Copom Cockpit: End of the Cycle with Caution and Flexibility

- The Copom will meet again on June 17 and 18, and we expect the current monetary tightening cycle to come to an end, with a unanimous decision to keep the Selic rate at 14.75% pa. The decision is likely to reflect the advanced stage of the cycle, the expected lagged and cumulative effects of monetary policy, and an environment of above-usual uncertainty.
- Since the last Copom meeting, the domestic scenario has shown mixed signals: the labor market remains strong, but first-quarter GDP came in below expectations, and early data for the second quarter point to moderation in activity. Inflation remains above the target, but recent releases have shown downward surprises, with no further deterioration at the margin. In the FX market, the BRL appreciated slightly, while commodity prices in reais remained relatively stable. The rise in geopolitical tensions tends to increase commodity price volatility, particularly in the energy sector. It is worth noting that inflation expectations from surveys of independent economists have shown stability, while breakeven inflation measures have declined substantially.
- In its recent communication, the Central Bank has emphasized a more cautious tone, given the high level of uncertainty and the lagged and cumulative effects of monetary policy, as well as flexibility, reinforcing a data-dependent approach. The BCB's inflation projection – assuming an exchange rate of R$5.60 and a revision of the output gap toward a more heated economy in the relevant horizon (around 0.3 percentage points) – is expected to remain stable at 3.6% for 4Q2026, with the baseline scenario factoring in a slowdown in economic activity and a widening output gap ahead. The projection under a scenario with the Selic rate held steady at 14.75% throughout the relevant horizon (assuming the same exchange rate and output gap shock) stands at around 3.3%, likely close enough to the target for the committee.
- We assess that the balance of risks for inflation is likely to remain balanced, with risks on both sides and greater-than-usual variance. In this context, we expect the committee to reinforce its commitment to bringing inflation back to target, maintaining its strategy of keeping interest rates at a contractionary level for an extended period, and signaling that it will not hesitate to resume the tightening cycle if the inflation outlook deteriorates.

1 – Inflation Forecasts

The tables below summarize the projections based on our estimated replica of the BCB's small-scale model, as well as the changes in the Focus survey since the committee's last meeting. The exchange rate used (at R$5.60/US$) reflects the BCB's procedure of using the average of the previous 10 business days.

Compared to what was presented at the May meeting, the committee's inflation projections in the baseline scenario – which assumes an exchange rate consistent with purchasing power parity and an interest rate aligned with the Focus survey – are expected to remain stable at 4.8% for 2025 and 3.6% in the relevant Q4 2026 horizon. It is important to note that these projections may be affected by a potential larger revision of the output gap toward a more robust economy.

Since the last Copom meeting, inflation expectations reported by the Focus survey have declined to 5.25% for 2025 (from 5.53%) and to 4.50% for 2026 (from 4.51%). The median projections for the Selic rate for 2025 and 2026 remained stable at 14.75% and 12.50%, respectively.

It is worth noting that the inflation projections under a scenario with the Selic rate held steady at 14.75% throughout the entire projection horizon stand at around 3.3%, which should provide policymakers with some comfort to pause the adjustment cycle.

IPCA forecasts (%) according to "Central Bank model"*					
Period	December Meeting	January Meeting	March Meeting	May Meeting	June Meeting (forecast)
2025	4.5%	5.2%	5.1%	4.8%	4.8%
2026	4.0% (2Q26)	4.0% (3Q26)	3.9% (3Q26)	3.6% (4Q26)	3.6% (4Q26)
Exogenous variables					
Exchange Rate (R$/US$)	6.00	6.00	5.80	5.70	5.60
Selic Interest Rate (%) 2025	13.50%	15.00%	15.00%	14.75%	14.75%
Selic Interest Rate (%) 2026	11.00%	12.50%	12.50%	12.50%	12.50%
Inflation Expectations (Focus) 2025	4.59%	5.50%	5.66%	5.53%	5.25%
Inflation Expectations (Focus) 2026	4.00%	4.22%	4.48%	4.51%	4.50%

Source: Bloomberg, Central Bank of Brazil, Itaú.
* Model developed by Itaú replicating Copom's model.

Focus forecasts *(%, year-end)*						
	2025		2026		2027	
	Previous Copom	Current*	Previous Copom	Current*	Previous Copom	Current*
IPCA	5.53	5.25	4.51	4.50	4.00	4.00
GDP growth	2.00	2.20	1.70	1.83	2.00	2.00
Selic rate	14.75	14.75	12.50	12.50	10.50	10.50
Exchange rate (BRL/USD)	5.86	5.77	5.91	5.80	5.85	5.80

*considering the latest Focus report.

Source: BCB, Itaú.

2 – Asset Prices Evolution

Since the last Copom meeting and up to the publication of this report, the exchange rate has appreciated to 5.54 reais per dollar (from 5.75), reflecting a weaker dollar globally. The country risk perception, as measured by the 5-year CDS, declined by 26 bps to 155 bps. The yield on the 10-year US Treasury rose to 4.40% (from 4.27% at the previous meeting), while Brent crude oil prices increased to 74 dollars per barrel (vs. 61 previously). With the rise in geopolitical tensions in the Middle East, upward pressure has been exerted on oil prices in recent days, but it still seems too early to take this scenario as a baseline.

