Brazil Macro Monthly:
Better current conditions, but fiscal risk remains

October 2020

xp investimentos

Better current conditions, but fiscal risk remains

- Recent data show a stronger recovery in the economy this year and some short-term pressure on consumer inflation.
- We revised our 2020 GDP forecast from -4.8% to -4.6% and from 3.0% to 3.4% in 2021. Regarding CPI, we increased our 2020 forecast from 2.6% to 3.1% in 2020 , but we kept it at 2.6% in 2021.
- The base scenario is to maintain the current rule of spending ceiling. This, however, is still the main source of uncertainty in the scenario.
- In this scenario, we maintained our expectation of an exchange rate appreciation to USDBRL 5.20 at the end of 2020 and USDBRL 4.90 at the end of 2021, in line with the improvement in external accounts.
- With the scenario of maintaining fiscal regime inflation below target for 2021, we maintain our Selic rate forecast at 2.00% p.a. at the end of 2020 and 3.00% p.a. at the end of 2021.

Summary of the main estimates for 2020 and 2021

	2018	2019	2020 (E)	2021 (E)
GDP growth (%)	1.3	1.1	-4.6	3.4
IPCA (CPI, 12m, %)	3.75	4.31	3.1	2.6
SELIC rate (% p.y., end of period)	6.50	4.50	2.0	3.0
FX (USDBRL, end of the period)	3.87	4.03	5.20	4.90
Primary fiscal deficit (% GDP)	1.6	0.9	13.0	3.9
Gross debt (% GDP)	76.5	75.8	94.6	96.4

Source: IBGE, BCB, Bloomberg. Estimates (E): XP Investimentos.

Foreword: Resisting fiscal threat

The world economy is recovering, driven by increasing use of new technologies, intense government support, and optimistic prospects for a vaccine for Covid-19. The positive effects are reaching Latin America, especially thanks to the resumption of global demand and rising commodity prices. In this context financial assets have approached their pre-pandemic levels, despite considerable volatility. Nonetheless, this has not been the case for Brazil – at least not on the same magnitude.

If Brazil had followed the performance of other emerging currencies, for instance, the exchange rate should now range between 4.5 and 5.0 reais per dollar. Long interest rates have gone up, while the trend observed in most countries has been the opposite, approaching near zero. Fiscal risk is decoupling Brazil from the world.

The discussion of extending emergency aid or convert it into a boosted cash-transfer program ("Renda cidadã") sounds economically reasonable. However, it would only bring positive effects if it does not deteriorate (even further) the fiscal outlook. Brazil was the country that increased public expenditure the most in the last decade[1]. To avoid weakening the recently gained and still fragile fiscal credibility, any new social program must fit within the existing fiscal framework, of which the spending ceiling currently represents the main anchor.

In this context, after intense political uncertainty and innumerous alternatives for financing a new program, including some that raised concerns among market players, the lastest signs leaned towards a less pessimistic perspective. The economic team seems to be more coordinated to experienced law makers and to the Federal Accounting Court in constructing a reasenable alternative.

At the same time, it is important for the Central Bank to act in a timely and independent manner should the fiscal scenario deteriorate. In this sense, recent statements by the Governor Campos Neto contribute to maintain market expectations well-anchored.

Our base-case scenario foresees for the maintenance of the current fiscal rules, without cracks or bumps in the spending cap to accommodate more expenses. If confirmed, we see a 3.4% GDP growth next year - revised from 3.0% due to briskier current figures on industrial production and retail sales - and a stronger BRL (4.9 per dollar by 2021 year end).

The fiscal risk, however, remains. Political pressure will continue, both for a new social program and for increased investments. The expenditure ceiling will continue to be threatened if there is no willingness to alter mandatory expenditures and/or reallocate existing social benefits. This uncertainty may curb the performance of the Brazilian economy and financial assets in the coming quarters.

World Economy and Latin America[2]

The world economy is recovering briskly. The V-shape recovery became a viable thesis thanks to (1) technology, (2) the deliverance of an unprecedented level of fiscal and monetary stimulus from authorities all around the world, and (3) basic human nature -- meaning that humans necessarily felt the need at some point to "move on" and face the pandemic. At the beginning of April, we forecasted that the US economy would contract 6% in 2020 and then recover some 4% in 2021, thanks to the existence of a benevolent comparison base. Our new forecast is that the US economy will only fall 3.5% this year and that it will grow 5% in 2021.

