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Brazil Macro Compass

A Hawkish Cut?

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- **Owing to improved global risk appetite, following the release of promising news related to a COVID-19 vaccine and an apparent respite on the domestic political front, the BRL managed to post a gain about in line with peer this week (up 2% vs the USD from last Friday). In any case, FX volatility remains quite high, despite some moderate Brazilian Central Bank (BCB) support.**

- **Volatility remains high in the yield market as well. In the wake of substantial bear steepening that took place in the previous week, the last few days have seen a big rally and a flattening pattern, potentially following market optimism about the outlook for macro reforms and fiscal consolidation once the pandemic has ended. We continue to favor steepeners, as we see downside risks for the front end and upside risks for the back end.**

- **On Wednesday, May 6, the BCB announces its monetary policy decision. We expect the Copom (the policy committee) to cut the Selic rate by 50 bps, to 3.25%, a new historical low. This projection is in line with the yield curve, which still incorporates a probability of ~30%, of a more aggressive move (-75 bps), an alternative scenario that we cannot completely rule out. In the statement, we believe the Copom will signal a desired pause in the easing cycle soon, potentially conditioning eventual cuts in the future, if needed, on advances in the reformist agenda. The market may take that as a "hawkish" message, in our view.**

- **With respect to inflation, the headline IPCA-15 change of -0.01% MoM (2.92% YoY) was in line with our expectation of +0.03%. Some of our hypotheses were confirmed: for example, higher deflation in durable-goods helped core measures decline 0.04% MoM (2.46% YoY). However, we have seen an unusually big upward surprise in food and beverages, possibly due to the new price-survey method, in our view. Despite the high uncertainty, we expect the IPCA to continue posting negative changes until July.**

- **The BCB released March credit data this week, and, as expected, YoY headline expansion (+9.6% vs +7.5% in February) was driven by increased credit being granted to companies (mainly to finance working capital) and the depreciation of the BRL, which boosted the face value of USD loans.**

- **March fiscal accounts showed a still-limited impact from the COVID-19 health crisis, confirming expectations. Nonetheless, we expect the government's primary balance to be substantially worse in coming months, due to a combination of deteriorating economic activity, tax payment deferrals and massive public spending expansion to combat the pandemic and its effects.**

- **March labor market data released this week has shown us what Brazil is about to face in the coming months: despite the not so bad headlines, March data captures only the very begging of the Covid-19 crisis and the details indicate that the labor market is about to be hard hit by the pandemic.**

Local markets—FX: After the FX rate reached a new historical peak last week, the BRL saw some strengthening this week: at the time of this writing, the FX rate was trading close to USD/BRL5.48 from nearly USD/BRL5.60 last Friday—owing to both international and domestic factors. Abroad, researcher at the University of Oxford announced that they have inched closer to a possible vaccine against COVID-19, stoking market participants to consider riskier investment alternatives, thereby helping EM currencies strengthen across over the board. Additionally, updated U.S. GDP data for 1Q20 indicated that the country will require substantial incentives to get out of the doldrums, and this was confirmed by Fed Chairman Powell, in his press conference after the FOMC's decision: the U.S. monetary authority signaled that it will continue to inject liquidity into the financial system, implying a larger USD supply and, consequently, weakening pressure on the USD. Likewise, the ECB has also suggested that it will (if necessary) introduce more monetary stimuli in the Eurozone, thus providing further evidence that hard currencies may suffer some weakening pressure, in our opinion.

On the domestic front, the executive branch has made some attempts to mend its relationship with the legislative branch, which bodes well for the approval of measures aimed at addressing the impact of COVID-19 on the national economy. There were also signs of a resumption of a reformist agenda next year. Given this relatively favorable combination for the currency, the BRL is likely to end the week as one of the best performers among emerging currencies, according to our projections. However, according to our calculations, based upon the relationship between the currency and some international factors (behavior of emerging currencies, commodity prices, international interest rates and risk aversion), there could be room for the BRL to trade below the USD/BRL5.00 threshold. The nearly 40 cents difference to the actual level of the FX rate indicates a possible formation of premium, telling us how much work there is ahead to regain market confidence in the future of economic dynamics.

