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Brazil Macro Compass

The Devil Is in the Details

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- **In a week that saw global market conditions for EM and risky assets somehow impacted by the jitters related to the outbreak of the coronavirus in China, Brazilian assets, in general, posted a flatish pattern and an intermediate performance vis-à-vis peers. The highlight is the local yield curve, which saw upside pressures build following the release of less disinflationary details in a mid-month inflation preview. Yields across the curve took a U-turn after BCB Governor Roberto Campos Neto gave an interview in which he indicated that the authority continues to see a favorable inflation trend, as well as a fading of recent supply shocks (food costs). We continue to look for a 25bp cut (to 4.25%) in the Selic rate for the next Copom meeting (February 04-05).**
- **The mid-month preview of the IPCA—dubbed IPCA-15—came in line with expectations in January 2020. Underlying inflation numbers gained a bit of steam, but we see those pressures as temporary, so that we continue to project IPCA inflation fairly below the mid-target (4.0%) this year.**
- **Labor market data reinforce the perception that the Brazilian economy is on the mend, something that is likely to gradually gain traction during the the year, in our view.**
- **We believe that next week's external sector data could ease market concerns regarding the dynamics of Brazil's balance of payments.**
- **We expect 2019 public sector primary results to come in significantly below target, mostly due to the large amount of extraordinary revenue (e.g., proceeds from oil auctions) and a marked reduction in discretionary expenditures. However, we forecast 2020 fiscal data to show higher primary deficits, making it clear that the fiscal adjustment process remains incomplete.**
- **We believe that improved economic sentiment and better approval ratings for the current administration (as implied by this week's CNT/MDA pollster) could further reinforce the adminsitration's commitment to that agenda.**

Inflation: The IPCA-15, preview for the official inflation index,registered a 0.71% MoM change in January 2020, slightly lower than our forecast (+0.72% MoM) and a tad higher than market consensus (+0.70% MoM). Despite the significant deceleration (from a 1.05% MoM reading in December), it was not enough to bring the YoY change (4.34%) below the inflation goal set for 2020 (4.00%).

The main groups behind this disinflation were Foodstuffs and Transportation. Consumer price indices registered a temporary spike in December 2019, owing to the shock in animal protein prices that stemmed from the African swine fever (ASF) outbreak that has negatively affected Chinese pig herds. As this negative impact has subsided in the the last few weeks, the tracking of January IPCA has pointed towards the extension of the disinflation trend in the incoming readings. Key inflation surveys are showing declining protein and gasoline prices—the latter as a result of downward adjustments announced this week—which led us to forecast a 0.28% MoM change (4.27% YoY) for the January 2020 IPCA. Therefore, as we have stated for some time, after the uptick, inflation is likely to decelerate further downt he road.

However, we note that the IPCA-EX3 index (the most sensitive core inflation gauge to the economic cycle) rose 0.61% MoM, which was above the 0.34% MoM change recorded in the December reading, specifically due to price hikes for items related to the Housing and Personal Expenses groups. According to our calculations, in seasonally adjusted terms the IPCA-EX3 climbed to 0.45% MoM in January from 0.31% MoM in December. We think this number does not imply that the favorable inflation dynamics has changed. After all, we continue to see a high level of idle capacity in the

Brazilian economy (more details in the following section) and inflation expectations have remained anchored. Incidentally, we anticipate a smaller impact from the shock in animal protein prices and much lower headline inflation in 1Q20 (approximately 0.8%-0.9% in the period), thus reinforcing our assessment of a well-behaved path for inflation during 2020. We project this year´s IPCA around 3.3-3.4%, fairly below the centre target of 4.5%.

