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Brazil Macro Compass

Market Conditions Worsen amid Uncertainties

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- **Owing chiefly to frictions on the political front, doubts about the Brazilian fiscal outlook and prospects for a looser monetary policy, the Brazilian currency tested levels above the USD/BRL5.70 threshold and it closed the week with the worst performance among major EM currencies (the BRL weakened 6.2% as compared with last Friday.**

- **In rates, a substantial bear steepening took place this week on the heels of political tensions and, consequently, a more blurred fiscal outlook. We still believe that a substantial short-term budget deficit and a murky medium-term fiscal outlook will be prevailing factors for back-end yields in coming weeks and months. Broader financial conditions will likely be less friendly for economic activity in the short term, in our view.**

- **A lower-than-expected deficit in the tourism account led March's current account balance to register a USD0.9 billion surplus, topping our estimate (zero deficit). The report shows the first impacts of the COVID-19 on the balance of payments, as well as preliminary figures for April 2020, which pointed towards a substantial decline in direct investment in the country.**

- **We forecast a 0.03% MoM change for April's IPCA-15 inflation (a mid-month preview). Downward pressures intensified by the pandemic should deepen further, with fuel costs and some cyclical prices posting negative changes. Methodological difficulties in gathering price information, amid a broad-based lockdown of the economy, should bring uncertainty to this release. In any case, this should be the last positive headline CPI change for the next three or four months. We see considerable downside risks for our annual IPCA inflation forecast for 2020 (currently at 2.2%).**

- **Next week, we expect March fiscal accounts to show a still-limited impact from the COVID-19 crisis. However, results should be significantly worse in coming months, given the sharp deterioration in economic activity and the unprecedented expansion of public spending to mitigate the effects of the pandemic.**

- **On that note, we recently published a report on Brazilian fiscal policy amid a health crisis (*Fiscal Policy During the COVID-19 Crisis: New Challenges, More Risks and the Same Long-Term Goals*, dated April 22). In our updated baseline scenario, the 2020 public sector primary fiscal deficit should total BRL585 billion (8% of GDP). Accordingly, we expect the gross government debt-to-GDP ratio to soar approximately 12 p.p. between 2019 and 2020. We reiterate that most of the additional emergency spending to combat the pandemic should be limited to this year, while preserving the fiscal consolidation framework (particularly the constitutional spending cap rule). In order to support this crucial fiscal anchor, the federal government will need to speed up the approval of structural reforms after the crisis abates.**

- **The Brazilian Central Bank will release March credit data next week, and we expect to see the initial impact from the coronavirus crisis. Despite the expansion in total outstanding credit, lending costs should be driven higher on the heels of a spike in economic uncertainties.**

Local markets—FX: Despite the awkwardness brought about by unusual negative prices in the US oil futures market, which increased fears of further deterioration in the global economy, the international economic news flow had little influence on the Brazilian FX market this week, in our view. We think the hefty weakening registered by the BRL in the past few days stemmed mostly from the inauspicious set of domestic pieces of information that emerged.

Firstly, doubts about the dynamics of the fiscal balance after the COVID-19 crisis is over gained momentum on the back of the announcement of a recovery program possibly based upon an expansion in public spending (details are still to come). A more heated political backdrop also added to the uncertainty about the outlook for reforms. Secondly, recent statements made by the Brazilian Central Bank Governor, Mr. Roberto Campos Neto, about the power of monetary policy to deal with the current situation, were taken by market participants as a hint that the Brazilian monetary authority is likely to loosen the monetary policy at a faster pace than previously anticipated.

These events likely triggered a rush to the USD, in our opinion. Consequently, the Brazilian FX rate breached the USD/BRL5.70 threshold and it traded at USD/BRL5.58 by the close on Friday, which led the BRL to end this week with the worst performance—as compared with last Friday—amongst all currencies in the world (a 6.2% weakening in the period).

Local markets—rates: A substantial bear steepening took place this week on the heels of political tensions and, consequently, a more blurred fiscal outlook. The front end (near the one-year zone) widened 20 bps for the week, with Jan-21 DI futures ending at ~3.10%; the back-end (three-year segment and beyond) sold off by 100-170 bps, with Jan-25 DI futures standing close to 7.50%. As an upshot, the steepness of the curve (as measured by the Jan-25 vs Jan-21 gap) is back on the rise, crossing above 440 bps—the highest reading since March 24. Last week this gauge closed just above 300 bps.

