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Brazil – Exchange Rate

Why Has The BRL Weakened in 2017?

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In 2017, the most important BRL drivers evolved in a way that would normally be consistent with BRL strengthening:

1) Country risk premium decreased (5-year CDS: from 280 bps to 165 bps)

2) The DXY has also fallen (USD lost 9.4% against a basket of currencies of important economies)

3) Commodity prices increased (CRB index: from 424 to 430)

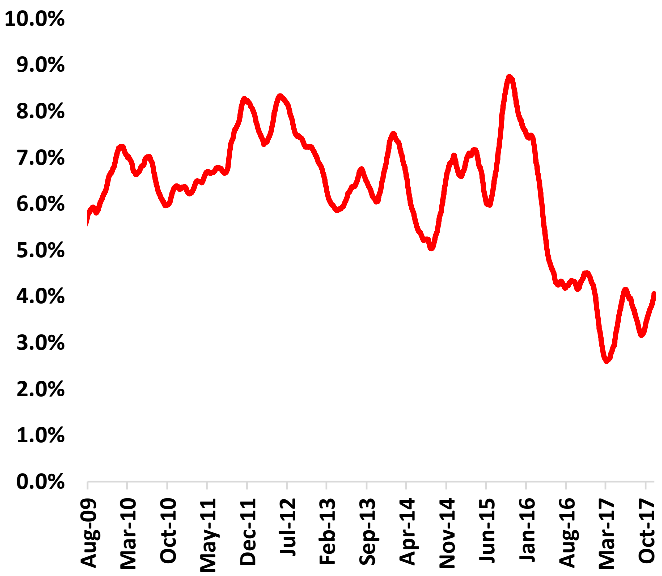
4) the FDI versus current account deficit gap reached historical highs at 3% of GDP

As curious as it may seem, the currency moved in a direction opposite to what those fundamentals would suggest.

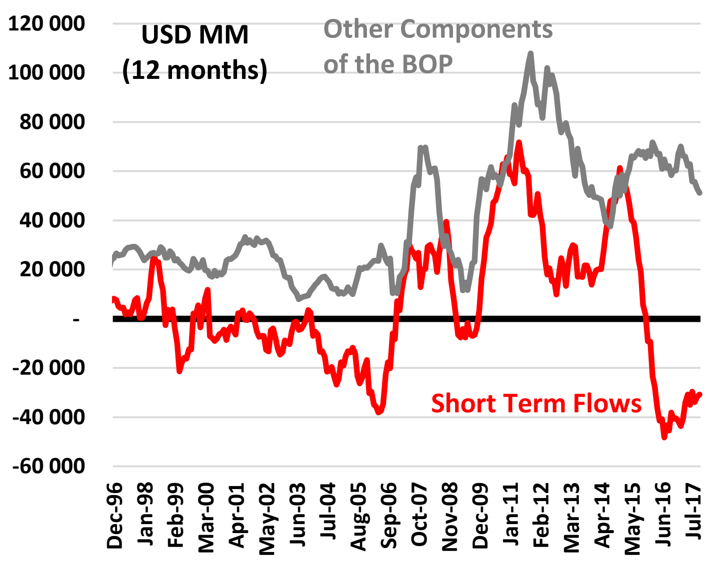
We discussed what we view as the main reason for this phenomenon in our report *Monetary Easing: The BRL is the Limit* (March 20, 2017). On that occasion, we called attention to the reduction of premia associated with fixed income investments in local markets vis-a-vis offshore alternatives, which we argued could eventually lead to a more meaningful relationship between interest rate differentials and the exchange rate.

In our view, the aggressive Selic rate reduction over the last 18 months is the main factor behind the BRL depreciation, in spite of the favorable evolution of the abovementioned variables.

Expected Premium for Fixed Income Investment Domestic vs. Offshore (p.a. 5-year)
Local Yield (-) US Treasury (-) Brazil CDS (-) Expected BRL Depreciation



Balance of Payments (Short-Term Flows vs. Other Components)
Short Term: Derivatives, Short-Term Fixed Income, Private Sector Deposits Abroad



Source: Santander estimates based on Bloomberg and BCB data.

