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Brazil Macro Compass

Surfing the Wave in Markets, Feeling the Pain in Activity

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- **Local nominal yields kept rallying and flattening this week, buoyed by the improving global risk appetite and a perception of reduced tail risk from the perspective of local politics and fiscal policy. Judging from DI futures, the market is now pricing in nearly a 60-70% probability of a 75-bp cut in the Selic rate at the next Copom meeting (June 18-19), as per our call. We continue to see a little downside risk for short-term interest rates, despite our perception that we are nearing the effective lower bound for the policy rate in an emerging economy facing serious fiscal challenges.**

- **The catalysts for the rally in the domestic fixed income market have also led the Brazilian currency to register a significant strengthening this week, which brought the FX rate below the USD/BRL5.00 threshold (a level not seen since mid-March). Reflecting its high beta pattern, the Brazilian currency was the top performer among peers for another week, posting an ~8% gain against the greenback. Nevertheless, we continue to see fluid conditions for the FX outlook.**

- **April industrial production has confirmed expectations of an intense contraction on the heels of the social distancing measures implemented in an attempt to flatten the COVID-19 curve. The 18.8% monthly drop registered in the seasonally adjusted series was by far the steepest in the series. Still, the result was better than our forecast (-35.5%) and consensus (-31.7%).**

- **The USD4.5 billion trade surplus registered in May 2020 brought further evidence that the COVID-19 pandemic has hit imports harder than exports, in our view. This backdrop suggests upside risks to our 2020 trade surplus forecast (USD35.2 billion) as well as our current account projection (deficit of 1.6% of GDP).**

- **May IPCA comes out on Wednesday, and we expect the headline to show a deepening from April's fall (-0.31%), registering deflation of 0.45% MoM (+1.80% YoY). In the details, core measures should remain muted, with the IPCA EX3 core – a bellwether for demand-led inflation – down 0.09% MoM, and with its quarterly annualized sequential trend running close to zero. This would confirm a largely disinflationary effect from the pandemic.**

Local markets—rates: Nominal yields kept rallying and flattening this week, buoyed by the improving global risk appetite and a perception of lower tail risk from the standpoint of political conditions and fiscal outlook. At the time of this writing, the front end (Jan-21 DI future) was down 11 bps compared to last Friday, with the yield at 2.18%. The back end (Jan-25 DI future) was down 17 bps for the week, with the yield at 5.79%. As a result, the (Jan-25 vs. Jan-21) steepness was down to 361 bps, from 367 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.

Since the easier (global, local) financial conditions are supporting Brazilian assets, thereby removing a hurdle for implementing further monetary easing by the BCB, the local yield curve is now pricing in even more rate cuts for the current cycle. Judging from DI futures, the market is now pricing in nearly a 60-70% probability of a 75-bp cut in the Selic rate at the next Copom meeting (June 18-19), as well as high chance for a 25-bp move at the August 04-05 gathering. We not only remain in the 75-point camp for June (in line with analysts' consensus), but we also admit the possibility of additional easing afterward (our baseline is terminal Selic at 2.25%), so that risks may still be a little biased to the downside for the front end of the curve. As for the belly and back end, despite the continued respite from the National Treasury's approach to limit supply of duration to the market, we continue to see execution risks for the substantial fiscal and macroeconomic reforms necessary to fully mend the debt outlook. While that implies upside risk for the back end, an extension of the global rally, amid massive stimuli from major central banks, makes it bad timing to position for a steeper yield curve, in our view.

Local Markets—FX: The aforementioned favorable flow of news that improved global risk appetite and brought some respite to market participants regarding the domestic fiscal and political situation contributed to keeping the Brazilian currency on its appreciation trend for the third week in a row and led it to run below the USD/BRL5.00 level, which had not been seen since mid-March. Curiously, despite the stronger currency, the Brazilian Central Bank (BCB) intervened in the spot market last Monday, when it sold USD530 million to market participants. We think the move had to do with the fact that all emerging market currencies but the BRL were strengthening against the USD on that day, and, thus, the BCB decided to curb dysfunctionalities on the domestic FX market, according to its recent statements that it feels bound to intervene more heavily on such occasions. However, it is important to bear in mind that the move was not perceived as an attempt to set a given level for the FX rate.

Despite the favorable performance this week, we continue to see risks of a weakening of the BRL based on the likelihood of eventual frustrations concerning the prospects for fiscal policy, especially if temporary measures to fight COVID-19 turn out to become perennial outlays for the coming years. Therefore, we think it will continue to be important to follow news on that front in order to anticipate further strengthening of the BRL or a reversal of its recent trend.