To a lesser extent, the movement of the curve follows the BCB signs of (what could have been) a possible acceleration in the pace of rate cuts in the next Copom meeting, pressuring down the front end. Back-end yields may have possibly been propped up by further indications from authorities that there are no plans of large BCB interventions in the local bond market (following the new temporary mandate provided by the War Budget amendment). To a much greater extent, this week´s bear steepening seems to have stemmed from an increasingly heated political environment, which continued to feed perceptions of uncertainty about the outlook for macro reforms and fiscal consolidation after the crisis abates.

Looking ahead, we still 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 prevailing factors for back-end yields in coming weeks and months. Amid a sea of (global, local) uncertainties, we continue to think that the room for flattening in local yields is quite limited, with more chances of movements in the opposite direction. Thus, broader financial conditions might remain less friendly for economic activity in the short term, despite the possibility of more BCB rate cuts.

Balance-of-payments: The current account balance registered a USD0.9 billion surplus in March, which was above our estimate of a balanced result in the period (USD0.0 billion). The result led the current account deficit to USD49.7 billion in 12-month-to-date terms (or 2.8% of GDP). The outcome is compatible with our forecast for a USD50.7 billion FY deficit in 2020 (3.5% of GDP), thus underpinning our expectation for relative stability in the current account balance in absolute terms, when compared to the USD49.5 billion shortage recorded in in 2019. However, given the significant drop we expect GDP to register in USD terms, the deficit should account for a larger chunk of it.

Regarding the components of the current account balance, we learned that the trade balance posted a USD4.2 billion surplus last month, while the services account registered a USD1.8 billion shortage—net tourism outlays reached as high as USD0.2 billion and equipment rental net payments amounted to USD1.3 billion in the period—and the primary income account recorded a USD1.6 billion negative imbalance—net interest payments summed USD0.8 billion and the remittance of profits and dividends tallied the same USD0.8 billion. The USD0.1 billion surplus in the March secondary income account concluded the list of contributions to the result of the current account balance last month. In 12-month-to-date terms, the trade balance surplus marginally climbed to USD36.9 billion from USD36.5 billion in the previous reading, while services shortage reached USD34.4 billion (USD35.0 billion in the previous month) and the primary income negative imbalance totaled USD53.1 billion (USD55.8 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—March 2020 figures underpin our assessment that the dynamics of current account balance will likely be mostly set by the trajectory of the trade balance and primary income, the latter basically responding to a shrinkage in the remittances of profits and dividends. In our view, both things tend to nearly compensate each other, thus our expectation for relative stability in the current account deficit in 2020.

Regarding the financial account, the net inflow of foreign direct investment reached USD7.6 billion last month, which translated into a USD79.5 billion contribution in 12-month-to-date terms. Hence, the most important external funding source shows that it has been 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 remains sound for now. However, given the prospects for a decline in the volume of FDI owing to the COVID-19 crisis and the Brazilian low-growth environment this year, this “cushion” tends to become thinner in our opinion, which may put some extra pressure on the BRL. Incidentally, preliminary figures for April 2020 provided by the Brazilian Central Bank pointed toward a net FDI inflow of USD1.1 billion until April 22, which led the monetary authority to project a USD1.5 billion net inflow for the month as a whole. If that proves right, it will be the lowest level since June 2019, when the country received USD0.6 billion in FDI, but highly influenced by revisions carried out by the BCB in the historical series. We expect the annual FDI net inflow to decline to USD60 billion in 2020 from USD78.6 billion last year.

Inflation: April’s IPCA-15 will be released next week and we forecast the index to have recorded a 0.03% MoM change (2.97% YoY). We expect some of the crisis-related downward signals seen in the March IPCA to have deepened further, as this reading will cover a larger period of the lockdown.

Particularly, we highlight the fall in fuel prices (also being affected by an international supply-shock on top of the global demand collapse), which will be a major downward pressure for headline inflation in this reading and the following ones. Moreover, some cyclical items should have also posted negative variations, according to our calculations, such as furniture and electronics (durable goods) and personal expenses (services), making it possible for even some core measures to have registered negative changes.

Beside the unprecedented uncertainty about the effect of the quarantine on prices, we note that this will be the first release with the new price-survey methodology, in which price data were fully collected by phone calls/on-line inquiries, bringing additional uncertainty to estimates.

Finally, we believe this might be the last positive MoM change in the next 3 to 4 months, although it is possible that we may see a monthly deflation already in this reading. Hence, we acknowledge that the scenario suggests downside risks for our annual inflation forecast for 2020 (currently at 2.2%).

