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Brazil Macro Compass

Q1 GDP: A Dip Before the Plunge?

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- **Amid favorable developments abroad and a relatively constructive flow of news on the domestic front, the Brazilian FX rate receded from the historical high of the previous week and inched closer to the levels of early this month.**
- **May IPCA-15 will be released on Tuesday. We forecast -0.55% MoM change (2.00% YoY), which would be the most negative monthly change for the whole series since its initiation in 2000.**
- **We estimate that the 1Q20 GDP (to be released on Friday) will fall 0.3% YoY (and 1.6% QoQ in seasonally adjusted terms), a rather unpleasant appetizer for an expected drastic economic contraction in 2Q20.**
- **For the April current account, with the report due for release on Tuesday, we forecast a USD3.2 billion monthly surplus. We anticipate that external sector data should hint at the significant improvement that we expect for this year.**
- **We expect April fiscal accounts (due on Thursday and Friday) to show a substantial impact from the COVID-19 crisis. In addition to plunging tax collection, on the heels of weaker economic activity and tax payment deferrals, we expect the report to show a massive expansion of public spending aimed at mitigating the economic (and health) effects of the pandemic.**

Local markets—FX: After having reached an historical high in the previous week, when the Brazilian FX rate breached the USD/BRL5.97 level in intraday terms, the BRL has strengthened in recent days, inching closer to the levels observed in early May (at the time of this writing, the pair was hovering around USD/BRL5.55). Both domestic and external factors have favored the BRL's recent performance.

Abroad, the highlights were: (i) the retreat observed in the global risk aversion (as measured by the VIX index); (ii) the maintenance of an upward trend for commodity prices; and (iii) USD weakening stemming from statements by U.S. authorities that they will continue to inject ample liquidity into that economy. On the domestic front, an agreement among various government entities to freeze government wages until 2021 conveyed a constructive message about the outlook for fiscal consolidation post-crisis. Those better market conditions allowed the Brazilian Central Bank (BCB) to reduce the volume of its interventions in the FX market in the last few days—it provided USD0.5 billion via USD swaps this week, as compared with USD3.3 billion in the previous one (via a mix of USD swaps and USD spot). The market also took cue from recent "business as usual" remarks from BCB officials, signaling room to provide more support for the local FX market if necessary. Despite the positive performance of this week, uncertainties and frailties prevailing at the present juncture—both domestically and abroad—should keep the FX market on high volatility mode, in our opinion.

Local markets—rates: In the last few days, nominal yields nearly wiped out the sell-off seen in the previous week, favored by a better risk appetite abroad and (preliminary) signs of better fiscal coordination between government entities and branches. At the time of this writing, the front-end (Jan-21 DI future) was falling 10 bps compared to last Friday, with the yield at 2.80%. The back-end (Jan-25 DI future) was down 28 bps for the week, with the yield at 6.43%. As a result, the (Jan-25 vs. Jan-21) steepness stands at 396 bps, slightly down from 415 bps on May 15. The curve is pricing in (nearly in full) another cut of 50 bps in the Selic rate for the next Copom meeting (June 18-19) – probably a last move in this cycle. We still see a high probability of another 75-bp Selic cut, implying a little downside risk for the front-end. For the back-end, we continue to see high fiscal uncertainties feeding premium for longer rates. In spite of constructive signs of late, we still see a cloudy outlook for the execution of macroeconomic and fiscal reforms in the post-crisis – a strictly necessary condition for the convergence of government debt in the short run. Thus, we still see limited room for a flatter yield curve in the short run.

Fiscal Policy: As published yesterday (May 21) by the Brazilian Internal Revenue Service, federal tax collection totaled BRL101.1 billion in April 2020, roughly in line with our expectation (BRL98.2 billion) and worse than market consensus (BRL110.3 billion). Adjusted by inflation, this result meant a sharp decline of 29% YoY.

The dismal performance of federal tax revenues last month can be explained by the deterioration in economic activity and (mainly) temporary measures of tax exemption and deferral of tax payment (total amount of ~BRL35 billion in April), which were announced by the federal government in order to mitigate the daunting economic hit from the COVID-19 crisis. Regarding tax breakdown, we highlight the sharp decline (in real terms) observed in: (i) Personal Income Tax – IRPF (-82.6% YoY); (ii) Contribution for Social Security Financing – COFINS (-52.8% YoY); (iii) Contributions to the Social Integration Program and Public Servants' Fund Financing Program – PIS/PASEP (-49.1% YoY); (iv) Social Security Revenue (-33.1% YoY); (v) Tax on Industrialized Products – IPI (-25.5% YoY); and (vi) Tax on Financial Transactions – IOF (-38.1% YoY). For the full-year 2020, we expect federal tax collection to register an unprecedented contraction of 9.5% YoY (in real terms), which is equivalent to tax losses of ~BRL150 billion compared to 2019.

