Santander Corporate & Investment Banking

ECONOMICS

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Brazil Macro Compass

How Should We Start?

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Direction given, but at which speed?

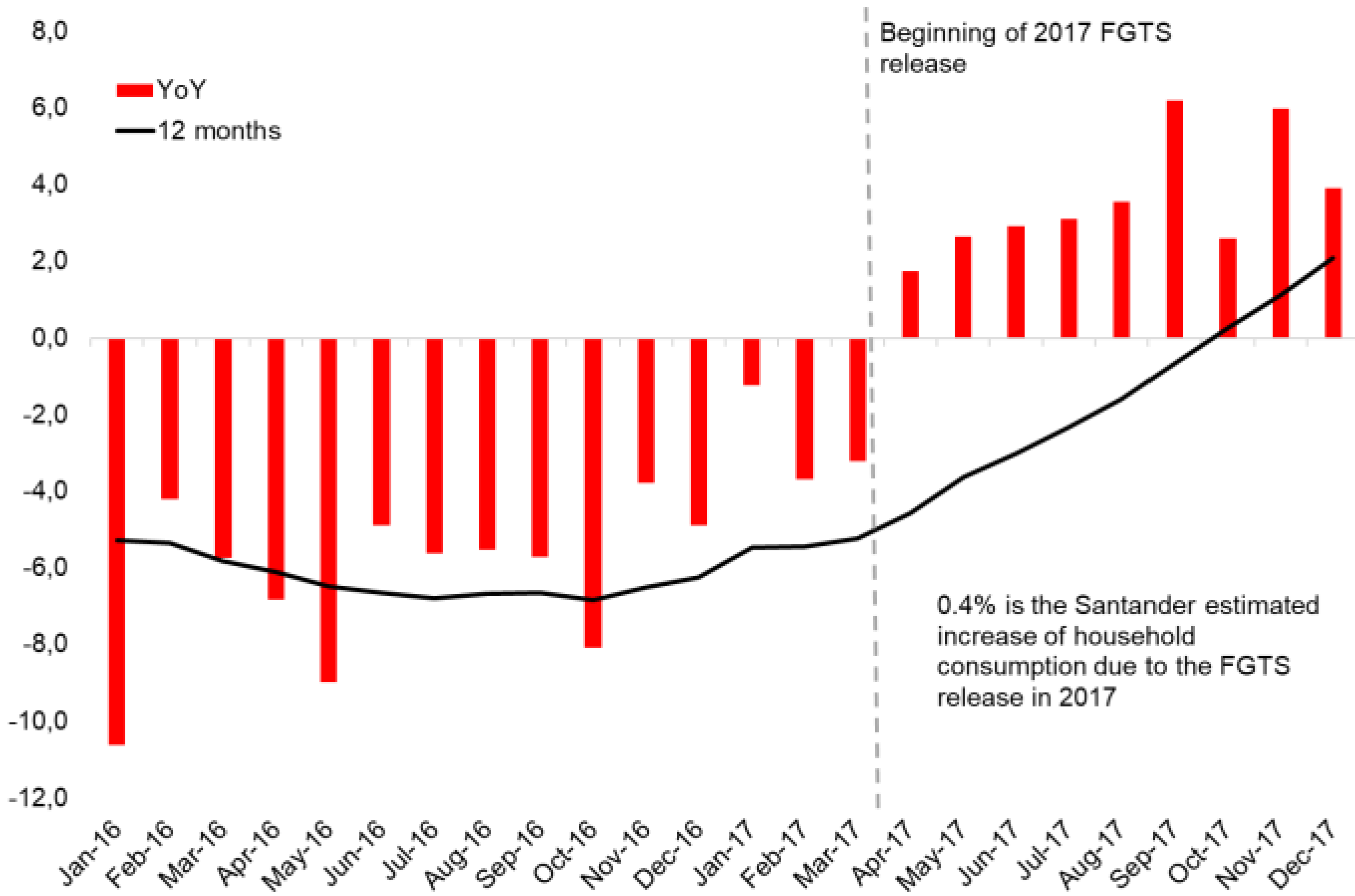
Based on prices in the domestic yield curve, we believe it likely that the Brazilian Central Bank (BCB) will embark on an easing mode by the end of this month, when it holds its Copom meeting (July 30-31). After all, market quotes imply that the Selic target rate should be some 41bps lower than the current 6.50% pa level after the meeting, as compared to only 18bps at the end of June. While the former situation means there are implied probabilities of 35% for a 25-bp cut and 65% for a 50-bp reduction, the backdrop three weeks ago pointed to an approximate 30% probability for the BCB to keep the base interest rate unchanged. Hence, the approval of the pension system reform bill has not only seemingly eliminated doubts about the likelihood of an interest rate cut, but it has also led most market participants to expect a bolder start than usually seen in recent easing cycles.

