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Brazil Macro Compass

Picking Up the Pieces (of Real Activity) in May

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- **On the heels of negative news regarding the widening COVID-19 outbreak in the U.S., the risk-off mood prevailed this week, leading the BRL (a high-beta currency) to be among the worst emerging market performers.**

- **In the Copom minutes and inflation report, the Brazil Central Bank (BCB) reaffirmed its forward guidance of limited room for additional rate cuts. We see the materialization of the BCB scenario (which is similar to ours) as consistent with our expectation of the Selic rate on hold, at 2.25%, until 1Q22. We still see the bar high for a new rate cut and believe that such a move would primarily hinge on a much longer and stronger (than expected) economic hit from the pandemic.**

- **The National Monetary Council (CMN, in Portuguese acronym) announced the (IPCA) inflation target for 2023 at 3.25%, giving continuity to a process of a gradual reduction and convergence to that of peer countries in recent years. Conditional upon the implementation of macro and fiscal reforms, a more ambitious inflation target helps reduce expectations (and pricing) for long-term nominal interest rates, eliminates indexation mechanisms, and favors a more efficient allocation of resources in the economy.**

- **We look for an industrial production gain of 5.3% MoM (s.a.) for May (data due this coming Thursday), implying a partial recovery from April's ~19% slump and potentially revealing a pattern of the gradual recovery that we envision for the whole economy in coming months, following the gradual easing of social distancing measures.**

- **Although May's current account surplus fell short of our estimate (USD1.3 billion vs USD2.2 billion, respectively), its dynamics were in line with our assessment of a stronger compression in outlays than in revenue, thus reinforcing our perception of a major current account deficit adjustment this year. We expect June's trade balance (due to be released next Wednesday) to provide evidence of that appraisal.**

- **We expect May fiscal accounts (due on Monday and Tuesday) to continue showing a significant impact from the pandemic. In addition to the poor performance of federal tax collection, which tumbled 33% YoY owing to weaker economic activity and tax payment deferrals, we note the massive expansion of government spending aimed at mitigating the negative effects of the virus outbreak.**

Local markets—FX: Despite some good news at the beginning of the week, which confirmed the perception that global economic activity has been faring better than expected since April, the worrying increase in the number of COVID-19 cases in the U.S. weighed on market participants' confidence, triggering a risk-off approach, in our view. Accordingly, following its high-beta pattern, the BRL took a hit and was among the worst emerging market performers this week; the FX rate is poised to close the week north of USD/BRL5.40, a level last seen only at the end of May.

The monetary authority has refrained from intervening these days and announced a partial roll-over (so far) of a USD repo line falling due next Thursday. This hands-off approach, for now, could be contributing to the weakening BRL this week, in our view. The BCB may yet announce the full rollover of the operation in the next week, but in the absence of such a decision, we believe that the BRL is likely to remain under pressure in the short term if global financial conditions continue to deteriorate.

Local markets—rates: Nominal yields shifted slightly higher this week, possibly following the rise in global risk aversion. In the front end, Jan-21 DI futures are closing the week at 2.08% (+6 bps from last Friday), potentially helped by the Copom' s signal that this could be the end of the easing cycle. The belly and back end moved likewise, as increased Covid-19 cases in advanced economies raised global fears of a second wave of contagion. By the time of writing, the Jan-25 (in DI future) was trading at 5.90% (+8 bps from last Friday). The Jan-25 vs.Jan-21 steepness was little changed for the week: 380 bps vs. ~190 bps early this year.

The market continues to price in a likelihood of nearly 50-60% for another 25-bp cut in this cycle. While our baseline scenario projects a terminal rate of 2.25% (i.e., no more cuts), the downwardly skewed risks for economic activity does support a market pricing at the midway point for a final (and "residual") rate cut at some point this year. As per the back end, the lack of conviction in global and local developments (e.g., pandemic, politics) for the short term entails a cautious approach (i.e., little or no exposure), in our opinion.