1) *Folha de São Paulo, October 11, 2020.*
2) *From the XP Inc. Global Strategy team.*

The situation in China has proven to be even more impressive. At this time, we are forecasting that China will actually grow this year, posting an expansion of at least 2.5%, with 2021 following through with an 8% expansion. In the Eurozone, we believe the contraction of GDP will prove materially milder than expected by market consensus. We think that the speed of Germany's inventory building process will surprise analysts as we move forward. In terms of 2021, considering a vaccine and better therapeutics available, we forecast that the tourism sector and domestic demand, in general, will expand much faster than expected by the consensus, making 2021 a banner year for the Eurozone.

Faster growth will not generate overrun reflation, however, as the world's output gap will remain very sizable for years to come. Yes, underlying inflation will most likely accelerate somewhat in 2021, but not to levels that would force world Central Banks to adjust policy guidelines. Our view of the world is also necessarily tied to a weaker USD environment. According to standard valuation models, the USD is at least 20% expensive vis-à-vis its long-term equilibrium, and EM currencies, the Renminbi, the GBP, and the EURO are expensive at current levels. Besides, a mean-reverting world is, in our view, consistent with a materially higher cost of raw materials.

Regarding Latin America, the region became the epicenter of the pandemic during the summer and we anticipated that it was going to experience one of the sharpest economic contractions across the globe and a more protracted recovery, due to high informality rates and income inequality, an inadequate health infrastructure, high commodity price dependency, and a slowing trend in economic activity heading into the crisis. Going forward, we expect this crisis to have long-lasting effects on businesses, labor markets, and poverty, which will partly hurt the economic recovery.

However, we think that markets are still too bearish on the performance of investment-grade LatAm economies in 2021. Financial conditions have eased dramatically, thanks to unprecedented actions by world and local monetary and fiscal authorities to move to a highly accommodative stance.

This backdrop, together with our more constructive view on the performance of the US, Europe, and China, as well as our narrative of ongoing USD weakness, should be supportive of economic activity in LatAm, especially via exports and commodity prices.
Regarding the majors, in Mexico, we expect GDP to fall by 9% in 2020, one of the deepest contractions in the region. On the positive side, weaker Peso and strong recovery in the US could deliver some positive surprises going forward in terms of growth. Thus, we are currently forecasting a stronger-than-expected 4% y/y rebound in GDP in 2021[3].

In Chile and Colombia, we expect economic activity to fall this year by 5% and 6.5%, respectively, following a rebound of 4.5% and 5% in 2021, in that same order. Fiscal policy will be more supportive in Chile than in Colombia, given the former's better standing going into the crisis, while monetary policy rates should remain unchanged at their historic lows of 0.5% and 1.75%, respectively, throughout the rest of 2020 and most, if not all, of next year.

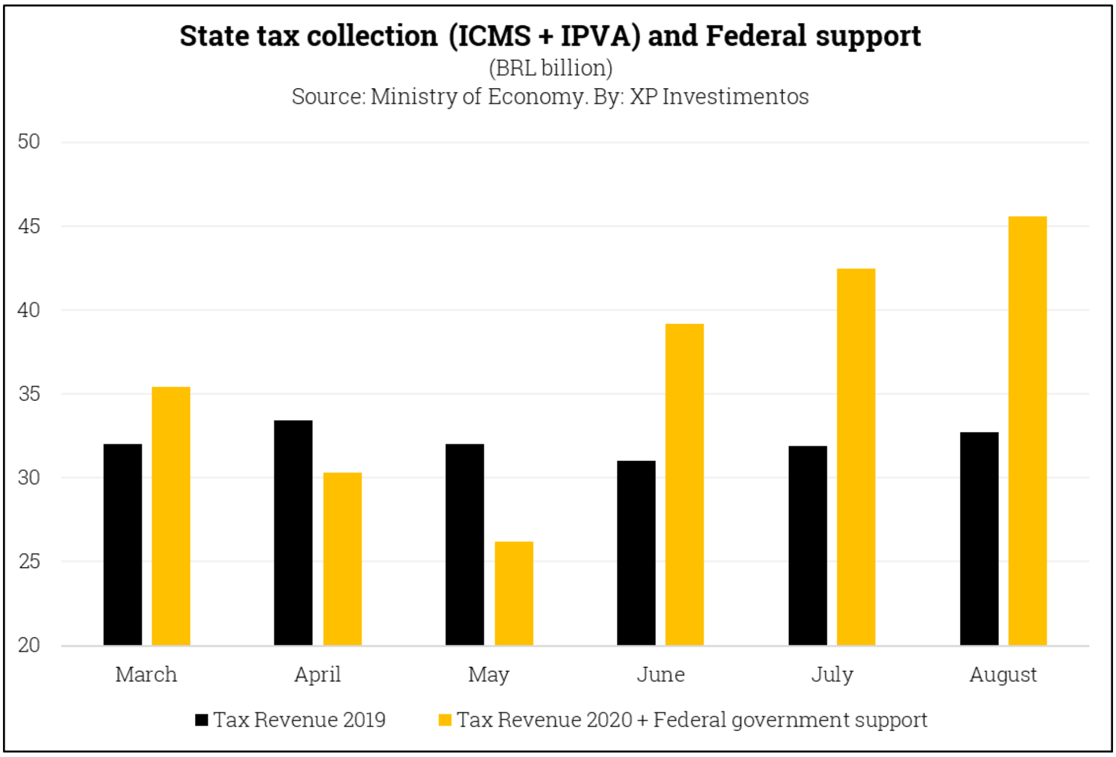
3) Extension cost of BRL10 billion, compared to BRL 3.7 billion budgeted in PLOA in 2021.