Following the release of tax revenue data, we estimate that the central government's primary deficit will have amounted to BRL118.5 billion in April 2020 (this data is due out next Thursday, May 28). In addition to tumbling tax collection, we note the impact from the massive expansion in primary spending aimed at fighting the pandemic (e.g., emergency aid for informal workers, micro entrepreneurs and low-income households; extraordinary funds for the Ministry of Health). It is important to bear in mind that the central government recorded a primary fiscal surplus of BRL6.5 billion in April 2019, while for full-year 2019, the primary balance was -BRL95.1 billion (-1.3% of GDP).

Additionally, next Friday (May 29) the BCB will publish the consolidated public sector's fiscal balance for April 2020, which includes the federal government, regional governments and state-owned companies. We anticipate a monthly primary deficit of BRL122.5 billion, with the following breakdown: -BRL119.4 billion for the federal government; -BRL2.7 billion for states and municipalities; and -BRL0.4 billion for state-owned companies.

In our updated baseline scenario, we see the 2020 central government primary fiscal deficit totaling ~BRL785 billion (11.3% of GDP), whereas the consolidated public sector is expected to register a negative primary fiscal balance of BRL810 billion (11.7% of GDP) in the year. Thus, we estimate that the gross public debt-to-GDP ratio will climb by ~18 pp from 2019 to 2020 (from 75.8% to 94.2%). More importantly, we calculate this indicator will peak only in 2028 at ~103%, implying a difference ~30 pp compared to the pre-pandemic crisis. Henceforth, we project a gradual decline in public debt. (For details, please see our May 18 report, *The Shock Is Even Worse and Stimuli Much Bigger.*)

Regarding the political environment, we highlight the conciliatory climate during the videoconference held yesterday (May 21) between the president, ministers, state governors, Lower House and Senate speakers and the president of the Supreme Court. The leaders reached an important agreement: the presidential sanction of the emergency aid bill for states and municipalities (PLP 139/2020) will be accompanied by a veto on the provision that exempted several public servants' categories from salary freeze for one and a half year. According to the Ministry of Economy's estimates, the potential fiscal savings from the salary freeze is around BRL120 billion. The formalization of the agreement, with the president's sanction, is expected soon (deadline is May 27). It is worth noting that Congress could overturn the presidential veto, but we think that this now seem an unlikely scenario, given the government approximation to centrist political parties in order to build a parliamentary coalition base.

Next week:

Real Activity: Brazilian 1Q20 GDP will be released next Friday (May 29). In our view, the anticipated negative figure is just a foretaste of 2Q20, when we expect Brazil's economic activity to hit the bottom thanks to the COVID-19 crisis. Bear in mind that the social-distancing measures in the country were largely adopted only from the second half of March and that economic activity indicators until February pointed to solid growth-compatible with a 1.7% YoY growth in the 1Q20.

However, the full and partial shutdown of most of the economy at the end of March was enough to impact economic growth. For 1Q20, we forecast a YoY GDP fall of 0.3% in comparison (-1.6% QoQ, in seasonally adjusted terms).

Regarding the composition of GDP, with respect to supply, only agriculture should present positive figures in the quarterly comparison due to the robust soybean harvest, according to our estimates; on the other hand, both industry and the service sector should fall sharply. With respect to demand, strong investment growth (in the aftermath of positive results in January and February) and some increased government consumption will not be enough to avoid a fall in the domestic absorption, as household consumption should fall steeply, in our view. Furthermore, we forecast a robust negative external sector contribution, with a tepid fall in exports and a strong increase in imports.

Inflation: May IPCA-15 is set to be released on Tuesday (May 26). We forecast -0.55% MoM change (2.00% YoY), which would be the most negative monthly change for the whole series since its initiation in 2000.

We expect industrial goods prices to fall again (-0.63%), but less so than in April. Conversely, we expect services to turn from a positive change in April to deflationary in May (-0.32%). Moreover, we forecast that administered prices will deepen their fall (-1.77%), driven by a sharp decrease in gasoline prices. Also, we expect food-at-home to post a 1.34% deceleration. Finally, EX3 core should rise 0.08% m/m, per our estimate, meaning only 0.39% in terms of trend (quarterly seasonally adjusted annualized).

