The end of Brazil's easing cycle

Brazil's monetary easing is likely inching towards a definitive conclusion this Wednesday with the SELIC rate dropping to 4.5%. We think monetary policy is now about to enter a prolonged period of inaction, and the accommodative environment that's here to stay will help accelerate ongoing changes in local credit markets and deepen the recovery

Central Bank of Brazil headquarters in Brasilia

One last 50bp rate cut

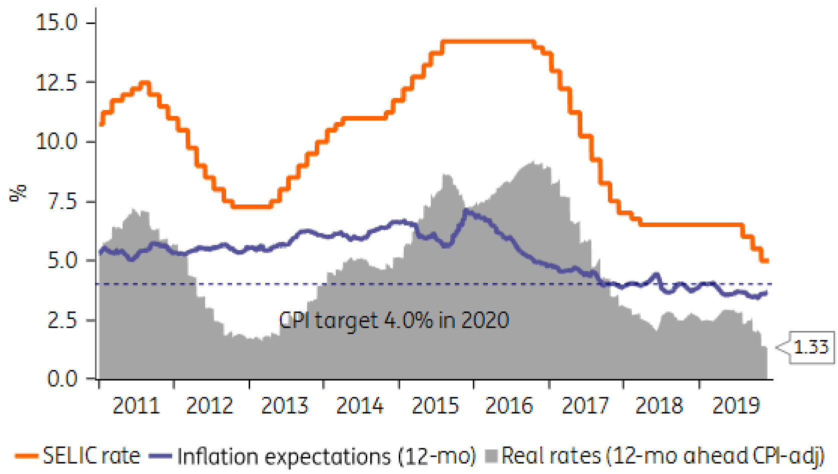
FX volatility has marked LATAM local markets in recent weeks. Often, that volatility has been motivated by social unrest, but specific idiosyncratic risks stood out in the case of the Brazilian real.

Among the factors that help explain recent BRL volatility, we would highlight frustration with FX inflows resulting from the "transfer-of-rights" oil auctions and investor concern regarding the increase in the current account deficit. Mixed messages from the economic team also may have added market noise, eventually leading the central bank to broaden its FX intervention by conducting a few standalone USD auctions in the spot market.

FX volatility had already helped trim expectations regarding future rate cuts, with some calling into question the central bank's ability to cut the policy rate by 50bp, as previously signalled by authorities, this coming Wednesday.

We agree that FX volatility is a crucial factor driving the monetary policy outlook at this end-stage of the cycle. However, we don't think that the volatility seen so far is sufficient to derail the 50bp cut expected for Wednesday.

With real rates set to drop below 1%, monetary policy is now deep into expansionary territory



Source: Macrobond, ING

The growth factor

Another decisive factor that should help shape the outcome of this policy meeting was the recent 3Q GDP report. In particular, the stronger-than-expected result (as depicted in the chart below) should be the determinant factor behind the less dovish, firmly neutral policy guidance we expect the bank to adopt at this meeting.

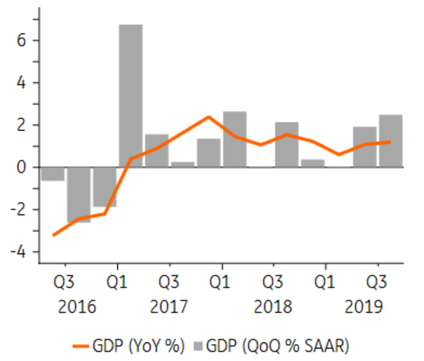
In our view, the relief provided by the GDP result, in addition to initial evidence of strong consumption during the year-end holidays (i.e. strong "Black-Friday" sales), should prompt monetary authorities to signal that the easing cycle has been concluded and that the policy rate should remain steady in the foreseeable future.

Economic recovery appears to be gaining traction

A more positive assessment regarding the outlook for the economic recovery was already taking hold in recent weeks, as seen in the chart below which displays the evolution of analyst expectations regarding GDP growth.

