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Article

Brazil: Monetary easing reaches final stage

With the local yield curve pricing 150bp in rate hikes next year, will the central bank be able to keep the benchmark SELIC rate steady until 2019?

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Record-low policy rate is a key achievement of the Temer administration

Brazil's central bank, BACEN, should bring the policy rate to a record-low this week. An extended period of monetary stimulus should help solidify the recovery in economic activity, with GDP set to expand closer to 3% next year. But electoral uncertainties and the still-unanchored fiscal outlook suggest a choppy market performance for local assets in 2018.

BACEN clearly telegraphed its intention to cut the SELIC policy rate by 50bp, to 7%, at its last policy meeting of the year, on Wednesday. The big question for this meeting is whether the bank will keep the window open for one last cut in February, or shut it down.

7%

SELIC rate expectations

It could reach its lowest ever level this week

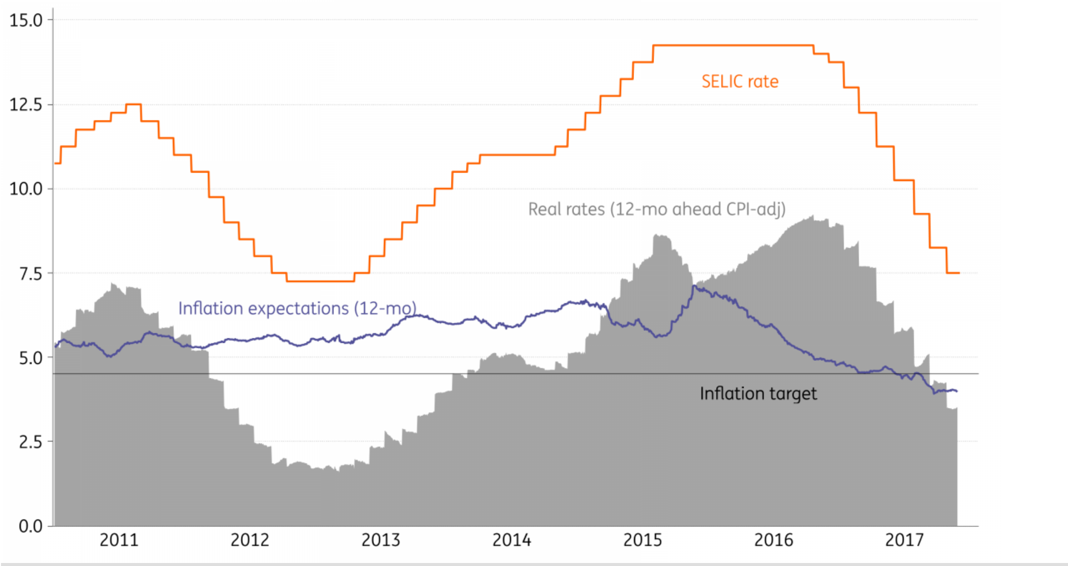
Our expectations

Our expectation is that this will be the last cut of this cycle, with the SELIC rate stabilizing at 7% in the foreseeable future, after accumulating an impressive total drop of 725bp in little more than a year. A 7% terminal rate for the cycle would be more consistent with the medium-term inflation targets, according to the latest inflation forecasts produced by the bank. The fact that those forecasts also incorporate a 100bp hiking cycle in 2019, in a "market" scenario that incorporates analyst surveys, also suggests that additional rate cuts now would increase the risk of a rate hiking cycle taking place sooner than expected.

In addition, a more cautious policy stance, at this stage, would also be consistent with the facts that:

1. the recovery in economic activity is now clearly underway
2. the policy rate is already deep in expansionary territory and, especially,
3. electoral uncertainties are likely to weigh on local assets and result in a weaker FX throughout 2018.

Low real rates and fully-anchored inflation expectations



Source: Macrobond

Beware of political surprises

Still, given that recent inflation data has been slightly better than expected while, more importantly, there's a possibility the Lower House succeeds in its last-ditch effort to approve a social security reform over the next two weeks, policymakers may opt for a more uncommitted guidance this week. Our assumption is that the reform will not be voted on this year, but Congress could still surprise. In that case, reform approval would result in a significant FX rally that prompts a drop in the bank's inflation forecasts, which are currently fairly in line with the target in the 2018-19 horizon. This could help justify one last cut (25/50bp) in February. Current pricing in the local yield curve suggests market expectations of a 50% chance of a last 25bp cut in February.

Beyond February, the local yield curve also incorporates about 150bp in rate hikes next year, starting in June. This contrasts with our expectation of stability for the policy rate throughout the year but is consistent with a scenario of heightened political uncertainties and FX volatility ahead of the October general elections.

In our view, should FX volatility turn excessive, BACEN would react in a typical way, by intervening in the FX market through FX swaps or even direct spot intervention. There's plenty of ammunition for that. But given the benign expected trajectory for inflation next year, the policy rate should remain stable for an extended period after this cycle is concluded.
Beyond 2018, we still believe there's substantial scope for the policy rate to remain in expansionary territory for a prolonged period of time. However, that outlook should remain highly dependent on the electoral result, the FX market's reaction to it and the new administration's commitment to fiscal austerity.

Entering 2018 with much-improved macro trends

As evidenced by the 3Q GDP report released last week, economic activity is clearly recovering, albeit at a very gradual pace. In fact, last week's release, which registered the first expansion in fixed investment in almost 4 years, triggered a moderate increase in expectations for GDP growth in 2017, with our forecast moving from 0.7% to 1.1%. Our 2018 GDP growth forecast increased slightly and is now within the 2.5-3.0% range.