Economic activity: This week, some soft data such as the FGV's Consumer Confidence Index (ICC) came out. In June, the ICC increased by 14.5% MoM (s.a,), partly recovering from the steep drop seen in April. The gain was influenced by the expectations component: the Expectations Index (IE) was up 18% MoM (s.a.). The assessments on the current situation also changed signs after dropping for three consecutive months: the Current Situation Index (ISA) rose 8.6% MoM (s.a.) in June. Despite this slight recovery, the headline ICC is still 21% below the level reached at the beginning of the year and remains close to the historical lows.

Monetary Policy: This week, the BCB published minutes from the June 16-17 Copom policy meeting, during which the authority cut the Selic rate by 75 bps, to 2.25%, a new historical low. The authority also published its 2Q20 inflation report, detailing inflation simulations and the latest BCB studies. Here, we summarize what we view as the key takeaways from the recent policy-related messages conveyed by the Central Bank.

On the scenario assessment, the BCB continues to point to generally favorable conditions for the conduct of monetary policy. As per the external environment, for instance, the Copom highlights major economies' large-scale and coordinated policy actions (both in terms of fiscal and monetary stimulus) that aim to mitigate the crisis. Yet the authority noted an asymmetry in resources that make the impact much stronger in EMs than in DMs, which explains the rise in global risk aversion and the capital flight from developing economies. Despite an expected notable adjustment in Brazil's external accounts (i.e., a much lower current account deficit) highlighted in some boxes of the inflation report, the BCB sees the global context as challenging overall.

In the field of activity, the BCB is looking for a 2020 GDP contraction of 6.4%, in line with consensus (and our own forecast). In the press conference following the release of the inflation report, BCB officials highlighted the sharp expected contraction in otherwise less volatile components like services (supply side) and consumption (demand side). This is seen as a particular feature of this crisis. The authority indicates that high-frequency indicators are confirming a partial (but heterogeneous across sectors) rebound in May and June, following a huge April slump. The BCB scenario assumes a gradual activity recovery, but recognizes that the uncertainty about the speed is high. The Copom sees its own forecast as pessimistic, with the board believing that the government stimulus measures (such as the emergency aid to households) twists to the upside for this year's GDP estimates.

In the realm of prices, the BCB continues to see underlying inflation at levels below the ones consistent with achieving the inflation target for the relevant policy horizon. In what seems to be the key simulated scenario (the so-called "hybrid"), the BCB estimates IPCA at 2.0% for 2020 (target: 4.0%), 3.2% for 2021 (target: 3.75%) and 3.5% for 2022 (target: 3.5%). This simulation points to a decline of 0.4 p.p. in the projection for the key policy horizon now (YE2021), as compared to the last inflation report (out in March). This hybrid simulation assumes a stable FX rate at BRL4.95/USD all the way up to YE2022, and a consensual path of Selic rate at 2.25% (YE2020), 3.00% (YE2021) and 5.00% (YE2022). The other simulations (i.e., using other set of key assumptions for the Selic and BRL) also point to estimated inflation around 3.0-3.2% for the focal policy horizon of 2021.

On the balance of risks, the BCB referred once again to upside and downside inflation risks. On the upside, the Copom cites a permanent fiscal deterioration or frustrations about economic reforms, as well as the potential mitigating effects on aggregate demand from credit and transfer programs implemented by the government. On the downside, the BCB points to the persistence of economic slacks and the possibility of large precautionary savings in the wake of a lengthier pandemic. In the inflation report, the BCB also simulated alternative scenarios, such as one with a more persistent degree of economic uncertainty (leading to an IPCA projection of 3.0% for 2021, vs 3.2% in the baseline) and another one testing a continued rise in oil prices up to USD60 per barrel by YE2021 (taking the estimated 2021 IPCA up to 4.1%).

The forward guidance remains the same as in the communique. In both the Copom minutes and inflation report, the BCB expressed a belief that the magnitude of the monetary stimulus implemented is compatible with the economic impacts of the pandemic. The committee continues to see room for further monetary policy stimulus as "uncertain" and likely "small." The text also kept the indication that the Copom still "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." In the press conference, BCB officials made clear that the cautious tone (as inflation is simulated below the target for the key policy horizon) does not mean abandoning the efforts to meet next year's inflation target. Instead, it means a greater emphasis by the board on the balance of risks, amid such unusual uncertainty.

