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Brazil Macro Compass

Copom Meeting: Between Slower Growth and Higher Inflation

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Upcoming Data: Rate Decision, April Inflation

We expect Brazil's Monetary Policy Committee (Copom) to keep its benchmark overnight rate at 6.50% on the May 8 meeting. Despite the recent disappointments with economic activity data that led us to revise our GDP growth forecasts in 2019 and 2020 to 1.3% and 2.5%, respectively (see our report *No News Is Bad News*, April 22, 2019), we believe that the balance of risks for future inflation has deteriorated since the last rate decision (March 20), which should still call, in our view, for a cautious stance on monetary policy. We attribute most of that deterioration to two factors: first, the recent weakening of BRL, which has been an underperformer among EM currencies. A weaker BRL adds to inflationary pressures on prices of tradable goods, especially fuel (see table below). Second, we believe that that the spread of African swine fever in China will be a substantial supply shock to the animal protein chain, contributing to higher headline inflation in both 2019 and 2002 (see "In-Depth Research" and "Chart of the Week" below). Although we do not expect significant spillovers to core inflation, and even considering a persistent negative output gap, we believe further monetary easing at this point could lead markets to start forecasting headline inflation above the target midpoint in 2020 and beyond, an outcome that, in our view, is not desirable from an expectations management standpoint ─ we believe it will be less costly through time to keep expectations well anchored, using the gap between core and headline inflation as a buffer to accommodate such shocks instead of trying to narrow it with more stimulative policy. We maintain our view that this combination of persistent economic slack and temporary headline inflation risks on top of well-behaved underlying inflation will be compatible with a stable policy rate for a long period, until the end of 2020 (see our report *Low for [Much] Longer*, March 29, 2019).

Selected Financial and Economic Indicators, Changes Between Copom Meetings

Market prices	**20-Mar**	**02-May**	**Change**
BRL/USD rate	3.78	3.96	4.8%
5-year CDS	162	175	13 bps
1-year rate	6.40%	6.65%	25 bps
1-year breakeven inflation	4.34%	4.42%	8 bps
5-year rate	8.28%	8.60%	32 bps
Crude oil WTI (USD)	60	61	2.1%
Crude oil WTI (BRL)	226	242	7.0%
CRB Food (USD)	338	342	1.1%
CRB Food (BRL)	1,277	1,354	6.0%
Market expectations*	**20-Mar**	**26-Apr**	**Change**
2019 CPI inflation (12m, year-end)	3.88%	4.01%	13 bps
2020 CPI inflation (12m, year-end)	4.00%	4.00%	0 bps
2019 GDP growth	2.00%	1.70%	-30 bps
2020 GDP growth	2.80%	2.50%	-30 bps

*Median of expectations in the Focus weekly survey. Sources: Brazil Central Bank, Bloomberg, Anbima, Santander.

We expect April CPI inflation, to be released on May 9, at 0.66% m/m (5.0% y/y). The substantial rise in the headline

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index in the past few months is not a reason for concern, in our view: y/y inflation should fall significantly after the June 2018 outlier is dropped from the comparison, and the seasonal rise in produce prices should start to be reversed this month, with the end of the rainy season. Core inflation should remain well-behaved, at 0.39% m/m (2.8% annualized 3-month seasonally adjusted rate).

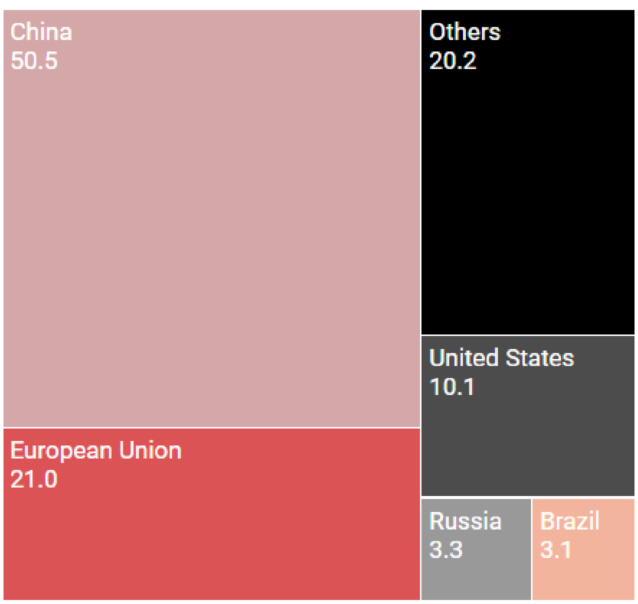
In-Depth Research: Inflation Forecasts Revision

In *Year of the Pig: Good Fortune? (April 30, 2019)*, we updated our inflation forecasts to incorporate the expected effects of the African swine fever (ASF) in China on the prices of animal protein. In our view, ASF will cause a sizeable disruption in the global supply of pork meat, with demand from China (the largest in the world ─ see the "Chart of the Week" below) shifting to other sources of protein, mainly poultry and beef. We expect the consequent rise in domestic prices to add 40 bps and 60 bps to 2019 and 2020 headline CPI inflation, respectively. With that, we now expect year-end inflation at 4.0% and 4.5% in 2019 and 2020, respectively (from 3.5% and 4.0%).

