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Brazil Macro Compass

The Final Move?

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- **This week some benchmark Brazilian assets were affected by the market jitters related to the coronavirus outbreak and its potential (notably adverse) impact on the global economy. With risky assets and commodities taking a hit, both Brazil's currency and stocks have been dragged down, in contrast to the bull flattening seen in the local yield curve. In fact, the decline in Brazilian long yields this week could be mirroring the potentially disinflationary global effect of this disease, possibly confirming that this is not an idiosyncratic sell-off. In any case, uncertainty remains high, with the news (about the coronavirus and its impact) still fluid and preliminary.**
- **On Wednesday, February 8, the Brazilian Central Bank is scheduled to announce its monetary policy decision. In line with consensus—and largely the yield-curve—we project a 25-bp cut in the benchmark Selic rate to 4.25% p.a., which would mark a new historical low. Although we expect an additional cut of same magnitude in March, we increasingly believe that the move in February could be the last in the cycle.**
- **Activity indicators in December 2019 are likely to provide mixed signs, in our view, with the labor market pointing toward a gradual improvement, while industrial production still faces some headwinds.**
- **After December 2019's IPCA spike, we expect it to have registered a 0.33% MoM change in January 2020, mainly due to a milder impact from the shock observed in animal protein prices in recent months.**
- **The public sector's 2019 primary result was much better than the budget target (i.e., a lower primary deficit). In addition, the gross public debt-to-GDP-ratio fell in 2019 compared to the previous year. However, public debt deleveraging has not yet been accompanied by a structural reduction in public spending. Following last year's pension overhaul, further measures need to be approved, particularly with regard to payroll expenses.**
- **While data referring to 2019 calmed market participants with respect to the soundness of Brazil's balance of payments, the release of trade balance for January 2020 is likely to bring back some concerns, in our view.**

Monetary policy: The 4Q20 inflation report showed that the BCB's main inflation simulations for 2020—the key policy horizon for now—still point to little space for more stimulus. Considering how the data has evolved, we see no substantial changes neither in the forecasts nor in the balance of risks. We do not believe that a slight acceleration of underlying inflation indicators, as shown in January IPCA-15 (mid-month preview of the IPCA), signals an important change in this favorable trend and outlook, especially considering that, since the last Copom meeting, inflation expectations have receded and economic activity has shown reduced momentum. The latter raises doubts about the strength of the ongoing economic recovery, particularly considering the difficulty in measuring the effects of temporary stimulus for consumption via the release FGTS account funds.

On the one hand, a slower Selic rate cut (of 25 bps) and the statement's tighter tone might help the BCB convey a message that the cycle is (very) near completion. On the other hand, an interest rate adjustment of minimum magnitude at this juncture would provide the Copom the optionality to stimulate activity a bit more later (with a final move in March) should the economy show further signs of weakness. In the event, that would allow the authority to make the decision (of ending the cycle) with a little more information on the transmission of stimuli already implemented.

All in all, we believe the Copom's policy message will only seek to indicate that the cycle is close to the end, with the authority still retaining a little discretion to add a little more stimulus if necessary.

Lastly, although our scenario projects an additional cut of the same magnitude (25 bps) in March, we believe there is an increasing likelihood that a February rate cut might be the last in the cycle.

Economic activity: According to the PNAD household survey, the national unemployment rate stood at 11.0% (of the economically active population) in the three months to December. This result was in line with consensus (and our) estimates. This result is about 0.6 p.p. below the reading seen in the same period of 2018, suggesting a certain acceleration in the speed of the YoY fall in joblessness. The seasonally adjusted and sequential jobless rate also moved lower, reaching 11.6%, according to our own calculations—the lowest level since 2Q16. In any case, the unemployment rate remains at a high level, standing well above the natural (or structural) level of the Brazilian economy, which we estimate at approximately 9.5%.

