MONEX

Hawkish central bank to offset depreciation, but political risks may tip the balance

Author

Ima Sammani
FX Market Analyst
+31 (0)20 808 3644
Ima.Sammani@monexeurope.com

In Q4, the Brazilian real traded in its narrowest quarterly range against the US dollar since the onset of the pandemic, however, this had more to do with bullish and bearish drivers balancing out price action rather than a lack of events. In terms of events, headlines were plentiful: Brazil's central bank (BCB) hiked interest rates by a total of 300bps as annual inflation as measured by IPCA, the BCB's preferred measure, rose to a multi-decade high of 10.74%. At the same time, the Federal Reserve backed down from its previous stance on inflation and acknowledged price pressures are more persistent and may hold for longer than previously thought, which bolstered expectations for faster and earlier rate hikes in the US. Additionally, risk sentiment was briefly hampered by Omicron concerns but as more and more studies showed the health impact of Omicron was likely going to be milder than what was previously seen with Delta, sentiment gradually recovered. All the while, a volatile political backdrop remained in Brazil throughout the three months.

> **For BRL traders, the combination of a responsive and hawkish BCB, along with a quick recovery in sentiment**, halted the bearish BRL trend that had been in place since the summer period, while at the same time, a hawkish Fed meant gains were capped too.

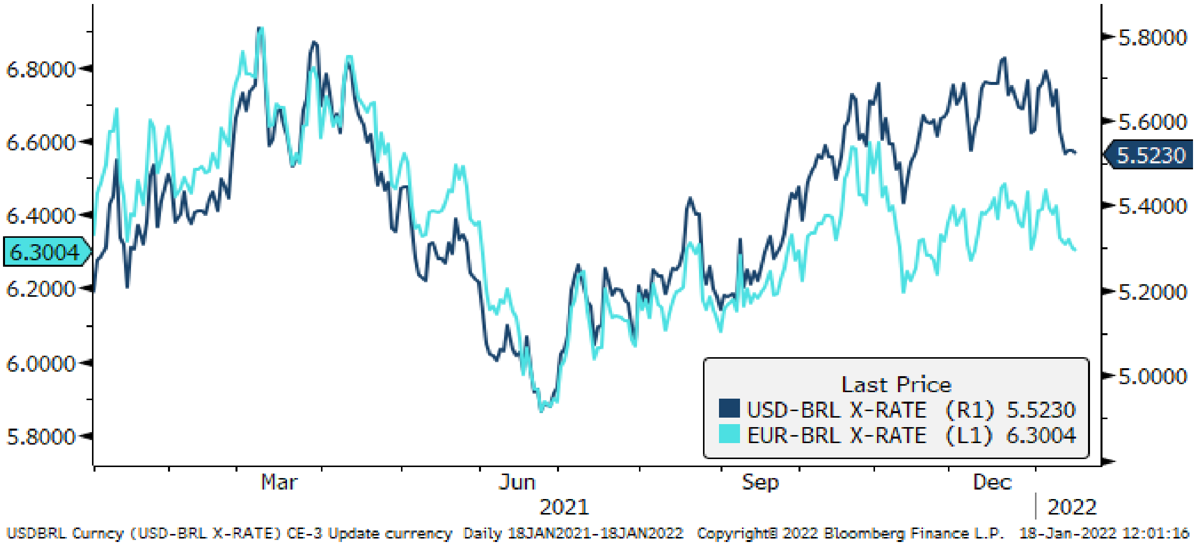
On balance, this meant USDBRL traded between the 5.4 to 5.7 level for most of the quarter. Looking ahead to the next quarter, BRL drivers are likely to remain centred around the inflation outlook and the BCB's responses to the ever-growing price pressures, along with developments in the US monetary space and fixed income markets. As the year progresses, the Brazilian general elections that are set to be held in October will become increasingly relevant for FX markets given the real's reputation of weakening in times of political uncertainty and upcoming elections. This may especially be the case this time around as far-right President Jair Bolsonaro's approval ratings have slipped to a record low of 19% recently, with 60% of the population unsatisfied with his work.

BRL
Outlook

January 2022

MONEX

Brazilian real traded in narrow quarterly ranges against EUR and USD throughout Q4 given balance of risks



Since the turn of the year, the only breakthrough in recent USDBRL ranges occurred after a disappointing US CPI report dampened expectations of policy normalisation by the Federal Reserve, leading to broader USD weakness. This was then coupled with higher commodity prices and overall supportive risk appetite, which sparked renewed optimism for BRL bulls. However, it must be noted that the recent flurry of BRL strength in the early parts of January have only seen USDBRL return to the trade in the middle of its Q4 range at 5.55. Rising Treasury yields in the US will likely put pressure on BRL over the course of the year despite the BCB's aggressive tightening cycle, however gains in USDBRL should be capped to some extent given Brazil's inflation problem and political uncertainty ahead of the elections.