For the full IPCA we recently raised our short-term MoM forecasts to -0.41% in May, +0.17% in June and +0.33% in July. Our revisions were mostly driven by volatile gasoline prices. Considering only this revision, we see upside risk to our yearly forecasts of 1.4% in 2020 and 2.9% in 2021. However, abstracting from short-term volatile price adjustments, we still believe the steep fall of GDP dominates the scenario and imposes a major disinflationary pressure. (For details, see our May 18th report, *The Shock is Even Worse and Stimuli Much Bigger (Revising GDP, inflation, Interest Rate and FX Forecasts*.)

Labor market: The April National Households Survey (PNAD) is schedule to be released on Thursday (May 28). However, IBGE has signaled that it has faced difficulties in data collection due to social-distancing measures; as such, we believe that release of this data could be postponed. Nonetheless, we estimate that the unemployment rate will reach an all-time high of 16.9% (16.1% seasonally adjusted) up from 12.2% registered in March, due to the massive deterioration in employment conditions stemming from the deleterious effects of the pandemic.

Credit markets: Next week, the BCB will release financial credit data for April. We expect higher loan demand from individuals and the corporate sector, mainly for short-term credit and working capital, respectively, leading total outstanding credit in the economy to grow 10.1% YoY in the period (from 9.6% YoY in March).

Important aspects to observe in April's data are the share of credit granted by public financial institutions to the economy and the interest rates being charged in all segments. The BNDES and the BCB have already announced several measures aimed at partially supplying resources to the main affected sectors. Based upon April data, we should be able to observe how these initiatives are helping distinct sectors access the credit market and perhaps obtain data that shows increased participation of public credit compared to March 2020.

Balance of payments: The combination of a high trade surplus and a smaller-than-usual gap in the services and primary income lines should have led the Brazilian current account balance to register a US$3.2 billion monthly surplus in April, according to our projections. In 12-month-to-date terms, we expect the imbalance to have receded to USD44.5 billion last month (2.5% of GDP) from USD49.5 billion in December 2019 (2.7% of GDP), if our estimate proves to be right.

On one hand, we expect the sharp economic slowdown stemming from the COVID-19 crisis and significant (and swift) BRL weakening to have not only curbed imports and tourism outlays but also to have reduced the remittance of profits and dividends, at least in USD terms. On the other hand, weekly figures have indicated a better-than-expected performance of exports, notwithstanding the reduction in international trade flows. Since we expect the bulk of the negative impact of the pandemic to materialize in 2Q20 and a gradual recovery to commence after that, if exports are able to keep their current trend, there could be an even greater compression of the current account deficit in 2020 than we foresee. For now, we expect it to retreat to USD20.2 billion by December (1.6% of GDP).

This eventually stronger expected narrowing of the current account deficit may offset the downbeat indication that we expect foreign direct investment to bring. Based upon preliminary figures, we estimate net FDI inflow at USD2.0 billion in April (USD76.4 billion in 12-month-to-date terms). Although compatible with our forecast of USD57.4 billion for 2020, it is low compared to the monthly average inflow of ~USD6.5 billion observed since 2010.

MACRO AGENDA

Indicator	Date	Estimate	Prior
IPCA-15 May/20 (Δ% MoM)	Tue, May 26	-0.56	-0.01
IPCA-15 May/20 (Δ% YoY)	Tue, May 26	1.99	2.92
Current account balance Apr/20 (US$ billion)	Tue, May 26	3.2	0.9
Foreign Direct Investment Apr/20 (US$ billion)	Tue, May 26	2.0	7.6
Total Balance of Credit Operations (Δ% YoY)	Thu, May 28	10.1	9.6
Unemployment Rate (%)	Thu, May 28	16.9	12.2
Central Government Primary Fiscal Balance - Apr/20 (BRL billion)	Thu, May 28	-118.5	-21.2
GDP 1Q20 (Δ% QoQ)	Fri, May 29	-1.6	0.5
GDP 1Q20 (Δ% YoY)	Fri, May 29	-0.3	1.6
Public Sector's Primary Budget Balance - Apr/20 (BRL billion)	Fri, May 29	-122.5	-23.7

Sources: Bloomberg, Brazilian Central Bank, IBGE, The National Treasury Secretariat and 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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