Regarding the composition of this job recovery, we see signs of improvement. Firstly, the data shows some (slight) acceleration in the pace of expansion of the employed population in the last few months, with YoY and QoQ growth of 2.0% and 1.4%, respectively (seasonally adjusted, annualized rate) in the 4Q19. This pace tops the expansion rate of the labor force, which grew 1.2% YoY and fell 0.1% QoQ. The labor market participation rate has been stable, remaining close to the historical average (62.0%). Second, we estimate that approximately 64% of new jobs created in 2019 were formally registered, compared to 40% over the course of 2018. The PNAD survey also indicates that 56% of the current stock of employed workers are registered. This report seems to confirm the positive formal employment data seen in the CAGED (establishment, payrolls) survey.

In terms of wages, the survey shows a still gradual growth in real income (adjusted for inflation), with average income rising 0.5% YoY and 3.7% QoQ. The real wage bill (adjusted for inflation) grew at a clip of 2.5% YoY and 4.9% QoQ. Given the fact that the unemployment rate remains fairly above the natural level, we continue to project moderate growth in real average income.

Like the rest of the economy, the labor market will continue to recover gradually, per our forecast. While an excess of labor tends to keep putting a lid on the expansion of the average income, a greater share of formal employment tends to prop up consumption. We expect to see further declines in the unemployment rate for 2020, increasingly favored by formal jobs.

Still regarding economic activity, on Tuesday (February 2) IBGE will release its Monthly Industrial Survey for December 2019. We expect a YoY decrease of 0.9%, which implies a 0.5% MoM contraction in seasonally adjusted terms. If our estimates prove right, industrial production would have grown only 0.2% QoQ, in seasonally adjusted terms in 4Q19, thus being partially responsible for the frustration with the pace of economic recovery in the period. For the last year as a whole, industrial production would have fallen 1.1%, mainly due to the sharp decrease in the mining segment (-9.5%) in the aftermath of the Brumadinho dam collapse.

Inflation: The IPCA—Brazil's official inflation index—surged to 1.15% MoM in December 2019, with the YoY change reaching as high as 4.31%. As we have stated previously (see our January 24 report, *The Devil Is in the Details*), that was supposed to have been a temporary spike stemming from the shock observed in animal protein prices on the back of the outbreak of African swine fever (ASF) issue that affected the Chinese pig herd. In that sense, we expect the IPCA's January 2020 performance to prove that our assumption was right, as we expect it to have registered a 0.33% MoM change, which—if indeed prove correct—would mark a significant deceleration, although not enough to bring the YoY change (4.31%) below the inflation goal set for 2020 (4.00%).

We anticipate that the highlights for this expected January slowdown will come from the Foodstuff and Clothing groups, with the former likely to have been favored by a smaller impact from animal protein prices, while the latter should have cashed in at the beginning of year sales. Hence, for this first quarter, the IPCA's tracking tilts downward. The main inflation monitors show a drop in protein, horticulture, electricity and gasoline prices, leading us to forecast a 0.70-0.75% change for the IPCA in 1Q20—a period that could, in our view, be of significantly relevance for the Copom's decision next week.

Fiscal balance: Brazil's central government registered a primary deficit of BRL14.6 billion in December, surprising both our expectation and market consensus, which were pointing toward a slight primary surplus. The difference between the actual result and our forecast can be attributed to the higher growth of discretionary expenses, mostly the capitalization of state-owned companies. Despite this negative surprise in the monthly reading, the central government's primary balance for full-year 2019 of -BRL94.5 billion (-1.3% of GDP) was much better than the budget target set for last year (-BRL139 billion, or -1.9% of GDP). The large amount of extraordinary revenue, especially the proceeds from oil auctions (e.g., BRL23.7 billion derived from the Transfer of Rights – ToR – auction) and dividend payments from public banks, greatly contributed to this difference. For 2020, we project the central government's primary deficit at BRL107.5 billion (-1.4% of GDP), not far from the target defined in the annual budget (-BRL124.1 billion or -1.6% of

GDP). Factors such as: (i) the faster pace of economic growth (we see Brazil GDP growing at 2.3% this year); (ii) minimum wage stability in real terms; and (iii) stability in civil public servants' wages in nominal terms will be decisive for the central government to meet its fiscal primary target (and comply with the spending cap rule) in the current year, in our view.

