Macro Brazil

July 30, 2024

Copom Cockpit: stable interest rates, for now

- The Brazilian Central Bank's Monetary Policy Committee (Copom) will meet again on July 30 and 31, with a backdrop that has once again become more complex since the previous decision.

- Despite some improvement in the external environment, the perception of local risk remained high, and asset prices, in general, experienced strong volatility. The exchange rate, which is one of the most volatile inputs for the BCB's inflation model, advanced from BRL 5.30/USD at the previous meeting (and 5.15 in the May meeting) to around 5.55 (average of 10 days ending last Friday, the value used by the BCB to run the model).

- Economic activity data released since the last decision continued to show resilience and a heated labor market – with wages under pressure, consistent with increased services inflation ahead. Incidentally, after a sequence of benign releases, the mid-July IPCA-15 brought a significant and worrying upside surprise in this component, marking, in our view, an inflection point towards a higher trend in underlying services. Since the last Copom meeting, the inflation expectation for 2025 has risen an additional 16 basis points, to 3.96%, while for 2026 it has remained unchanged (3.60%).

- Simulating the BCB model with these inputs, we expect an increase in inflation projections from 3.4% to 3.7% in 2025 and from 3.2% to 3.3% in 2026, under the reference scenario. In the alternative scenario, with constant interest rates, the increase should be from 3.1% to 3.5% in 2025. The forecast for the accumulated inflation until 1Q26 will likely be released, at 3.2%.

- Under these conditions, the committee is likely to renew its promise of vigilance and state that it will assess whether the strategy of maintaining monetary policy at a contractionary level for a sufficient time will be able to ensure the process of disinflation and re-anchoring of expectations. A possible hawkish, but entirely appropriate, signal would be the description of an asymmetric balance of risks to the upside, accompanied by the statement that the committee will not hesitate to resume the adjustment cycle (upwards). We also assess that a minority of the committee must already have such an assessment of the balance of risks, which tends to surface in the communication cycle associated with the next Copom meeting.

1 – Inflation forecasts

The tables below summarize the estimates based on our model, which seeks to replicate the Central Bank's small-scale model, and changes in the Focus survey since the last committee meeting. The exchange rate used (5.55 BRL/USD) follows the Central Bank's procedure of averaging the rates of the last 10 business days.

When compared to forecasts presented at the June meeting, we expect the committee's inflation forecasts in the reference scenario (which considers the exchange rate according to purchasing power parity and the interest rate according to the Focus survey) to rise to 4.2% from 4.0% for 2024, and to 3.7% from 3.4% for 2025. The projection for 2026, which tends to gain increasing relevance in the next meetings, should increase to 3.3% from 3.2%, also above the target, albeit by a limited margin. In the alternative scenario, with constant Selic rate, the increase should be from 3.1% to 3.5% in 2025. The forecast for the accumulated inflation until 1Q26 will likely be released, at 3.2%.

Since the last Copom meeting, inflation expectations reported by the Focus survey advanced to 4.10% from 3.96% for 2024, while rising 0.16pp to 3.96% for 2025, and remaining unchanged at 3.60% for 2026 — thus above the target for the entire horizon. Forecasts for the Selic rate were unchanged at 10.50% for 2024, 9.50% for 2025, and 9.00% for 2026.

IPCA forecasts (%) according to "Central Bank model"*					
Period	**May Meeting**	**June Meeting - reference**	**June Meeting - alternative****	**July Meeting (forecast) - reference**	**July Meeting (forecast) - alternative****
2024	3.8%	4.0%	4.0%	4.2%	4.2%
2025	3.3%	3.4%	3.1%	3.7%	3.5%
2026 / 1Q26	--	3.2%	-- / --	3.3% / --	-- / 3.2%
Exogenous variables					
Exchange Rate (R$/US$)	5.15	5.30	5.30	5.55	5.55
Selic Interest Rate (%) 2024	9.63%	10.50%	10.50%	10.50%	10.50%
Selic Interest Rate (%) 2025	9.00%	9.50%	10.50%	9.50%	10.50%
Selic Interest Rate (%) 2026	8.75%	9.00%	10.50%	9.00%	10.50%
Inflation Expectations (Focus) 2024	3.72%	3.96%	3.96%	4.10%	4.10%
Inflation Expectations (Focus) 2025	3.64%	3.80%	3.80%	3.96%	3.96%
Inflation Expectations (Focus) 2026	3.50%	3.60%	3.60%	3.60%	3.60%

Source: Bloomberg, Central Bank of Brazil, Itaú.
* Model developed by Itaú replicating Copom's model.
**Maintaining the interest rate constant throughout the relevant horizon.