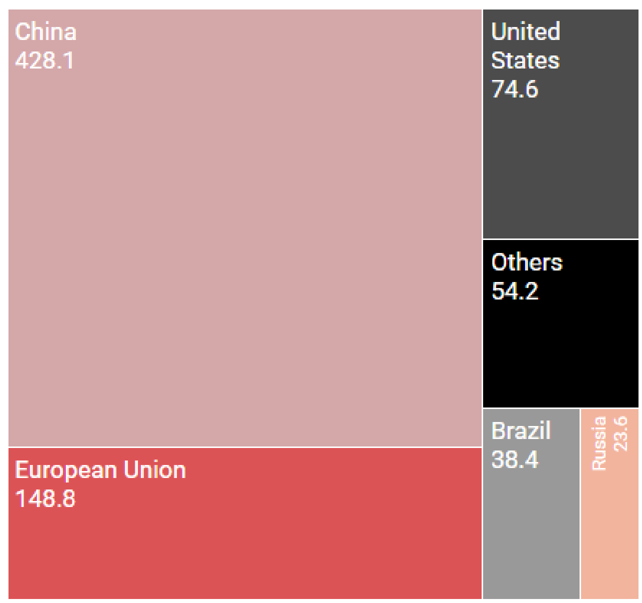
Chart of the Week: World of Pork

Our "Chart of the Week" shows the importance of China in the global pork meat market, which is likely to be affected by the spread of African swine fever in that country (see "In-Depth Research" above). China alone is expected to account for about half of global pork meat consumption this year, according to USDA forecasts. In terms of stocks, China is even more dominant ─ about 56% of world's pigs are in the country, which stresses the importance the evolution the outbreak has on inflation estimates.

Pork Domestic Consumption (millions of metric tons)



Swine Stocks (millions of heads)



2019 forecasts. Sources: United States Department of Agriculture, Foreign Agricultural Service.

What's New: March Industrial Production

March industrial production came in at -1.3% m/m, below our forecast (-0.8% m/m) and market consensus. Even considering possible issues with seasonal adjustment due to the unusual late Carnival holiday this year, the performance of Brazil's industry has been quite weak: production contracted 0.7% q/q in 1Q19, and the 12-month rolling average of that indicator is at -0.1% y/y, the slowest since August 2017. Capital goods production was the main negative highlight in 1Q19, posting a 3.7% q/q contraction. With that result, the odds of a GDP contraction on 1Q19 have increased – our 0.1% q/q forecast carries a negative bias. National accounts data will be released on May 30.

Political Agenda: Pension Reform Special Committee Kicks Off

The Lower House Special Committee on the pension reform proposal starts working on May 7. The committee rapporteur's main task is to prepare a report that can be approved by the majority of its members, incorporating to the government draft changes proposed (so-called 'amendments') by groups of representatives (an 'amendment' need to be subscribed by at least 171 representatives to be presented to the committee). We expect those changes to substantially water down the original government draft (see our report *Pension Reform—The Moment of Truth: From Intentions to Bargaining*, March 28, 2019), bringing fiscal savings in 10 years to around 60% of the total should the draft was approved without any modification. Representative Marcelo Ramos, the committee's chair, expects the report to be voted by the group of 49 representatives in June, which would allow for a first floor voting before the mid-year recess. However, we believe that the process is likely to be lengthier, considering the attempts of the opposition to delay the works and, more importantly, the time needed for the government to build the three-fifths majority required to approve the reform at the floor. We expect a first floor vote by the end of August.

Number of the Week

-1.3% Industrial production contracted 1.3% m/m in March, the worst monthly performance since September 2018.

Quote of the Week

"*800 billion guarantee his [Bolsonaro's] reelection... We believe we should have [savings] of around 500 billion. 600 billion would be a cap for that reform.*"

— **Representative Paulinho da Força,** a union leader, during the Labor Day celebrations (May 1, 2019).

What We've Been Reading

- "Brazil's Damaged Engine Signals Disappointing Growth Ahead," by David Biller (*Bloomberg*, May 2, 2019). Successive disappointments with growth are leading some analysts to believe that Brazil's economic problems are structural rather than cyclical.
- "Why the Future of Brazil's Economy Rides on Pensions," by Rachel Gamarski and Simone Iglesias (*Bloomberg QuickTake*, May 2, 2019). A quick guide to the ongoing reform process.
- "How Brazil and South Africa became the world's most populist countries," by Dom Phillips, Jason Burke, and Paul Lewis (*The Guardian*, May 1, 2019). A survey applied to 23 countries found that populist ideals resonate the most among Brazilians – more than 40% of respondents were identified as "firm populists".
- "A decade of reporting by the FT's outgoing Latin America editor," by Andres Schipani (*Financial Times*, April 26, 2019). What has (not) changed in the region since 2009.

Recent Publications (Available on Our Website)

- *Inflation—Year of the Pig: Good Fortune?* (April 30, 2019)
- *Economic Activity: No News Is Bad News* (April 22, 2019)
- *Will Credit Be Enough to Revive Consumption?* (April 1, 2019)
- *Monetary Policy: Low for (Much) Longer* (March 29, 2019)
- *Pension Reform—The Moment of Truth: From Intentions to Bargaining* (March 28, 2019)

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