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Brazil Macro Compass

Weak March as a Prelude to an Expected 2Q20 Downturn

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- **Volatility remains high in Brazilian asset markets, and that is particularly true for the FX rate. This week, a more aggressive Brazil Central Bank (BCB) intervention pared the BRL's weekly loss. We continue to see FX risks skewed toward further depreciation, but recognize the apparently unattractive levels to be short BRL.**

- **The nominal yield curve continued its steepening movement this week, but this time more on the bearish side as yields shifted higher, especially past the one-year region in the curve. With the market pricing in a last rate cut of 25-50 bps, we see downside risk for the front end and still expect fiscal noise to prop up yields on the back end.**

- **In the minutes of the last Copom policy meeting (held on May 5-6), the BCB board highlighted that interest rates are likely to "close to a level where further reductions in the policy rate could be accompanied by instability in financial markets and asset prices." This reinforces our expectation of a final rate cut (of 75 bps) in June, as we forecast the terminal Selic rate at 2.25% at the end of the cycle.**

- **Many March activity indicators published this week have shown significant deterioration in Brazil's economic activity late in the first quarter. These figures confirmed our and market expectations of an unprecedented economic hit from the COVID-19 crisis.**

Local markets—FX: Volatility remains high in Brazilian asset markets, and that is particularly true for the FX rate. Although this week's BRL change (by the time of writing, -1.6% to ~BRL5.82/USD) does not put Brazil in the bottom-five performers among major currencies, the FX rate tested levels close to BRL6.00/USD in the intraday on Thursday (a milestone and new record-low in nominal terms). We believe that the currency was favored by a more aggressive BCB intervention, having sold more than USD3 billion in FX swaps and in the spot market. In our view, that action seems to have introduced a little more uncertainty for what looked like as unidirectional (bearish) positions in the local FX market. Yet the authority seems to be the main BRL buyer at this juncture.

For the short run, we continue to see Brazilian assets impacted by weak external conditions (given a limited global risk appetite, amid fears of second wave of COVID-19 contagion, an apparent resurgence of Sino-American tensions) and mounting domestic fiscal/political uncertainties. A possibly stronger FX intervention by the BCB (if continued ahead) introduces an element of difficulty for BRL bears. Still this is part of the usual BCB approach when it comes to FX interventions, as the authority seeks to lean against the wind but not to avoid (let alone reverse) the FX trends dictated by (expected) fundamentals. All in all, we continue to see FX risks skewed towards further depreciation, despite the unattractive levels to be short BRL after the massive depreciation so far in 2020 (~46% year to date vs. USD).

Local markets—rates: The nominal yield curve continued its steepening movement this week. While last week was a bull-steepening, this week saw a bear-steepening — meaning rather different effects for financial conditions, of course. At the time of this writing, the front-end (Jan-21 DI future) was rising 13 bps compared to last Friday, with the yield at 2.61%. On the other hand, the back-end (Jan-25 DI future) was rising 37 bps, with the yield at 6.76%. As a result, the steepness rose to 416 bps on May 15, from 392 bps on May 8. We believe the yield-curve movement follows the recent rate cut implemented by the BCB – and the signaling of more cuts ahead – amid a high uncertainty scenario.

Last week the market was pricing another cut of at least 50 bps in the Selic rate, but now it is pricing only 34 bps for the next Copom meeting in June. We still believe there is a high probability of another 75-bp Selic cut (or at least 50 bps), so it seems to be a downside risk for the front-end of the curve. For the back-end, we continue to see high fiscal uncertainties feeding premium for longer rates. Hence, there seems to be space for the steepening movement to continue.

Economic activity: A wide set of March's economic activity indicators was published this week. Due to the adoption of social distancing measures started in the last half of that month, a sharp decline in domestic activity was (largely) expected by us and the market. These expectations were confirmed, as the figures have shown an unprecedented economic hit from the pandemic.

First, (part of) the services sector dropped 6.9% MoM - seasonally adjusted (s.a.) - in March 2020. Compared to March 2019, there was a 2.7% fall, implying that the services sector declined 3% QoQ s.a. in 1Q20.

Regarding the Monthly Retail Survey, the core retail sales surprisingly fell only 2.5% MoM s.a. in March, significantly better than market expectations. However, the surprise was almost entirely explained by the 14.6% MoM rise in the "Supermarkets" category, which accounts for over 45% of the overall index. Even though, the core retail sales dropped 2% QoQ s.a. in 1Q20. As per the broad picture — it includes "Building Materials" and "Vehicles" — retail sales plunged 13.7% MoM s.a. in March, leading to a 4.4% QoQ s.a. decline last quarter.

