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Brazil Macro Compass

Gradual (and risky) improvement

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- **On the heels of constructive news related to global economic activity – improving investor's risk appetite – as well as relatively tranquil days on the domestic political environment and an isolated spot market intervention by the Brazilian Central Bank (BCB), the BRL is poised to end the week as the best-performing currency (up 2.9% to USDBRL 5.33). Still, amid lingering uncertainties at global and local levels, FX volatility in Brazil is to remain quite high.**

- **Nominal yields saw a bull flattening pattern this week, possibly on the heels of a more constructive global backdrop for risky assets. Yet we continue to see a steep yield curve in Brazil, as unprecedented monetary stimuli contrasts with a greater uncertainty about macro and fiscal reforms going forward.**

- **May Industrial Production confirmed expectations of growth following a massive plunge in April, on the back of a gradual easing of the social distancing measures. The monthly gain of 7.0% was better than our forecast (5.3%) and the consensus (6.7%). Overall, the incoming numbers of real activity point to sequential gains for May and June, following the economy's sudden stop in April. Yet it will take time before we see a return to pre-crisis levels.**

- **On Wednesday, IBGE will publish the retail sales data for May: based on our proprietary coincident retail indicator IGet, we look for a gain of +10.2% MoM sa (-20.9% YoY) for the broad sales index.**

- **May's fiscal accounts came in line with expectations, showing a substantial impact from the COVID-19 crisis on the government finances. These figures reinforce our forecast that the 2020 public sector primary fiscal deficit will amount to ~ 12% of GDP, counting on a longer-lasting deferral of tax payments and extension of some primary spending measures to combat the pandemic. In this regard, we highlight this week's official announcement of the extension of emergency financial aid for informal workers and low-income households (dubbed "coronavoucher") for two more months at its current value (BRL600 per month). This implies a fiscal cost of about BRL100 billion.**

- **On the heels of lower-than-expected imports, June trade surplus (USD7.5 billion) overcame street estimates, reinforcing our perception that the pandemic will weigh more on imports than on exports.**

- **On Friday, IBGE releases the IPCA inflation for June. We expect a change of +0.29% MoM (+2.16% YoY), which would be the first positive reading after two months in red ink. We continue to see a benign scenario for inflation, with a muted dynamic for core inflation, as economic slacks will remain high for a considerable period and inflation expectations well anchored.**

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Local markets—FX: The turn of 1H20 to 2H20 saw a nearly 15-cent strengthening in the FX rate, moving from USDBRL5.46 to USDBRL5.33 between Tuesday and Wednesday. This movement puts the BRL as the best-performing currency for the week (amongst the majors), up 2.9% versus the USD. We believe that positive surprises regarding economic activity data around the globe (US labor market data, Chinese PMIs, Brazilian industrial production) reinforced the market's perception that the worst of the COVID-19 pandemic may be behind us and that a recovery trend has already begun. This backdrop tends to increase market participants' risk appetite and it also raise the perceived chances that the BCB should refrain from cutting the Selic target rate further, both of which benefits the performance of the Brazilian currency. On top of that, the domestic political environment has been more tranquil of late, as the Executive and Legislative branches continue to improve relations. Nonetheless, early this week the BRL was underperforming its peers without any practical reason, which led the Brazilian monetary authority to intervene in the spot FX market, thus mending (what could have been) dysfunctional circumstances that were prevailing.

This mix of factors helped the BRL to start the 2H20 at a stronger footing than it ended the 1H20, but it has not prevented the FX rate to follow a very bumpy trajectory, which means the volatility of the Brazilian currency remains quite high. As we have been stating for a while, that is the pattern that we expect the Brazilian FX rate to pursue for the coming months: although the global economic recovery and progress on the domestic reformist agenda should lead the BRL to strengthen from the current levels (we forecast it at USDBRL4.95 by the end of 2020), the strengthening path should be bumps down the road.

Local markets—rates: Nominal yields saw some sort of a bull flattening this week, possibly on the heels of a more constructive international backdrop for risky assets in recent days. The front end traded with a slight downward bias on a weak-over-week basis, with the Jan-22 DI future poised to close the week at 2.88% (-9 bps from last Friday); the back end observed a bigger rally as the Jan-27 DI future was trading at 6.44% at the end of the week (-37 bps from last Friday). As an upshot, the Jan-27 vs.Jan-22 steepness fell to 356bps from 384bps in the end of last week. Those numbers compare to reading of ~150 bps early this year, meaning a still steep yield curve in Brazil, as an unprecedented level of monetary policy stimulus (e.g., real ex-ante 1-year rate averaging at -0.6% in June) contrasts with a greater uncertainty about the (much-necessary) macro and fiscal reforms going forward.

