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ECONOMICS

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Brazil Macro Compass

Back to the Hard Reality

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- **The release of industrial data for July reinforced our thesis of a gradual recovery for the Brazilian economy. We believe that retail sales are likely to reveal a contraction in the same period, whereas the services segment should have remained stable in July 2019.**
- **The IPCA registered a 0.11% MoM change in August 2019, thus corroborating our view of tame inflation readings—far below the Central Bank's inflation target for 2019 (4.25%).**
- **This week we expect critical indications as to the direction of Brazilian fiscal policy, with news regarding the auction of transfers of oil rights. According to the government, the auction is estimated to inject approximately R$70 billion into public coffers.**
- **The international front has brought some relief to market participants on the back of positive Chinese economic data, some soothing signs regarding the trade war between China and the U.S., and last but not least, the reduced likelihood of a no-deal Brexit.**

Economic activity: The slight euphoria derived from the positive GDP surprise in 2Q19 was short-lived. The YoY decline of 2.5% in July 2019 industrial production—released by IBGE on September 3—frustrated both market participants and us, marking a return to a harsh reality: the economic recovery remains quite gradual. What's more, the breakdown has shown a relatively worrisome trend: mining activities delivered a poor performance—despite some recovery in quarrying on the back of resumption of production in some plants after the Brumadinho dam collapse—and the manufacturing sector also disappointed, signaling the exhaustion of the momentum that had been observed so far. Hence, as the base effect derived from the truckers' strike in May 2018 is over, the outlook points to tough times in 3Q19.

In this context, the stream of economic activity indicators to be released this week should expose a weak performance in July 2019. According to our estimates, the broad retail sales gauge is likely to have declined 0.6% MoM in seasonally adjusted terms, while other segments are likely to have led the service sector as a whole to remain stable in the same terms. Consequently, we expect the IBC-BR—a proxy built up by the Brazilian Central Bank to mimic the behavior of GDP on a monthly basis—to have declined 0.5% MoM in seasonally adjusted terms.

Additionally, the first activity indicators for August 2019 are beginning to be released, and ANFAVEA's data—vehicle sales and production—caught our attention, not only due to 6.6% MoM fall in production in seasonally adjusted terms but also because of another phenomenon that has been in place for some time and must be observed with close attention. Domestic sales of trucks have grown 45.7% on average in 12-month-to-date terms (since August 2018). We believe that the truckers' strike may have launched a vertical integration process in companies on the back of their perception of high dependence on autonomous haulers and their uncertainties about the freight table; hence the significant growth in truck sales, putting even more pressure on the fragile category of autonomous truckers whose possible reaction could have severe impacts on the economy. It is worth remembering that their strike withdrew 0.7 p.p. from 2018 GDP, according to our estimates.

Inflation: The officially targeted inflation index (IPCA) registered a 0.11% MoM change in August 2019, which has meant a 3.43% YoY increase, far below the inflation target set for the year (4.25%). Administered prices remain the main driver for inflationary pressures (+0.60% MoM), while foodstuff prices worked the other way declining 0.84% MoM. Taking those elements into account, we forecast IPCA to register a 0.06% MoM change in September 2019—or 3.0% in YoY terms—which we believe could underpin our call for an extra interest rate cut of 50 bps in mid-September, taking the base interest rate to 5.5% p.a. if our forecast proves accurate.

Congressional activities: After a relatively quiet period in the political arena, we expect to face some decisive moments for the Brazilian fiscal problem in coming weeks. Initially, we anticipate seeing further progress in Social Security Reform, which is now being assessed by the Senate. The rapporteur of the bill in the Constitutional, Citizenship and Justice Commission (CCJ), Senator Tasso Jereissati, presented his report with some amendments, which included the creation of a lower contribution rate for informal workers, the inclusion of former congressional representatives in the new rules, and changes in the death pension rules. Those changes have brought some additional dilution of fiscal savings in the proposal delivered by the Lower House, but the constitutional amendment—dubbed PEC in Portuguese—should still deliver significant savings: nearly BRL870 billion, according to government's calculations. However, the inclusion of the so-called "Parallel PEC", which deals with the inclusion of state and municipal civil servants in the reform among other points, was noteworthy. According to the government, if the Parallel PEC is approved by the Congress, fiscal savings may reach R$1.3 trillion within the next 10 years.

Besides, the Senate also approved PEC 98/2019 this week, a proposal that would allow the federal government to share the proceeds from the collection in pre-salt auctions with states and municipalities. Auctions may bring R$70 billion to public coffers, with transfers of 15% to municipalities and an additional 15% to states and the federal district. The proposal now goes to the Lower House. The government wants the auction to take place on November 6 and the National Petroleum Agency (ANP – *Agência Nacional de Petróleo*) has released the associated notice, complying with the requirement of releasing it up to two months in advance. Nonetheless, the Lower House and the Federal Audit Court (TCU) must approve the bidding rules, ensuring that all bidders have access to the same information. And last week, TCU requested revisions to the contract of transfer of pre-salt oil rights, potentially slowing progress and frustrating the government's will. Moreover, despite the government's efforts to hold the auction in November, the speaker of the Lower House (Representative Rodrigo Maia) is already talking about postponement, as he considers it important for the Lower House to vote on PEC 98/2019.

We expect the inflow of resources to impact the Brazilian primary result, but it does not stop there: it should generate large inflows of foreign currency, as major companies participate in the auction and buy off part of the exploration rights. In our view, the only doubt is to the timing of such inflows: if the government succeeds in its intention to hold the auction in November, the resources should be available in December 2019. If any delay materializes, money may only come in 2020.

International influence: After having faced tense moments in the international front over the last weeks, market participants welcomed the cooling off of the U.S.-China trade war. The two countries agreed to resume talks, with a visit by the Chinese Ministry of Commerce to the U.S. scheduled for early October.

Additionally, favorable data was released regarding major world economies. Chinese PMI (industrial data) rose from 49.9 in July to 50.4 in August (above the level of 50 that indicates expansion), thus reducing fears of a hard landing in the country. When we look at non-industrial PMI, the data is even more encouraging: 53.8 in August. Therefore, it looks like we are going to have a gradual slowdown instead of a crash in the Chinese economy, similar to what we have observed in several economies around the world.

On top of that, the decision carried out by the British Parliament that the United Kingdom is not allowed to leave the European Union without reaching an agreement with the bloc has also brought some respite to market participants, as it reduced the chance of a traumatic Brexit next October 31. Consequently, Prime Minister Boris Johnson will have to resume talks with EU negotiators in order to pave the way for a more coordinated departure from the bloc, which should help global risk aversion to diminish in the coming days.

Number of the Week

R$70B

Expectation of revenues to be obtained with the auction of transfer of rights of oil wells.

Quote of the Week

Our problem is not to discuss the cap for public spending. Our problem is to discuss public spending.

— **Rodrigo Maia**, speaker of the Lower House, about requests to change the rule that imposes a ceiling to public expenditures.

Recent Publications (Available on Our Website)

- *In Search of Growth* (August 29, 2019)
- *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)

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