Santander Corporate & Investment Banking

ECONOMICS July 26, 2019

Brazil Macro Compass

The first dive

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Eyes on the Central Bank

With the end of July approaching, all eyes turn to the Copom meeting that will be held on July 30-31. We expect the Brazilian Central Bank (BCB) to undertake a 50-bp reduction in the base interest rate, which is a view in line with current market prices, as they imply that the Selic target rate should be some 46bps lower than the current 6.50% pa level in August.

In our view, several fundamentals justify the beginning of a new cycle of interest rate cuts. First, the dynamics of price indices are favorable, as current inflation is fairly contained and market participants' inflation expectations remain anchored, indicating that they are confident that the BCB will meet the inflation target set for 2019 as well as for the coming years. In addition, the Brazilian economy's production factors are running with a large level of slack, as evidenced by the slow pace of activity recovery. Finally, international financial conditions have become more expansionary, following signs that interest rates will fall in the main developed economies, thus promoting a scenario of broad liquidity and greater risk appetite, in our view. Along these lines, we see room for further strengthening of the Brazilian exchange rate, which should also contribute to the aforementioned low inflation scenario.

However, it is important to note that, despite the sluggishness observed in industrial activity and the slow recovery of the economy, we continue to see a slight acceleration in core inflation, which leads us to believe that the size of the interest rate cut in 2019 may be smaller than some market participants believe. We expect the Selic rate could reach as low as 5.25% pa in 2019 and remain at that level throughout 2020. Given that this likely cut should support an acceleration in the economic recovery, we think risks to the inflationary balance in the medium term are likely to increase, which explains why we do not expect the Selic rate to breach the 5.25% pa threshold.

In-Depth Research: The "Perfect" Calm?

In recent months, the global view regarding the risks of investing in Brazil has changed dramatically. In mid-July the Brazilian Lower House managed to successfully conclude the first-round vote on the pension reform bill, and, in our opinion, representatives have paved the way for a smooth second-round vote in early August. With this, the FX rate declined from USD/BRL3.85 to USD/BRL3.75 between the end of June and July 15 – the first trading session after the vote – whereas the Brazilian five-year CDS spread fell to 128bps from 150bps in the same period.

On top of this positive impact, market participants saw additional evidence that several monetary authorities around the globe may be on the verge of easing in the near future. If the aforementioned hypothesis is confirmed, we believe it is plausible to assume certain behaviors for some variables that we usually rely on to run our FX forecast models, namely CDS spreads for Brazil and emerging markets, the CRB and DXY indices, and the interest rate differential between Brazil and the US.

Regarding CDS spreads, we believe the Brazilian spread should outperform the emerging markets spread based on additional progress in the reform agenda. As for the trend in the CRB index, we think it should stay relatively flat for the rest of 2019, but register a marginal drop in 2020 due to an additional slowdown in global economic growth. Looking at the DXY index, we think it should follow a falling trajectory due to the likely monetary easing in the US. Last but not least, the interest rate differential between Brazil and the US should narrow, in our view, as we expect the Selic target rate cuts to be greater than those expected for the Fed funds target rate. All these factors led us to revise our FX forecasts for Dec19 and Dec20 to stronger levels than previously estimated. We now expect USD/BRL3.70 and USD/BRL3.80 for those respective periods, versus USD/BRL3.90 and USD/BRL4.10 previously.