Brazil: better short term, fiscal risk remains

Fiscal policy: the main concern

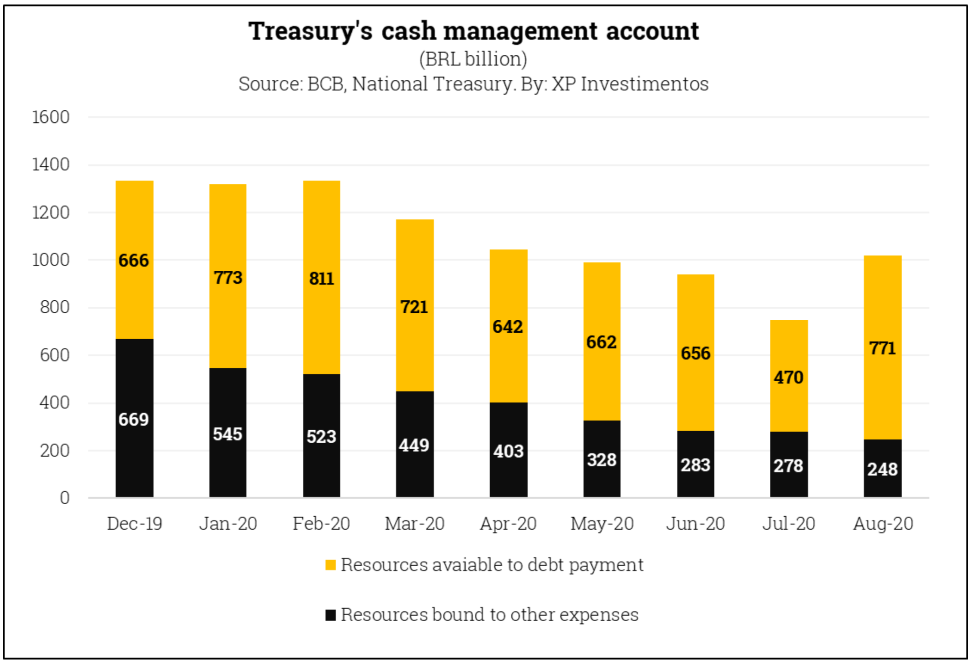
The fiscal policy front remains the biggest risk to a positive economic recovery scenario.
The government's primary fiscal deficit continues to widen, reflecting the (needed) support packages implemented as a response to the Covid-19 shock. On a more positive note, the stronger-than-expected output recovery helps on the tax revenue front. Tax collection improved in September both at federal and subnational levels. Besides the effect of improved economic activity, results showed a complete recovery of taxes deferred in April. Meanwhile, state governments saw a strong resumption in tax collection, what effectively reduces the pressure for a new round of transfers by the Union.

The biggest concern remains 2021. The uncertainty that surrounds a new permanent cash transfer programme (whose additional cost to existing Bolsa Família averages at BRL 30bn), and the sustainability of the spending cap framework raised concerns of market players, with consequences to the Treasury's financing conditions.