On that note, the Copom minutes made clear references to the so-called "effective lower bound" of interest rates. Although none is able to quantify precisely, the BCB sees it as a dynamic variable. The theory behind this is (in a thesis that we do support) is that if this effective limit for the policy rate is crossed below, then the interest rate stimulus could become counterproductive, especially for an emerging economy with fiscal difficulties (clearly the case of Brazil). In the minutes, the BCB mentions those limitations both from the standpoint of financial conditions, as well as from a prudential perspective (i.e., financial stability).

While not fully closing door on the possibility of a "residual" rate cut at some point in the future if necessary (i.e., after watching the impact of the pandemic and the government stimuli on the economy), the BCB signaled the possibility that further actions to support the economy might even come from the realm of macroprudential and regulatory measures. The rationale would be to foster the policy transmission through the credit channel via actions aimed at reducing capital costs (and no longer the funding costs). No wonder that more of regulatory measures have been announced earlier this week, possibly generating an estimated push to new lending of nearly BRL270 billion.

Considering all the recent Copom communications (statement, minutes, and inflation report) the materialization of the BCB scenario (which is similar to ours) is consistent with our expectation of Selic rate on hold, at 2.25%, until 1Q22. We still set the bar high for a new rate cut, which would primarily hinge on a much longer and stronger (than expected) economic hit from the pandemic (note: while our baseline scenario assumes reforms in coming years, we do not at all believe a massive change in the long-term fiscal outlook is likely in the next few months).

The CMN announced that the midpoint (IPCA) inflation target for 2023 is 3.25%, with a tolerance band of +/- 1.5 p.p.. This decision gives continuity to a process of gradual reduction in recent years. From 2005 to 2018, the midtarget was 4.50%, until the council decided in 2017 to reduce the target for 2019, to 4.25%. The 2020, 2021 and 2022 the targets are 4.00%, 3.75% and 3.50%, respectively. In the end, this process should lead to a convergence of Brazilian inflation (target) for most emerging countries (including LatAm peers, such as Chile, Mexico and Colombia, where the target is 3.00%).

According to the Ministry of Economy, the disinflationary effect of the pandemic means that the decision to continue lowering the inflation target does not imply additional costs. We understand that this decision makes good use of the cyclical effects of recent crises (this one included) and of a structural process (from 2016 onward) of re-anchoring of expectations, seeking to make the current scenario of low inflation in Brazil a perennial one. Depending on the implementation of macroeconomic and fiscal reforms, a more ambitious goal (and more aligned with peers) helps to reduce expectations (and pricing) for the long-term nominal interest rates. At the end of the day, a structurally low inflation naturally eliminates indexation mechanisms and favors the planning of consumers and companies in a more efficient allocation of resources.

Fiscal accounts: As published last Tuesday (June 23) by the Brazilian Internal Revenue Service, federal tax collection totaled BRL77.4 billion in May 2020, a result slightly worse than our expectation (BRL81.0 billion) and market consensus (BRL81.1 billion). Adjusted for inflation, this result meant a sharp decline of 32.9% YoY (April: -29% YoY).

The poor performance of federal tax revenue in May can be explained by: (i) the deterioration in economic activity, which reduces the tax base; and—mainly—(ii) measures of tax exemption and deferral of tax payments (total amount of ~BRL32 billion last month), which were announced by the federal government aimed at mitigating the economic hit from the pandemic. Excluding these government provisions, we estimate that federal tax revenue would have dropped by about 5% YoY in real terms (or -BRL6.0 billion).

Regarding the breakdown, we highlight the steep decline (in real terms) observed in: (i) Tax on Financial Transactions – IOF (-66.9% YoY); (ii) Personal Income Tax – IRPF (-59.2% YoY); (iii) Contribution for Social Security Financing –

COFINS (-54.9% YoY); (iv) Contributions to the Social Integration Program and Public Servants' Fund Financing Program – PIS/PASEP (-46.8% YoY); (v) Social Security Revenue (-39.0% YoY); and (vi) Tax on Industrialized Products – IPI (-31.3% YoY).