Asset prices		
	Previous Copom	Current*
UST 10Y	4.27	4.40
Oil price (Brent)	61	74
Agricultural commodities**	617	637
CRB RIND Index***	565	561
CDS 5Y	181	155
Exchange rate (BRL/USD)	5.75	5.54

*considering closing prices on the eve of publication of the report.
**geometric average of soy, corn and wheat prices, in US dollars.
***Commodity Research Bureau Index of Industrial Raw Materials.
Source: CRB, BBG, Itaú.

3 – Data Evolution

The table below presents the indicators released between the last Copom meeting and the upcoming one. Regarding inflation data, there were downward surprises in May: the IPCA for the month rose 0.26%, below the market consensus of 0.32%. The breakdown showed qualitative improvement, with a decline in the core services index. The average of core inflation measures was in line with our projection and, for the first time this year, approached the seasonally adjusted range consistent with the inflation target. Another relevant release was the May IGP-M, which posted a deflation of 0.49%, below the market forecast of -0.36%. The result was mainly driven by a 0.82% drop in the Wholesale Price Index, reflecting a sharp decline in raw material prices, while the other components posted moderate increases.

On the activity side, the indicators pointed to a more heated economy at the beginning of the year. The highlight was the 1Q25 GDP, which, although below expectations, had a robust quarterly change of 1.4% (vs. consensus of 1.5%). However, more recent data indicate considerably weaker economic activity starting in the second quarter, such as April's industrial production, which expanded by only 0.1%, a result well below the median of market expectations (+0.4% m/m). In the retail sector, IBGE's broad index fell 1.9% in April, a weaker result than the market consensus (-1.3% m/m), while core retail sales declined 0.4%, a slightly smaller contraction than the median projection (-0.5%). Finally, in the services sector, the PMS survey recorded growth of 0.2% in April. In the breakdown, the 'Services Provided to Households' component was in line with our estimate, while 'Professional, Administrative and Complementary Services' came in weaker than expected, introducing a slight downward bias to our 2Q25 GDP projection. In the labor market, formal job creation in April surprised positively, with 258 thousand jobs (vs. 170 thousand expected), and the unemployment rate for March stood at 6.6% (vs. consensus of 6.9%).

Economic Indicators: Result vs. Consensus

Release Date	Indicator	Result	Consensus
9-May-25	IPCA (Apr/25) - MoM	0.43%	0.42%
14-May-25	IBGE Services Sector Volume (Mar/25) - MoM	0.30%	0.50%
15-May-25	Core Retail Sales (Mar/25) - MoM	0.80%	1.00%
19-May-25	IBC-Br (Mar/25) - MoM	0.80%	0.40%
27-May-25	IPCA-15 (May/25) - MoM	0.36%	0.44%
28-May-25	Formal job creation (Apr/25) - Thousands	258	170
29-May-25	IGP-M (Apr/25) - MoM	-0.49%	-0.36%
29-May-25	Unemployment rate (Apr/25)	6.60%	6.90%
30-May-25	Primary fiscal result (Apr/25) - BRL bn	14.2	18.8
30-May-25	GDP (1Q25) - QoQ	1.40%	1.50%
3-Jun-25	Industrial production (Apr/25) - MoM	0.10%	0.40%
10-Jun-25	IPCA (mai/25) - Var. mensal	0.26%	0.32%
12-Jun-25	Core Retail Sales (Apr/25) - MoM	-0.4	-0.5
13-Jun-25	IBGE Services Sector Volume (Apr/25) - MoM	0.2%	0.2%
16-Jun-25	IBC-Br (Apr/25) - MoM	0.2%	0.1%

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 – Evolution of the *Copometer* Communication

At its latest monetary policy meeting, the Copom unanimously decided to slow the pace of monetary tightening, raising the Selic rate by 50 bps to 14.75% pa, as widely expected by the market.

