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Corporate & Investment Banking

ECONOMICS

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Brazil Macro Compass

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Window of opportunity

- **Economic activity data continues to send mixed signals, with declining production and services growing. In net terms, we believe that gradualism will continue to characterize the process of economic recovery in the months ahead.**
- **In turn, the benign behavior of inflation continues to surprise. The latest monthly IPCA readings have surprised downwards, leading us to revise our forecasts for inflation in 2019 and 2020 to 3.3% and 3.5% respectively, from 3.6% and 3.9% previously.**
- **In our view, the combination of slowly recovering economic activity, ample idleness, declining current inflation, anchored inflationary expectations and advancing congressional reforms opens room for further cuts in the Selic rate. Assuming that the international scenario does not show further deterioration in the short term, we expect Brazil's basic interest rate to reach 4.50% p.a. by the end of this year.**
- **The evolution of the global scenario comprises the main risk factor for our economic forecast, especially via exchange rate impact and despite the almost absent pass-through. The sources of uncertainty are already known: trade war, Brexit and elections in Argentina. Increased exchange rate volatility inhibits investments.**

Economic activity: As highlighted in last week's edition, we continue to see mixed signals in economic activity data. Although Q2 GDP (+ 0.4% vs. Q1) released on August 29 has excited most market players, the monthly industry survey released on September 3 once again frustrated expectations by presenting a significant fall of 2.5% YoY in July 2019 industrial production.

This week, in turn, there was data on retail trade, services and the monthly GDP proxy calculated by the Central Bank (IBC-Br). Well above market expectations, the monthly trade survey (PMC) revealed that the restricted retail sales indicator rose 4.4% year-on-year in July—which translated into a 1.0% MoM increase after seasonal adjustment. There was growth in eight of the nine retail segments, with sales of furniture and appliances being the main highlight.

As for the expanded index of retail sales—which includes sales of automobiles and building materials in addition to the components of the restricted measure—growth was even more pronounced. The year-on-year expansion of the broader index was 7.7% and a rise of 0.7% compared to June this year, after seasonal adjustment. Compensating for part of the 0.9% month-on-month decline in the vehicle and auto parts segment—seasonally adjusted—sales of building materials increased 1.1% MoM (sa), a year-on-year increase of 8%. This is a sector that has attracted the attention of many analysts, especially after the (positive) surprise of the Construction GDP in the 2Q19.

Following the same line, the July monthly survey of services (PMS) also showed a positive result: an increase of 0.8% MoM (seasonally adjusted), or 1.8% YoY. If it were not for the MoM (sa) contraction of 1.3% registered by the technical and administrative services segment, the growth of the services indicator could have exceeded 1.0% MoM (sa). Nevertheless, the result was sufficient to indicate a positive carryover for the service sector's performance in 3Q19 (0.4%), somewhat relevant after quarterly contractions in both 1Q19 and 2Q19. That is, if this trend is confirmed, we will have one more sign that the economic recovery remains on track.

In line with the indicators mentioned above, the IBC-Br, the GDP proxy calculated monthly by the Central Bank, fell by 0.2% MoM (sa). In the 12-month period, the indicator stands at 1.1%, reinforcing our estimate of 0.3% GDP growth in

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the third quarter over the second quarter of 2019.

In short, the presence of positive and negative surprises in the July activity data seems to indicate that gradualism will continue to characterize the process of economic recovery in the months ahead. However, it is worth remembering that the truck driver strike in mid-2018 may still be distorting the seasonal adjustment of the economic data series. Because of this, it may be necessary to continue closely following the upcoming information releases to identify any potential changes in the recovery dynamics.

Inflation: The main domestic price indices have been showing monthly variations below 0.2% since May. As a result, market participants' median projections have been falling weekly in the Focus survey. For example, the median of September inflation expectations is 0.15%, corroborating the current annual projections of 3.54% and 3.82% for the end of 2019 and 2020, respectively. In addition, forecasts for the end of 2021 and 2022 follow the official target (3.75% and 3.50%, in that order). That is, according to market expectations (as well as ours), we should have inflation below the target (or in line with it) for a few years.