While we concur with the view the BCB is indeed likely to reduce the Selic target rate at the next Copom meeting, we believe the first move will be slightly smaller than most market participants are anticipating. In our view, the Brazilian monetary authority is likely to focus mostly on inflation dynamics for 2020, which we expect to point toward a 3.7% annual forecast for the IPCA next year, as compared to the 4.0% targeted level. This is not such a wide gap, which means the room for loosening the monetary grip is not that large as well. We continue to believe that there would be mounting medium-term risks to meet inflation targets as the base interest rate falls below 5.50% pa. Hence, assuming that cautiousness should continue to guide the BCB's strategy, a 25-bps cut seems to us a move more compatible with the total adjustment we expect for the Selic target rate.

Chart of the Week: The FGTS influence

Our "Chart of the Week" looks at the behavior of the core retail sales index — which factors out the contribution of building material stores and vehicles & autopart dealers — from January 2016 to December 2017 in an attempt to illustrate the impact that the release of FGTS funds had on household consumption. Back then, there was an injection of R$43.5 billion into the Brazilian economy in March-April 2017, which led retail sales to increase substantially. Now, according to the Economy Minister, Paulo Guedes, the government intends to release up until R$63.0 billion in order to fuel the pace of growth, but technocrats from the Economy Ministry have reportedly talked down such an amount, which makes it difficult to estimate the actual impulse that the Brazilian economy is likely to record this time. According to the Chief of Staff, Onyx Lorenzoni, a variety of details are due to be presented next Wednesday, when the government is likely to officially announce the incentive plan.

Core Retail Sales (%)



Sources: Bloomberg, Santander. Market data as of July 11, 2019.

What`s New: May Economic Activity Data

As reported by the Central Bank earlier this week, the IBC-Br (a monthly proxy for GDP) grew 0.5% between April and May, a result slightly below market expectations. In the comparison with May 2018, the indicator increased by 4.4%. It is worth noting that this relatively strong year-on-year growth was largely due to the depressed comparison base caused by the truck drivers' standstill last year. In fact, excluding this effect, we perceive that the growth rate of the Brazilian economy remains slow. As a result, we estimate that GDP grew 0.2% in the second quarter of this year, compared to the previous quarter. Compared to the second quarter of 2018, we estimate an increase of 0.7%.

Upcoming Data: July IPCA-15

This week we will have the IPCA-15 of July (July 23), which is the survey of inflation by IBGE from June 12-13. We expect a monthly variation of 0.15%, causing 12-month accumulated inflation to remain at 3.29%. The slight increase in inflation between May and June was mainly due to the increase in food prices at home, which had risen in recent days as a result of the polar air mass in several regions of the country, affecting the production of vegetables and fruits. We see this event as a passing shock that will dissipate in the coming months, benefiting from the period without rain. In turn, we expect deceleration in the prices of administered goods, due to the gasoline sub-item, which had a readjustment of -4% this month in refineries. We expect this drop to reach gas stations gradually over the next few months.

The central government's primary result will also hit the wires next week. We estimate a deficit of R$15.2 billion in June, leading the 12-month accumulated deficit to R$121.3 billion. As observed in recent months, tax revenues should register low growth (there was an average decline of 0.5% y/y from January to May, in real terms), reflecting the slowdown in Brazilian economic activity. As an offset, the government continues to compress discretionary (non-mandatory) expenditures, which contracted 12.5% in the first five months of 2019 (in real terms, on average). As we have emphasized, the approval of pension reform (the Senate should pass the bill by late September, in our view) is a necessary, but not sufficient condition for rebalancing public finances in Brazil, since other measures must be implemented for the accomplishment of the main fiscal rules (e.g., primary deficit target and spending cap).

Looking at the labor market indicators, net formal job creation (Caged report) is expected to add up to only 25k in June, bringing the 3-month seasonally-adjusted and annualized pace to 105k jobs. For full-year 2019, we expect total net hiring of 450k.

Number of the Week

R$933 billion The government's estimate for total fiscal gains resulting from the pension system reform bill approved by the Lower House in its first-round floor vote.

Quote of the Week

"*The release of FGTS funds should turn into a chicken flight.*"

— **Marcelo Ramos,** Chairman of the Special Commission in charge of the Pension Reform Bill in the Lower House (July 18, 2019).

What We've Been Reading

- "For Wall Street, Brazil Is Back, Baby!" by Kenneth Rapoza (*Forbes*, July 10, 2019). Summing up the recent bullish wave.
- "The swashbuckling meat tycoons who nearly brought down a government," by Dom Philllips (*The Guardian*, July 2, 2019). A retelling of the story of one of Brazil's biggest "national champions."
- "An evening with João Gilberto, the bright wallflower of bossa nova," by Ted Gioia (*The Guardian*, July 7, 2019). One of the best of the many eulogies that followed the death of the great singer/guitarist.

Recent Publications (Available on Our Website)

- *Fiscal Policy: Climbing the Cliffs in Bad Weather* (June 18, 2019)
- *Economic Activity and Credit: Highway to Heaven?* (June 7, 2019)
- *Is It Time to Upgrade Core Inflation Measures?* (May 21, 2019)
- *Inflation—Year of the Pig: Good Fortune?* (April 30, 2019)
- *Economic Activity: No News Is Bad News* (April 22, 2019)

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