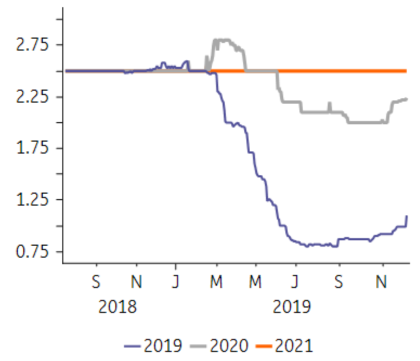
In our view, GDP will accelerate to 2.6% next year, after printing 1.2% this year. With a carryover of about 1.0% at the start of the year, the balance of risks to our forecast looks balanced, in our view. This compares with analyst expectations at a lower 2.2%.

3Q GDP report was solid, depicting a gradual recovery



Source: Macrobond, ING

GDP growth expectations re-entered an uptrend (%)



Source: Macrobond, ING

The economy's critical driver

The yet-to-be-seen impact of the monetary stimulus, which affects consumption after a significant time-lag, should be the critical driver behind the acceleration in economic activity over the coming quarters.

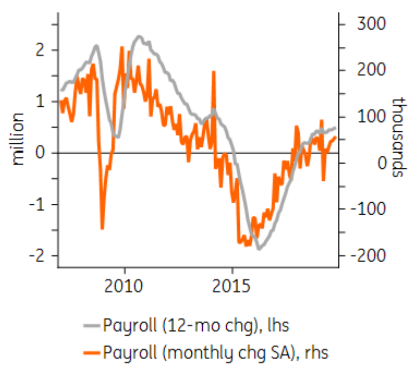
As seen in the 3Q GDP report, renewed evidence of the steady recovery in the construction sector, a key credit-sensitive and labour-intensive sector, bodes especially well for a faster recovery.

Monetary policy has also had a tremendous impact over local capital markets' activities, as seen in the surge in local market issuance, both through fixed-income instruments and IPOs. As reported by Anbima last week, these issuances increased almost 40% YoY in the year through October.

Investment has been the fastest-growing component of the domestic demand, but prospects for consumer demand are also improving. Apart from the initial evidence from the holiday season sales mentioned above and the one-off impact of the approved withdraw of funds from workers' unemployment savings accounts (FGTS), evidence from labour markets and bank lending are also increasingly favourable.

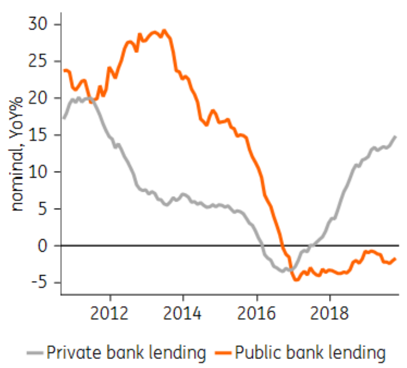
As seen in the charts below, recent trends in labor markets and bank lending also continue to show steady improvement. This suggests a favourable momentum for both labour income and credit availability, which bode well for the continued recovery in consumer demand.

Steady increase in payroll



Source: Macrobond, ING

Private bank lending surges while state banks shrink



Source: Macrobond, ING

Downside risks remain

External demand, along with the persistent fiscal contraction, should remain important headwinds and source of downside-risks for our GDP outlook. The sharp retrenchment in the state presence in the economy, especially evident in the sharp drop in lending by state banks (see chart above), remains a considerable drag on near-term growth, but that drag is increasingly being offset by private banks.

As seen recently, external trade remains an important net-negative contributor to GDP growth. This reflects the fact that, despite the depreciation seen in the BRL, exports have weakened due to weak global demand and, in particular, the lingering recession in Argentina. Given that prospects for a recovery in Argentina remain remote, this should contribute to weigh down industrial exports throughout 2020, especially in the auto sector.