The market continues to price in a likelihood of nearly 50% 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 and the eventuality of more favorable market conditions do support a market pricing at the midway point for a final (and "residual") rate cut. As per the back end, we continue to believe that the lack of conviction in global and local developments (e.g., pandemic, politics) entails a cautious approach (i.e., little or no exposure).

Economic activity: According to the Caged (establishment) survey, formal job creation continued to weaken in May. The net (unadjusted) job destruction stood at 331k, meaning a considerably less pronounced payroll contraction than forecasts (-907k). This result follows job separations of 1.459k and hiring of 598k. After seasonal adjustments, we calculate that net job destruction totaled -351k, much worse than the historical average for the month (net job creation of 64 k). Year-to-date, the net job destruction stands at 1.3 million, much worse than the 133k new jobs created in the same period of 2019. The three-month moving average now points to a payroll contraction of 490k jobs per month, a fresh new historical low.

The IBGE's National Household Survey (PNAD) came out this week. The unemployment rate stood at 12.9 % (of the economically active population) in the three months to May, slightly lower than the consensus (13.0). This reading means a gain of 0.6 p.p. from the year-ago level. We calculate that the seasonally adjusted joblessness moved up to 12.5%, compared to 12.0% in April. This is the highest reading since Feb-18. The details of the survey show that employment recorded its deepest fall on record by registering a -7.5 % YoY drop; the economically active population (PEA) also fell by -6.9 % YoY. The labor market participation rate reached the mark of 56.8 %, an all-time low. The decline in the job-market participation rate is "concealing" the bad signal sent by the unemployment rate, from the standpoint of actual labor market conditions. In a simple counterfactual exercise, if the work force had remained stable at the same levels of February, the unemployment rate would have reached an all-time high: 19.0% (18.8 % s.a.)

The formalization rate of the labor market reached 59.5 % of the employed population, which is the all-time high and a slightly higher result if compared to 58.5% recorded in the previous month. This result follows the asymmetrically stronger employment impact from the pandemic (in particular, the need of social isolation measures) on the category of informal workers (-6.1 % MoM), in comparison with formal workers (-2.0 % MoM). This asymmetry also impacted the wage statistics, which show that real average income was up 4.7 % YoY whereas the real wage bill fell by a clip of 3.0 % YoY. In other words, the increase in real average income is due to a (spurious) composition effect, as low-wage informal workers out of the labor market move out of the wage statistics. Not by coincidence, the real wage bill is heading

south, and this is the most important signal for consumer spending. As per the latter, the attenuating factor is the transitory effect from the massive programs of government transfers to households.

All in all, May numbers herald a continued deterioration in the labor market conditions. Going forward, we expect joblessness to grow significantly and wages to remain sluggish (at best) in coming months, following the more lasting effects of the Covid-19 crisis (in the so called “new normal”).

Soft data suggest a continued sequential improvement in real activity, but not enough to fully recover from the April slump. According to FGV, industrial business confidence rose 26.4 % MoM (s.a.), reaching to 77.6 points. That result was slightly better than in the preview (76.6 points). The index has shown its second gain in a row after the sharp drop seen in April. This positive result for June follows an increase both in the current situation component (up 15.5 % MoM) and the expectations component (up 38.8 % MoM). Current and expected demand gained 27.0% and 16.7%, respectively. While expected demand still stands well below current demand, the gap has been narrowing markedly, which is a better sign for industrial activity ahead. Expected production also showed a positive result (up 77%) for a second straight month. But these gains occur from very depressed levels. Despite the positive headline result, industrial confidence is still 23.5% below the level seen before the COVID-19 crisis, which suggests a gradual "normalization" of economic activity. As an example of this "normalization", industrial capacity utilization rose to 66.6 %, a much better result than the all-time low reached in April (57.3%), but still well below the historical average of 80%. Low capacity use is to remain an important headwind for investment spending this year.

May industrial production (IP) data confirmed expectations of a slight growth following a massive plunge in April, amid a gradual easing of the social distancing measures implemented to flatten the Covid-19 curve. The 7.0% MoM (s.a) gain registered in May was better than our forecast (5.3 %) and the market consensus (6.7 %). In relation to May 2019, IP was down 21.9%, while our projection and the market consensus were -23.5% and -22.0%, respectively. On a quarterly basis, industrial production decreased 18.2 % QoQ (s.a.).

