Santander Corporate & Investment Banking

ECONOMICS

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Brazil Macro Compass

Slow Activity Recovery; Muted Core Inflation

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- **This has been just another week of relatively calm news flow on both the domestic and international fronts, though this failed to quell volatility in the Brazilian FX rate. Although the USD/BRL is to end the week close to last Friday's level, in recent days it traded in a wide range (from BRL5.29/USD to BRL5.45/USD).**
- **The nominal yield curve during this period traded with a slight downward bias and nearly in parallel for some key maturities. Yet the steepness of the term structure remains high, mirroring the execution risks for the fiscal reforms post-crisis. Asset prices continue to indicate investor perception of near equal likelihood of either a final residual cut (of 25 bps) in the cycle or a rate stability outcome for the next Copom meeting (August 4-05). We continue to look for a stable Selic rate of 2.25% until 1Q22.**
- **The Brazil Central Bank's (BCB) monthly activity indicator capped the releases of activity indicators for May, posting a result considerably worse than our and market projections. The index shows that activity remains quite far from the pre-crisis level (i.e., -13.9% since February). Yet our proprietary retail sales index (IGet) posted another gain for June, reinforcing the signs that April was the worst month for activity, with a gradual sequential recovery in place afterwards. Regarding GDP forecasts, we are maintaining our projections for 2Q20 and 2020 at -10.2% and -6.4%, respectively.**
- **Next Friday, IBGE releases the IPCA-15 (mid-month official CPI preview) for July. We expect a reading of +0.48% MoM (+2.31% YoY), driven by the recovery of gasoline and the concentration of electricity tariff adjustments that have been postponed since the beginning of COVID-19 crisis. Despite higher inflation in July, we continue to anticipate a benign path for inflation, with a muted dynamic for core prices.**

Local markets—FX: The Brazilian FX rate continued in quite volatile trajectory this week, fluctuating within a pretty wide range in the last few days. Apart from technical features related to market participant exposure, we did not identify any fundamental reason for this pattern as, in our view, the calendar of releases during this week did not provide any significant update that could have changed market participant confidence. Nonetheless, the lack of novelties did not prevent the Brazilian currency from reaching as high as BRL5.45/USD last Tuesday, nor did it prevent it from going as low as BRL5.29/USD on Wednesday in intraday terms. In the end, we believe that the currency will likely end the week relatively close to the week-ago level. Given the still high uncertainties with respect to (global and local) macro fundamentals, and with further push from technical features, we continue to expect currency volatility to remain high in the coming weeks and months.

Local markets—rates: Judging from the price action early on Friday (at the time of writing), the nominal yield curve this week traded with a slight downward bias and nearly in parallel across some key maturities. In the front end, the Jan-22 DI future was heading to close the week at 2.98% (-4 bps from last Friday); in the back end, the Jan-27 DI future was trading at 6.33% (-4 bps from last Friday). As an upshot, the Jan-27 vs. Jan-22 steepness in DI futures was poised to end the week at the week-ago level (335 bps, among the narrowest gaps since mid-April). Yet this reading compares to ~150 bps seen early this year: that means a still steep yield curve in Brazil, reflecting the still high execution risks for the fiscal reforms post-crisis.

In recent days, investors continued to digest speeches from BCB officials, suggesting a bit of "optimism" on the pace of economic recovery since April and limited concerns about (non-fiscal) upside risks for inflation ahead. The market continues to price in a probability of nearly 50% for (a final, "residual") cut of 25 bps — the consensus among analysts.

Our baseline scenario still looks for a terminal Selic rate of 2.25% in this cycle (i.e., no more cuts), but we still think that the market pricing should remain divided between a “residual” cut or a rate stability for the next Copom meeting (August 4-5).

Economic activity: In June, our coincident index for retail sales IGet posted gains of 6.3% MoM s.a, while the indexes weighted according to core and broad retail sales survey methodology registered monthly gains of 2.8% and 2.0%, respectively, after seasonal adjustments. In our view, this result reinforces the signal provided in the previously released indexes for economic activity up to now: April was the worst month for activity, with a gradual and sequential resumption, but with the economy still operating at levels below the observed before the crisis.