For full-year 2020, we expect total federal tax collection to plunge 11.5% YoY (in real terms), which is equivalent to tax losses of ~BRL180 billion compared to 2019. On this matter, we note that the federal government should allow tax debts to be paid in installments over the next few years. We estimate this measure could expand the 2020 central government's primary deficit by about BRL80 billion.

In our updated baseline scenario, we see the 2020 central government primary fiscal deficit totaling BRL820 billion (11.9% of GDP), whereas the consolidated public sector is expected to record a primary fiscal deficit of BRL845 billion (12.2% of GDP). (For details, please see our June 25 report, *Updating our Inflation, FX and Interest Rate Forecasts.*)

Public debt management: This week, Brazilian National Treasury published its Monthly Debt Report for May 2020. According to the publication, Federal Public Debt (FPD) issuances came to BRL86.7 billion in May, while redemptions amounted to BRL13.1 billion, leading to net issuances of BRL73.6 billion. We highlight that recent financing conditions in the domestic market for public securities have led the National Treasury to favor issuances of fixed-rate securities with shorter maturity and floating-rate securities. With respect to debt holders, we note that foreign investors continued to reduce their positions in the Brazilian public securities market, from 9.4% in April to 9.1% in May (the proportion was 12.7% one year ago). The average maturity remained on a downward trend, falling to 3.96 years in May from 4.04 years in April (it was 4.26 years in May 2019). On the brighter side, the outstanding cumulative 12-month average cost fell to 9.0% in May from 9.4% in April, while the average cost of new issuances in public offerings (domestic debt) dropped to 5.6% from 6.1% in the same period, the lowest value in the historical data series.

In short, contrasting to March and April, actual data for May and preliminary data for June show that public securities issuances have been gradually increasing, which is important for keeping the National Treasury's "liquidity cushion" at comfortable levels. We calculate this reserve — a management tool that serves to mitigate the rollover risk in stress scenarios — is currently a bit above BRL500 billion (6.9% of GDP), an amount enough to pay off federal debt maturities until December 2020.

Regarding this matter, we reiterate our belief that the BCB could possibly use FX results in 1H20 (mostly due to a higher value of foreign exchange reserves in BRL) to strengthen the "liquidity cushion". We believe the total amount to be transferred from the Central Bank to the National Treasury should be around BRL400 billion (it depends on the magnitude of the increase in foreign exchange reserves — in BRL — at the end of 1H20). This transfer of resources is subject to approval by the CMN, which will likely take place in August or September, in our opinion. We reiterate that, despite providing substantial "cash relief" for the Brazilian National Treasury concerning the public debt management, the transfer of BCB's FX result would have little (if any) effect from a fiscal standpoint, as the additional injection of liquidity into the financial system is offset by repo operations, which is also part of government debt.

Balance of payments: Chiefly due to higher interest payments than those displayed in the BCB's schedule (USD1.8 billion vs USD1.2 billion, respectively), the current account surplus fell short of our estimate (USD1.3 billion vs USD2.2 billion, respectively). That has not changed our mind with regard to the perception that there will be an important adjustment in the current account balance this year (we forecast a USD1.4 billion surplus in 2020 as compared with a USD49.5 billion deficit last year). After all, for the second month in a row, the country barely register the remittance of profits and dividends and tourism outlays have collapsed on the heels of the acute economic slowdown and travel restrictions stemming from the COVID-19 pandemic. Additionally, imports have also declined substantially, a backdrop that we think it should not be reversed anytime soon, as we anticipate the Brazilian economy will see a gradual recovery in the coming quarters. At the same time, while the pandemic has also hit exports, the drag has proven to be less pronounced than the one seen on imports, which bolsters our assessment of an improvement in the current account balance.

