Macro Brazil

December 9, 2024

Copom Cockpit: accelerating further, to 100bps

- The Brazilian Central Bank's Monetary Policy Committee (Copom) will meet again on December 10 and 11 and will likely accelerate the adjustment pace to 100 bps (from 50 bps in the previous meeting), taking the Selic benchmark interest rate to 12.25% pa.
- When compared to forecasts presented at the November meeting, 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) will likely rise to 4.8% in 2024 (from 4.6% in the November meeting), 4.6% in 2025 (from 3.9%), and, more importantly, 4.1% (from 3.6%) in the relevant horizon (2Q26).
- The past few months were marked by increasing uncertainty and risk aversion. Some of this pressure stemmed from the external background, but it was also largely driven by the government's announcement of a fiscal adjustment that, at least in a first moment, disappointed independent analysts.
- The exchange rate — a key variable for the inflation outlook — reached its weakest reading ever, accumulating steep depreciation (and quite decoupled from other emerging market currencies). Inflation expectations rose sharply, both on breakeven metrics implicit in asset prices and the Focus survey, where the median estimates for 2025 and 2026 surged, marking one of the sharpest increases in recent history, including on the critical date used as a reference for this week's Copom meeting. These concerning conditions require a more vigorous stance by the monetary authority.
- In addition to this deterioration, another important inflation driver evolved consistently and showed greater pressure: 3Q24 GDP surprised on the upside, indicating that economic activity has been more dynamic than anticipated. The labor market remained tight, with the unemployment rate reaching a new all-time low.
- In our view, the monetary authority's most likely reaction to these developments will be to further accelerate the tightening pace, lifting the benchmark interest rate by 100 bps to 12.25% pa. This unanimous decision would be justified by the deterioration in the baseline scenario and inflation forecasts, with the balance of risks remaining upwardly asymmetric, requiring authorities to move further into contractionary territory.
- For the next meeting, the Copom will likely affirm that they see another adjustment of the same magnitude (that is, 100 bps) and indicate that, given the deterioration of their forecasts and the balance of risks, as well as the possibility of further de-anchoring of expectations, the policy rate will remain at contractionary levels for as long as is necessary, in view of its firm commitment to inflation convergence to the target. With this backdrop, we believe that the terminal rate will likely be higher than our current forecast of 13.50% pa.

1 – Inflation forecasts

The tables below summarize the projections 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 level utilized (6.00 reais per US dollar) follows the Central Bank's procedure of averaging the rates of the last 10 business days.

When compared to forecasts presented at the November meeting, 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) should rise to 4.8% in 2024 (from 4.6%), 4.6% in 2025 (from 3.9%), and, more importantly, 4.1% (from 3.6%) in the relevant horizon (2Q26), with no signs of convergence towards the 3% target in the relevant horizon for monetary policy.

Since the last Copom meeting, inflation expectations reported by the Focus survey increased sharply to 4.84% in 2024 (from 4.55%), to 4.59% in 2025 (from 4.00%) and to 4.00% in 2026 (from 3.60%). The forecast for the Selic rate increased to 12.00% for 2024 (from 11.75%), to 13.50% in 2025 (from 11.25%) and to 11.00% in 2026 (from 9.50%).

IPCA forecasts (%) according to "Central Bank model"*

Period	September Meeting	November Meeting	December Meeting (forecast)
2024	4.3%	4.6%	4.8%
2025	3.7%	3.9%	4.6%
Relevant horizon	3.5% (1Q26)	3.6% (2Q26)	4.1% (2Q26)
Exogenous variables			
Exchange Rate (R$/US$)	5.60	5.75	6.00
Selic Interest Rate (%) 2024	11.25%	11.75%	12.00%
Selic Interest Rate (%) 2025	10.50%	11.25%	13.50%
Selic Interest Rate (%) 2026	9.50%	9.50%	11.00%
Inflation Expectations (Focus) 2024	4.35%	4.55%	4.84%
Inflation Expectations (Focus) 2025	3.95%	4.00%	4.59%
Inflation Expectations (Focus) 2026	3.61%	3.60%	4.00%

Source: Bloomberg, Central Bank of Brazil, Itaú.