Local markets—rates: Volatility remains high in Brazilian markets, particularly in the case of the yield curve. In the wake of substantial bear steepening that took place in the previous week, the last few days have seen a big rally and a significant flattening pattern, possibly on the heels of political signs and events that bolstered market perception about the government's commitment to macro reforms and fiscal consolidation in the aftermath of the pandemic. At the time of this writing, the front end (near the one-year zone) was tightening 45 bps vis-à-vis last Friday's levels, with Jul-21 DI futures near 3.09%; the back-end (the three-year segment and beyond) was tightening by 80-110 bps, with Jan-25 DI futures close to 6.54%. As an upshot, the steepness of the curve (as measured by the Jan-25 vs Jan-21 gap) fell to nearly 375 bps, from about 450 bps at the end of the previous week. Earlier this year, this steepness gauge was at ~190 bps.

In the front end, Thursday´s pricing indicate that the local fixed income market factors in about 70% likelihood of another 50-bp Selic rate cut (to 3.25%) in next week´s Copom policy meeting, with an implied 30% likelihood of a bolder move (an acceleration to 75 bps). While we believe the policy easing cycle is near a pause, the risks for the front end still look skewed to the downside, so that we would favor receiving positions in that segment. As per the back end, we continue to see more upside than downside, given a still murky outlook for fiscal policy consolidation and broader macro reforms in the aftermath of the crisis. For this segment, however, duration risks in such a fluid and unstable (local and global) environment make us prefer relative-value trades, favoring steepeners with some degree of DV01 neutralization.

Inflation: IPCA-15 registered a slight decline of 0.01% MoM in April, close to our expectation of +0.03%. This was the lowest MoM change for April since 1994. In the last-12-month period, inflation decelerated from 3.67% to 2.92%, well below the BCB's 4.00% target.

Despite the small difference between the realized headline number and our forecast, there were important (and unusual big) surprises in the groups, possibly related to the new phone/on-line price-collection method, in our view. Surprising on the upside, food and beverages were the highlight, due to significantly high inflation in fresh items. On the downside, durable-goods and fuel prices registered considerable deflation, surprising even our already really low expectation. More importantly, the average of all seven core measures declined 0.04% MoM, leaving the annualized (and seasonally adjusted) three-month moving average at 0.96%. Finally, diffusion was low, at close to 50.0%.

Looking ahead, we believe durable-goods will continue to post negative changes in the next readings, and expect services to decelerate more and register deflation in some items too. We also expect food to decelerate, but we reckon that the uncertainty caused by the price-survey method poses upside risks to our new -0.41% forecast for April's IPCA; May and June should also be negative, in our opinion. We continue to see considerable downside risks to our 2.2% annual IPCA inflation forecast.

Fiscal policy: As published by the National Treasury Secretariat, the central government registered a primary fiscal deficit of BRL21.2 billion in March 2020, a result slightly better than our expectation (-BRL25.2 billion) and market consensus (-BRL26.2 billion). A sharper-than-anticipated decline in primary spending (-5.4% between March 2019 and March 2020, in real terms) was responsible for the difference between the forecast and actual primary balance.

In turn, central government's primary revenue dropped 5.8% between March 2020 and March 2019 (in real terms), marking the second consecutive decline and confirming the poor tax collection by the Brazil's internal revenue service (*Receita Federal do Brasil*) last week. However, we note that the impact of COVID-19 on the government's primary balance was limited in March. In fact, we expect significantly worse effects in the following months. The combination of: (i) GDP growth tumbling; (ii) tax payment deferrals; and (iii) a sharp expansion of public spending aimed at fighting the COVID-19 crisis will likely lead to monthly primary fiscal deficits to exceed BRL100 billion from April to June, according to our estimates. It is worth noting that the central government's primary deficit totaled BRL95.1 billion in 2019 (1.3% of GDP).

Accordingly, our current forecast for 2020 central government's primary balance is nearly -BRL560 billion (-7.6% of GDP). For 2021, we foresee a primary fiscal deficit of approximately BRL215 billion (-2.8% of GDP), considering as a vital assumption that the unprecedented fiscal expansion spawned by the health crisis will be limited to 2020. Additionally, our baseline scenario incorporates the maintenance of the fiscal consolidation framework, especially the compliance with the constitutional spending cap rule. (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*.).

Furthermore, earlier today the BCB released the consolidated public sector's fiscal balance for March 2020. The actual primary fiscal deficit of BRL23.6 billion came in slightly worse than our forecast (-BRL22.5 billion) and median market expectation (-BRL22.8 billion), broken down as follows: -BRL21.4 billion for the federal government; -BRL2.7 billion for states and municipalities; and BRL0.4 billion for state-owned companies. The gross public debt-to-GDP ratio increased from 76.5% in February to 78.4% in March, while the net public-debt-to GDP ratio dropped from 53.5% to 51.7% in the same period, owing to the depreciation in the exchange rate (i.e., higher value of foreign exchange reserves in local currency). Looking ahead, we see the gross public debt gauge climbing by ~12 p.p. of GDP (from 75.8% to 87.5%) from 2019 to 2020, peaking only in 2022, at 90.7%. Regarding the net public debt measure, we anticipate an increase from 55.7% in 2019 to 66.2% in 2020 and a peak at 70.2% in 2024. These trajectories for Brazil's public debt consider that the federal government and Congress will remain credibly committed to strict fiscal discipline and the economic reform agenda, as mentioned before.

