ECONOMICS

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Brazil Macro Compass

The Devil Is in the Details

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Explain, Please

It has been a while since a Copom meeting caused such a fuss among analysts and fixed-income market participants. Although there was a consensus view about the direction that the Copom would choose for the Selic target rate at its meeting on Wednesday (July 31), there was dissent about the likely size of the interest rate cut. Some argued that Copom members would be better off if they chose a 25-bps cut in order to hint at more limited room for monetary easing than the 150 bps implied by the shape of the domestic yield curve. Taking a different view, others argued that a 50-bps cut, combined with more hawkish wording in the post-decision communiqué, could play the same role in curbing eventual unjustified euphoria with a protracted easing cycle. Since Copom decided to reduce the Selic target rate to 6.00% pa from 6.50% pa and suggested there is room for further cuts – although conditional upon additional improvement in the inflation balance of risks – the monetary authority has chosen the second approach, which coincided with our expectation of its likely decision.

Among the factors that led Copom members to shave points off the base interest rates, they cited the comfortable performance – in their view – of recent core inflation measures, in tandem with a benign international environment for emerging markets, and, finally, progress in passing the agenda of structural reforms. Add to that the Brazilian Central Bank's (BCB) assessment that the economic recovery should continue to be gradual, and Copom members have arrived at quite reassuring inflation projections for 2020 – the main focus of the monetary policy going forward – in their traditional simulations. In the baseline scenario, which assumes that both FX and interest rates prevailing at the meeting date remain at these levels indefinitely – USD/BRL3.75 and Selic target rate at 6.50% as of July 31 – the simulation pointed to a 3.6% annual change for the IPCA in 2020, compared with the 4.0% goal set by the National Monetary Council (Conselho Monetário Nacional, or CMN). In the so-called market scenario simulation, wherein Copom members assume the forecasts seen in the Focus report for the FX and interest rates for the end of this year and the next one – USD/BRL3.75 and USD/BRL3.80, Selic target rate at 5.50% pa for both December 2019 and December 2020 – the outcome was a forecast of a 3.9% annual change for the IPCA in 2020. That is, even with a looser monetary grip, inflation would remain below the targeted level in 2020, and, hence, a reduction in the base interest rate would not jeopardize the BCB's ability to meet its goal.

Besides cutting 50 bps, the BCB mentioned that *". . . the consolidation of a benign scenario for the inflationary outlook should allow additional adjustment in the size of monetary stimulus . . . ."* Moreover, Copom members stated that *". . . the Copom considers that concrete progress in this agenda is crucial for the consolidation of a benign scenario for the inflationary outlook . . ."* (sentences in italic are excerpts from the post-decision communiqué, our translation). The agenda the BCB is referring to is the agenda of structural reforms and adjustments that the Brazilian economy still requires, in our view. An eventual failure to achieve such adjustments continued to be pointed out by the BCB as the prime risk factor to the inflation balance of risks.

We believe the reforms are making progress, and, with this further improvement in the balance of risks, we think there should be room for additional cuts in the Selic rate, which should lead it to end the year at 5.25% pa on the back of another 50-bps cut in September 2019 and a final 25-bps reduction in October 2019. The release of the minutes of the Copom meeting last Wednesday should help us consolidate/reassess this view, as the minutes are likely to provide more details of the discussion among Copom members about the agenda of reforms and their assessment of the international environment after the initial interest rate decisions by monetary authorities in advanced economies.

