Santander
Corporate & Investment Banking

ECONOMICS

17 April 2020

Brazil Macro Compass

Brazil's Economy and Markets in the Time of the Pandemic: The Latest

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- **The international economic news flow has weighed on global risk appetite, and consequently, Brazil's FX market. Initial data releases related to March (e.g., U.S. retail sales) point to a profound contraction of global activity in the pipeline. As such, multilateral bodies have substantially revised down their global GDP growth forecasts for 2020 and 2021. In our view, these actions have paved the way for a reversal of BRL strengthening observed last week (at the time of this writing, the FX rate stood at USD/BRL 5.25, compared to USD/BRL5.11 a week ago).**

- **The yield curve continued to bull flatten this week, possibly owing to market anticipation of BCB actions in the local bond market in the wake of final approval of the so-called "War Budget" amendment (this amendment would grant the monetary authority temporary permission to buy government bonds and other securities). Looking ahead, we believe that a substantial short-term budget deficit (from the point of view of the government bond supply) and a murky fiscal medium-term outlook (from the standpoint of embedded risk premium) will be the prevailing factors for back-end yields in the coming weeks and months. In our view, this could limit the room for further flatness of the yield curve despite downside risks for the policy (Selic) rate and front-end yields.**

- **A diluted version of the emergency fiscal package for states and municipalities was approved by an ample majority in the Lower House this week, but we believe that political tensions surrounding the package could persist in the short term. The package, which aims to address the tax collection shortfall at the state and municipal level over the next six months, remains a controversial political talking point. In our view, the possibility of this measure being approved in the next couple of weeks (with potential adjustments made by senators) is a downside risk to our 2020 baseline scenario for the public sector's primary fiscal balance (which we currently expect the deficit to reach 6.2% of GDP).**

  The Senate approved this week a constitutional amendment known as "War Budget" (PEC 10/2020), which creates a temporary separate budget structure to allocate funds for costs incurred to combat the COVID-19 crisis; the amendment would also allow the Brazilian Central Bank (BCB) to purchase government bonds and private financial assets in order to stabilize financial markets. Following changes from senators regarding some rules for the bond-buying program, the proposal will return to the Lower House, where we expect a quick approval, implying that the measure would be enacted this month.

- **We expect the March balance of payment data (due next Friday, March 24) to point to a slightly lower current account deficit (on an annual basis) but unlikely a bellwether of things to come. Owing to recent developments related to the COVID-19 pandemic, we expect investor attention to turn to preliminary figures for April 2020 set to be released by the BCB. That data will be more useful in assessing the initial impact of the pandemic, which we believe could be negative on the balance of payments, on the heels of lower terms of trade and weaker external demand (and despite lower imports and dividend and tourism outlays).**

Local markets — FX: Although relatively in line with the median of market estimates, the 8.7% MoM seasonally-adjusted (sa) drop presented in the March 2020 U.S. retail sales survey (median estimate of -8.0% MoM sa), the indicator has confirmed that global economic activity is poised to registered a strong hit in the coming months owing to the fallout of COVID-19. Accordingly, multilateral bodies like the World Bank and the IMF have substantially revised their 2020 and 2021 forecasts for global GDP growth. The latter forecasts a 3.0% full-year contraction in 2020, followed by 5.8% full-year expansion in 2021. In October 2019, the expectation was for relatively steady expansion of ~3.5% for both years. That is, instead of running at an average pace of 3.5% in the current biennium, the IMF now expects the global economy to run at a speed ~60% slower (1.3% on average) versus its previous estimate. The IMF's announcement and the fledgling signs of a severe economic depression in coming months led to an increase in investors' risk aversion, thereby triggering a flight-to-quality during this week, in our opinion–an unfolding that does not favor the BRL.

In Brazil's case, the IMF's review was even worse, as the 5.3% full-year projected drop for 2020, combined with the 2.9% full-year projected expansion for 2021, resulted in an average annual contraction of 1.3% in the biennium. That is, Brazil's economy is now not expected to return to its pre-crisis level until mid-2022, in the IMF's view. Compared to our baseline scenario, these forecasts point to a much worse outlook, and look more similar to the downward alternative scenarios seen in our simulations. In any case, both sets of forecasts indicate a stronger average impact on the Brazilian economy than that expected for the rest of the world. This downbeat picture—both here and abroad—combined with tense circumstances on the Brazilian political front (for more details, see the "Fiscal Policy and Political Environment" section below) led the Brazilian FX rate to reverse last week's strengthening and inch closer to its historical peak (at the time of this writing, the BRL was trading at USD/BRL5.25, as compared to USD/BRL5.11 a week ago).