Focus forecasts *(%, year-end)*						
	2024		2025		2026	
	Copom (Jun)	Current*	Copom (Jun)	Current*	Copom (Jun)	Current*
IPCA	3.96	4.10	3.80	3.96	3.60	3.60
GDP growth	2.08	2.19	2.00	1.94	2.00	2.00
Selic rate	10.50	10.50	9.50	9.50	9.00	9.00
Exchange rate (BRL/USD)	5.13	5.30	5.10	5.25	5.12	5.25

*considering the latest Focus report.

Source: BCB, Itaú.

2 – Asset prices

Since the last Copom meeting and until the publication of this report, 10-year US Treasury yields were virtually stable at around 4.20%. Brent crude plummeted to $81/bbl from $85/bbl, while agricultural and industrial commodities also became cheaper. The exchange rate —now at 5.66 reais per dollar— depreciated significantly vs. the June meeting level of 5.43. Country risk measured by the 5-year CDS was little changed (-2bps to 157).

Asset prices		
	Last Copom (Jun)	Current*
UST 10Y	4.22	4.19
Oil price (Brent)	85	81
Agricultural commodities**	675	606
CRB RIND Index***	552	542
CDS 5Y	159	157
Exchange rate (BRL/USD)	5.43	5.66

*considering closing prices on July 26.
**geometric average of soy, corn and wheat prices, in US dollars.
***Commodity Research Bureau Index of Industrial Raw Materials.

Source: CRB, BBG, Itaú.

3 – Recent data

The table below shows the dataset released since the last Copom meeting. Overall, economic activity and the job market show continuing strength, while core services inflation accelerated from already elevated levels.

In May, industrial production receded 0.9% mom (-1.0% yoy), reflecting the impacts of the floods in Rio Grande do Sul state. On the other hand, real revenues in the services sector remained stable vs. the previous month (+0.8% yoy) and broad retail sales expanded 0.8% (+5.0% yoy), both beating market expectations. Floods in Rio Grande do Sul apparently had a milder-than-anticipated impact on economic activity in May. June figures continue to suggest resilient economic activity, with our IDAT-Activity index increasing 0.5% mom in June. In the labor market, the unemployment rate declined further in June, thanks to formal job creation, while the participation rate remained stable. Furthermore, real wages extended their upward trend.

Regarding inflation, after the consumer price index IPCA had a lower-than-expected reading in June, the mid-month index IPCA-15 was higher than anticipated and showed a worse breakdown, especially due to the acceleration in underlying services prices. Going forward, we expect the services component to remain under pressure because of the tight labor market. We also foresee an acceleration in industrial goods prices, reflecting a weaker exchange rate.

Economic Indicators: Result vs. Consensus

Release Date	Indicator	Result	Consensus
26-Jun-24	IPCA-15 (Jun/24) - MoM	0.39%	0.44%
27-Jun-24	IGP-M (Jun/24) - MoM	0.81%	0.85%
27-Jun-24	Formal job creation (May/24) - Thousands	132	200
28-Jun-24	Primary fiscal result (May/24) - BRL bn	-61.0	-59.5
28-Jun-24	Unemployment rate (May/24)	7.1%	7.3%
03-Jul-24	Industrial production (May/24) - MoM	-0.9%	-1.4%
10-Jul-24	IPCA (Jun/24) - MoM	0.21%	0.30%
11-Jul-24	Core Retail Sales (May/24) - MoM	1.2%	-0.5%
12-Jul-24	IBGE Services Sector Volume (May/24) - MoM	0.0%	-0.7%
15-Jul-24	IBC-Br (May/24) - MoM	0.25%	0.30%
25-Jul-24	IPCA-15 (Jul/24) - MoM	0.30%	0.22%
29-Jul-24	Primary fiscal result (Jun/24) - BRL bn	-38.8	-37.0
30-Jul-24	IGP-M (Jul/24) - MoM	-	-
30-Jul-24	Formal job creation (Jun/24) - Thousands	-	-
31-Jul-24	Unemployment rate (Jun/24)	-	-

Data in red suggest more hawkish results for monetary policy (higher inflation or stronger activity than expected) and data in blue suggest more dovish results.