Risks to the outlook are fairly balanced, with USDBRL downside likely to materialise if the Federal Reserve underdelivers compared to market pricing, or if a further improvement in risk sentiment and commodity prices boosts the real along with confidence in the BCB that they can maintain inflation at controllable levels. Upside risks include a confirmation of four interest rate hikes by the Federal Reserve over the coming year, as well as complications around the elections or fiscal situation in Brazil. On balance, we continue to be moderately bearish. on BRL up until the 2022 election period, but expect some mild relief post-elections which should allow USDBRL to fall back to levels seen at the start of the year.

> The inflation issue may play a more prominent role over the course of the year, as fiscal spending is set to increase further in the run up to the elections.

BRL
Outlook

January 2022

Monex's January forecasts

	1-month *(31st Jan 2022)*	3-month (31st Mar 2022)	6-month (30th Jun 2022)	12-month (31st Dec 2022)
USDBRL	5.7	5.8	5.85	5.7
EURBRL	6.441	6.496	6.611	6.498

BCB's aggressive tightening path to cap BRL weakness, but rising yields in the US won't make this easy

Brazil's central bank had the world's most aggressive tightening cycle over the last year in an effort to bring down inflation. They were the first to embark on a rate hike during the pandemic, along with the Central Bank of Russia, and have continued to hike rates aggressively since even though domestic growth levels may not have been reflective of such policy. The BCB had no other choice than tightening, given that inflation was surging and the central bank's own forecasts currently see inflation rising further above target through 2024. The BCB's key interest rate, the selic rate, sits at 9.25% and is set to be raised by another 150bps in February, according to the BCB's most recent statement. Both economists and markets estimate the rate may reach as much as 12% in the first half of 2022 as inflation expectations remain elevated. This is a more aggressive rate path than what markets have in mind for the Federal Reserve, which is set to increase interest rates by increments of 25bps at least three times this year, but at the same time markets view the Fed has more tools to counter inflation. The BCB's hawkish stance will offset depreciationary forces for a large part, although political risks come back into play throughout the year.

> We think the fact that the Federal Reserve is better equipped than the BCB to bring down inflation, coupled with election uncertainty over the coming year, **means USDBRL has some room to increase further over 2022.**

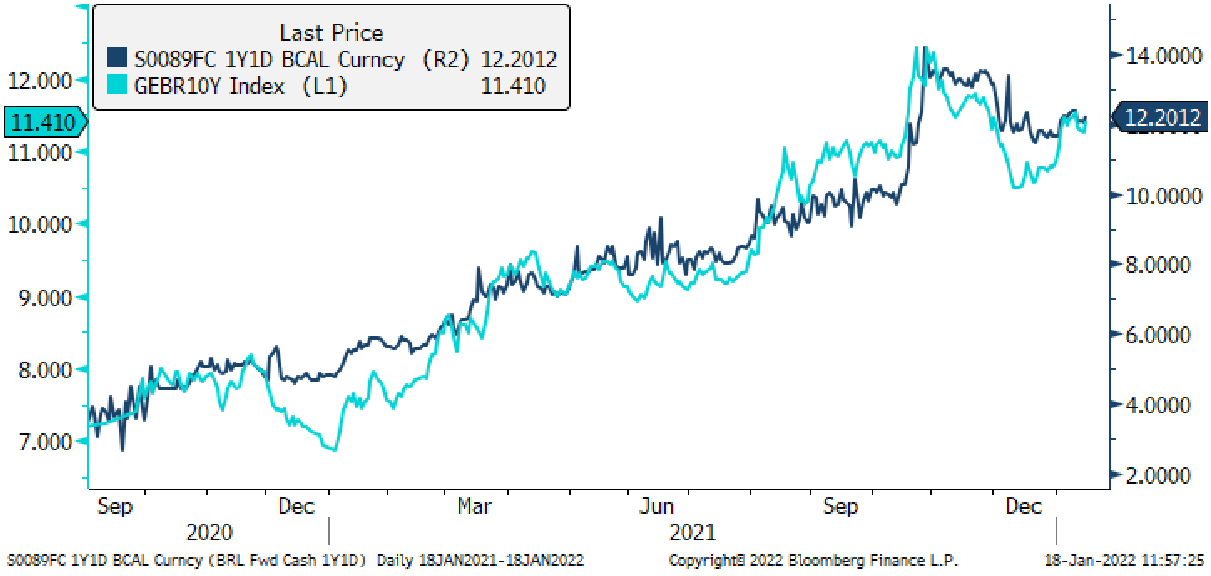
However, the upside is likely to be capped for a number of reasons. Firstly, an aggressive normalisation tightening path by the Federal Reserve has been priced in by markets already. While this means that over the last months, stronger market expectations and signals from the Fed have been supportive for the US dollar, the aggressiveness of market pricing also means risks are tilted towards the Fed underdelivering, which would result in USD weakness. Secondly, USDBRL is currently trading around historically high levels.