Credit Market: This week, the BCB released March financial credit data, the first data set to reflect the initial impacts of the pandemic.

As expected, the data showed higher demand from the corporate sector, mainly for working capital. In March, the total outstanding amount of credit in the economy grew 2.9% MoM and 9.6% YoY (versus 7.5% YoY in February).

Following measures announced by the BCB and BNDES in March that aimed to lend resources to small and medium-sized enterprises, as well as those sectors most affected by the pandemic, the share of credit granted to companies expanded 6.9% YoY (from 1.4% in February). This advance was due to two main causes: i) the companies' need for cash flow, such as working capital; and ii) the depreciation of the BRL, which increased the value of contracts referenced in dollars and generating an artificial expansion without economic significance. The household segment lost traction due to the lower use of credit cards, probably denoting greater consumer caution.

In other words, the strong acceleration of credit in March, as well as concessions in the corporate segment and credit extension to companies, should be viewed with caution given the significant retraction in the granting of new loans in the household segment with non-earmarked resources (affecting not only credit cards, but modalities such as payroll loans and vehicle purchases).

Additionally, based upon March data, we were able to observe a greater participation of public credit compared to the backdrop observed in February 2020 (47.9% vs 47.1%). We do not expect a change in the credit granting structure similar to those that took place in mid-2013 (public credit greater than the private one) and in 2019 (on the contrary, private credit greater than the public). However, we acknowledge that this is the first data set that shows a reversed trend in comparison to the previous data. We expect this change to be observed due to the measures to contain the coronavirus impact to the Brazilian economy; with reversion to the private credit expansion behavior observed until the beginning of 2019.

Economic activity: April confidence indicators hit the wires this week. As we expect April to mark the peak of declining economic activity in Brazil, this data has gained even more relevance. As largely expected, the sharp fall was dispersed across all sectors, with most reaching an all-time low. The industry confidence indicator registered the biggest fall, 40.3% m/m and reached 57.3% of the capacity utilization (all-time low). In turn, the services confidence indicator registered a 38.3% MoM decline. Lastly, the Retail, Building and Consumer Confidence Indices fell 30.5% MoM, 28.4% MoM and 27.4% MoM, respectively.

According to the IBGE's National Household Sample Survey (PNAD), the unemployment rate stood at 12.2% (of the economically active population) in the three months to March, 0.5 p.p. lower YoY, suggesting that (up to March) the unemployment rate grew rapidly. However, the seasonally adjusted series showed a slight increase in unemployment rate, which reached, according to our calculations, the 11.5% mark compared to 11.4% recorded in February. Moreover, the unemployment rate remains high, and we expect it to grow significantly in the coming months due to the social distance measures implemented to stop the spread of Covid-19.

Regarding the composition of this job recovery, the details suggest a change in positive trend observed so far. Firstly, the data shows a considerable lost of momentum in the pace of employment expansion in the past few months, with a tepid increase of 0.4% YoY and a 0.8% QoQ fall in seasonally adjusted terms. This rate is well below the economically active population (PEA) expansion rate of 1.1% YoY. Additionally, the labor market participation rate also fell, reaching 61.1%, but still remained close to the historical average (62.0%). Second, the informal jobs rate reached 42.4% of the employed population, compared to 43.1% in the previous quarter. Nevertheless, we believe that the informal sector is likely to suffer from the coronavirus crisis more than the formal one. Thus, in our view the increase in formalization recorded in March reflects the deterioration of the labor market, since the employed population in the formal sector fell 0.5% MoM compared to February. Third, the rate of underutilization of the labor force in March was 24.4% compared to 23.5% in February, confirming our expectation that the composition of the labor market worsened.

In terms of wages, the survey shows real income (adjusted for inflation) grew 0.8% YoY, boosted by the low inflation in the month. Furthermore, the real wage bill (also adjusted for inflation) grew at a clip of 1.5% YoY.