Regarding the components of the financial account, it was curious to note the repatriation of Brazilian capital for the third month in a row, in tandem with a positive surprise in the net inflow of direct investment in the country (IDP). The latter reached USD2.5 billion in May, while we estimated USD2.0 billion. The most promising came from the portfolio accounts, which registered an important deceleration in the volume of outflows in May as compared to the two previous readings (USD1.7 billion last month, down from USD9.1 billion in April and far below the USD23.0 billion registered in March). What's more, preliminary figures for June provided by the BCB indicated there is a chance of a net inflow for the period, which buttresses our assessment that there is room for the BRL to strengthen over the course of the year. Despite that apparently "sanguine" view on the BRL, we reckon the path for that should be a bumpy and volatile one (we forecast the FX rate to end 2020 at USD/BRL4.95).

Next week: Next Tuesday (June 30), the PNAD household survey for May will be released. The consensus for the national unemployment rate points to a reading of 13.2% (of the economically active population), meaning a sized increase from last year's 12.3%. The report should reinforce the worsening trend in labor market conditions due to the crisis of COVID-19. In May, we estimate that joblessness would have reached an all-time high if the workforce had remained stable, as the participation rate fell abruptly owing to the social isolation measures.

May Industrial Production data will be released next Thursday (July 2), and we envision a slight recovery from the April slump. Amid the easing of social isolation measures, coincident indicators suggest a slight recovery. We look for a sequential increase of 5.3% MoM (s.a.), consistent with an annual change of -23.5% YoY.

Trade balance data for June are due to released next Wednesday and we expect them to bolster our view that the drag stemming from the COVID-19 pandemic should weigh less on exports than on imports. According to our calculations, although Brazil should register a USD6.9 billion trade surplus this month, both exports and imports (adjusted for business days) are likely to fall as compared with a year ago. However, while we project exports daily average to fall 10.5% in YoY terms, imports daily average is likely to retreat 22.1%, in our view. Therefore, our expectation for a USD60.5 billion trade surplus in 2020 will have to do more with a strong decline in imports stemming from the economic contraction the country is bound to live than with a good performance of exports.

Following this week's release of tax revenue data (see comment above), we calculate that the central government's primary deficit will have added to BRL123.5 billion in May 2020 (this data is due out next Monday, June 29). In addition to tumbling tax collection, we note the impact from the massive expansion in primary spending to combat the COVID-19 crisis — total amount of BRL54.4 billion in May, of which 75% (BRL41.1 billion) were directed to the payment of the emergency financial aid for informal workers and low-income households, dubbed "coronavoucher". It is important to bear in mind that the central government registered a primary fiscal deficit of BRL14.7 billion in May 2019, while for full-year 2019, the primary balance was -BRL95.1 billion (-1.3% of GDP).

Lastly, next Tuesday (June 30) the BCB will release the consolidated public sector's fiscal balance for May 2020, which includes the federal government, regional governments and state-owned companies. We forecast a monthly primary deficit of BRL125.7 billion, with the following breakdown: -BRL123.0 billion for the federal government; -BRL2.4 billion for states and municipalities; and -BRL0.3 billion for state-owned companies.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Central Govt's Primary Fiscal Balance May/20 (BRL billion)	Mon, 29-Jun	-123.5	-92.9
Unemployment Rate May/20 (% NSA)	Tue, 30-Jun	13.2	12.6
Public Sector's Primary Budget Balance May/20 (BRL billion)	Tue, 30-Jun	-125.7	-94.3
Trade Balance Jun/20 (USD billion)	Wed, 01-Jul	6.9	4.5
- Exports Jun/20 (USD billion)	Wed, 01-Jul	18.2	17.9
- Imports Jun/20 (USD billion)	Wed, 01-Jul	11.3	13.4
Monthly Industrial Production May/20 (Δ% MoM s.a.)	Thu, 02-Jul	5.3	-18.8
Monthly Industrial Production May/20 (Δ% YoY)	Thu, 02-Jul	-23.5	-27.2

Sources: Brazilian Central Bank, IBGE, Brazilian National Treasury, SECEX and Santander.

Recent Publications (Available on Our Website)

- *Updating our Inflation, FX and Interest Rate Forecasts* (Jun/20)
- *FX Compass – BRL – A roller-coaster ride* (Jun/20)
- *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)

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