Among the categories, the biggest gain was in durable goods (up 92.5 % MoM). On the soft side, mining fell 5.6%. The diffusion index (percentage of industrial categories posting monthly growth) reached 81.9%, a considerably better result than the all-time low reached in the previous month (19.0%).

Details keep showing a heterogeneous pattern across sectors, with some segments suffering more than others. Emblematic examples are pharmaceutical products, showing a positive result for a second straight month, and food products, posting very slight decrease. Most of the sectors that posted big drops in the previous month posted positive growth for May. Yet these gains apply over very depressed levels. Here key examples are vehicles, transport equipment and machinery.

Preliminary soft data released for June points to continued improvement, although we must take into account the still low comparison base. All in all, the numbers suggest a gradual 'normalization' of economic activity.

Fiscal Policy: According to the National Treasury Secretariat, the central government’s primary deficit totaled BRL126.6 billion in May 2020, roughly in line with our expectation (-BRL123.5 billion) and market consensus (-BRL131.9 billion). The main reason behind the (relatively small) difference between the actual result and our projection was the slower-than-expected decline in government expenditures not related to the emergency measures to combat the Covid-19 crisis (-3.0% YoY in real terms; Santander forecast: -4.8% YoY).

In short, May fiscal accounts continued to show a significant impact from the pandemic. Central government’s primary revenue tumbled 36.9% YoY in May (adjusted by inflation), given the very poor performance of federal tax collection, as revealed last week by the Brazilian Internal Revenue Service. We note the impact from measures of tax payment deferrals and exemptions (adding to BRL32.2 billion in May), which were announced by the federal government aimed at alleviating the economic hit from the current crisis. Excluding these measures, we estimate that total primary revenue would have fallen by 10.2% YoY in May (or -BRL12.3 billion), owing to weaker economic activity.

Moreover, primary fiscal spending is rising as a response to Covid-19 outbreak, with a dedicated amount of BRL53.4 billion in May. Out of this total, 77% were directed to the payment of the emergency financial aid for informal workers and low-income households, the so-called “coronavoucher” (BRL41.1 billion).

The fiscal performance is expected to remain quite weak for some time ahead: according to our preliminary estimates, June central government’s primary deficit will reach ~BRL115 billion, a number comparable to primary deficits seen for an entire year, previously.

In our updated baseline scenario, we calculate that the impact of this year's GDP contraction (our forecast is -6.4%) on tax federal collection, combined with extended deferral of tax payments (Brazilian government should allow tax debts to be paid in installments over coming years), could imply primary revenue losses around BRL245 billion in 2020, as compared to the pre-pandemic outlook. On the expenditure side, we foresee that the wide set of primary fiscal spending measures to fight Covid-19 impact will add up to nearly BRL500 billion (~7% of GDP) in the current year. This estimate already considered a fiscal impact of ~BRL100 billion from the extension of "coronavoucher" for an additional 2 months (at its current monthly value of BRL600), as officially announced by the federal government this week. In the add-up, we expect the 2020 central government primary deficit to total BRL820 billion (11.9% of GDP). (For details, please see our June 25 report, "*Updating our Inflation, FX and Interest Rate Forecasts*").

A report by the Brazilian Central Bank showed that the consolidated public sector registered a primary fiscal deficit of BRL131.4 billion in May, slightly worse than our forecast (-BRL128.7 billion) and median market expectation (-BRL129.7 billion). The disaggregated results for public sector entities were as follows: -BRL127.1 billion for the federal government; -BRL4.8 billion for states and municipalities (mostly explaining the difference between our projection and actual result, since we expected a lower primary deficit in the month: -BRL2.4 billion); and +BRL0.4 billion for the state-owned companies. For the full-year 2020, we see the public sector primary deficit totaling BRL845 billion (12.2% of GDP), whereas the 2020 public sector nominal deficit (including nominal interest payments) is expected to reach BRL1.13 trillion (16.4% of GDP).

The gross general government debt rose to 81.9% of GDP in May, up from 79.8% in April; the net public sector debt increased to 55.0% of GDP from 52.8% in April. We foresee an expansion of the gross debt by 19 p.p. this year (to 94.8%) and further increases until 2027, when the indicator should peak at levels slightly above 100%, and follow a (gradual) convergence path afterwards. The net debt gauge will likely follow the similar dynamic: we estimate an increase from 55.7% in 2019 to 67.5% in 2020 and a peak at 77.2% in 2027.

