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Macro View

Monetary easing under renewed tensions in the global scene

Monetary easing has been seen in the global leading economies. Federal Reserve cut federal funds rate by 25 basis points. The European Central Bank (ECB) kept signalling an easing in monetary policy, as well as the Bank of Japan.

In China, although the People's Bank of China (PBoC) intervened to stabilise the Renminbi, the currency weakened to slightly above CNY 7.00 per USD, as a political retaliation against the latest US threat on levy tariffs on Chinese goods.

Investors worldwide fears further devaluation in Renminbi, that could trigger a global currency war. Rising global uncertainty and the poor performance of Mauricio Macri in a preview of Argentinean presidential election hit Brazil, weakening BRL, hindering Ibovespa, offsetting Copom’s decision to cut Selic rate to 6% p.a and the approval of the Pension Reform in the Lower House.

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Trade disputes and fears of global recession offset FOMC monetary easing…

Federal Reserve cut federal funds rate by a quarter point, to 2.00%-2.25% range – as anticipated by market players. FOMC's decision is envisaging strong labour market, sustained economic growth and tamed inflation (near 2% FOMC's objective). Yet, some uncertainties in the global economy increased, mostly due to the US-China trade talks, shadowing the outlook. Concerns of an US recession in the 12 months horizon remains on the spotlight, as the US 10y Treasury bond yield has been trading below 3.0% level and very close to the US 2y Treasury bond.

Trade talks were marked by ups and downs and could be a potential spark for a synchronized global recession (probably one of the reasons of lower yields on US Treasury bonds). President Trump announced in early Aug19 a 10%-increase in import tariff on additional USD 300bn of Chinese goods from Sep19 – rising trade tensions. Subsequently, he postponed this tariff increase to Dec19 – but the damage has been already in place. PBoC intervened to stabilise Renminbi, but the currency weakened to slightly above CNY 7 per USD. Investors worldwide fears further devaluation in order to pressure Washington.

Turning to Europe, the ECB kept signalling an easing in monetary policy, which would consider a plethora of stimulus, including rate cuts and commitment in keeping monetary loosening to counterbalance an undershoot in the EBC's inflation target of under 2% and a global slowdown. Additionally, the UK experience since the Brexit (set to be defined on October 31st) has showed that a drop in the pound led to an increase in inflation, resulting in a squeeze on living standards. Those events support a stronger USD, mounting concerns over a currency war.

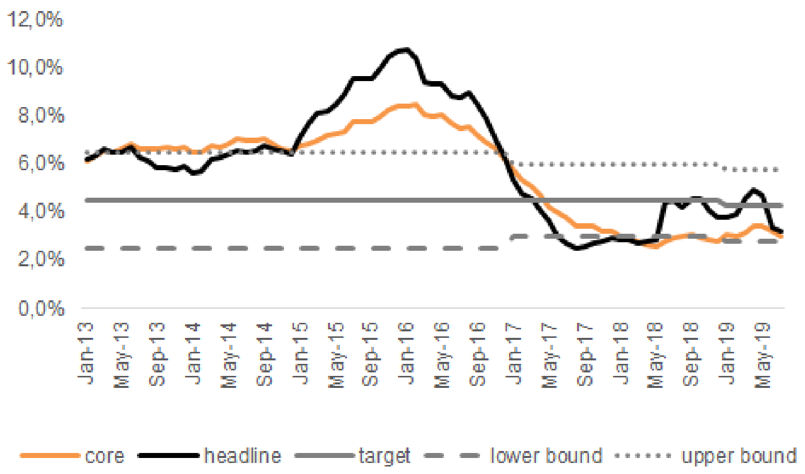
Brazil's Pension bill approved by Lower House…

Some positive developments have been seen in Brazil. The Lower House approved the Pension Reform bill by a large margin of 370 votes to 124, comfortably above the 308 needed votes. Now, the bill must get passed in the Senate, and it is expected to be completed by early Oct19. Investors, especially foreign ones, seem to be holding off investing in Brazil until the reform passes. Afterwards, other themes may emerge in the reformist agenda, which includes privatisations, deregulation measures and overhaul of the country's tax system.

…and IPCA below target level….

Inflation rate has been below the target level. In Jul19, IPCA rose 0.19% on a monthly basis. On a 12 months basis, IPCA has been below the 2019y 4.25% target (3.22% up to Jul19) and market expectations stays anchored. For 2020, market expectations are at 3.9%, slightly below target (4.0%) – assuming the hypothesis Selic rate might be lowered, at least, to 5.5% p.a. Coupled with a still fragile economic activity, risks of missing inflation target seem very low.

