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Brazil Macro Compass

The Last Act or Is a "Residual" Move Next?

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- **We believe that noise on the domestic political front, a narrower interest rate differential, a potential second wave of COVID-19 infections and some profit-taking are behind recent BRL weakening and expect the BRL to end the week as the worst performer among emerging market ones.**

- **The Monetary Policy Committee of the Brazilian Central (COPOM) cut the Selic policy rate in its eighth meeting: -75 bps, to 2.25% (new historical low), as widely expected. In the forward guidance, the BCB stated whether there is room for further stimulus is "uncertain" and likely "residual", as the authority considers the already implemented adjustment enough to counter the pandemic's impact. For the next few meetings, the authority signaled that it is taking a "wait-and-see" approach, as the committee will evaluate the pandemic's impact and the effect of government stimuli on the economy. We continue to look for stable rate until at least 3Q20.**

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

- **The IPCA-15 (mid-month official CPI preview) for June is scheduled to be released on Thursday, and we forecast -0.09% MoM (1.81% YoY). Although we believe that the biggest monthly impact of the lockdown is behind us (-0.59% MoM in May), we still anticipate a benign short- and medium-term inflation scenario.**

- **We expect the Brazilian current account balance for May (due on Wednesday) to reinforce the sharp adjustment in external outlays stemming from the COVID-19 pandemic. We look for a USD2.2 billion surplus in the period, thus bringing the current account deficit to USD40.8 billion in 12-month-to-date terms from USD49.5 billion in December 2019.**

Local markets—FX: After a rally brought the FX rate from close to USD/BRL6.00 to nearly USD/BRL4.80 at the beginning of the previous week, market participants have apparently decided to cash in some of their profit, in our opinion. This decision led the FX rate to end last week at USD/BRL5.05, which marked the first weekly weakening since May 15. This week, in addition to profit-taking dynamics, news of a potential second wave of COVID-19 in regions that have already started easing their lockdown and social distancing rules have also stoked market participants to seek some protection, a move that usually penalizes the BRL.

In that sense, the Brazilian Central Bank's (BCB) decision to reduce the base interest rate to 2.25% p.a. last Wednesday (more details in the Monetary Policy section) has dimmed further the appeal of the BRL, thus also putting some weakening pressure on the BRL. Last but not least, new noise on the domestic political front have also reminded us that negotiations between the executive and legislative branches are far from a given, hampering the prospects of the structural reforms the country needs. In our view, this mix of conditions is likely to lead the BRL to end the week as the worst performer among emerging market currencies; however, we believe that improvements regarding the outlook for the pandemic and the progress of reforms in the second half of this year are likely to lead the BRL to strengthen by YE2020.

Local markets—rates: Nominal yields steepened this week. The front-end was pressured down as the Copom confirmed a 75-bp cut in this week`s policy meeting without closing the door to another possible small adjustment. The belly and back-end sold off in wake of renewed tensions regarding the political outlook. As an upshot, the Jan-25 vs. Jan-21 steepness rose again, to 381 bps from 363 bps at the end of last week. The yield curve had been flattening for three weeks.

Looking ahead, we believe the market should continue to trade the front-end, pricing in a "halfway" probability of a 25-bp move in August (the "residual" adjustment as suggested by the BCB statement, see details below). Despite the apparent mending in the relationship between executive and legislative branches, this week`s events remind us that we are still not out of the woods from the political standpoint. Those elements help paint a mixed picture as per the expectations that macroeconomic and fiscal reforms could become a priority for sometime late this year or in 2021. Thus, from the standpoint of political fundamentals, we continue to dislike receiving positions on the back-end and flatteners.

Economic activity: A wide set of April's economic activity indicators was published this week. As the pandemic led to the adoption of social distancing measures during the whole month in most part of the country, 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 11.7% MoM - seasonally adjusted (s.a.) - in April 2020. Compared to April 2019, there was a 17.3% fall, implying that the services sector declined 9.1% QoQ (s.a.).

Regarding the Monthly Retail Survey, the core retail sales fell only 16.8% MoM (s.a.) in April. In comparison with the same month of 2019, the core retail sales contracted 16.8%. Furthermore, we highlight the sharp quarterly drop of 7.3% QoQ (s.a.) in April. All categories have registered sharp declines in the month. However, "supermarkets" and "pharmaceuticals" showed some resilience, as they were able to continue operating during the social distancing policies since they are considered essentials services. Per the broad picture, which includes "building materials" and "vehicles", retail sales plunged 17.5% MoM (s.a.) in April, leading to a 13.6% increase QoQ (s.a.).

Finally, the IBC-Br (BCB's economic activity index, viewed as a monthly GDP proxy) has consolidated April's economic activity indicators by falling 9.7% MoM (s.a.) and 6.9% QoQ (s.a.). Based on these numbers, we estimate that Brazil's GDP should drop more than 10% QoQ (s.a.) in 2Q20.

Monetary Policy: For an eighth meeting in a row, the Copom decided to cut the Selic (policy) rate. As widely expected (both in surveys and asset prices), the authority kept the pace at 75 bps, taking the rate down to a new historical low of 2.25% p.a. For markets, more important than the decision is the forward guidance, where the authority seems to have indicated a likely pause in the coming months, as well as an apparent unwillingness to cut interest rates much further subsequently.

While the BCB believes "the current state of affairs continues to recommend an unusually strong monetary stimulus", the committee sees the room for further monetary policy stimulus as "uncertain" and likely "small."