Last but not least, it is worth mentioning that PNAD data are quarterly, and the figures released only consider the beginning of the spread of the disease in Brazil—social distancing measures began in the last half of March. Hence, the outlook for the coming months is a sharp deterioration in the labor market. Moreover, the next data will indicate the effectiveness of public policies in relation to the maintenance of jobs. The data of unemployment assistance requests published recently by the Economy Ministry indicates that until the first half of April, the formal labor market has not been substantially impacted. Nevertheless, bear in mind that the informal sector represents more than 40% of Brazil's labor market, and this sector is likely to be hit hard by the crisis, in our view. In summation, the not so negative labor market data should be taken with a grain of salt, as we expect substantial worsening in the coming months.

Monetary Policy: On Wednesday, May 6, the BCB is set to announce its monetary policy decision: we expect the Copom to cut the Selic (policy) rate by 50 bps, to 3.25%, a new historical low. This projection is in line with most analysts and with the yield curve pricing. As of Thursday (April 30), the latter still incorporates a ~30% probability of a more aggressive move (-75 bps), an alternative outcome that we cannot fully rule out.

The outlook remains quite complex, amid significant economic (and health) uncertainties, as well as high volatility in financial conditions. On the one hand, we observe considerable downward pressures for economic activity and inflation expectations in the short term, owing to the macro effects wrought by the pandemic. The latter brings with it an economic and financial crisis that, among other consequences, will raise the level of economic slacks (already quite present beforehand) and dampen the price of those goods most sensitive to the economic cycle (i.e., core or underlying inflation). The sharp drop in raw material prices (notably oil) compensates a possible CPI-pass thru (which has been limited in the current juncture) from the massive FX rate depreciation. While the commodity tumble intensifies the deflationary pressures resulting (directly or indirectly) from the pandemic, it tends to have less weight on the BCB's decision, given the volatility of these items and the fact that the relevant policy horizon is now 2021 — for which those effects have lesser importance. For the coming year, we project inflation below but as not far from the target as is the case for 2020.

On the other hand, political and fiscal risks seem to be intensifying, increasingly clouding the medium- and long-term macroeconomic and inflationary outlook. These risks contribute to an increase in the neutral (or equilibrium) interest of the Brazilian economy — at least in the short term — making the monetary policy stance even more expansionary, even at the current Selic rate levels. This increased fiscal uncertainty also increases the likelihood of a less effective stimulus via the policy rate, in our view, given the building premium at the long end of the yield curve, pushing the cost of credit higher for longer horizons. We also understand that in a situation of fiscal uncertainties and reduced global risk appetite, there are limits to monetary expansion in the case of an emerging economy with low levels of domestic savings (i.e., still somewhat dependent upon external financing) and slow potential growth.

Taking into account this trade-off — deflationary shock on the one hand, fiscal and external restrictions on the other — and in view of an apparent deterioration in the balance of risks (which should be the greater focus of the BCB in times of great uncertainty), we believe that members of the Copom will choose to take a step back in what was perceived in the market as a sign of a possible acceleration in interest rate cuts, maintaining the speed at 0.50 p.p.. In the statement, our view is that the Copom will herald an intention to pause the easing cycle soon. We would welcome any sort of conditionality that eventual cuts in the near future, if necessary, will be conditional to stronger signs of commitment to macro reforms and fiscal adjustments for the after-crisis. That type of statement may be understood in the market as a "hawkish" message.

Our baseline scenario still contemplates an additional cut in of 25 bps (to 3.00%), but we believe that this final movement may not materialize (at least for now) if the BCB adopts an even more focused approach to risk management…to be seen.

Also next week: Brazilian cities started to introduce their social distancing policies since in March 2020 in an attempt to flatten the contagion curve of COVID-19 in the country. Hence, from the economic activity point of view, all eyes will be on the Monthly Industry Survey, set to be released on Tuesday, May 05, since this will be the first hard data from March to be released. We expect industrial production to sharply decrease 4.1% MoM in seasonally adjusted terms. In comparison with March 2019, we estimate stability, implying a 1.4% QoQ decrease in the seasonally adjusted series. Furthermore, we believe that the service sector to be more affected by the pandemic. Therefore, we forecast that the fall in March industrial production will be just a taste of the negative data that is forthcoming. Moreover, it is important to bear in mind that the measures to curb the outbreak were put in place at the end of that month; hence, it is likely that April will present a much worse picture.

MACRO AGENDA

Indicator	Estimate	Consensus	Prior
IPCA Apr/20 (Δ% MoM)	-0.41	-0.13	0.07
IPCA Apr/20 (Δ% YoY)	2.30	2.58	3.30
Monthly Industrial Production (Δ% MoM)	-4.1		-0.5
Monthly Industrial Production (Δ% YoY)	0.0		-0.4

Source: 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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