Chart 1 – IPCA (headline and core)

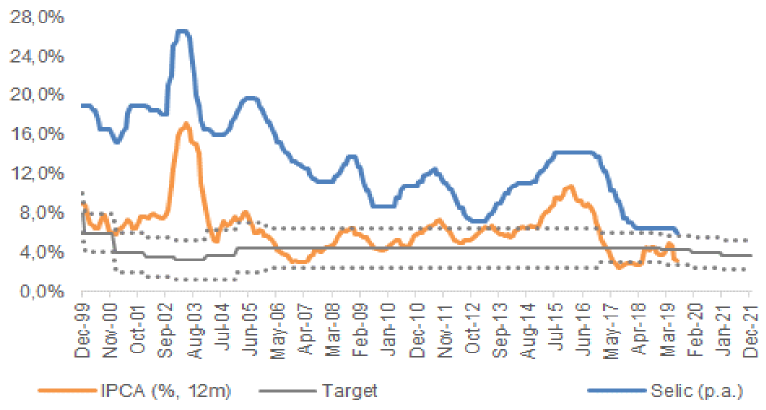


Source: IBGE. By Pezco.

…paved the way for a lower Selic rate….

Copom cut Selic rate in 50 basis point, to 6.0% p.a., arguing that advances in the country's Pension Reform underpin lower rates, by containing fiscal deficit in the medium term, as well as public indebtedness. Yield curve were pricing this potential outcome from Bacen, as pressure on food prices faded, bringing inflation rate back to sub-4% level on 12 months basis. Moreover, deflation in gasoline prices – fuelled by lower ethanol prices – also helped for subdued IPCA.

Chart 2 – Selic rate (% p.a) & IPCA (%, 12m basis)



Source: Bacen and IBGE. By Pezco.

…but the balance of risks looks uneven and worsened recently….

Yet, balance of risks does not look even. Global scene still demands caution, since there is a non-negligible likelihood of a global recession, especially in the US economy. The Reformist agenda has not been settled, as the Pension Reform needs to be approved by Senate, Tax Reform is in early stage of discussion and the bills to strengthen business environment need to advance.

We argued that, under such uncertain environment, Copom should have kept Selic rate unchanged. Besides, lacklustre economic activity in the H1 19 was influenced by negative shocks, like the accident in Vale's dam at Brumadinho (shrinking mining activity), recession in Argentina (contracting automobile industry), and food inflation (preventing a stronger retail sales).

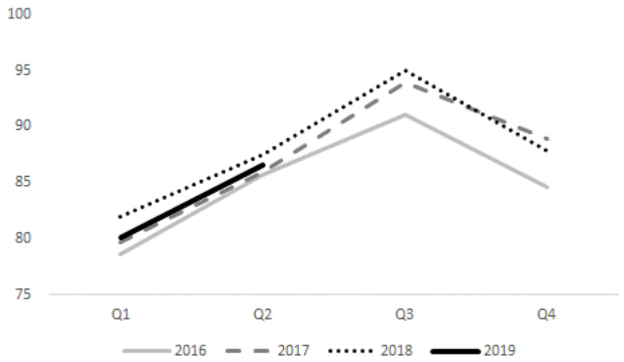
At the time Federal Reserve and BCB announced their monetary policy decisions, the reading was FOMC would have waited and seen while Copom would have cut further – leading to an assumption that interest rate differential favours USD against BRL. That might be one of the reasons for a weakening BRL since July 31. Additionally, escalating trade tensions added pressure on BRL.

New developments in Brazilian economic scenario should be closely monitored as there is no strong evidence economic activity will take off soon. We argue that economic fundamentals are stronger than other peer countries. But now, it seems growth is more dependent on animal spirit and relies on the confidence of economic agents – which has weakened in this year – with global recession, stronger USD and political noisy.

Looking ahead, the scenario remains supportive for a rebound in economic activity. We think Federal Reserve will reduce interest rates further, which may weaken the USD. In Brazil, reformist agenda may likely to advance, although under strong volatility. Besides, the margin for Federal Reserve to lower interest rate is higher than Bacen, which means interest rate differential may bottomed or close to it.

Industrial activity: disappointing picture, encouraging movie

Chart 1. Industrial production – Total (2012 = 100)



Source: IBGE. By Pezco.

Industrial production did not perform positively in the Q2 19. On a QoQ comparison, seasonally adjusted, production dropped for a third quarter in a row in Q2 19. Nonetheless, some promising signals can be observed. While mining activity slumped 10.2% in Q2 (following a -11.3% in Q1, essentially due to Brumadinho's dam incident), manufacturing activity rose 0.6% in Q2, after a 0.2% increase in the Q1.

There is not a strong evidence that growth in the industrial activity resumed, but signals that activity is not falling as it seems. According to chart 1, the level of the industrial production in Q1 and Q2 has been below the level observed in the previous year. Chart 2 and Chart 3 show that mining shrank sharply while manufacturing has been relatively good.