Economic activity: According to the Labor Ministry's CAGED survey, published this Friday, the Brazilian economy created 58,000 net formal jobs in the last month in seasonally adjusted terms–our expectations pointed to 50,000 net formal jobs. The reported amount brings the new formal jobs created in 2019 to 644,079 (in unadjusted terms)—a considerable improvement compared to 2018's net creation of 528,000 jobs. Moreover, the quarterly moving average of net job creation hovered around 76,000 jobs per month, suggesting a good outlook for 2020, when we expect the creation of almost 1 million net formal jobs. Next Friday, additional labor market data is set to be release with December's unemployment rate. On the back of the improvement observed in the net creation of formal jobs, we expect the (non seasonally adjusted) unemployment rate to have fallen to 11.0% from 11.2% in the previous reading. In seasonally adjusted terms, this estimate represents a small retreat to 11.7% from 11.8% in November. We do not expect the unemployment rate to fall in a stronger fashion before the second half of 2020, when we expect it to be clearer as to whether the Brazilian economy has gained momentum.

External sector data: Following the noise provoked by data reviewed by the Brazilian Central Bank on August and November 2019 that showed current account transation imbalances were much larger than market participants had anticipated, we expect December 2019 external sector data, due to be released next Monday morning, to reinforce our assessment that the pace of deterioration in the balance of payment is not quite so worrisome: we expect the current account balance to have recorded a US$4.3 billion deficit in the period, implying a full-year 2019 imbalance of US$49.3 billion. Although more than three times higher than the US$15.0 billion deficit observed in 2017—the first year considered in data reviews—we remind readers that that year marked the peak of adjustments in the current account balance that came in the aftermath of the Brazil's 2015-16 economic recession. As the economy(modestly) grew in the subsequent years, it was natural to observe larger current account deficits. However, bear in mind that the bulk of the US$34.3 billion deterioration observed in the period was concentraded in 2018 (US$26.5 billion), while 2019's widening shows lost momentum (US$7.9 billion). On top of a slower rhythm of deterioration in the current account balance, we also call our readers' attention to the fact that the country has continued to count on a sizeable net inflow of foreign direct investments (FDI), which has surpassed by far the imbalance previously mentioned. We expect the FDI to have reached as high as US$11.5 billion in December 2019; if our forecast proves accurate, this would amount to total 2019 FDI of US$80.6 billion. Thus, in addition to anticipating a non-explosive trajectory for the current account deficit, we also believe the country will be able to count on a steady source of financing, given the advances in reforms and a gradual improvement in economic growth.

Fiscal balance: Important fiscal policy indicators will hit the wires next week. First, Brazil's National Treasury will unveil the central government's primary result for December next Thursday (January 30). We expect a monthly surplus of R$3.8 billion, strongly influenced by the inflow of extraordinary revenue from oil auctions held at the end of last year (especially the net inflows of R$23.7 billion to the federal government coffers derived from the Transfer of Oil Rights – ToR – auction). If our forecast proves accurate, the central government will register a total primary deficit of R$76.5 billion for full-year 2019 (-1.1% of GDP), a much better result compared to the target (-R$139.0 billion, or -1.9% of GDP) set for the year. However, bear in mind that the significant difference between the actual primary result and target can mostly be attributed to the large amount of non-recurring revenue in 2019 (in addition to the oil auctions, we note the dividend payments from public banks to the federal government, as well as a marked reduction in non-mandatory expenditures, mainly investments.

The consolidated public sector's primary result for December (which includes federal government, regional governments and state-owned companies) will be published by the Central Bank next Friday (January 31). We estimate a monthly deficit of R$3.1 billion, implying a total negative balance of R$51.5 billion in 2019 (-0.7% of GDP), better than the target of -R$132.0 billion (-1.8% of GDP) defined in last year's public budget. Furthermore, we estimate that nominal interest payments ended 2019 at 5.1% of GDP, down from 5.6% of GDP in 2018, also contributing to the decline in nominal deficit in the period (from 7.1% of GDP to 5.9% of GDP). Finally, we expect public sector fiscal data to show the gross public debt-to-GDP ratio at 76.3% at year-end 2019, virtually the same level recorded at the end of the previous year.