The partial transfer of the Central Bank's FX gains on its international reserves to the Treasury – which increased BCB's prudential account – and the recent announcement of a joint response by the two institutions in the short-term securities market eased market sentiment.

Nonetheless, this concern should prevail for as long as there remain questions over the sustainability of Brazil's fiscal accounts, mostly translated into the maintenance of the expenditure cap and the sustainability of debt dynamics.

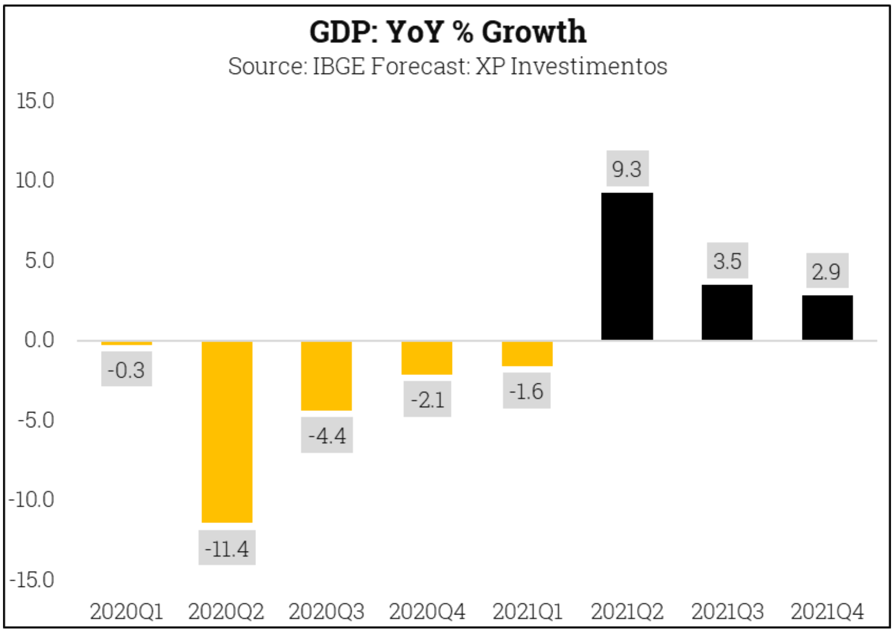


Our base scenario foresees the maintenance of the current spending cap framework in 2021. Recent improvement of the relationship between the economic team and the Legislative branch and the Federal Audit Court (TCU) brings positive signals. **We project the primary fiscal result at 12.9% of GDP in 2020, and 3.9% in 2021. General government's gross debt (DBGG) should reach 94.5% of GDP, in our estimations, and 96.3% em 2021.**

Nonetheless, the risks remain high, and the uncertainty will likely remain. A "soft landing" of the emergency aid throughout 1Q2021 is plausible. This would lead to some BRL 40bn worsening of the projected primary fiscal result – or 0.7% of GDP. Also, the discussions on a new cash transfer that may jeopardize the spending cap will most likely continue throughout 2021.

Economic Activity: Current Acceleration and Composition Improvement 2021 Numbers

After the historical drop in the GDP in the second quarter by -9.7%, indicators referring to the third quarter showed a significant recovery. The confidence indices, retail sales, industrial production and the formal labor market came out above expectations, suggesting that Brazil should end 2020 with a less severe GDP contraction than initially estimated.