Regarding the consolidated public sector (it includes federal government, regional governments and state-owned companies), the primary deficit of BRL13.5 billion in December positively surprised our forecast and market consensus (of around -BRL20 billion), leading to a full-year 2019 fiscal balance of -BRL61.9 billion (-% of GDP)—the annual budget target was defined in -BRL132 billion (-1.8% of GDP). Looking ahead, we expect a lower amount of non-recurring revenue to contribute, to a large extent, to some increase in the primary deficit in 2020. We expect the public sector to show a negative balance of BRL98.5 billion (-1.3% of GDP), implying a gap of BRL20 billion in comparison to this year's budget target (-BRL118.9 billion, or -1.6% of GDP).

Last but not least, the gross public-debt-to-GDP ratio ended 2019 at 75.8%, below the level observed at year-end 2018 (76.5% of GDP). This result illustrates the significant deleveraging of Brazilian public debt that we have seen recently, which has been based upon: (i). the continued decline of the cost of debt rollover in the wake of a lower perception of fiscal risk and falling interest rates*;* (ii) a cyclical GDP recovery; (iii) BNDES—The Brazilian Development Bank—advance payments to the National Treasury; and (iv) positive net results from Central Bank operations in the FX spot market (allowing for the reduction of repo contracts). For instance, we estimate that BNDES payments reduced public debt by 6.5pp between 2015 and 2019 (-1.7pp in 2019), whereas the positive net result from Central Bank operations stripped out 1.6pp last year. Our forecasts for the gross public-debt-to-GDP ratio are: 75.3% in 2020; 74.6% in 2021; 74.1% in 2022. That is, gross public debt will continue to fall (albeit gradually) in the coming years, a much better scenario than anticipated a few years ago.

However, the deleveraging of public debt has not yet been accompanied by a structural reduction of public spending. Following the pension overhaul enacted last year, further measures need to be approved, particularly with regard to payroll expenses. For 2020, we expect the approval of a fiscal emergency package aimed at cutting mandatory expenditures, although with possible changes after negotiations in Congress. Taking into account this assumption, our baseline scenario indicates compliance with the spending cap rule in the coming years (at least until 2023) and the return of fiscal primary surpluses from 2023 onward.

External sector data: Although larger than we anticipated, the current account deficit (CAD) registered in December 2019 (-USD5.7 billion versus -USD4.3 billion) confirmed our broader view that the deterioration in the Brazilian external sector data lost momentum last year. Whereas the annual imbalance increased USD9.2 billion in 2019—to USD50.8 billion from USD41.5 billion in 2018—the CAD widened USD26.5 billion between 2018 and 2017. Furthermore, given our expectation for a gradual recovery of the Brazilian economy in the coming years, we think this soothing pattern tends to continue and we project the annual CAD to reach USD56.2 billion in 2020.

Were it not for the USD13.6 billion contraction observed in the trade balance last year, the CAD would have recorded an even better outcome in 2019. We note that this deterioration did not come from an increase in imports—actually, there was a USD1.5 billion drop in these disbursements—but it rather came from the USD15.1 billion acute contraction in export proceeds observed last year. For 2020, we think exports should stabilize as the world economy started presenting some green shoots here and there–although we reckon the coronavirus epidemic is likely to weigh on general confidence indicators in the coming months. However, we expect imports to modestly grow on the back of the stronger footing that we expect the Brazilian economy to show ahead, which means the trade balance should continue to shrink this year. The big question is the likely size of this deterioration.

The trade balance for January 2020 is due to be released next Monday and will help us in beginning to answer that question, though the latest weekly figures do not bode well. Working-day adjusted averages for both exports and imports have shown a double-digit decline YoY to date—18.4% and 12.8%, respectively—partially explained by the fact that data for January 2019 were inflated by accounting operations related to oil platforms that were not indeed exports and imports. Nonetheless, when we factor out that influence, we arrive at a working-day adjusted average for imports in 2020 similar to the one observed last year, while the same treatment for exports results in a 12% YoY drop, compared with 2019. If this trend continues for the remainder of this year, then assumptions of a soft deterioration of the current account deficit will need to be revised.

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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