MoM change in March, which translated into a 3.30% YoY change–below the 4.00% YoY print seen in the previous reading, which coincides with the BCB's mid-target set for the end of this year. The headline result surprised both us and the other market participants, as our estimate pointed to a 0.14% MoM increase (pretty close to the median of market participants' estimates of 0.13% MoM), mainly on the heels of hygiene products—a segment that has been showing some atypical price volatility of late.

The monthly headline was downward pressured by groups whose inflation pattern is usually volatile, such as electronics and fuel. These segments helped offset the spike registered by "Food at Home", owing to the impact of lockdowns on the demand for items of basic basket food products. Anyway, underlying inflation figures remained fairly tame, confirming the lack of demand-led price pressures in the Brazilian economy. For example, the IPCA EX3 (a core gage, including cyclical goods and services that are more sensitive to monetary policy swings) rose 0.12% MoM, thus keeping inflation at 3% in YoY terms. As for the moving QoQ sa dynamics, the picture was pretty similar, pointing to 2.9% annualized inflation.

The all-item diffusion index stood at 58.1% (53.9% sa, according to our calculation) and our own ex-food diffusion gauge printed 49.8% (meaning 49.3% sa). The seasonally adjusted three-month averages for these indices stood at 51.3% for the headline and at 49.1% for the ex-food index (the 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 recently changed our IPCA forecasts for 2020 (2.2%) and 2021 (3.1%); for details see our April 6 report, *Covid-19: The Dominance of Uncertainty - Updating Brazil Forecasts*.

Fiscal policy and political environment: Due to lack of consensus, senators delayed the analysis of the constitutional amendment proposal known as "war-time budget" (PEC 10/20, acronym in Portuguese), which had been approved by the Lower House last week. A remote voting session in the Senate has been scheduled for the next week (April 13), since some lawmakers have questioned the possibility of a fast-track procedure in the legislative process involving the assessment of constitutional amendments. On the one hand, some senators claim this decision may establish a risky precedent in the future, whereas others are more concerned about the implementation of the BCB's asset-purchasing program. The bill authorizes the creation of a temporary separate fiscal budget to allocate all expenditures directed to mitigate the impact from the COVID-19 pandemic in Brazil and to suspend fiscal constraints like the so-called "Golden Rule" (according to which, government is allowed to borrow resources only to invest and not to fund current public spending) and revenue earmarking. Furthermore, the proposal allows the BCB to buy public bonds and private financial assets in order to stabilize financial markets. Despite the delay this week, we expect the PEC 10/20 to be approved by the Senate next week.

This week's legislative agenda has also been marked by intense discussions on measures for state public finances. The Fiscal Balance Plan (or simply the Mansueto Plan, named after Treasury Secretary Mansueto Almeida) originally proposed financial aid for states in exchange for fiscal austerity measures (e.g., a gradual reduction in payroll spending, decreased tax exemptions and the privatization of state companies) to promote long-term fiscal consolidation in subnational governments. Nevertheless, the COVID-19 pandemic led representatives to expand the scope of the proposal to include emergency provisions granting more fiscal relief for states and municipalities to alleviate the hit to regional public coffers in the coming months, which distorted the structural approach set in the original text. Given the lack of consensus among lawmakers, political party leaders decided to assess the Mansueto Plan after the pandemic crisis, focusing on another proposal aimed at providing emergency financial aid for regional governments in the short-term. This proposal includes financial compensation to offset lower tax revenue in states and municipalities, suspension of states' debt service payments to the federal government, debt renegotiations and higher debt limits for new loans also guaranteed by the federal government. We estimate a total fiscal impact of ~BRL175 billion (2.4% of GDP) if this proposal is enacted with its current content. This alternative bill will likely be brought to a (remote) vote next week after possible changes in the text, owing to remaining doubts and some discomfort in the federal government's economic team with the substantial fiscal impact from these supposedly one-off measures. In our view, market participants' perception on fiscal risk will possibly worsen significantly if these short-term relief measures are not accompanied by transparent and credible counterweights.

Next week: The IBC-Br (the BCB's economic activity index, viewed as a monthly proxy for the GDP) will be released next Tuesday, April 14, and will consolidate the set of February economic activity indicators. We estimate a 0.3% MoM sa growth in that period, meaning that if our forecast proves right, a 1.0% YoY increase in February. As for the moving QoQ sa dynamics, after a 0.6% in December, the IBC-BR would have receded to 0.0% in February, thus reinforcing the perception the Brazilian economy was pursuing a trajectory of gradual recovery before the emergence of COVID-19, which was compatible with our previous view. In Congress, the eyes will turn to the debates at the Lower House of a bill proposing financial aid to Brazilian states, and the Senate may vote on the "war-time budget" bill.

MACRO AGENDA

Indicator	Estimate	Consensus	Prior
BCB's Economic Activity Index Feb20 (Δ% MoM sa)	0.3%	0.2%	0.2%

Source: BCB

Recent Publications (Available on Our Website)

- *Covid-19: The Dominance of Uncertainty - Updating Brazil Forecasts* (April 06,2020)
- *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)

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