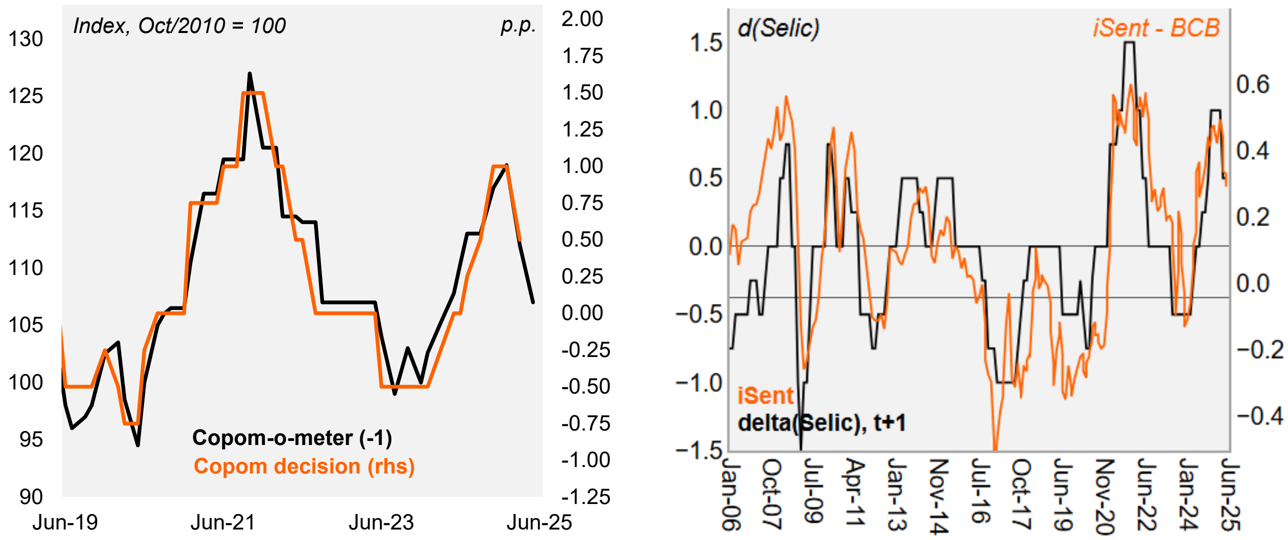
The meeting minutes reinforced the perception that the committee considers monetary policy to have reached a significantly contractionary level. This assessment aligns with the authorities' view of the current economic environment, marked by signs of activity moderation and the beginning of a turning point in the labor market. The committee emphasized that the lagged effects of the ongoing tightening are expected to intensify over the coming quarters, particularly in credit and household consumption. The minutes also downplayed the potential impact of the new payroll loan program, treating it as a structural change with limited short-term effects on aggregate demand.

Throughout the minutes, the committee repeatedly referenced the current level of interest rates and the importance of allowing time for the lagged effects of previous decisions to materialize, signaling a willingness to keep the Selic rate unchanged for an extended period. At the same time, the committee emphasized the importance of maintaining flexibility in conducting monetary policy amid an adverse external environment and heightened uncertainties – particularly those related to U.S. economic policy and its impact on global financial conditions.

To anticipate Copom's decisions, we use the Copometer—an index that measures the degree of monetary restriction or expansion implied in the Central Bank's communication. Applying a methodology based on scores assigned to the committee's key communications, we assessed that the indicator is consistent with the Selic rate remaining stable at the next meeting.

In addition to the Copometer, we developed [iSent – Itaú's Central Bank Sentiment Classifier] – based on GPT-4 and built by our data science team using sentences from official documents published by central banks, labeled by our economists. Our labeled dataset consists of about one thousand sentences from documents released by Brazil's Central Bank. Every sentence was classified as dovish, neutral, hawkish, or out of context, and the index is constructed based on the relative frequency of each class within a document. The index ranges from -1 to 1, with higher values indicating a more hawkish tone. The iSent-BCB shows strong alignment with both current and future changes in Brazilian interest rates (with a correlation of approximately 0.8). Visual analysis also confirms that the index tracks well with Selic rate changes one meeting ahead. In fact, it has accurately captured most shifts over the past 19 years, particularly during the hiking cycles of the late 2000s and early 2020s. In general terms, the index suggests a softer tone in the recent monetary policy communication, although not enough to ensure interest rate stability.

Copom-o-Meter and Itaú iSent Classifier



5 – Our view

The Copom will meet again on June 17 and 18, and we expect the current monetary tightening cycle to come to an end, with a unanimous decision to keep the Selic rate at 14.75% pa. The decision is likely to reflect the advanced stage of the cycle and the perspective that the lagged and cumulative effects of monetary policy will become more evident, in an environment of above-usual uncertainty.

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Macro Research – Itaú
Mario Mesquita – Chief Economist

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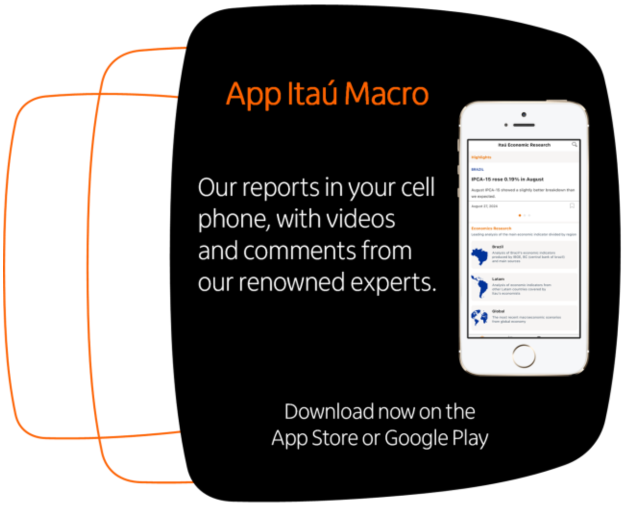

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