The BCB's monthly activity indicator ended the sequence of releases of the main activity indicators for the month of May. The IBC-Br posted a gain of 1.3 % MoM s.a, a result considerably worse than our forecast 3.7% MoM (-12.7% YoY) and the market consensus 4.7 % MoM (-11.7 % YoY).This result is far from offsetting the decline recorded in the last two months, with the seasonally adjusted index running about 13.9% below the level seen in February. In terms of trends, the quarterly rolling result points to a contraction of -11.4 %, affected by April's slump in activity, while the three-month moving average registered a fall of -5 %, after reaching an all-time low in the previous month.

The result for May follows a dichotomy between relatively solid readings for industrial production, and retail sales and a disappointing result for the service sector, as the latter continues to see more lingering effects from the pandemic (tight restrictions, lower demand). With the opening and fully operating regime of the establishments, we expect a gradual resumption of economic activity. Preliminary soft data released for June points to continued improvement, although we must take into account the still low comparison base. All in all, the numbers suggest a gradual “normalization” of economic activity.

Regarding GDP projections, with the release of the main activity indicators for May, our tracking for the second quarter worsened, reaching -10.6%. Despite that, we kept our projections for 2Q20 and full-2020 at -10.2% and -6.4%, respectively.

Inflation: On Friday, IBGE releases the IPCA-15 (mid-month official CPI preview) inflation for July. We expect a reading of +0.48% MoM (+2.31% YoY). July’s readings (including the final CPI) will be pressured by administered prices (1.42% MoM), driven by the recovery of gasoline and the concentration of electrical energy tariff adjustments that had been postponed since the beginning of COVID-19 crisis.

On the other hand, free prices will have a much milder acceleration, reaching only 0.16% MoM. The rise will be concentrated in industrial goods (+0.31% MoM), where some specific tradable items were less impacted by the fall of demand generated by social distancing (such as the demand for personal computers due to the rise in work-from-home employees). Services are expected to post a minor positive MoM change of 0.11%, as the sector still sees headwinds from partial shutdowns. Moreover, it will be important to monitor airline ticket inflation, given the rare divergence in high-frequency price surveys, leading to an upside risk of +8 bps to our headline forecast. Finally, we expect food-at-home number to start their usual seasonal cooling down at mid-year, reaching almost zero in MoM terms.

Despite higher inflation in July, we continue to see a muted pace for core prices, as economic slacks are expected to remain high for a considerable period, despite the cushioning of demand generated by government stimulus and the reopening of a number of regional economies. Well-anchored inflation expectations also to play a big role: We forecast 2020 IPCA inflation at 1.5% (with small upside risks) and at 2.7% for 2021 (with downside risks).

Next week: The Brazilian Internal Revenue Service will publish the federal tax collection information for June 2020. Our estimate is BRL90.5 billion, which would mean a contraction of ~27% compared to June 2019, in real terms. This weak performance of tax revenue would be explained by the sharp deterioration in economic activity, combined with temporary measures of tax exemption and deferral of tax payment announced by the federal government aimed at mitigating the economic hit from the COVID-19 crisis.

Regarding economic activity, next Friday the FGV will release the consumer confidence index for July. The extraordinary preview released this week, with data collected up to July14, shows improvement in all confidence indexes for July, suggesting the continuity of the upward trend that began in May. This preview further indicates a likely positive number in the making from the standpoint of consumer sentiment late next week.

MACRO AGENDA

Indicator	Date	Estimate	Prior
IPCA-15 Jul/20 (% MoM)	Fri, 24-Jul	0.48	0.02
IPCA-15 Jul/20 (% YoY)	Fri, 24-Jul	2.31	1.92
Federal tax collection Jun/20 (BRL billion)	20-24/Jul	90.5	77.4

Sources: Brazilian Internal Revenue Service, IBGE and Santander.

Recent Publications (Available on Our Website)

- *Updating our Inflation, FX and Interest Rate Forecasts* (June, 2020)
- *FX Compass – BRL – A roller-coaster ride* (June, 2020)
- *Inflation: How Low and How Long?* (June, 2020)
- *FX Compass - BRL – Despite a little help from our friends* (May, 2020)
- *The Shock Is Even Worse and Stimuli Much Bigger* (May, 2020)

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