Brazil: Rate cuts to continue

Brazil's central bank is expected to maintain its relatively aggreesive rate cutting pace

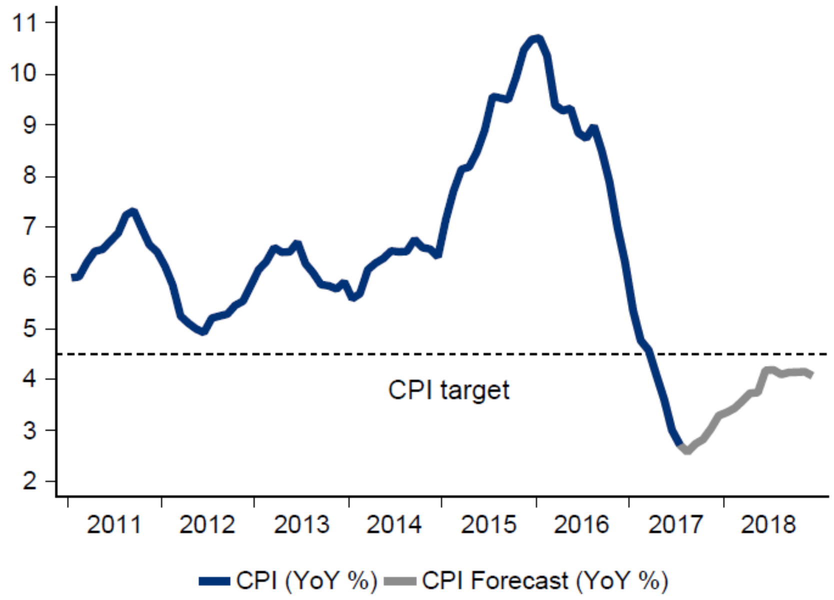
Central Bank meets 6 September

We're expecting the Brazilian central bank to cut its SELIC rate by 100 basis points to 8.25% on Wednesday and we're looking for yet more cuts. We think the cycle should be concluded at the October 25 meeting, when authorities opt for a final 75bp rate cut to 7.5%.

We're also not ruling out another 50bp reduction in December

A further rate cut could happen at the end of the year if social security reforms advance decisively in Congress, triggering a rally of the Brazilian real (BRL). This scenario may have received an unexpected lift on Tuesday night after alleged evidence of wrongdoing surfaced in the General Prosecutor's office. For President Temer, this could weaken corruption charges against him and strengthen his political standing.

Brazil's benign inflationary path



Source: Macrobond

FX reaction

The BRL has performed surprisingly well in recent months when considering the gravity of the political instability seen in Brazil since May. And we expect the currency to continue to benefit from the confluence of a favourable external environment and the gradual improvement in the domestic drivers affecting the BRL. Among those domestic drivers, economic factors are the ones that stood out recently, having surprised with better-than-expected results all round. These include external accounts, with the current account deficit narrowing towards 0.5% of GDP, inflation, and economic activity.

> *The latest, and perhaps most surprising development, was Friday's 2Q GDP report*

GDP growth remained subdued in 2Q, coming just slightly above expectations, but the report confirmed a stronger and broader-based foundation for the recovery. Domestic consumption picked-up pace and helped make-up for the expected seasonal slowdown in agriculture, following its remarkable 1Q performance. The GDP report also confirmed that investment and government spending remain a drag on economic activity, while net-exports have become, once again, important net-positive contributors to GDP growth. This result should help increase GDP growth expectations for the year slightly.

Our own forecast increased from 0.4% to 0.7%. Despite this improvement, Brazil's medium-term growth outlook remains challenging, depending heavily on a recovery of fixed investments, which has contracted an accumulated 30% since peaking in 2013, in quarterly SA terms. For now, such a recovery remains uncertain, with the success of the impressive pipeline of privatisations and public concessions possibly limited by political uncertainties, which could extend until at least the conclusion of next year's elections.

Political risks

Overall, domestic drivers suggest that the USD/BRL could end the year closer to the bottom of the 3.10-3.20 range that has prevailed of late. This assumes that the economic recovery continues to gain traction, political risks remain contained and fiscal policy legislation continues to broadly follow the austerity guidelines predicated by the economic team. If a social security reform is approved, the currency could temporarily overshoot, and trade below 3.0. But next year’s elections should remain the chief medium-term catalyst for the BRL, with political and fiscal uncertainties likely imposing a higher volatility and a weakening bias for the BRL, ahead of the October 2018 ballot.