What's New: IGP-M and Industrial Production

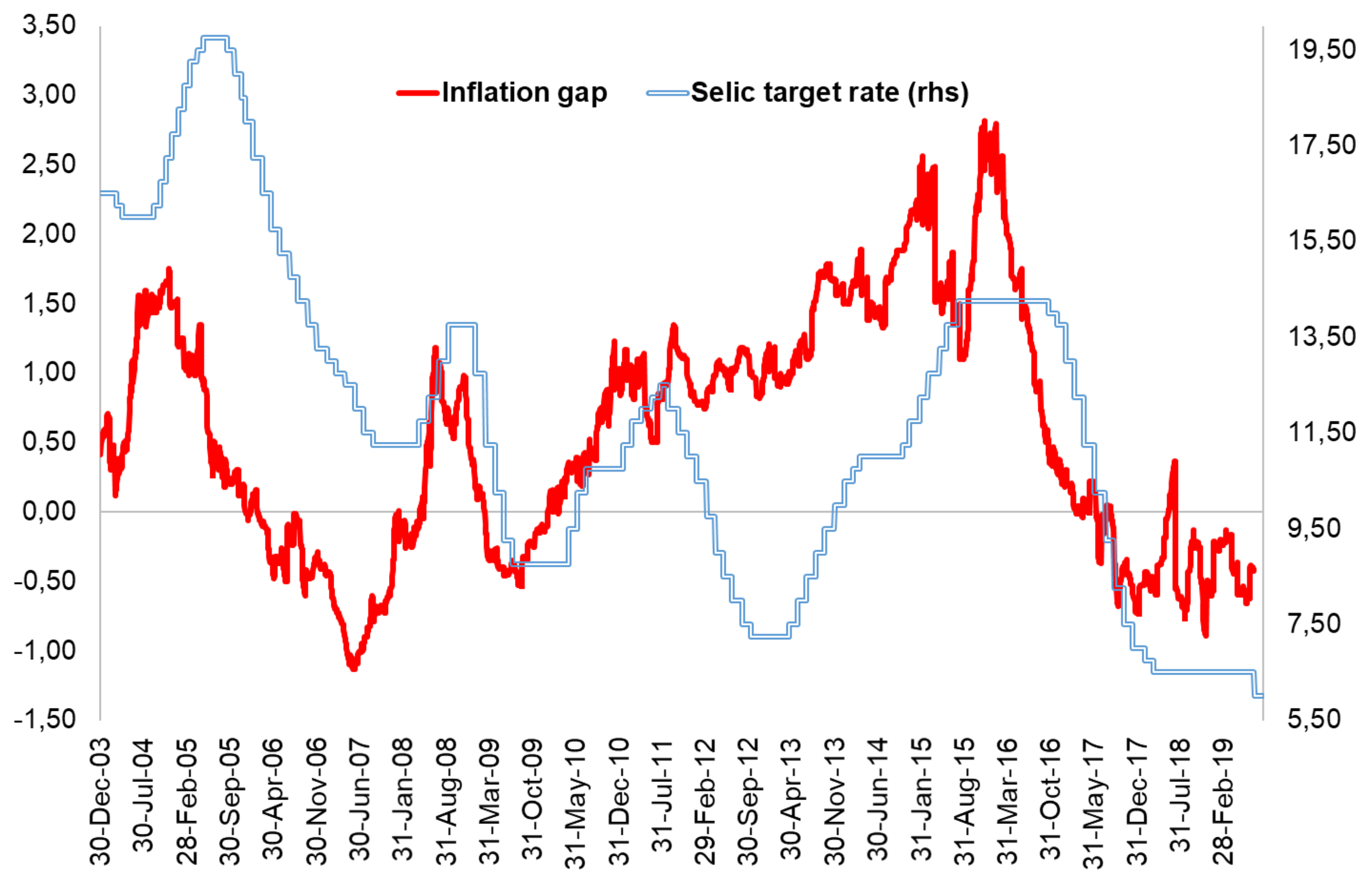
The first important piece of information on economic activity for June 2019, namely industrial production, registered a 0.6% MoM contraction in seasonally adjusted terms, which translated into a 5.8% YoY drop. Both readings were slightly better than what we were anticipating, which was a 0.8% MoM sa fall and a 6.5% YoY decrease. We had warned in previous releases that such an outcome has much to do with the slow recovery of the mining and quarrying segment after the collapse of the Brumadinho dam, in tandem with the poor performance of vehicle manufacturers owing to the Argentine economic crisis – which has dramatically reduced the demand for Brazilian vehicles lately.

Regarding inflation, the release of the IGP-M for July 2019 revealed a 0.40% MoM change, pointing to less pressure than in June 2019, when the index printed a 0.80% MoM increase. The outcome was in line with our simulation – we expected the IGP-M to have registered a 0.41% MoM change – but far below market consensus, which expected a 0.53% MoM increase. In YoY terms, the index receded to 6.39% from 6.52% in the previous month.

Chart of the Week: Setting New Records

Our "Chart of the Week" takes a look at the behavior of the base interest rate compared to the difference between what market participants expect for inflation 12 months ahead and the targeted level – dubbed the inflation gap. Except for the period between mid-2011 and mid-2012, every time the inflation gap widens, the Brazilian monetary authority increases the Selic target rate, and the other way round when it narrows. That helps to explain why the BCB cut the Selic rate last week and why we anticipate further cuts that should lead it to reach 5.25% pa by the end of this year.

Gap between market expectation and actual inflation target vs. monetary policy



Sources: Brazilian Central Bank, Santander.

Upcoming Data: IPCA, Retail Sales and Services Surveys

This week is the scheduled release of the official inflation targeted index (IPCA) for July 2019. We expect it to have registered a 0.23% MoM change, hence higher than the 0.01% MoM change seen in June 2019. Nonetheless, if our forecast proves correct, inflation in YoY terms should have declined to 3.27% from 3.37% in the previous reading.

The fundamental reason for the acceleration of inflation between June 2019 and July 2019 relates to administered prices. Despite the downward adjustment in fuel prices (gasoline prices fell some 6.0% and diesel prices ~2.1%), the impact of higher costs related to electricity fares and ethanol prices has more than offset that deflationary impact. Electricity rates rose due to adjustments in production costs owing to less favorable rain patterns, whereas ethanol prices reacted to a stronger demand for the product in July 2019. For the coming months, while electricity rates are not likely to see any respite, in our view, ethanol prices should dwindle, as sugarcane mills have increased production of the biofuel.

On the economic activity front, the main releases next week are the June figures for retail sales and volume of services. We expect headline retail sales at +0.5% m/m. Regarding the services indicator, we project a 0.2% m/m fall.

Number of the Week

6.00% The Brazilian Selic target rate reaches a new historical low, whose lifespan is likely to be ephemeral, in our view.

Quote of the Week

"*This isn't the start of a long series of rate cuts.*"

— **Jerome Powell**, Federal Reserve Chairman, during the press conference following the 25-bps cut in the Fed funds target rate on Wednesday, July 31.

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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