Local markets — rates: The yield curve continued to bull flatten this week. At the time of wirting, the front end (around the one-year zone) tightened about 15-20 bps, with Jan-21 DI futures trading at ~3.05%; the back-end (three-year segment and beyond) rallied around 40-50 bps, with Jan-25 DI futures standing close to 6.10%. Amid continued noise on the political front, clouding the outlook for much needed fiscal consolidation and macro reforms in the post-crisis, we see one possible explanation: market expectations that the BCB could implement some sort of "operation twist" in Brazil—that is buying aggressively longer-term government bonds in the wake of an expected approval of the "War Budget" (PEC10/20). While we particularly believe the BCB could use its new (temporary) mandate to increase focus on providing liquidity and making markets functional, rather than engaging in massive buying of Brazilian Treasury securities to intentionally pressure downward longer yields (for policy transmission purposes), market anticipation of BCB interventions could have put downward pressure on longer-term interest rates in recent days. The steepness of the curve (as measured by the Jan-25 vs Jan-21 gap) is clearly off recent peaks (490 bps as of March 23), even though the term structure remains much steeper than earlier this year (~300 bps now, vs. ~190 bps then).

Looking ahead, we believe that a substantial short-term budget deficit (from the point of view of the government bond supply) and a murky fiscal medium-term outlook (from the standpoint of embedded risk premium) will be the prevailing factors for back-end yields in the coming weeks and months. On one hand, we recognize downside risks for the policy rate outlook and the front end of the curve: while our "terminal" Selic rate forecast of 3.00% is nearly fully priced in, we recognize that further BCB cuts could eventually materialize if the length and size of the pandemic shocks in Brazil prove even stronger. On the other hand, we believe that the neutral rate could be facing upward pressures owing to a cloudy medium- to long-term outlook for government debt, and that the term premium could also be upwardly driven by both macro fundamentals and a massive bond supply in the future, limiting the downside for back-end yields. All in all, we do not see much room for a substantial and sustained flattening of Brazilian yields from current levels, especially if we assume the BCB will take a parsimonious approach on eventual buying of long-term government bonds.

Fiscal policy and political environment: On Monday, April 13, Congressional representatives sought middle-ground with the federal government's economic team regarding the emergency federal fiscal package for states and municipalities. Yet frictions about the type and size of stimulus are likely to persist in the coming days, in our view

The Lower House rapporteur's previously introduced proposal had raised further concerns of fiscal slippage, which were intensified by conflicting estimates of its fiscal impacts in tandem with a turbulent political environment. The authorization for states to take on new debt of up to 8% of their net revenue in 2019, which would be guaranteed by the National Treasury (implying a fiscal cost of around BRL55 billion), was the draft's main controversy, given the economic team members' assessment that new credit lines may fund public spending not necessarily limited to near-term fiscal relief. Then, a new version was presented this week that reduced the potential fiscal impact on the federal government (to BRL90 billion from around BRL140 billion, according to our estimate), since it has stripped out the aforementioned allowance for states to borrow and the possibility for states to suspend their debt service payments to the National Treasury. The emergency lifeline to regional governments was approved by an ample majority in the Lower House (431 to 70) and no topic in the new proposal was aggressively questioned by legislators despite the attempt of the federal government to change the provision aimed at compensating for the tax collection losses of the ICMS and ISS duties levied by states and municipalities, respectively.

While the federal government's economic team sought to transfer a fixed amount of resources to the subnational entities over the next three months (up to BRL40 billion), Congressional representatives approved the new draft with financial compensation for the next six months tied to tax collection levels (assuring that subnational entities will receive the same amount registered between April and September 2019). According to rapporteur's estimates, this provision would cost federal coffers approximately BRL80 billion, a much higher level than originally proposed by the federal government. Furthermore, officials from the Ministry of Economy fear that this measure may create incentives for regional administrations to give up on collecting taxes properly or even grant tax exemptions to local companies, owing to the (potentially massive) economic hit from the COVID-19 outbreak combined with the assurance that the national government will offset the entire loss of revenue from ICMS and ISS taxes. In short, the economic team fears that in the end this initiative could give state and municipality administrations a blank check.

The federal government could attempt to change this initiative in the Senate by limiting the amount of transfers, and even a presidential veto on the bill cannot be ruled out. However, we note that the proposal passed the Lower House with 431 members voting in favor and only 257 votes needed to overturn a presidential veto. We believe that political discrepancies between state governors and federal executive power concerning the shelter-in-place policies could exert some influence, albeit indirectly, on this standoff. If this measure is approved in the next couple of weeks (even with possible adjustments from senators), it would bring a downside bias to our current baseline scenario for 2020 public sector's primary deficit (which we currently expect to reach 6.2% of GDP).