As we have emphasized in our reports (for example, see our December 13, 2019 report, A Better Outlook), forecasts for public sector debt have improved significantly in the recent period. Factors such as (i) the sharp decline of the cost of debt rollover (in the wake of historically low interest rates), (ii) cyclical GDP recovery, (iii) BNDES – The Brazilian Development Bank – payments to the National Treasury and (iv) positive net result from Central Bank operations in the

FX spot market (allowing for the decrease in the amount of repo contracts) over the second half of 2019 explain, to a large extent, these more favorable expectations. Nevertheless, the deleveraging of public debt has not been accompanied by a structural reduction of public spending: the proportion of total mandatory expenses to GDP fell only 0.7pp from year-end 2016 (approval of the spending cap rule) to year-end 2019. Important advances in the fiscal adjustment agenda have taken place in recent years, including a robust pension overhaul, but further measures need to be approved, especially with regard to payroll expenses.

The 2020 primary balance should reinforce this need for further reforms, in our view. We expect deficits of R$107.5 billion (-1.4% of GDP) and R$102.3 billion (-1.3% of GDP) for the central government and consolidated public sector, respectively (2020 budgetary law sets the targets at -R$124.1 billion (-1.6% of GDP) and -R$118.9 billion (-1.6% of GDP). In other words, the difference between actual results and the target is expected to be much lower than that observed in 2019, especially due to the lower amounts of non-recurring revenue. Our baseline scenario incorporates neither the Eletrobrás privatization (R$16.2 billion, as stated in the 2020 public budget) nor revenue from the oil areas that have not received any bids during the ToR auction and that could be offered again, as they are likely to be auctioned under a new legal framework that we do not expect to be ready before 2021. Therefore, we expect the public sector's primary deficit to remain high, making it clear that the fiscal adjustment is not complete.

That said, we believe that the reformist agenda will not be abandoned. For 2020, we expect the approval of a fiscal emergency package aimed at reducing mandatory expenses, although with possible changes after negotiations in Congress. Based on this assumption, our calculations indicate that Brazilian government will comply with the spending cap rule in the coming years, allowing the return of fiscal primary surpluses from 2023 onward.

Government's approval rating: According to a public opinion poll released this past Wednesday (January 22) by CNT/MDA pollster, the federal government's approval ratings have improved in recent months. Based on polling carried out on January 15-18, 34.5% of respondents considered the current federal government to be excellent or good, a better figure compared to the last survey (29.4% registered in August 2019). In turn, the assessment of government as bad or very bad declined from 39.5% to 31.0% in the same period. Combating corruption, public security and economy were the areas in which the government performed best, according to the survey. For example, 58.6% of respondents expect more favorable economic conditions in 2020, compared to last year, while only 10.4% believe that the scenario will worsen. Regarding the labor market, 43.2% of respondents expect a more benign situation in the next six months, while 18.9% expect a worse scenario (34.3% foresee stable conditions). In our view, factors such as the stronger pace of net creation of formal jobs throughout the second half of 2019, low interest rates and release of FGTS (private worker's mandatory saving accounts) funds may have contributed to improve the economic sentiment (and, consequently, to improve government's approval ratings).

Survey results point to a better assessment of the government between two specific periods, so for now the data does not make a trend. However, we think that the significant contribution from improved economic conditions should reinforce the government's commitment to the reformist agenda, including fiscal measures. As mentioned before, we believe that fiscal consolidation is a necessary condition for higher (and sustainable) economic growth in the long term.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: We hope they'd got it* (January 23, 2020)
- *Brazil Macro Propositions for 2020* (January 13, 2020)
- *Macroeconomic Scenario: A Better Outlook* (December 13, 2019)
- *Macroeconomic Scenario: Better Days Ahead* (October 31, 2019)
- *Brazil Economic Activity: In Search of Growth* (August 29, 2019)

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