ECONOMICS

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Brazil Macro Compass

Eyeing the Forward Guidance

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- **Next Wednesday (June 17), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We believe the Copom will once again trim the Selic (policy) rate by 75 bps, to 2.25%, a new historical low. This projection is in agreement with most analysts' forecasts and the pricing of the yield curve, which still signals a perceived probability of nearly 30% that the cut will be less bold (i.e., 50 bps). Although we believe the Copom will change its forward guidance, not ruling out the possibility of additional stimulus, our scenario projects that this is the last act in the cycle.**

- **The final scraps of real activity data for April are expected to come out in the week of June 15. Reports on the tertiary sector (retail, services) and the IBC-Br BCB's broad economic activity index, sort of a monthly GDP proxy, will hit the wires. We expect those to tell us that April was the worst point in terms of the pandemic's impact on the economy. All in all, the figures are consistent with our forecast of a major economic slump (-13.0% QoQ) in 2Q20.**

- **May's IPCA registered a -0.38% MoM change (1.88% YoY), above our forecast of -0.45% and the market's median expectation of -0.46%. The annualized (and seasonally adjusted) three-month moving average of all main core measures stood at a muted 0.2%, much lower than this year's mid-target (4.00%). Despite the surprise to the upside, this was the lowest MoM change in 22 years, so it reaffirms our expectation of a benign scenario for inflation generated by COVID-19 effects on the output gap and also reinforces the view that there is space for additional interest rate cuts.**

- **In FX, after three weeks of a substantial BRL improvement, market participants seemed to have found a level to cash in their profits. A bearish tone on U.S. activity from the FOMC along with fears of a second wave of COVID-19 contamination were apparent reasons for some profit-taking. The FX rate is ending the week close to the USD/BRL5.05 level, and we believe a fresh set of good news on the fiscal front is necessary to prompt significant BRL strengthening from current levels.**

Local markets—rates: Nominal yields kept rallying and flattening this week despite a hiccup in global risk appetite, amid further constructive (but still preliminary) signs from the political environment. At the time of this writing, the front end (Jan-21 DI future) was down 2 bps compared to last Friday, with the yield at 2.16%. The back end (Jan-25 DI future) was down 13 bps for the week, with the yield at 5.67% – close to the new historical low. As a result, the (Jan-25 vs. Jan-21) steepness was down to 352 bps, from 363 bps at the end of last week. That is one of the narrowest gaps since late April, when the temperature started to rise on the political front.

Easier financial conditions at both the global and local level continue to support Brazilian assets, keeping at bay what could have been a potential obstacle to implementing further monetary easing by the BCB. As an upshot, the local yield curve continues to price in more rate cuts for the current cycle. Judging from DI futures, the market now sees a nearly 70% probability of a 75-bp cut in the Selic rate at next week's Copom meeting, as well as a high probability of a 25-bp move at the (subsequent) August 04-05 gathering.

Although we believe the BCB will not completely rule out future cuts in next week's Copom statement (see our commentary below), we still see the terminal Selic rate for the cycle at 2.25%, which implies little (if any) downside for the front end of the curve. As for the belly and back end, an apparent mending in the relationship between the executive and legislative branches continues to favor expectations that macroeconomic and fiscal reforms could become a priority sometime late this year or in 2021. While the bar is quite high in terms of the extent of reforms needed to stabilize government debt in the long run, calmer news flow in the short term prompts us to take a more neutral stance toward long-term nominal interest rates in Brazil. In other words, steepening pressures may remain dormant for some time, in our view.

Local markets—FX: The Brazilian currency is about to end the week around the level of USD/BRL5.05, after having breached it and approached USD/BRL4.80 earlier this week. That was a level that led market participants to cash in the three weeks' improvement which brought the Brazilian FX rate all the way down from nearly USD/BRL6.00. A bearish tone on U.S. activity from Fed chairman Jerome Powell and fears of a second wave of contamination in areas of the U.S. that have already eased social distancing policies were apparent reasons for investors to take profits. For the coming weeks and months, we believe that eventual news on the Brazil reform agenda could lead to a strengthening of the BRL, especially when discussion of items related to the approval of measures regarding curbing/restructuring public expenditures starts to take place. However, we call our readers' attention to the fact that such discussions are far from being a given, which may limit the room for further appreciation of the BRL from the domestic standpoint.

Inflation: May's IPCA registered a -0.38% MoM change (1.88% YoY). The result was above our forecast of -0.45% and the market's median expectation of -0.46%.

The group of food-at-home decelerated to 0.33% MoM (+8.1% YoY), but was the main upside surprise (contributing +7 bps of difference). Services fell 0.45% MoM (+2.7% YoY), in line with our expectation, while industrial goods remained stable in the month, a slight upside surprise, as we expected -0.17% MoM. Finally, administered prices fell 1.02% MoM (-0.9% YoY), a bit lower than our expectation – still driven by a (smaller) fall in gasoline.

The average of all seven core measures fell 0.09% MoM, with the annualized (and seasonally adjusted) three-month moving average reaching a muted 0.2% (target for 2020: 4.0%). In particular, the trend of the IPCA EX3 core – a measure highly correlated with the output gap – is hovering around -0.4% MM3saar. Also, diffusion stood at 46.6% on a seasonally adjusted basis, close to the lowest historical levels.

