Brazil Macro Compass

Come 2020

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- **We expect the release of Brazilian GDP data for 2Q19 next Thursday to reinforce the broad outlook—which we concur with—that the economic recovery is likely to continue to be gradual.**
- **In our view, some of the fatigue has to do with sizeable imbalances the public budget has recorded of late. Unfortunately, we do not expect the fiscal figures slated for next week to hint at any substantial changes in this picture for now.**
- **On top of concerns with budget issues, market participants should also pay heed to two important summits—namely, the G7 meeting and the Fed Jackson Hole Symposium—which may influence Brazil's international relations and its currency.**
- **Incidentally, recent BRL dynamics have suggested that changes in the way the Brazilian Central Bank (BCB) has intervened in the FX market should not translate into an artificial strengthening of the currency.**

Economc activity: In Brazil, the main source of concern among market participants has been the pace of the economic recovery, and we believe that 2Q19 GDP data (due to be released on Thursday) should confirm recent signs from leading indicators that it remains slow. According to our estimates, Brazil's GDP should have grown 0.8% in YoY terms, which would represent—if our calculations are correct—a 0.3% expansion in QoQ seasonally-adjusted terms. Although higher than the previous reading (0.5% YoY), we would note the 'base effect' associated with the truckers' strike (May 2018), which weighed on production levels in 2Q18. Hence, we believe the number should not be taken at face value.

From a supply standpoint, we expect the highlight to come from the agricultural sector, which we estimate to have increased 1.0% in QoQ seasonally-adjusted terms, driven by strong harvests of cotton and corn and higher exports of livestock (driven by the impact of African Swine Fever on Chinese herds). On the other hand, we expect the industrial sector to have contracted 0.1% in QoQ seasonally-adjusted terms, as the accident at the Brumadinho dam continued to weigh on the performance of mining activities. Last but not least, the services sector should have expanded 0.3% in QoQ seasonally-adjusted terms, according to our estimates. From the demand viewpoint, we estimate that while domestic absorption should have increased 0.8% in QoQ seasonally-adjusted terms—driven by investments—net exports are likely to have decreased 0.2% in QoQ seasonally-adjusted terms, driven by higher imports. If confirmed, these figures would be compatible with the maintenance of our full-year forecast of 0.8% GDP growth in 2019.

The release of 2Q19 GDP data is relevant, especially as it should include a discussion of the outlook for the coming quarters. There are those with a more upbeat view on the pace of the recovery, reflecting higher confidence in the approval of the pension reform, the low level of interest rates (by Brazilian standards), the agenda of reforms, and short-term incentives such as the partial withdrawal of FGTS resources (a kind of compulsory insurance for private workers against dismissal). However, confidence indices released so far have not supported that assessment, in our view, as activity indicators have shown only modest improvement. Therefore, it looks to us like the recovery should continue to expand in a very gradual fashion in the coming quarters with a sounder economic pace likely to materialize only in the next year.

Fiscal issues: Some news and critical decisions related to fiscal balance have taken place in recent days, such as the government's proposal to the Senate referring to the so-called "new federative pact," whose main pillars touch upon

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greater flexibility in the budget framework and higher transfers from the federal administration to states and municipalities. The final document with all details is due to be presented to Congress next Monday and would lead to an expected increase of R$500 billion in transfers to subnational entities within 15 years.

The pact aims at bringing some relief to states and municipalities as, according to the National Treasury, there are only three states abiding by the Fiscal Responsibility Law with respect to personnel spending (states are only allowed to spend up to 54% of their net revenues on public servants, retirees and pensioners). Besides, a third of the 27 states do not have enough funds to meet their financial obligations, which reflects the degree of fiscal deterioration at the subnational level. However, there is great concern regarding how states and municipalities will use the extra resources they are supposed to receive, as expenditures have continued to grow recently (especially on personnel) without the implementation of any effective mechanisms for control or correction, but rather the other way round. Therefore, although we admit the current fiscal outlook for subnational entities is quite challenging, we want to emphasize that the new federative pact must include adequate conditions/counterparts to ensure that the new resources will not be directed toward more current expenditures, but rather toward either investments or in support of measures for fiscal adjustment or reforms. That is, we believe the fiscal improvement of the public sector as a whole must come from the expenditures side rather than the revenues side. Therefore, as we have been stubbornly insisting, the imminent approval of the pension reform in the Congress should serve as a crucial step toward fiscal consolidation, but it is far from doing the job by itself.

***International environment*:** Usually seen as a bellwether forum for future moves by the FOMC, this year the annual symposium held in Jackson Hole gained an extra role, which is the defense of the autonomy of the U.S. monetary authority given mounting criticism against FOMC Chairman Jerome Powell by President Trump. Developments at the event this year suggested that the FOMC might deliver further cut(s?) in the Fed fund target rate ahead, which could bring some relief to Chairman Powell in terms of his criticism from the president, and could open room for the rest of the world—including Brazil—to continue reducing their interest rates as well. In addition to the debates in Jackson Hole, market participants should also closely monitor the G7 meeting in Biarritz, France, as the summit may bring updates on the trade war and, more importantly, on eventual sanctions against Brazil as a result of the rapidly spreading wildfires in the Amazon forest. It is important to keep in mind that environmental issues are part of the trade agreement between the European Union and Mercosur, and could lead to a postponement in its implementation (as well as preventing other agreements from being reached). As such, any setback at this event could weigh on the prospects for the already-challenged Brazilian economy.

Number of the Week

$1.3B Amount of greenbacks provided by the Brazilian Central Bank in the spot FX market under the new intervention scheme.

Quote of the Week

"*It is an international crisis. Members of the G7, let's talk in two days about this emergency.*"

— **Emmanuel Macron**, French president, tweeted on August 22 about wildfires in the Amazon forest.

Chart of the Week: Not an artificial barrier

Our "Chart of the Week" shows the recent behavior of the BRL. Last week we wrote that the change in the way the BCB would start intervening in the FX market did not aim to artificially strengthen the Brazilian currency, but rather to respond to an apparent modification in the nature of the demand for USD from derivatives to greenbacks. Given the performance of the USDBRL cross in recent days, we think this assumption has proven correct, as even though the BCB has sold US$1.3B in the spot market—and squared that exposure with the issuance of the same amount in reverse swaps (equivalent to purchase of USD in the futures market)—the currency weakened to BRL4.12/USD from BRL4.05/USD on the day the change was announced. Hence, notwithstanding the provision of greenbacks in the spot market, there was no hindrance for the BRL to react to occurrences such as the reaction to an aggravation in the trade war between China and the U.S., criticisms about the FOMC's conduct from President Trump and potential risks on the domestic fiscal front. In sum, the provision of greenbacks should not prevent the Brazilian Real from behaving according to its fundamentals.

BRL/USD

Announcement of the change in FX intervention 4.05

23-Aug 4.12

4.20
4.10
4.00
3.90
3.80
3.70
3.60
3.50

01-Jul 03-Jul 05-Jul 07-Jul 09-Jul 11-Jul 13-Jul 15-Jul 17-Jul 19-Jul 21-Jul 23-Jul 25-Jul 27-Jul 29-Jul 31-Jul 02-Aug 04-Aug 06-Aug 08-Aug 10-Aug 12-Aug 14-Aug 16-Aug 18-Aug 20-Aug 22-Aug

Source: Bloomberg, elaborated by Santander.

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- *Economic Activity: No News Is Bad News* (April 22, 2019)

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