Economic Activity: April industrial production has confirmed the expectations of a sharp decline due to the social distancing measures implemented in an attempt to flatten the COVID-19 curve. The 18.8% monthly drop registered in the seasonally adjusted series was by far the steepest fall in the historical series. Nevertheless, the result was considerably better than our forecast (-35.5%) and market consensus (-31.7%).

Relative to April 2019, there was a 27.2% decline, implying that industrial production decreased 10.8% QoQ (seasonally adjusted). We highlight that data released so far indicates that this should be the trough for Brazilian industrial production, since the coincident indicator for May points to mild improvement, and our expectations of a gradual easing of social isolation rules points to a continued (albeit gradual) path to normalization.

The details show a widespread decline among most industrial sectors in April; the diffusion index (percentage of industrial categories with monthly growth) reached 19.0%, the lowest level in the data series. Among the categories, the biggest drop was durable goods, which registered a 79.6% MoM fall in the seasonally adjusted series, due to the stoppage of production of some items such as vehicles. In contrast, the smallest contraction was in the production of intermediate goods, which fell by 14.8% MoM after seasonal adjustment.

The April industrial production report was the first of a batch of hard data covering a full month of the pandemic. The result suggests that the hit on the Brazilian economy could be somewhat less devastating than (we and) the market have anticipated. However, we believe it is too early to project a more modest decline in the Brazilian economy, since the data released so far show a quite depressed level of economic activity through May. With the available information, we reiterate our forecast of a 6.4% GDP contraction for 2020.

Inflation: This week the IGP-DI surprised to the upside, registering +1.07% MoM (+6.81% YoY), whereas our forecast was +0.80% and the median market expectation was even lower, +0.62%. The surprise was concentrated in industrial prices, but, as pass-through on durable goods to consumers has been low, we believe this should not threaten the rather constructive trend for the IPCA (consumer inflation).

Trade Balance: The Brazilian trade balance registered a USD4.5 billion surplus last month – we expected a USD4.8 billion excess – thus leading to a positive result of USD16.3 billion in year-to-date terms. Adjusting for the number of working days in the period (20 in May 2020 compared with 22 a year ago), daily average exports receded 4.2% in YoY terms. Daily average imports declined 1.6% in the same comparison, partially supported by the import of an oil platform. In year-to-date terms, daily average exports receded 4.5% in the first five months of 2020, while daily average imports remained nearly stable in the same period (-0.6% drop).

When we factor out transactions related to oil platforms, which are chiefly associated with accounting adjustments from previous tax issues, daily average imports showed a much more pronounced contraction (21.7% drop in YoY terms, or a 5.2% retreat in YTD terms). On the other hand, daily average exports managed to deliver a relatively better performance (4.2% YoY contraction, or a 3.1% YTD drop), which signals that imports seem to have been hit harder than exports so far.

Part of the explanation for this better performance of exports has to do with the strong contribution from soybeans and animal proteins, which accounted for a little more than a third of export proceeds in May 2020. The average daily volume of soybeans exported in 2020 increased 38.6% in year-to-date terms, while the daily average volume of animal proteins expanded 11.6% in the same terms.

The resilience shown by export proceeds and the swift contraction registered by import outlays brings an upward bias to our trade balance projection of USD35.2 billion in 2020, which also implies the same bias for our forecast for the current account deficit this year, currently at USD20.2 billion (or 1.6% of GDP).

Next Week:

May IPCA (due on Wednesday) is the main economic release of the week. We expect consumer inflation to deepen April's decline (-0.31%), registering -0.45% MoM (1.80% YoY). We project that transportation will continue to be the main driver of the decrease, with airplane tickets dropping 27.1%, while we expect gasoline to reduce the pace of its decline but still drop around 4.5%. Compared to April, we estimate food at home will pass from to 2.2% to -0.1%, helping to make the IPCA change even smaller. Industrial items and services in general should also post negative changes, according to our projections.

In the details, core measures should continue their trends, with the IPCA EX3 core – a bellwether for demand-led inflation – down by 0.09% MoM, bringing the sequential quarterly annualized pace close to zero. Therefore, we continue to see inflation at historical low levels in the short/medium term (1.4% in 2020 and 2.9% in 2021), which paves the way for the central bank to continue to cut interest rates so as to stimulate the economy.

MACRO AGENDA

Indicator	Date	Estimate	Prior
IPCA May/20 (∆% MoM)	Wed, 10-Jun	-0.45%	-0.31%
IPCA May/20 (∆% YoY)	Wed, 10-Jun	1.80%	2.40%

Sources: 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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