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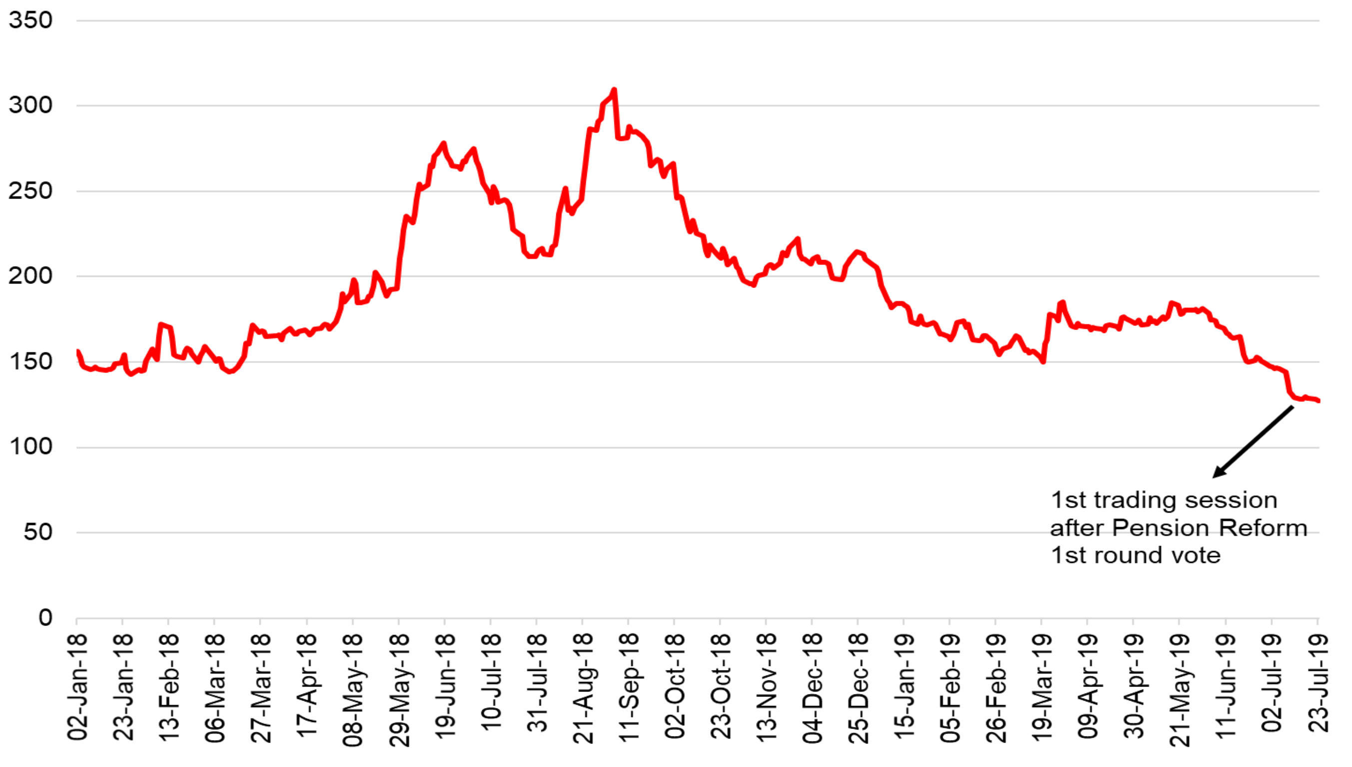
Chart of the Week: Brazilian CDS Spread

Our "Chart of the Week" looks at the behavior of the 5Y CDS spread — which measures a country's risk of default. In the last year, with the volatility of the elections in Brazil, the spread for Brazilian CDS jumped during the electoral campaign period – from some 200bps in July 2018 to a little more than 300bps in September 2018 – as both national and international investors were wary of the path that Brazilian monetary policy could take.Following the euphoria seen at the beginning of the new administration, we continue to witness a steady improvement in other countries' view of the risk of investing in Brazil.

Curiously, the current level of the Brazilian CDS spread – close to 130 points – typically indicates a country with investment-grade status, which is not the case for Brazil. We expect confidence in Brazil to grow as fiscal adjustment reforms move forward, which should increase the impetus for economic growth. We believe that the CDS spread is likely to close around 120bps at the end of 2019.

Brazilian 5Y CDS spread (bps)



Sources: Bloomberg, Santander. Market data as of July 23, 2019.

What's New: Labor Market Data and FGTS

Formal jobs creation in June came in roughly in line with our estimates, with net creation of 48k jobs in the month. The slightly positive number should confirm a weak recovery in the labor market, and we expect the unemployment rate for June, to be released on July 31, to decline to 12.0% from 12.3%. In seasonally adjusted terms, if our simulations prove to be right, the jobless rate would have declined to 11.8% from 11.9% in the previous reading, which reinforces the view that the Brazilian economy continues to grow, albeit slowly.

Based on these data, the Brazilian government has announced the release of BRL42 billion of the FGTS (forced saving accounts) between this year and next. Furthermore, it has also decided to create an annual withdrawal rule in order to stimulate economic activity. Our preliminary estimates suggest that the one-off injection may add 0.2% to 2019 and 2020 GDP growth, while the permanent withdrawal rule may boost household consumption by 0.2% every year.

Upcoming Data: Industrial Production and IGP-M

We expect June industrial production, to be released next week, to have contracted 0.8% m/m in June. If confirmed, our estimate would mean this indicator has registered the third quarterly contraction in a row in seasonally adjusted terms (-0.9% q/q in 2Q19). The mining industry has not yet recovered from the Brumadinho dam collapse, and the manufacturing industry is suffering as a result of labor market conditions and the Argentine economic crisis, which reduced that country's demand for Brazilian vehicles.

FGV will release the July IGP-M (July 30) next week. We expect an increase of 0.41% for the month and 6.42% in YoY terms. If our estimates prove right, these numbers point toward some deceleration between June and July in both m/m and YoY terms (from 0.80% to 0.41% for the former and from 6.52% to 6.42% for the latter). The main reason for this disinflation is the recent decline in iron ore prices, which account for an important portion of the index, and that should influence prices of industrial products ahead.

Number of the Week

48.5K

Brazil's net creation of formal jobs in June, according to the General Register of Employed and Unemployed (Caged) released by the Ministry of Economy.

Quote of the Week

"*Annual FGTS withdrawal represents an extra salary forever.*"

— **Paulo Guedes**, Minister of Economy, commenting on the release of forced savings accounts (FGTS, acronym in Portuguese) announced this week.

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 Phillips (*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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