* Model developed by Itaú replicating Copom's model.

Focus forecasts *(%, year-end)*

	2024		2025		2026	
	Previous Copom	Current*	Previous Copom	Current*	Previous Copom	Current*
IPCA	4.55	4.84	4.00	4.59	3.60	4.00
GDP growth	3.10	3.39	1.93	2.00	2.00	2.00
Selic rate	11.75	12.00	11.25	13.50	9.50	11.00
Exchange rate (BRL/USD)	5.48	5.95	5.40	5.77	5.35	5.73

*considering the latest Focus report.

Source: BCB, Itaú.

2 – Asset prices

Since the last Copom meeting and until the publication of this report, the main change in asset prices involved the exchange rate, which depreciated sharply to 6.05 from 5.75 reais per US dollar. The perception of country risk as measured by the 5-year CDS went up slightly. Meanwhile, 10-year US Treasury yields receded slightly. Brent crude prices oscillated to the downside, to US$72/bbl from US$76/bbl, while agricultural and industrial commodity prices had a slight drop.

Asset prices		
	Previous Copom	Current*
UST 10Y	4.27	4.17
Oil price (Brent)	76	72
Agricultural commodities**	620	615
CRB RIND Index***	552	545
CDS 5Y	165	167
Exchange rate (BRL/USD)	5.75	6.05

*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 – Recent data

The table below shows the dataset released since the last Copom meeting. The positive surprise with 3Q24 GDP (+0.9% qoq/sa and +4.0% yoy vs. consensus at +0.8% and +3.8%, respectively) was the highlight, driven, on the supply side, by stronger growth in the services sector, and on the demand side, by strong household spending (thanks to a resilient labor market — demonstrated by the unemployment rate hitting an all-time low of 6.2% — and favorable credit conditions).

As for inflation, the latest mid-month consumer price index IPCA-15 printed above expectations in November (0.62% mom vs. consensus at 0.5%), with higher-than-anticipated price increases in volatile items that are not part of core inflation measures, such as airfares and travel packages. As for core inflation measures, underlying services prices came in below estimates, thanks to food consumed away from home, and underlying industrial prices were in line with expectations.

Economic Indicators: Result vs. Consensus			
Release Date	Indicator	Result	Consensus
07-Nov-24	Primary fiscal result (Sep/24) - BRL bn	-5.3	-5.4
08-Nov-24	IPCA (Oct/24) - MoM	0.56%	0.54%
12-Nov-24	Core Retail Sales (Sep/24) - MoM	0.5%	1.4%
13-Nov-24	IBGE Services Sector Volume (Sep/24) - MoM	1.0%	0.70%
14-Nov-24	IBC-Br (Sep/24) - MoM	0.80%	0.50%
25-Nov-24	IPCA-15 (Nov/24) - MoM	0.62%	0.50%
27-Nov-24	Formal job creation (Oct/24) - Thousands	132.7	192.5
28-Nov-24	IGP-M (Nov/24) - MoM	1.30%	1.17%
29-Nov-24	Unemployment rate (Oct/24)	6.2%	6.2%
03-Dec-24	GDP (3Q24) - QoQ	0.9%	0.8%
03-Dec-24	Primary fiscal result (Oct/24) - BRL bn	40.8	41
04-Dec-24	Industrial production (Oct/24) - MoM	-0.20%	0.10%
10-Dec-24	IPCA (Nov/24) - MoM	-	0.38%
11-Dec-24	IBGE Services Sector Volume (Oct/24) - MoM	-	0.6%