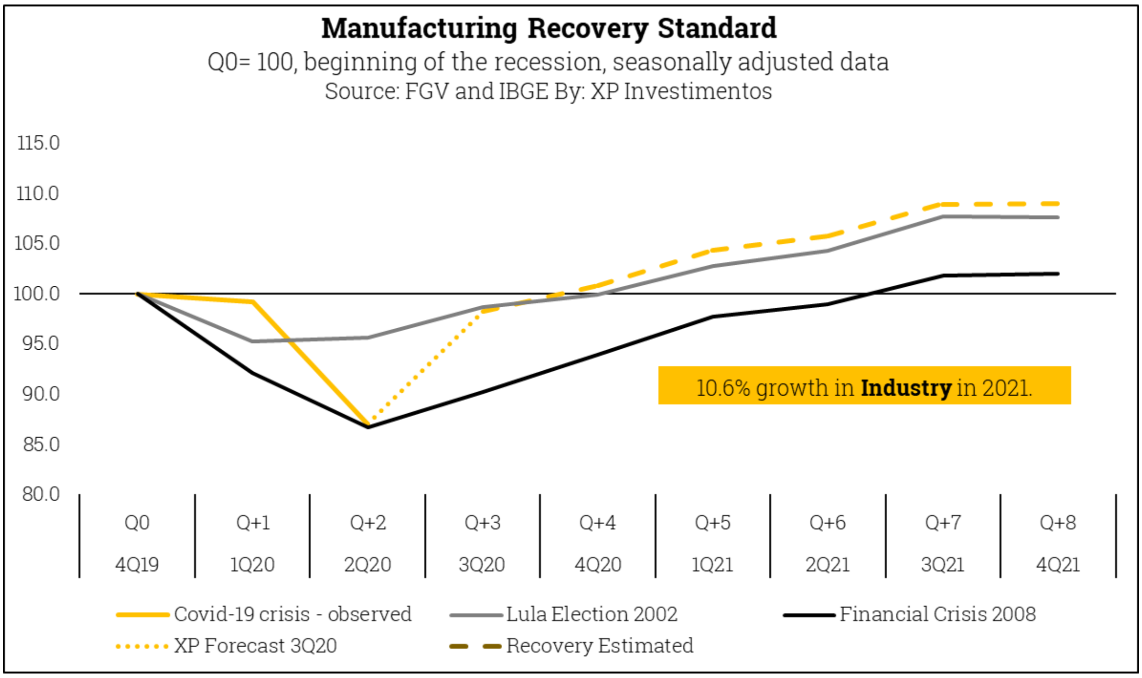
We revised the 3Q GDP, especially due to the performance of retail (+17.5% Q/Q) and the manufacturing industry (+21.3% Q/Q). **We now expect 7.8% compared to the previous quarter (6.8% before). With this bigger traction in the second half, the year 2020 should end with a fall of 4.6% (-4.8% before).**

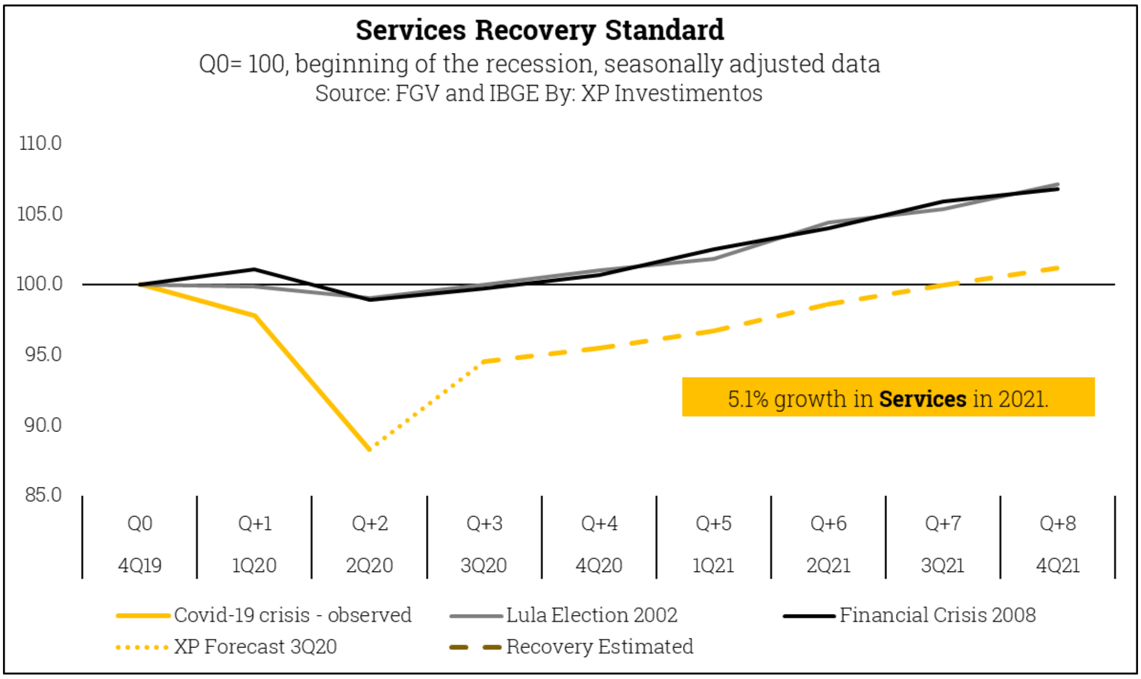
The benign sector composition of 2020 **led us to increase the GDP of 2021 by 0.4 percentage points (from + 3.0% to + 3.4%).** The industrial sector, driven by the resumption of retail trade and the exchange rate depreciation, is expected to be the main driving force this year. The maintenance of the fiscal regime, low interest rates, consumption rebound by the richest families (interrupted by pandemic) and the improvement of financial conditions should partially offset the end of government support measures. We expect the economy to continue to recover in 2021, however, at a slower pace than the rise in the third quarter of this year.