The Senate approved this week a constitutional amendment known as “War Budget” (PEC 10/2020). The measure creates a temporary separate budget structure to allocate funds for costs incurred to combat the COVID-19 crisis and suspends fiscal constraints (e.g., the “Golden Rule”, according to which the government is allowed to issue public bonds only to finance capital expenditures). Furthermore, the proposal allows the BCB to purchase public bonds and private financial assets in secondary markets in order to stabilize financial markets.

Regarding the latter, the rapporteur of the proposal in the Senate made some adjustments to the draft previously approved in the Lower House, addressing senators' concerns over the scope of the bond-buying program. These adjustments clarified that financial private assets purchased by the BCB are required to have at least a “BB-“ credit rating status assigned by large rating agencies and must also have a reference price released by an accredited financial market institution. In addition, the rapporteur introduced provisions that require the BCB to publicize all its transactions on a daily basis and elucidate them to Congress every 30 days, as well as to provide an explicit description of the types of assets the monetary authority can purchase. Finally, the rapporteur's draft dropped the obligation for the Ministry of Economy to authorize the financial asset purchases and the requirement for the National Treasury to fund 25% of the transactions.

Since the constitutional amendment proposal was amended in the Senate, it will require another round of deliberations in the Lower House, which should be concluded (with approval and subsequent enactment of the measure) by the end of April, in our view.

Balance-of-payments: Next Friday, April 24, March external sector data is slated to be released and we expect the current account balance to have registered neither a deficit nor a surplus in the period, which would mean that the imbalance in 12-month-to-date terms has fallen to USD50.2 billion from USD52.9 billion in February. Additionally, if our expectation for a net FDI inflow of USD7.5 billion in March proves right, the volume amassed in 12-month-to-date terms will reach USD79.8 billion in 1Q20. Both pieces of data could misleadingly support views of a soother trajectory for the BRL this year, as it would suggest that there are more than enough resources to fund the expected CAD in 2020.

However, as presented in our April, 6 report *Covid-19: The Dominance of Uncertainty – Updating Brazil Forecasts*, we now anticipate a relative stable CAD in 2020 (USD50.7 billion), compared with 2019's USD49.5 imbalance, meaning a wider gap with respect to the size of the economy – expected to shrink markedly in USD terms. We also believe that net FDI inflow could decline to USD60 billion in 2020 from USD78.6 billion last year, which would mean a smaller cushion as far as CAD funding is concerned. In our view, however, market wariness about Brazilian balance of payments could intensify, assuming our scenario that there will be less abundant external credit. Hence, we expect the BCB's presentation of preliminary figures for April, which it normally release at the same the balance of payments report, should get more attention this time than it usually does.

Economic activity: The IBC-Br (the BCB's economic activity index, viewed as a monthly GDP proxy) consolidated the economic activity data in February, as the indicator was increased 0.4% MoM after seasonal adjustment, somewhat above our forecast and market consensus. In comparison with February 19 the IBC-Br grew 0.6% YoY and fell 0.2% QoQ in the quarterly comparison after registering 0.5% QoQ growth in 4Q19 in seasonally adjusted terms.

However, this February data is pre-coronavirus crisis; therefore, it does (almost) not help to analyze the course of Brazilian GDP growth in 2020, once again we reiterate that the magnitude and duration of the outbreak remains quite uncertain, hence requiring continued monitoring. Initial scraps of soft April data (likely to be the peak of economic activity fall in Brazil, in our view) were released this week. The preview of Brazilian confidence indicators reached an all-time low. The industry and service confidence indicators registered the biggest fall, at more than 40% MoM in April while retail, building and consumer confidence indices fell around 30% MoM. Last but not least, April's uncertainty index preview also has hit the wires, registering an all-time high of 211.6 pts, up 44% over March, which was already significantly above the previous peak of 136.8 pts in September 2015, when Brazil lost its investment grade. Confidence and leading indicators are providing an early sign of considerable deterioration in economic conditions, as supposed to be seen in hard (real activity) data from March onwards.

Next week: Shortened by a national holiday next Tuesday, the calendar of domestic economic events will count solely on external sector data for March (for more details, please refer to the previous section), which should intensify market attention to political news flow, in our view. On that front, we believe the appraisal of measures related to fight economic impacts of the COVID-19 will remain in the spotlight.

MACRO AGENDA

Indicator	Estimate	Consensus	Prior
Current Account Balance Mar/20 (US$ million)	$0.0	- -	- -$3,904
Foreign Direct Investment Mar/20 (US$ million)	$7,500	- -	$5,996

Source: BCB, Bloomberg and Santander.

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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