Drivers

The performance of the BRL during 2017 has been peculiar, considering the evolution of the factors that are usually considered its main drivers. First, the prospects for a very benign year in terms of flows, as a result of increasing foreign direct investments and the still contained current account deficit, not only materialized but surprised favorably. The difference between FDI and the current account deficit reached 3% of GDP last year. Under normal circumstances, this considerable amount of net inflows would be enough to trigger a meaningful appreciation of the currency.

And second, drivers usually incorporated into econometric models aimed at estimating a fair value for the exchange rate based on other asset prices have failed to predict the currency's depreciation last year. Commodity prices (iron ore, for instance) have risen, which contributed to better-than-expected performance of the trade balance in the year. Moreover, the DXY showed the USD depreciating 9.6%, on average, against important currencies (but not against the BRL) in the year. Finally, Brazilian risk premiums collapsed in 2017, as shown by the 5-year CDS approaching 160 bps (from 240 bps 12 months prior). According to one of our main models which includes all those variables, the BRL should have appreciated some 11%, considering the dynamics of the abovementioned variables. Instead, it remained relatively stable in 2017, down 1.5% at year-end 2017.

So what happened? Why has the BRL performed so poorly, given the benign behavior of fundamentals?

Interest Rate Differentials

It seems clear that, since the currency has not followed the path suggested by the evolution of FDI, the current account deficit, the value of the USD, commodity prices and risk premia, it may have instead reacted to a new factor (or, perhaps, not so new). In our view, the BRL has not strengthened as expected due to the substantial reduction of interest rate differentials between Brazil and other economies, notably the U.S. We argue that, for the first time during the inflation targeting regime with floating exchange rate, Brazil is expected to undergo a reasonably long period of base rate below its neutral level.

Since the beginning of the century, monetary policy has been almost always focused on bringing inflation down to the target and preventing demand- or FX-driven inflationary pressures, which has led the BCB to maintain the base interest rate (the Selic) above its neutral level for most of the last 20 years. These higher-than-neutral interest rates have usually been consistent with an attractive "carry trade", and at a level consistent with generous net short-term capital inflows.

The present situation is quite unusual. Inflation is currently below target, the output gap is huge and the BCB enjoys a high degree of credibility in terms of its ability and willingness to sustain inflation around the objective. Therefore, the monetary authority has been able to bring the Selic toward the lower end of its historical range. This environment has led to a compression of the expected return on short-term investments in Brazil.

The End of the Comfortable Carry

We discussed the end of the comfortable carry in our report *Monetary Easing: The BRL is the Limit* (March 20, 2017). On that occasion we attempted to quantify this development by estimating the expected returns from investing in domestic fixed income instruments versus offshore investments, based on local yields, risk premium, the return of Treasury Bonds (U.S.) and expected depreciation of the BRL. The chart on the left-hand side of the previous page illustrates the results. While, since 2009, the expected premium of investing domestically versus offshore, on a 5-year fixed income instrument, have been oscillating around 6%, this measure has recently been reduced to the range of 3% - 4%.

The End of "Tsumoney"

It should come as no surprise that, as returns collapsed, so did short-term flows – defined as fixed income short-term investments, banks assets abroad, etc. The chart on the right-hand side of the previous page shows that, while the less volatile components of the balance of payments increased in recent years (particularly due to an increase of FDI coupled with a falling current account deficit), short-terms flows fell into the negative territory.

Carry Trade and Elections

We would note that negative short-term flows could be a result of uncertainties surrounding upcoming elections and not due to compressed yields. In our view, increased political risk should lead to increased country risk, as proxied by CDS premia. But this measure has been falling considerably in recent months, also likely as a result of local monetary policy. Another interesting possibility is that markets could be assessing political risks associated with capital controls much more than those associated with an eventual default, considering the current balance of international reserves and the favorable difference between FDI and the current account deficit.

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