We developed an exercise on how the recession could be for two of the three major sectors from the perspective of supply. Considering the output level of 2Q20 and using the XP forecast for 3Q20, we can see where the manufacturing and service sectors were in the crisis of 2003 and 2008. We selected the two aforementioned periods based on similarity with the current crisis and availability of data (by CODACE[4]).

We did not include the agriculture sector on the exercise for the year, as it has gone through the current crisis virtually unscathed. In fact, CONAB recently released its initial estimates for 2021, pointing to a new record harvest this year (4.2% compared to 2020).

4) Economic Cycles Dating Committee - FGV





The results of the exercise indicate that, based on the patter observed in the previous crisis, the manufacturing sector should grow by an average of +10.6% in 2021. The service sector, on the other hand, should see a 5.1% increase.

Using these projections, the estimate for total GDP growth in 2021 could reach 6.1%, meaning it would achieve pre-pandemic levels already in 2Q21. This exercise denotes that, were it not for the severe fiscal uncertainty, the dynamics of the Brazilian economy could be much better in the immediate post-pandemic period.

External sector: Real is weaker than fundamentals due to fiscal uncertainties

The current account balance reached 2.4% of GDP in August (3-month moving average, annualized, and seasonally adjusted). A strong adjustment from roughly 3% of GDP deficit few months ago. This reversal is mainly due to the pandemic, that slashed imports, profit remittance, tourism outflows, etc.

The strong depreciation of the exchange rate suggests that the trend may intensify. There is a very long, but consistent lag, for the fluctuation of the exchange rate to redirect consumers and companies, to effectively changing the result of external accounts (see graph). Considering a country which relies on external savings, it makes no sense to carry significant current account surpluses.

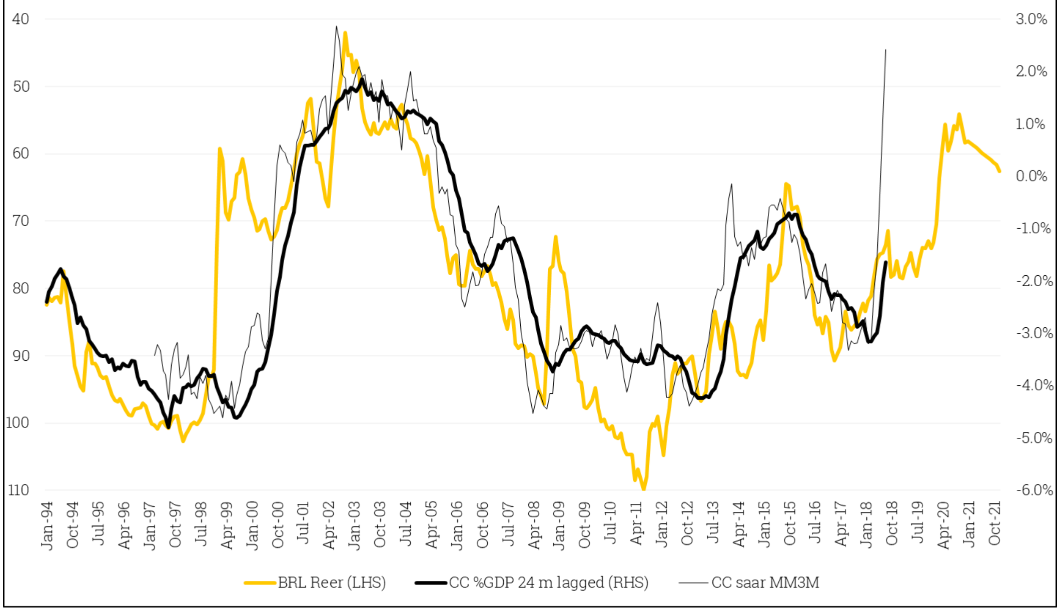
From this perspective, the exchange rate at 5.5 reais per dollar seems excessively depreciated. For the effective real exchange rate in Brazil to return to the historical average, for instance, the BRL would have to stand slightly below 4.0 reais per dollar, creating the necessary current account deficit for importing foreign savings.