The only previous moments where the pair was trading higher than the current range occurred in Q2/Q3 2020, where the onset of the pandemic meant overall risk sentiment had deteriorated vastly, and Q1 2021, which was right before the BCB had started tightening policy to fight inflation. Current risk sentiment, despite the spread of the Omicron variant, is significantly more robust than in 2020 given that many of the uncertainties around the virus and the global recovery have subsided while global demand recovered, which means investors are more willing to delve into emerging market currencies compared to 2020.

Compared to Q1 2021, market expectations for policy normalisation have increased significantly, which signals markets are more confident now that the **BCB will address the surge in inflation**.

Naturally, inflation expectations have also increased since Q1 2021, but less so than policy expectations. This is evidenced by the chart below of the 1Y1D forward cash rate, which serves as a proxy for market implied policy rates, and Brazil's 10-year nominal bond yield. While an increase in nominal yields always reflects heightened inflation expectations, it does not always indicate heightened policy expectations. Nevertheless, the narrowed gap between the two lines since Q1 2021 suggests policy tightening expectations have played a more prominent role for markets, which is supportive for the real and should help limit losses against USD to an extent. All together, these factors should put a floor under BRL to avoid excessive weakening of the currency. Still, we think political risks will tip the balance and lead to a moderately weaker real over the 6-month period.

Developments in the 1Y1D forward cash rate as a proxy for implied rates vs 10Y nominal yields are supportive of the real and should help limit losses against USD



Fiscal amendments and a new budget ahead of challenging elections

While much of the inflationary pressures stem from global issues such as fuel and food price surges, Brazil has its own inflation problem too as there are concerns about rising government spending ahead of the 2022 presidential elections. Brazil's fiscal balance has been a point of concern for the nation, with the main reason for this being a constitutional amendment bill in Q4 2021. The amendment allows the federal government to cap its court-ordered debt repayments to free up space on the budget, with many worried that this renders the spending cap rules useless.

Brazil's Congress recently approved the budget bill for 2022. The budget includes an increase to the national minimum wage of 10.04%, BRL4.9bn worth of funds earmarked for political parties to finance the 2022 elections, and the Brazil Aid, which is designed to supersede the Family Allowance cash transfer programme. All of these measures combined with the bypass on the constitutionally mandated cap on public spending mean Brazil's budget deficit will only increase further over the next year, which places debt dynamics on a dangerous trajectory. On the other hand, a temporary increase in public spending may be unavoidable in the near- to medium-term future given the rise in poverty and unemployment..

> "In either case, it is clear this will **only further embolden inflation expectations** which the BCB has made clear it will address."

Recent opinion polls for the 2022 elections suggest Bolsonaro faces an uphill battle to be re-elected, as voters are dissatisfied with his handling of the pandemic and the economy. The worst wave of Covid led to strict lockdowns, oxygen shortages and at its worst point more than 3,000 deaths a day, bringing the total number of deaths to over 600,000 – second only to the US death count. Later on, a Senate investigation revealed that the President had ignored six offers of Covid-19 vaccines from Pfizer, which further deepened discontent among voters. Bolsonaro has also been criticised for destructive environmental policies in the Amazon rainforest, both globally and domestically, while many blamed him for the crippling Brazilian economy. His fading popularity has allowed a comeback by former leftist President Luis Inacio Lula da Silva, whose number of votes in recent opinion polls sits at 46% compared to Bolsonaro's 23%. Previous periods of election uncertainty have led to moderate BRL weakness, however, volatility may increase further in the run up to the elections this time around given opinion polling has been more aggressive than previously and Bolsonaro's approval ratings have slipped to record-lows, while at the same time he has indicated he will not accept the results of the vote if he loses. Our forecasts foresee mild BRL strength towards the end of the forecasting horizon, as depreciationary trends tend to ease on a clear victory, even if the election outcome is not the most market-friendly one.

Disclaimer