This is also the perspective that emerges from our assessment of inflation dynamics in the rest of 2019, but especially during the year 2020. According to our calculations, it is possible that the medians observed in the Focus survey show further downward revisions, since we obtained a 3.5% projection for next year's IPCA. Our projections foresee a trajectory of declining core inflation measures and free-market prices—excluding foodstuff items at the household level—running below 3% and a smaller impact of African Swine Fever (PSA) on domestic prices. **As a result, we now expect the IPCA annual change to record a 3.3% in 2019 and 3.5% in 2020 from 3.6% and 3.9% previously.** It is worth noting that on October 11, IBGE is due to release the new IPCA weighting for 2020, reflecting the implementation of the new Family Budget Survey (POF) of 2017 and 2018. With this, our inflation projections for 2020—and the market's—may undergo new revisions in early October.

Interest Rate: Several countries will have monetary policy meetings in the coming weeks, and lower interest rate levels are expected as a result of these meetings. By the way, the European Central Bank—whose meeting took place on 9/11 and 9/12—kept the basic interest rate in the economic bloc at zero, in addition to (i) increasing the custody cost for deposits made by banks with the institution (charging rate of 0.40% per annum and now the cost is 0.50% per annum) and (ii) implementing a large package of net sovereign and corporate bond repurchases (€ 20 bilion per month) that will not be reversed until there is an increase of the basic interest rate (according to the ECB). Low inflation expectations (close to 2%) and a lack of economic dynamism in the region led the ECB not only to act, but also to call on countries with better fiscal conditions to assist in the task of reheating the bloc's economy.

On September 17 and 18 we should hear from the Federal Reserve. For the US economy, data released in recent months and some cooling of the trade war with China led the market to raise interest rate bets at this meeting. The US future yield curve prices in a 25-basis-point cut in September.

For Brazil, we face a slightly different scenario than at the last Copom meeting in July: Brazil's structural reforms are continuing, with the Senate Social Security Reform expected to be approved in October; and 12-month inflation remains below 3.5%, with market expectations for 2019 and 2020 decreasing each week. On the other hand, the exchange rate is much higher than in July (BRL depreciated around 7,5% from July 31 to September 12). The main question today is how sharper cuts in the Selic rate could affect the exchange rate level, which has reached close to USD/BRL4.20 in recent days.

Our forecast remains a cut of 50 bps at the next meeting (September 17 and 18), as we have seen a calmer international scenario in recent days, structural reforms in the Congress agenda are continuing, and inflation expectations are well below the Central Banks's target. With economic activity data still showing signs of a modest recovery (as highlighted in section 1 of this report) and confirming our expectation of GDP growth below 1.0% in 2019, we have changed our interest-rate forecast for the end of the year. In addition to the 50-bp Selic rate cut at the September meeting, we now expect two additional cuts of 50bps each at the October and December meetings, bringing the Brazilian economy's basic interest rate to 4.50% pa by the end of 2019, which should be maintained until the beginning of 2021.

Risks: What would be the risks for our 4.50% Selic rate scenario? First, the international scenario. We have seen a decrease in the great turbulence observed in August, but there are still many factors that can affect Brazil. One is Argentina's presidential election to be held in October this year, whose outcome has significant implications for the Argentine economy and could potentially impact some Brazilian sectors, especially the automobile. Elsewhere, and despite the cooling of the US-China trade war and the possible resumption of official negotiations in October, we still foresee an environment of considerable uncertainty as to the end of the conflicts between the two countries. With the US elections approaching and the active role of President Donald Trump in the negotiations, we will probably see a lot of news on this subject in the coming months.