Fiscal Policy: On Wednesday (April 29), the National Treasury Secretariat will publish the central government’s primary result for March. We estimate a monthly deficit of BRL25.2 billion, a result similar to the one seen in the previous month (BRL25.9 billion). As unveiled by the Brazilian Internal Revenue Service this week, federal tax collection dropped 3.3% in March 2020 as compared with March 2019, in real terms, which meant the second negative variation in a row. In our view, the impact of the COVID-19 crisis on the government’s primary revenue should have been limited in the period. However, looking ahead, we expect very negative effects, especially over the second quarter. The combination of deteriorating economic activity and a sharp expansion of public spending aimed at mitigating the economic hit from the pandemic will likely lead to monthly primary fiscal deficits to exceed BRL100 billion from April to June, according to our calculations. We note that the central government’s primary deficit totaled BRL95.1 billion in 2019 (1.3% of GDP).

Furthermore, next Thursday (April 30) the Brazilian Central Bank will release the consolidated public sector’s fiscal balance for March, which includes the federal government, regional governments and state-owned companies. We anticipate a monthly primary deficit of BRL26.5 billion, with the following breakdown: -BRL26.0 billion for the federal government; -BRL0.7 billion for states and municipalities; and BRL0.2 billion for state-owned companies.

Additionally, we recently published a report focused on Brazilian fiscal policy during the COVID-19 crisis (for details, please see the April 22, 2020 report *Fiscal Policy During the COVID-19 Crisis: New Challenges, More Risks and the Same Long-Term Goals*.) Due to the very high degree of uncertainty under current conditions, we explicitly outlined simulations for alternative scenarios in that report. In our updated baseline scenario, for example, we expect the public sector’s primary fiscal deficit to reach some BRL585 billion (8% of GDP) in 2020—we expected some -BRL100 billion (1.3% of GDP) before the health crisis. For 2021, we calculate a primary fiscal deficit of nearly BRL220 billion (2.9% of GDP), taking on a crucial assumption: that the (massive) fiscal expansion resulting from the pandemic will be limited to 2020. Accordingly, we see the gross public debt-to-GDP ratio climbing approximately 12 p.p. between 2019 and 2020 (from 75.8% to 87.5%), peaking only in 2022 at 90.7% of GDP. As we have consistently emphasized, the additional emergency spending to combat the COVID-19 crisis should be focused on the core of the problem while preserving the fiscal consolidation framework. We also highlight the imperative to comply with the constitutional spending cap rule, which is currently the most important anchor for Brazil’s fiscal policy, in our opinion. In order to support this fiscal rule, the federal government will need to speed up the approval of structural reforms in the post-crisis period.

Credit Market: Next week, the Brazilian Central Bank will also release financial credit data for March, the first one with the initial impacts of the coronavirus.

We expect a general increase in credit costs, which means higher interest rates being charged on all segments. On the other hand, grace periods granted for the payment of loans to individuals and a higher demand from the corporate sector, mainly for working capital, should have led the total outstanding amount of credit in the economy to grow in March: we expect a credit expansion of 7.8% YoY in the period (from 7.5% YoY in February).

An important aspect to observe in March's data is the share of credit granted by public financial institutions to the economy. Since 2014, we have seen a change in the composition of credit in Brazil, with private institutions having turned into the main credit providers. However, with the economic impacts of COVID-19, several sectors will need assistance and extension of loan payment terms. The BNDES and the Brazilian Central Bank itself have already announced several measures in order to partially supply resources to meet that demand. Consequently, based upon March data we are likely to be able to observe how these initiatives are helping distinct sectors to access the credit market and, perhaps, data should also unveil a greater participation of public credit compared to the backdrop observed in February 2020.

Real activity: Next week the National Households Survey might be released on Thursday, and we expect the March unemployment rate to rise to 11.5% from 11.4% in seasonally adjusted terms (and to 12.2% from 11.6% in the original series).

MACRO AGENDA

Indicator	Estimate	Consensus	Prior
IPCA-15 Apr/20 (Δ% MoM)	0.03%	0.01%	0.02%
IPCA-15 Apr/20 (Δ% YoY)	2.97%	2.93%	3.67%
Central Govt's Primary Fiscal Balance Mar/20 (BRL billion)	-R$25.2	-R$26.8	-R$25.9
Total Balance of Credit Operations (Δ% YoY)	7.8%	- -	7.5%
National Unemployment Rate Mar/20 (% nsa)	12.2%	12.5%	11.6%
Primary Budget Balance Mar/20 (BRL billion)	-R$26.5	-R$26.5	-R$20.9
Net Public Debt Mar/20 (% of GDP)	53.2%	53.1%	53.5%

Source: BCB, Bloomberg, IBGE and Santander.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: Post COVID-19* Concerns (April 23, 2020)
- *Fiscal Policy During the COVID-19 Crisis: New Challenges, More Risks and the Same Long-Term Goals* (April 22, 2020)
- *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)

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