Initially, the recovery benefitted from the surge in agricultural output, in 1Q, but since then domestic demand has become the dominant driver. This is, in large part, thanks to the achievements on the monetary policy front, with low and fully-anchored inflation and low-interest rates, which has boosted real wages and is helping ease credit constraints and bring the credit deleveraging cycle to an end.

The near-term outlook for inflation remains generally benign

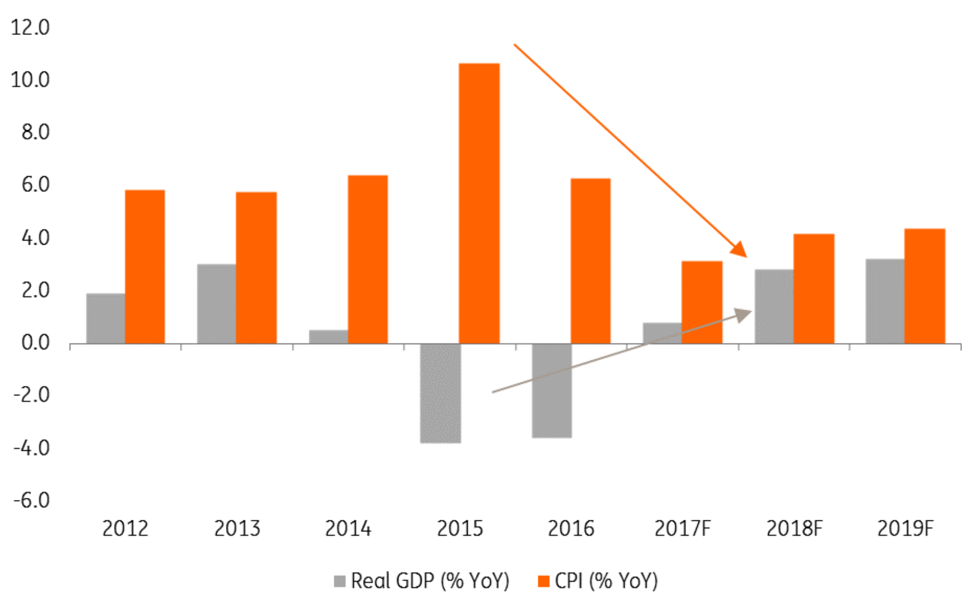
There is some possibility that inflation will end the year below the targeted range, at less than 3%, while the outlook for next year remains constructive. Less favourable base-effects (especially across food prices) will result in a gradual rise in yearly CPI but, thanks to...

1. the still pervasive indexation (favourable inertia),
2. well-anchored inflation expectations and
3. the large output gap, especially in the labour market

...inflation is likely to stay lower than the 4.5% CPI target throughout the year.

Our forecast of 4.2% for year-end 2018 CPI incorporates some FX weakness, ahead of the October elections, but FX uncertainties, along with weather-related food and electricity supply shocks, should remain the primary sources of upside risk for inflation dynamics in 2018.

Starting 2018 with low inflation and stronger activity



Source: Macrobond, ING

Fiscal and political challenges cloud the medium-term outlook

Despite the important achievements on the inflation and activity fronts, Brazil's medium-term outlook remains highly uncertain, marked by a fiscal trajectory that is far from anchored, signalling considerable challenges for President Temer's successor.

The economic recovery is having a noticeable positive impact on tax collection, while government spending has remained under control. This has helped stabilise the deficit and solidify prospects for a gradual improvement for the near-term fiscal deficit, as the recovery gains traction. But that adjustment should remain far too gradual to credibly alter the (explosive) long-term trajectory of the government's debt-ratios.

A social security reform remains essential, but its approval remains unlikely

In order to anchor the long-term fiscal trajectory, that social security reform remains essential. Curbing fast-growing social security deficits is critical to ensure that the fiscal austerity implied by the current fiscal framework, characterized by strict limits on government spending and its ability to issue debt, survives intact for the next 5-7 years which is needed to stabilise the public debt trajectory. Public debt rose 20ppt in the past 3 years, to 74% of GDP now, and is on track to rise to more than 85% of GDP over the next few years.

The recent government effort to boost popular support for this reform seems to have helped, but the tight calendar and President Temer's eroded political capital suggest that approval remains unlikely.

The outlook for the presidential election also remains highly uncertain.There's some greater clarity about the candidates, with Luciano Huck and João Dória apparently having dropped out of the race, helping consolidate Geraldo Alckmin's place as the market-favourite centrist candidate.

Finance Minister Henrique Meirelles also appears to be considering running, perhaps in alliance with the DEM party (and, presumably, the support of Temer's PMDB party). Meirelles appears to have developed a close working relationship with DEM's leader in the Lower House, speaker Rodrigo Maia, but prospects for his candidacy remain exploratory at best.

There are other considerable uncertainties that will continue to prevent a high-conviction call about the electoral result for quite some time still. Chief among them is whether former president Lula will be able to run or not, which should be decided by the courts during 2Q. The question of whether Lula would run with a radical-left platform (as recent statements seem to indicate) or switch to a market-friendly programme (as he did when he got elected in 2002) would eventually also become critical to assess market reaction to his candidacy.

Voter intention polls should provide little clarity, or comfort, until at least 2Q.

Other important questions involve the state of the alliance of the large parties that formed the governing base of the Temer administration. Specifically, whether President Temer's PMDB party will support the PSDB candidate (presumably Alckmin) or whether it may form an alliance with the DEM party and support a different candidate (Meirelles? Rodrigo Maia? Dória?). Voter intention polls should meanwhile provide little clarity, or comfort, until at least the second quarter.

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