Chart 2. Mining Activity (2012 = 100)

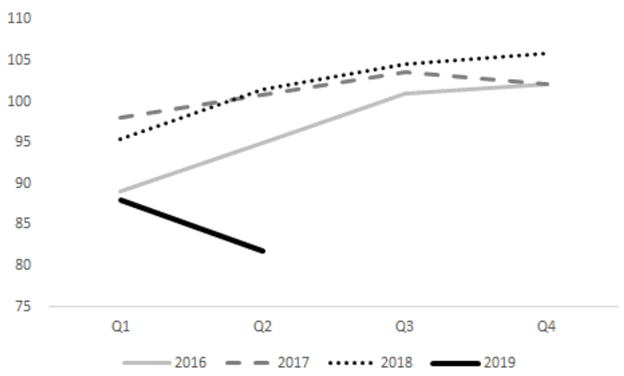
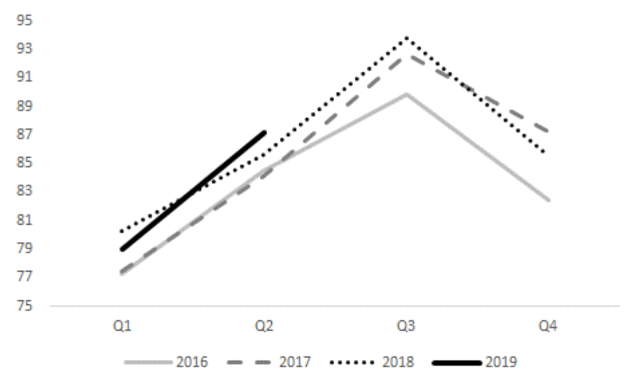


Chart 3. Manufacturing (2012 = 100)



Source: IBGE. By Pezco.

Moreover, analyzing manufacturing components, it is observable that cyclical categories – i.e. production of capital goods and durable goods – have performed positively in Q2, albeit a weaker Q1.

Chart 4. Capital Goods (2012 = 100)

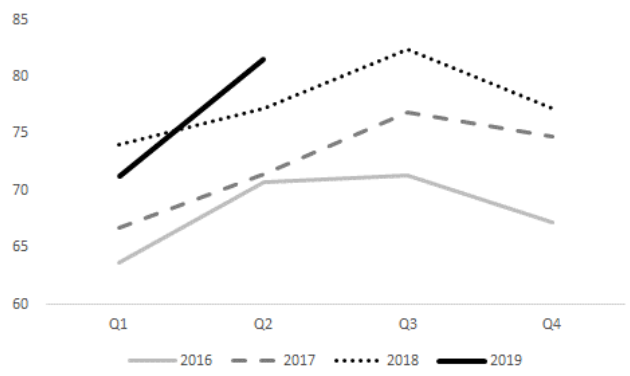
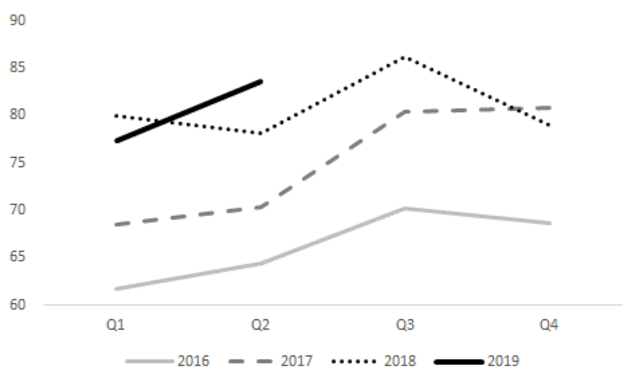


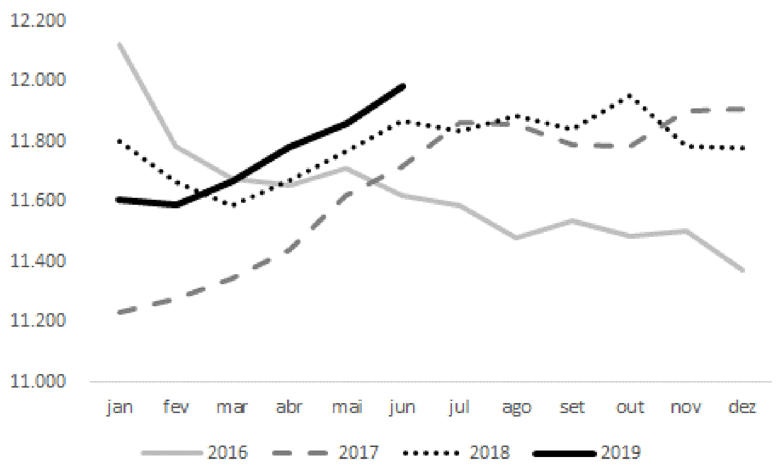
Chart 5. Consumer Durable Goods (2012 = 100)



Source: IBGE. By Pezco.

Besides, employment in industrial sectors have been positive. According to the data from IBGE, employed people in the industrial activity has increased in recent in the Q2 (YoY comparison).

Chart 6. Employed people (PNAD, thousand of people)



Source: IBGE. By Pezco.

With no further deterioration of the economic scenario, it is likely that the industrial activity may resume growth sooner.

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