Furthermore, we do not yet have a definite agreement on the departure of the United Kingdom from the European Union (EU), the now-famous Brexit. Current Prime Minister Boris Johnson has suffered a series of defeats in the British Parliament—which is suspended until October—including the passage of a law preventing the UK from leaving the EU without prior agreement. From now on, either the Prime Minister decides to go against the approved law or seeks agreement, either within the British Parliament (with a view to leaving by the EU date, 31 October), or with the European Parliament (requesting an extension of the exit deadline).

All of these effects may generate great volatility for Brazilian assets. October should be a busy and important month to determine the pace and size of the cuts until the December meeting, as analysts are divided on the magnitude of the cut at this meeting and whether or not the cuts will continue until the December meeting. Under the current scenario, we reiterate our Selic rate projection of 4.50% p.a. at the end of 2019 and 2020.

Last but not least, it is important to highlight that the large idle capacity has limited the FX pass-through to domestic prices. That is, even under an alternative scenario in which some weakening of the BRL materializes—as opposed to our view of stability of USD/BRL near 4.00—the impact over the IPCA is likely to be meagre, which in turn would not prevent additional cuts to the Selic target rate.

Number of the Week

€$20B

The volume of monthly net asset purchased set by the new EU Quantitative Easing released this week that will not be reversed (according to the ECB) until there is an increase of the basic interest rate.

Quote of the Week

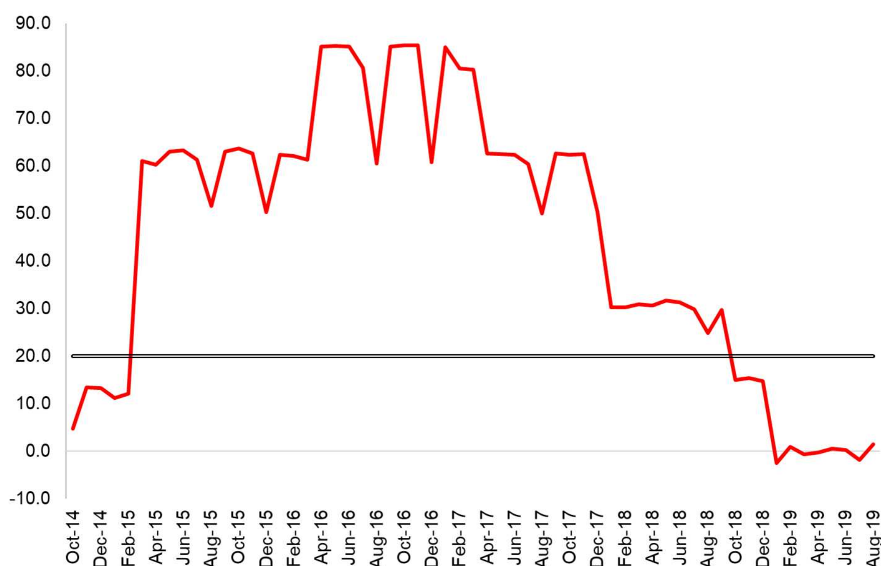
On behest of the president, there will not be either the introduction of a new "CPMF" (tax on financial transactions) or an increase in the tax burden in Brazil.

— **Jair Bolsonaro**, Brazil's President, about the prospects for the tax reform in the country.

Chart of the Week: With a little help from my friends

Our "Chart of the Week" shows the past evolution of monthly net asset purchases set by the ECB quantitative easing program that was resumed last Thursday. On top of resuming purchases of sovereign and corporate bonds—that won't be reversed until the moment in which the European monetary authority increases the base interest rate in the region—ECB Chairman, Mr. Draghi, urged Eurozone members to grant fiscal incentives aiming at fostering a faster economic recovery, which signals to the limits of the monetary policy in the region.

ECB Asset Purchase Program (APP) Monthly Net Purchases - €billion



Source: Bloomberg.

Recent Publications (Available on Our Website)

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- *Economic Activity and Credit: Highway to Heaven?* (June 7, 2019)
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