Finally, the IBC-Br (BCB's economic activity index, viewed as a monthly GDP proxy) has consolidated March's economic activity indicators by falling 5.9% MoM s.a. and 1.9% QoQ s.a. in 1Q20. Based on these numbers, we estimate that Brazil's GDP dropped around 1.5% QoQ s.a. last quarter.

Inflation: There were no major releases this week and next week will also be calm on the inflation front, but some events are noteworthy. For instance, gasoline prices rose in the refineries by 10%, which we estimate it will impact IPCA by +15 bps in June. As we had already been considering that increase in our scenario, our forecasts for the short-term inflation have remained unaltered. However, we have changed our expectation for the "tariff flag" applied on electricity prices in June - from green to yellow -, which means an impact of +10 bps in June's IPCA and -10 bps in July's. Therefore, our new forecasts for consumer inflation in the short term are: -0.43% in May, +0.03% in June and +0.16% in July. We have also revised our year-end expectation to 1.4% from 2.2% in 2020 and to 2.9% from 3.1% in 2021.

Monetary Policy: Early this week, the BCB published the minutes of the last Copom policy meeting (held on May 5-6), in which the authority somewhat surprised the market with a Selic rate cut of 75 bps, to 3.00% p.a., a new historical low. In the scenario assessment, the Copom highlights that "projections point to a global recession with few historical precedents" (par. 12) and "unless there are medical advancements in the fight against the pandemic, it is plausible to consider a scenario in which the recovery is more gradual and marked by comings and goings" (par. 13). The BCB also reaffirms that "the pandemic shall exert a disinflationary impact on the Brazilian economy, together with a sharp increase in economic slack" (par. 14).

On one hand, the authority justifies a more intense rate cut, as "the demand-driven disinflationary shock, although accompanied by greater fiscal fragility, has triggered a downward revision on inflation expectations towards levels not compatible with the target, particularly, within the relevant horizon for monetary policy" (par. 17). Thus, we understand that the Copom may have chosen, at that moment, to focus more on the evolution of the central scenario rather than the broader balance of risks (where the fiscal policy issue could have had more influence).

On other hand, the BCB brings a discussion about the existence of "an effective lower bound for the Brazilian policy rate". The minutes show that most of the monetary policy committee understands that "this limit would be significantly higher in emerging economies than in developed countries, due to a risk premium" and that "this premium tends to be higher in Brazil, given the country's relative fiscal fragility and the uncertainties regarding its prospective fiscal path." The BCB board believes that interest rate is likely "close to a level where further reductions in the policy rate could be accompanied by instability in financial markets and asset prices." (par. 15). The Central Bank also indicates that abandoning the reform and adjustment agenda "may threaten the downward path of the structural interest rate" (par. 16).

Even in the face of an apparent BCB recognition of a deterioration in financial conditions (manifesting via the FX sell-off and the yield curve steepening, among other assets, probably making transmission of policy stimulus more difficult), we believe a strong fall in economic activity in 2Q20 will have greater weight in the next decision of the committee. Thus, we forecast a cut of 75 bps at the next meeting (June 16-17). In view of the authority's recognition that fiscal risks impose a more binding lower bound for interest rate, we believe that the June movement should end or cycle. Thus, we look for 2.25% terminal Selic rate in the cycle.

Next week: The Brazilian Internal Revenue Service will publish the federal tax collection for April 2020. Our estimate is BRL98.2 billion, which would mean a decline of 31% compared to April 2019, in real terms. The dismal performance of tax revenues is explained by the sharp deterioration in economic activity combined with temporary measures of tax exemption and deferral of tax payment (total package of ~BRL135 billion from April to June) recently announced by the federal government in order to mitigate the huge economic hit from the COVID-19 crisis.

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Indicator	Date	Estimate	Prior
Federal tax collection – April/20 (BRL billion)	May 18 – May 22	98.2	109.7

Sources: Brazilian Internal Revenue Service and Santander.

Recent Publications (Available on Our Website)

- *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)
- *FX Compass – BRL: It's more than solely the COVID-19* (March 26, 2020)
- *FX Compass – BRL: They Have Not Got It (Yet)* (February 20, 2020)

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