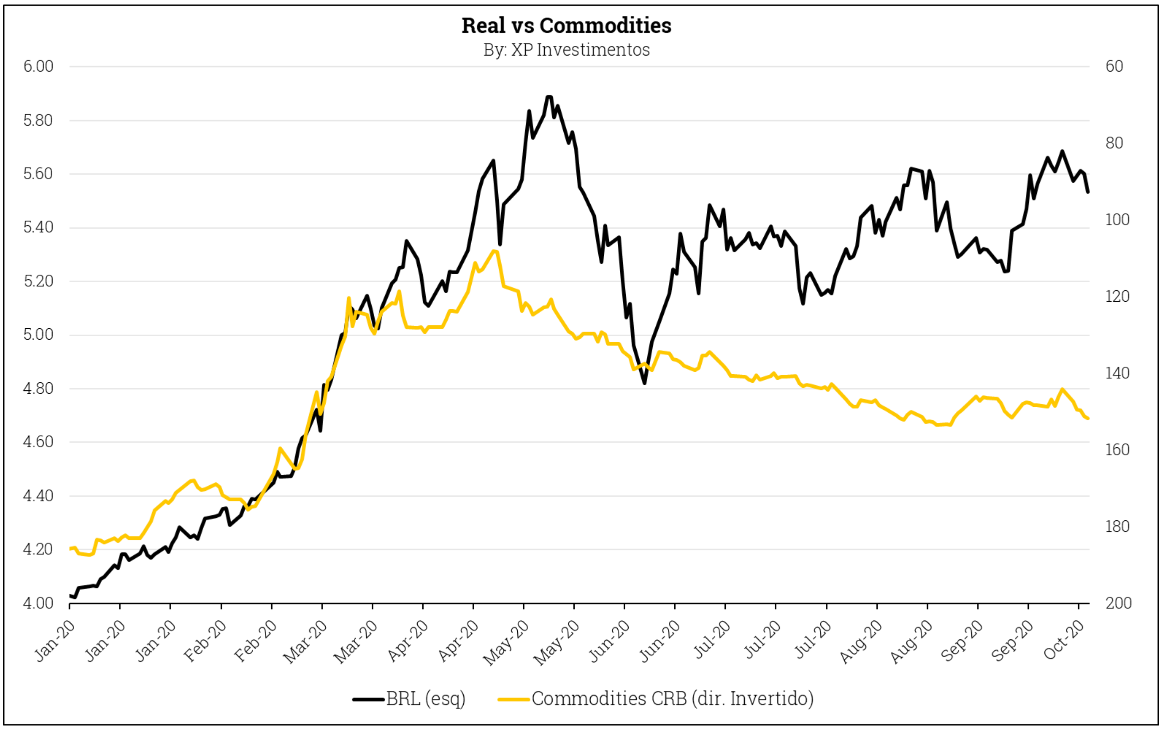
Short-term fundamentals also indicate that the real is oversold at current levels. The exchange rate has decoupled from the trend observed in commodity prices and other emerging market currencies. The historical correlation with these variables would indicate the exchange rate closer to 4.5 reais per dollar.

As with economic output and expected performance in the pos-pandemic period, the uncertainty about the sustainability of public accounts has weighed on the performance of the real. In our base-case scenario, the ceiling is kept unchanged for 2021. **Thus, we expect the exchange rate to drop to 5.2 reais per dollar at the end of the year, and 4.9 at the end of 2021.** Considering that the fiscal risk will remain for the foreseeable horizon, the exchange rate appreciation will be less intense than suggested by the global environment and the Balance of Payments.

Brazil: REER (BIS) vs Current Account Deficit (24m lagged)

Source: BIS, BCB. By: XP Investimentos.



