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## Brazil Macro Compass

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# Signs of a More Auspicious Outlook

- **Economic activity data for the last quarter of 2019 have been encouraging. The unemployment rate in November surprised favorably, both in terms of headline and composition, given signs of improvement in formal jobs. After a good performance in previous months, we expect November industrial production (due for release next Thursday, January 9) to post a small decline, though still consistent with an expansion for the fourth quarter.**
- **We forecast December IPCA at a hefty 1.13% MoM, strongly influenced by supply shocks impacting food and fuel prices. This result would be consistent with full-year inflation of 4.29% in 2019, slightly above the central target for the year (4.25%). We continue to (fore)see a benign inflationary scenario (outlook), owing to large economic slacks and well-anchored expectations.**
- **A recent batch of data for December confirm a hefty (cyclical, seasonal) FX outflow, as well as a stronger-than-expected trade surplus. We anticipate a benign scenario for external financing in 2020, possibly offsetting a probable increase in imports (given the better activity). In our view, the outlook for the balance of payments does not imply greater risks to the 2020 exchange rate. Thus, and counting on a less tensioned external scenario, we continue to anticipate a YE2020 FX rate of USD/BRL4.00.**
- **November's budget results were better than expected. Additionally, the December reading will be influenced by a high amount of extraordinary revenue (related to oil field auctions in November). As an upshot, the public sector´s primary deficit will end 2019 significantly below the target. Still, we reiterate that the Brazilian fiscal adjustment is not complete and that new measures and reforms are needed to contain mandatory expenses.**

**Economic activity indicators continue to underpin the prospects for a recovery:** On December 27, the National Household Sample Survey (PNAD) was released, providing employment data on the quarter ended in November. The unemployment rate fell to 11.2%, up from 11.6%. In seasonally adjusted terms, we observed a marginal fall in unemployment to 11.8%, up from 11.9%, in line with our estimate. In addition to the fall in the unemployment rate, another positive factor was the increase in formal employment, corroborating the five consecutive months of positive net formal job creation data. Among the sectors, we highlight that construction continues to gain space. Along with the service sector, these are the fastest growing in the annual comparison. Moreover, the change in the real wage of the employed population increased by 1.2% YoY in November, despite inflation speeding up in the month. Furthermore, the real wage bill and average real wage growth has reversed it decelerating trajectory of the past 12 months. The released data confirm our perception that unemployment will continue to gradually fall over the coming months. Nevertheless, we acknowledge that the latest labor data has been encouraging, and we believe that we could see faster-than-expected improvement in 2020.

Still regarding economic activity, on Thursday, January 9, IBGE will release its Monthly Industrial Survey (PIM) for November: we expect a decrease of 0.6% compared to the same month of 2018, which would imply a reduction of 0.5% compared to October, in seasonally adjusted terms. According to our calculations, the fall in industrial production in November was driven mainly by the manufacturing industry, as we expect mining to show robust growth due to high oil production in the month. However, despite the apparently negative result, we highlight that the quarter ended in

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November should grow by 1.2% over the previous quarter in seasonally adjusted terms, according to our projections. Thus, we remain optimistic about the performance of Brazilian industrial production in the last quarter of 2019.

**Inflation indices were hit by strong one-offs at the end of last year:** On Friday, December IPCA (Brazil´s official inflation index) will come out: we forecast a gain of 1.13% MoM, with the YoY change going up further to 4.29%, thus slightly above the targeted level of 4.25%. According to our calculations, December's IPCA spiker (vis-à-vis the December IPCA preview: +1.05% MoM) was driven by: (i) the shock in animal protein prices (beef, chicken, etc.), which we believe could have contributed 62 bps to the headline; and (ii) the hike in fuel prices, whose contribution we estimate as high as 19 bps. We note that the IPCA would have recorded a 0.32% MoM change were it not for those temporary factors, indicating a still tranquil inflation backdrop.

For instance, we estimate that the IPCA-EX3 (the most sensitive core inflation gauge of monetary cycles) increased 0.43% MoM, compared with 0.28% in the mid-month preview, especially due to hikes in edible items. Were it not for that temporary shock, the IPCA-EX3 was supposed to have decelerated last December, which reinforces our assessment of a benign inflationary outlook, given the maintenance of an economic rhythm still below the potential GDP growth rate and well anchored inflation expectations.