The Copom states that now "the Committee judges that the magnitude of the monetary stimulus already implemented seems compatible with the economic impacts of the COVID-19 pandemic." The board also claims that, for the next meetings, "the Committee sees as appropriate to evaluate the impact of the pandemic and of the set of credit and transfer programs in place, and foresees that any possible adjustment to the current monetary stimulus would be residual."

Interestingly, the Copom cites a new element in the balance of risk, which weighs on the upside. The authority mentions that "the credit and transfer programs implemented in response to the pandemic may cause a smaller-than-estimated decline in aggregate demand, introducing an asymmetry to the balance of risks." This new element adds to other risk factors previously highlighted by the BCB, such as a permanent fiscal deterioration or frustrations about economic reforms (upside risk) as well as the persistence of economic slacks and the possibility of large precautionary savings in the wake of a lengthier pandemic (downside risk).

The inflation projections continue to support the theoretical (and in our view narrowly considered) outlook for cuts. The Copom projects IPCA inflation at 2.0% (previously: 2.4%) for 2020 and at 3.2% (previously: 3.4%) for 2021, assuming Selic rate at 2.25% for YE2020 and 3.00% for YE2021. With the policy rate constant, at 3.00%, the BCB sees IPCA inflation at 1.9% (previously: 2.3%) for 2020 and at 3.0% (previously: 3.2%) for 2021. All simulations assume exchange rate (USD/BRL), at 4.95, versus 5.55 previously.

Our own numbers indicate that in order to push the model estimates for 2021 (the focal policy horizon now) to the mid-target of 3.75%, one would have to assume Selic rate at zero. That is clearly a level the BCB is unwilling to test, maybe implicitly bearing in mind previously discussed limitations for interest rate easing in an emerging economy facing severe fiscal challenges.

In our view, however, the next policy steps will probably hinge more on the balance of risks than on point estimates for inflation. And we continue to think this caution taken by the BCB is warranted.

At least for now, the activity-inflation outlook seems consistent with our scenario. If such a scenario materializes, we believe this move by the Copom could have been the last in the cycle. Thus, we see the statement reinforcing our expectation of Selic rate at 2.25% (at least) until 3Q21.

With the cold numbers from standard Taylor rules pointing to zero interest rate at this juncture, we believe the more cautious approach by the BCB (as it sails such unchartered waters)- can pay off. It helps strengthen this low-inflation regime seen nowadays; it helps consolidate a path of low interest rate for the medium run. To conclude: if Brazil is able to pass macroeconomic reforms to both speed up growth and keep the constitutional spending cap intact, the likelihood of a scenario of “even lower rates for even longer” will get stronger, in our view.

Next week: The **IPCA-15** (mid-month official CPI preview) for June will be released on Thursday. We believe May’s reading (-0.59% MoM) should have been the trough of the monthly change, with the strongest impact of the lockdown’s effects; so for June, we expect a deceleration of the fall in prices. We forecast -0.09% MoM (1.81% YoY). Both services and industrial goods should reduce de rhythm of deflation but still remain at the negative side. Hence core measures will also remain muted. Food-at-home will continue the slowing trend, but will probably stay slightly positive. On the other hand, administered prices should turn positive, driven by a recover in gasoline prices. All in all, we continue to see a really benign scenario for inflation both in short and medium-term horizons.

The strong economic deceleration stemming from the COVID-19 has curbed Brazilian external outlays such as imports, tourism and, more important remittance of profits and dividends, while it has affected less intensely export proceeds (the main source of Brazilian external proceeds). We expect the **current account balance** in May (due on Wednesday) to confirm that backdrop, as we estimate it to have registered a USD2.2 billion surplus in the period, which would have meant—if our calculations prove to be right—a USD40.8 billion deficit in 12-month-to-date terms last month, thus hinting at a sharp shrinkage as compared with the USD49.5 billion annual shortage registered in the end of 2019.

Given that we expect the Brazilian economy to present a gradual recovery in the coming years, while the international environment should outperform us in our view, this declining trend for the current account deficit should be extended for a while. On top of the result on its own, the release will also be a hallmark because it will bring a new review in the historical series as announced by the BCB last year. From this year onward, the Brazilian monetary authority will carry out two annual reviews on external sector data every June and November of each year.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Copom minutes	Tue, 23-Jun	- -	- -
Current Account Balance May/20 (USD billion)	Wed, 24-Jun	2.2	3.8
Foreign Direct Investment May/20 (USD billion)	Wed, 24-Jun	2.0	0.2
IPCA-15 (% MoM)	Thu, 25-Jun	-0.09%	-0.59%
IPCA-15 (% YoY)	Thu, 25-Jun	1.81%	+1.96%
Federal tax collection – May/20 (BRL billion)	22/26-Jun	81.0	101.2

Sources: Brazilian Internal Revenue Service and Santander.

Recent Publications (Available on Our Website)

- *Inflation: How Low and How Long?* (Jun/20)
- *FX Compass - BRL – Despite a little help from our friends* (May/20)
- *The Shock Is Even Worse and Stimuli Much Bigger* (May/20)
- *FX Compass – BRL: Post COVID-19 Concerns* (Apr/20)
- *Fiscal Policy During the COVID-19 Crisis: New Challenges, More Risks and the Same Long-Term Goals* (Apr/20)

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