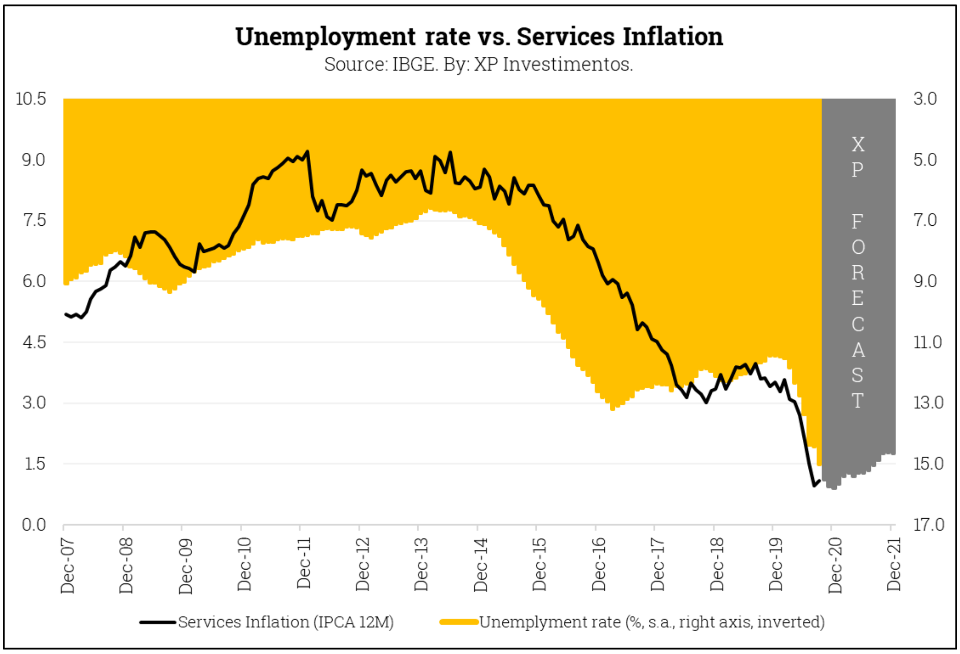


Inflation: short-term pressure is unlikely to extend to 2021

CPI inflation rose in recent readings. As the economy is gradually reopening, bars and restaurants have managed to passthrough PPI food pressure to prices. Other services, as air transport, are also rebuilding margins. This movement, coupled to meet prices and the announcement that Brazilian Institute of Geography and Statistics will collect School fees in December, **lead us to revise our 2020 IPCA forecast from 2.6% to 3.1%.** However, for the coming year, we understand that the inflationary scenario may remain well-behaved.

Among drivers for a more benign outlook for 2021 are: i) recent CONAB forecast of record agricultural production for the 2020/21 harvest; ii) ample spare capacity, which should extend beyond 2020 even with our better growth forecast for next year; iii) some payback of the PPI shocks; iv) the adjustment in prices of school fees expected to 2021 partially brought forward to this year, and v) the stronger BRL contemplated in our baseline scenario.

Thus, we maintain our 2.6% IPCA forecast for 2021.



Monetary Policy: same fiscal regime, same forward guidance

The BCB Monetary Policy Committee (Copom) kept the Selic rate at 2.00% on its September meeting. In Its official communication, the Copom highlighted that "current economic conditions continue to recommend an unusually strong monetary stimulus", but with little room for additional rate cuts due to "prudential and financial stability reasons". Additionally, it has signaled that the Selic rate should remain at 2% while inflation expectations remain below target, conditional on the maintenance of the current fiscal regime.

We believe that both the Copom's forward guidance and our baseline scenario, which foresees the maintenance of the expenditure cap rule, are consistent with our forecast for the Selic. That is, that the Selic will remain 2% p.a. for the coming quarters, and rise gradually to 3% p.a. in the second half of 2021. The large output gap suggests no rush to bring the Selic to its neutral level (3% in real terms[5] , according to ours and the Copom's[6] estimations).

Under an alternative scenario that the fiscal outlook deteriorates further, the Copom may rise the Selic earlier. A firm and timely action by the Central Bank will be crucial to keeping expectations well anchored.

We simulate the monetary policy reaction under some deterioration on the fiscal outlook, which prompts a 10% devaluation of the real. Under those circumstances, our policy reaction function points to a Selic at 3.50% by end 2021, with the Copom starting to raise rates as soon as the 1Q of next year.

5) Quarterly Inflation Report, September 2020
6) Quarterly Inflation Report, September 2020

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