Source: IBGE, Brazilian Central Bank and Bloomberg

4 – Communication changes and Copom-o-Meter

At its last monetary policy meeting, on June 18 and 19, the Copom kept the Selic rate unchanged at 10.50%pa, as widely expected, and put a stop to a string of seven consecutive cuts in the benchmark interest rate. The decision was unanimous, in contrast to the previous meeting, marked by dissent around the easing pace.

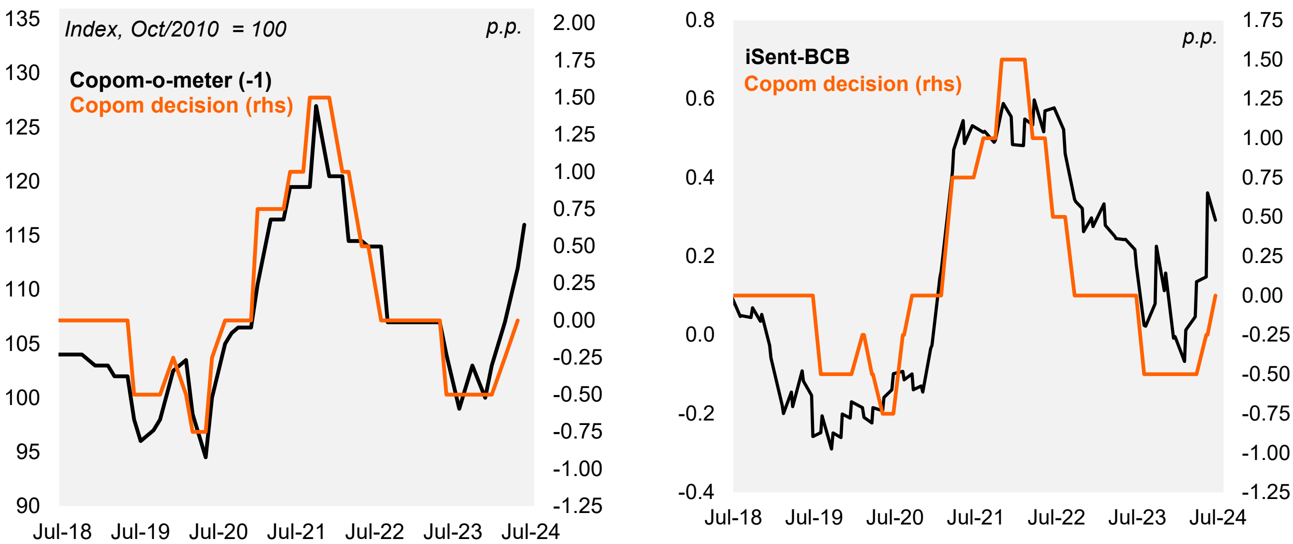
In its decision to interrupt the easing cycle, the committee noted that the uncertain global scenario, resilient domestic activity, rising inflation forecasts, and unanchored expectations require greater caution. The committee mentioned that it is monitoring the implications of fiscal policy on monetary policy and asset prices (meaning the exchange rate).

In the minutes of that meeting, the tone was a little more hawkish, with an upward revision of the neutral interest rate hypothesis to 4.75% from 4.50%, and assuming that the output gap has been closed —making it more difficult to reach the 3.1% inflation projection for 2025.

In order to try to anticipate Copom's decisions, we use the Copom-o-meter, an index that measures the degree of restriction or expansion implicit in the Central Bank's communication. Applying the methodology (based on scores attributed to relevant communication by the committee), we reckon that the content of recent communications, with more hawkish messages, is compatible with discussions about increasing the Selic rate, emphasizing the need for a cautious stance by the authority.