Hence, despite the upside surprise, the number is still extremely low in historical terms for both the headline (the lowest in 22 years) and the core, reaffirming the disinflationary trend resulting from COVID-19. Looking forward, we believe the benign environment will continue, and we forecast monthly inflation of 0.16% in June, 0.28% in July, and 0.04% in August. We still forecast annual inflation at 1.4% for 2020 and 2.9% for 2021. The negative effect of COVID-19 on economic activity still poses downside risks for those forecasts. On the other hand, we cannot rule out upside risks from volatile prices such as food and gasoline – which, even if they materialized, would not change the benign scenario, in our view, especially for the core measures. Therefore, from a purely inflationary standpoint (i.e., not considering other elements in the balance of risks, such as fiscal policy), we see space for the central bank to continue cutting interest rates at the next Copom meeting (see details below).

Economic Activity: In May, the IGet (proprietary retail sales index) data, based on Santander's credit and debit card transactions from one of the biggest acquirer companies in Brazil, suggests – like other economic activity indicators released so far – that the worst point of the Brazilian COVID-19 crisis has passed. However, there is still a long way back to the pre-crisis level. The May IGet for core retail sales grew 7.4% in comparison to April, seasonally adjusted. Compared to May 2019, the index has fallen 22.6%. Regarding quarterly dynamics, the index dropped 21.4% QoQ (seasonally adjusted) in the three months to May. The details show that almost all segments present some recovery at the margin, the exception being a slight 0.4% MoM (seasonally adjusted) fall in "Supermarkets," which have been the least affected as they are considered as offering essential goods and have continued to operate during the social distancing measures adopted in most of the country.

As for the broader index, which includes Building Materials and Vehicles, the IGet grew 8.5% in May compared to the immediately previous month, in the seasonally adjusted series. In relation to the same month of 2019, the contraction was 34.1%, implying a drop of 28.7% (seasonally adjusted) in the quarter ended in May. Finally, the breakdown of the categories shows growth in the monthly comparison in both categories.

Monetary Policy: On Wednesday (June 17), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We believe the Copom (monetary policy committee) will once again trim the policy rate by 75 bps, to 2.25%, a new historical low. This projection is in agreement with most analysts' forecasts and the pricing of the yield curve, which still signals a perceived probability of around 30% that the move will be less bold (i.e., -50 bps).

On the one hand, the pandemic's clearly disinflationary effects support the views of most analysts about the need for additional stimuli. On the other hand, the deterioration of the fiscal outlook – especially in an emerging economy –

indicates to us the need for greater caution in terms of monetary policy steps, especially given a largely expansionary stance currently. As already signaled by the committee at its last meeting, reducing interest rates beyond an “effective minimum” level can potentially prove counterproductive, given a possible deterioration in financial conditions. For now, we assume this level at above 2%, but uncertainty is great as to the value of this parameter and the magnitude of its fluctuations.

Although this limit on interest rates varies over time, it needs to fluctuate more than the monetary policy stance, as it reflects, at least in part, the dynamics of asset prices and the volatility of expectations and market conditions. And, given that excessive volatility in the monetary policy instrument could be detrimental to the anchoring process, a crucial element in the inflation-targeting system, it would be advisable, in our view, to leave some “space” or distance between the baseline interest rate and the point estimate for this effective (minimum) boundary.

That said, we believe the Copom will change its forward guidance, but only to maintain some degree of freedom in an environment of still high uncertainty. We anticipate that Copom will leave the door ajar for additional stimulus. Even so, we believe the committee will reinforce a message of caution regarding the possibility of future Selic rate cuts, which are likely to be implemented sparingly (conditional on the environment, of course), given the proximity of the effective lower bound. We project a 2.25% terminal Selic rate for this cycle, with the normalization process (read rate hikes) to start only in 2H21.

Next week:

The final scraps of real activity data for April will come out the week of June 15, between Tuesday and Thursday. Reports on the tertiary sector (retail, services) and the IBC-Br BCB’s broad economic activity index, viewed as a monthly GDP proxy), will hit the wires, probably telling us that April was the worst point in terms of the pandemic’s impact on the economy (see below the numbers, indicating whopping contractions in key sectors). All in all, these figures are consistent with our forecast of a major economic slump (-13.0% QoQ) in the 2Q20. We look for a full year GDP contraction of 6.4% for 2020, accounting for a gradual recovery of economic activities as social isolation measures are eased from mid-June onward (with a full “normalization” expected for September).

MACRO AGENDA

Indicator	Date	Estimate	Prior
IBGE Retail Sales Apr/20 (Δ% MoM sa)	Tue, 16-Jun	-12.1	-2.5
IBGE Retail Sales Apr/20 (Δ% YoY)	Tue, 16-Jun	-14.1	-1.2
IBGE Broad Retail Sales Apr/20 (Δ% MoM sa)	Tue, 16-Jun	-23.6	-13.7
IBGE Broad Retail Sales Apr/20 (Δ% YoY)	Tue, 16-Jun	-32.6	-6.3
IBGE Services Survey Apr/20 (Δ% MoM sa)	Wed, 17-Jun	-10.5	-6.9
IBGE Services Survey Apr/20 (Δ% YoY)	Wed, 17-Jun	-16.1	-2.7
COPOM Meeting – Selic target rate (% pa)	Wed, 17-Jun	2.25	3.00
IBC-BR Apr/20 (Δ% MoM sa)	Thu, 18-Jun	-11.2	-5.9
IBC-BR Apr/20 (Δ% YoY)	Thu, 18-Jun	-16.2	-1.5

Sources: Brazilian Central Bank, IBGE, Santander.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: Despite a little help from our friends* (May 21, 2020)
- *The Shock Is Even Worse and Stimuli Much Bigger* (May 18, 2020)
- *FX Compass – BRL: Post COVID-19* Concerns (April 23, 2020)
- *Fiscal Policy During the COVID-19 Crisis: New Challenges, More Risks and the Same Long-Term Goals* (April 22, 2020)
- *COVID-19: The Dominance of Uncertainty - Updating Brazil Forecasts* (April 06,2020)

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