These forecasts assume that (i) the unprecedented fiscal stimulus stemming from the pandemic will be limited to 2020 and (ii) Government and Congress will continue to pursue the Brazilian fiscal consolidation in the long-term. Owing to the very challenging starting point (i.e., a very high primary fiscal deficits for 2021), we calculate the need for a total fiscal adjustment of at least 5 p.p. of GDP (BRL350 billion) in coming years. In our view, the first (and most important) step in order to ensure fiscal solvency would be to support the constitutional spending cap framework.

Trade Balance: The USD7.5 billion surplus registered by the Brazilian trade balance in Jun20 came higher than our estimate (USD6.9 billion), which translated into a positive result of USD23.8 billion in the first half of 2020 or USD46.2 billion in 12-month-to-date terms. Notwithstanding the fact that actual export proceeds have fallen short of our expectations (USD17.9 billion vs USD18.2 billion, respectively), there was a larger discrepancy between our estimate for import outlays and the actual outcome (USD11.3 billion versus USD10.4 billion, respectively), which resulted from an acute deceleration in the daily average operations observed in the last 7 days of June in the imports related to extractive and manufacturing items–chiefly crude oil, fuel, fertilizers and vehicles. That is, we believe the outcome reinforced our perception that the pandemic should hit exports in a milder fashion than it should weigh on imports.

Taking into account the seasonally adjusted daily averages of exports and imports in the last three months – both deducted of deals related to oil platforms, which are related to tax issues rather than to actual sell/purchase of goods – these figures indicated an annualized surplus of USD73.2 billion, which is far higher than our forecast of USD60.5 billion for 2020. However, it is important to bear in mind that we assume that the Brazilian economy should resume a gradual recovery in 2H20, which should foster some revival in imports during that period. Meanwhile, from the exports standpoint, two factors that exports to be more resilient in 1H20 – namely, soybeans and animal proteins (beef, pork and chicken meat) – are likely to dwindle in 2H20, as the bulk of the soybeans harvest has already been shipped abroad and the demand for animal proteins have shown some accommodation of late. Therefore, for now we remain comfortable with our trade surplus forecast for 2020.

Inflation: On Friday, IBGE releases the IPCA inflation for June. We expect a reading of +0.29% MoM (+2.16% YoY), which would be the first positive change after two months of deflation, hence marking the end of the biggest effects of COVID-19 on prices. The result will be driven by a pickup in administered prices (+1.07% MoM), especially gasoline (+4.50% MoM).

Free prices will also recover from the fall of 0.16% in May, but should stay around zero. Services will remain in negative territory (-0.32% MoM) – as we know from the IPCA-15 that airline tickets had a big fall (-26.1% MoM) – but less so than in May (-0.45% MoM). Industrial goods should rise +0.20% with some tradables less impacted by the fall of demand generated by the social isolation (such as personal computers, seeing a better demand amid an increase in home-office

activities) still pressuring the group. Finally, food-at-home should accelerate to around +0.59% MoM, contrasting with the deceleration that we projected a few weeks ago.

Despite the change of sign in headline IPCA expected for June, we continue to see a benign scenario for inflation. Particularly, we continue to see a muted dynamic for core prices, as economic slacks will remain high for a considerable period, despite the cushioning in demand generated by government stimulus and the reopening of a number of regional economies. Well-anchored inflation expectations also to play a big role. We forecast IPCA inflation at 1.5% for 2020 (with a small upside risks) and at 2.7% for 2021 (with downside risks).

Next week: In economic activity, the week's highlight are the retail sales and services report for May. Despite the sharp drop seen in April, we believe that was the worst point in terms of the pandemic's impact on the economy, since most of a good chunk of the tertiary sector (i.e. retail, services) were closed or partially operating owing to the social distancing measures. Therefore, and based on our proprietary IGet index, our May core retail sales forecast is +9.1% MoM s.a. (-11.1% YoY). As per the broad index, we estimate +10.2% MoM s.a. (-20.9% YoY).

MACRO AGENDA

Indicator	Date	Estimate	Prior
IBGE Retail Sales May/20 (% MoM sa)	Wed, 08-Jul	9.1	-16.8
IBGE Retail Sales May/20 (% YoY)	Wed, 08-Jul	-11.1	-16.8
IBGE Broad Retail Sales May/20 (% MoM sa)	Wed, 08-Jul	10.2	-17.5
IBGE Broad Retail Sales May/20 (% YoY)	Wed, 08-Jul	-20.9	-27.1
IBGE Services Survey May/20 (% YoY)	Fri, 10-Jul	-	-17.3
IPCA Jun/20 (% MoM)	Fri, 10-Jul	+0.29	-0.38
IPCA Jun/20 (% YoY)	Fri, 10-Jul	+2.16	1.88

Sources: IBGE 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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