In addition to the Copom-o-meter, we created [iSent, Itaú's Central Bank Sentiment Classifier], based on GPT-4, developed by our data science team using sentences published in central bank's official documents labeled by our economists. Our labeled dataset consists of approximately 1,000 sentences extracted from official documents published by the Brazilian Central Bank. Each sentence was classified as dovish, neutral, hawkish, or out of context. the index is constructed on the relative presence of each class. The index ranges from -1 to 1, getting higher as the tone is perceived as more hawkish. iSent-BCB shows good adherence to current and future moves in interest rates in Brazil (correlation around 0.8). A visual analysis confirms a good adherence of the index and the Selic rate shift one meeting ahead. In fact, the index did well in capturing most of the shifts in the past 18 years, most notably the hiking cycles in the late 2000's and early 2020's. For the next meeting, the sentiment captured in the latest meeting documents is consistent with an increase in the interest rate, which is not our current call but partly reflects an actual risk.

Copom-o-Meter and Itaú iSent Classifier



Source: BCB, Itaú

5 – Our view

In the two most recent Copom Cockpit publications (May and June), we began this section by stating that the committee would meet again against a backdrop that had become more complex and challenging. This is the case once more – in practically all dimensions.

Starting with the aspect that has seen some relief since the previous meeting, it is possible to say that the external environment has become a little less adverse, with inflation and economic activity data in the US that have brought the prospect (already fully incorporated into asset prices) that the Fed will begin its monetary easing cycle sooner than previously expected. We now expect a first interest rate cut in September, followed by four more each quarter. Market pricing today is consistent with this scenario, or even a slightly faster movement.

Despite this improvement, the exchange rate, which is one of the most volatile inputs for the BCB's inflation model, rose from R$5.30/dollar at the previous meeting (and 5.15 at the May meeting) to around 5.55 (average of 10 business days ending today, the value used by the BC to run the model). The BRL remained decoupled from its peers, although the pressure in the last few days seems to have been more related to global issues, with depreciation of the main "carry currencies", those of countries that offer more attractive interest rates. The perception of local risk remained high and asset prices in general experienced strong volatility, with doubts about the direction of public finances still being the main vector of pressure. The uncertainty surrounding the announcement of spending cuts in 2024, which were announced a few days in advance at R$15 billion (an amount that, in our view, does not make it impossible, but does not guarantee, compliance with the rules of the framework in 2024), has been left behind. This announcement was eagerly awaited, but apparently, judging by the dynamics of assets, the advancement of the calendar has merely shifted the focus to the next key date, August 31 (deadline for submitting the budget proposal for 2025), and to more structural measures to contain public spending, whose dynamics threaten the current annual limit of 2.5% in real terms.

The economic activity data released since the last decision continued to show a picture of a tight and resilient labor market – with wages under pressure, which is consistent with an increase of service inflation ahead. By the way, after a series of benign releases, the IPCA-15 for July brought a significant and worrisome upward surprise in this component, marking, in our view, a shift in the upward direction of the underlying services indicator. Since the last Copom meeting, inflation expectations for 2025 have increased by an additional 16 basis points, to 3.96%, while for 2026 they have not changed (3.60%). Simulating the BCB model with these inputs, we expect inflation projections to rise to 3.7% from 3.4% in 2025 and from 3.2% to 3.3% in 2026 (which tends to gain increasing relevance in the next meetings), in the baseline scenario. In the alternative scenario, with constant Selic rate, the increase should be from 3.1% to 3.5% in 2025. The forecast for the accumulated inflation until 1Q26 will likely be released at 3.2%.

With this background, we understand that monetary policy is on the verge of an inflection (our simulation of the BCB models indicates that, under current conditions, the Selic level necessary to bring inflation to the target in the relevant horizon would already be at least 11.00% per year). This condition should lead the committee to renew its promise of vigilance and state that it will assess whether the strategy of maintaining monetary policy at a contractionary level for a sufficient time will be able to ensure the process of disinflation and re-anchoring of expectations. A possible hawkish, but entirely appropriate, signal would be the description of an asymmetric balance of risks to the upside, accompanied by the statement that the committee will not hesitate to resume the adjustment cycle (upwards). We also believe that a minority of the committee must already have such an assessment of the balance of risks, which tends to appear in the communication cycle associated with the next Copom meeting.

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