**External sector data bringing some respite to market participants:** While weekly data on FX flows in the spot market continued to suggest net outflows of greenbacks from the Brazilian economy—US$2.4 billion between December 24 to 27, according to the Brazilian Central Bank (BCB), which consolidated the prospect for the largest annual outflow ever seen in the country (a US$43.3 billion leakage that we believe is unlikely to be dramatically altered by December 30 figures)—the release of trade balance data for the last month surprised favorably, as export proceeds overcame import outlays by US$5.6 billion (we expected a US$3.2 billion positive outcome and market consensus pointed at a US$4.3 billion one), thus leading the Brazilian foreign trade to register a US$46.7 billion surplus in 2019 from US$58.0 billion in 2018.

Regarding the aggravation in the net FX outflow observed last year (to US$43.3 billion from a US$1.0 billion leak in 2018), it is important to bear in mind that both commercial and financial segments contributed to the negative outcome. However, when one compares to their respective balances in 2018, it is easy to grasp that the commercial segment was the main culprit for the setback. While it managed to generate a net inflow of US$47.7 billion in 2018, the commercial segment registered a net inflow around US$17.9 billion–roughly, a US$30 billion contraction. In the same terms, the financial segment outflow reached US$61.2 billion in 2019, as compared with US$48.7 billion in 2018. On top of the retreat stemming from the Argentine economic crisis and a mild performance of international trade, it is worth remembering that part of the export proceeds might have been used to settle exporters' external debt, as they have not been forced to convert their revenue into BRL since 2008. Likewise, the BCB has pointed out that payment in advance of external obligations is the main reason for the increase in the financial outflow. Hence, although we reckon the prepayment of external corporate debt weighed on FX flows last year, we expect this factor to lose steam in the coming months and the important question for evaluating prospects for the FX flows during this year refers to the behavior of foreign trade.

In this sense, the positive surprise delivered by the trade balance last December boded well for our expectation of a less distressing period than the one observed in 2019 (for further details, please refer to our December 16 report, *A Better Outlook*. After being hit by a strong contraction of manufactured goods on the back of Argentina's economic crisis, we find it difficult to anticipate another equivalent drop in export proceeds in the coming months. However, we reckon that this is a risk factor that must be carefully followed in the short term. In tandem with that (as we expect the Brazilian economic recovery to remain gradual, despite some strengthening derived from short-term incentives), we think import outlays are going to expand likewise rather than boom. Thus, we assume the shrinkage in the trade balance is going to slow down going forward and, consequently, exert less pressure on FX flows.

Last but not least, the better-than-expected trade balance registered last December is likely to translate into a lower-than-projected current account monthly deficit in the period. Before the release of foreign trade data, we estimated the current account deficit would have reached as high as US$6.8 billion in December, but now we project the imbalance to have hovered around US$4.4 billion. If our calculations prove right, the current account balance will have registered a US$49.4 billion deficit in 2019—some 2.7% of GDP—which will help ease market participants' minds regarding the soundness of Brazil's balance of payments.

**Fiscal balance positively surprised in November:** As published by the Central Bank of Brazil last Monday, the Brazilian public sector (Federal administration, states, municipalities and stated-owned enterprises) recorded a primary deficit of BRL15.3 billion in November, positively surprising both our expectation (-BRL17.6 billion) and market consensus (-BRL17.4 billion). The disaggregated results among public entities were as follows: -BRL18.2 billion for the

federal government; +BRL2.9 billion for regional governments (which largely explains the difference between our forecast and actual results, since we expected a slight negative balance for November); and -BRL0.04 billion for the state-owned companies. Considering the last 12 months ended in that month, the public sector's primary deficit totaled BRL89.5 billion (-1.24% of GDP). For full-year 2019, nevertheless, we forecast a much lower primary deficit (-BRL68.5 billion or -1.0% of GDP, considerably below the target of -BRL132 billion/-1.8% of GDP set for the year), mainly due to the expected inflows in December arising from the oil auctions held in the last two months (e.g., Transfer of Rights—ToR—auction).

Moreover, as we have emphasized (please see our December 16 report, *A Better Outlook*), the sharp decline of the cost of debt rollover has led to more favorable figures for Brazil's public debt. For instance, our estimates indicate that the gross public-debt-to GDP ratio will end 2019 at 76.8% (November: 77.7%). In our view, the stronger pace of economic growth and the maintenance of interest rates at historically low levels for an extended period should lead the gross public debt to peak in 2021 (not exceeding 80% of GDP, a much better scenario than anticipated a few years ago). Our baseline scenario considers the continuity of the fiscal reform agenda, compliance with the spending cap rule and (gradually increasing) primary surpluses from 2023 onward.

## Recent Publications (Available on Our Website)

- *A better outlook* (December 2019).
- *Better days ahead* (November 2019)
- *FX Compass–BRL: One down. Many others to go.* (October 2019)
- *In Search of Growth.* (August 2019)
- *Climbing The Cliffs In Bad Weather* (June 2019)

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