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

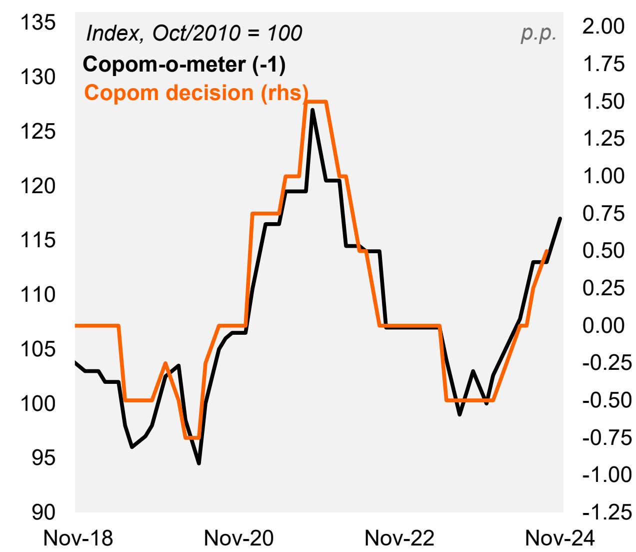
At its last monetary policy meeting, on November 5 and 6, the Copom unanimously decided to speed up the monetary tightening pace to 50 bps (from 25 bps in the previous meeting), taking the Selic rate to 11.25% pa, as widely expected.

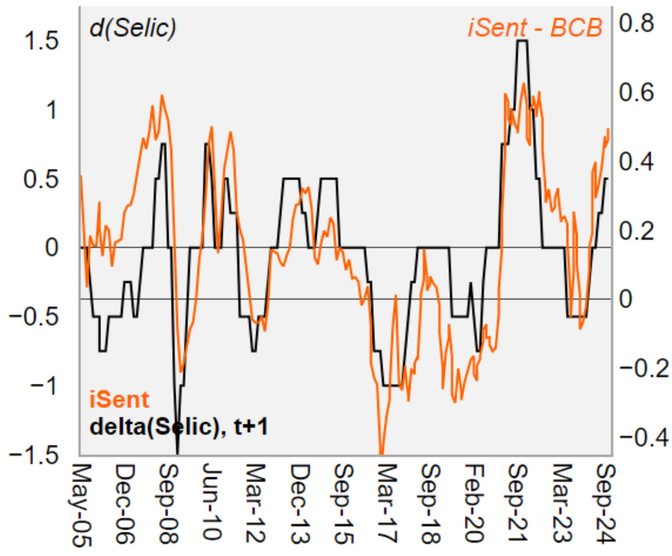
The post-meeting statement did not convey a particular pace for upcoming decisions, but the importance of structural fiscal measures (to be announced at the time) was quite clear. The minutes of that meeting indicated that authorities could extend the monetary tightening cycle if inflation expectations continued to deteriorate. The document also signaled that maintaining the 50-bp pace was appropriate at that time, considering prospective uncertainties and economic conditions. However, given the possible deterioration in economic conditions and inflation expectations, authorities left the door open for a faster tightening pace in the future.

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 messages convey more hawkish tones, and given current conditions, are compatible with expectations of a faster hiking pace for the Selic rate.

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 phrases published in official documents released by monetary authorities and 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 based on the relative presence of each classification within the document. 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 ~0.8). A visual analysis confirms that the index is a good fit with the change in the Selic rate one meeting down the road. In fact, the index was able to capture most shifts seen during the past 18 years, particularly the hiking cycles of the late 2000s and early 2020s. For the next meeting, the index suggests that recent communication is consistent with a faster increase in the benchmark rate.

Copom-o-Meter and Itaú iSent Classifier





5 – Our view

The past few months were marked by increasing uncertainty and risk aversion. Some of this pressure stemmed from the external background, but it was also largely driven by the government's announcement of a fiscal adjustment that, at least in a first moment, disappointed independent analysts. The exchange rate — a key variable for the inflation outlook — reached its weakest reading ever, accumulating steep depreciation (and quite decoupled from other emerging market currencies). Inflation expectations rose sharply, both on breakeven metrics implicit in asset prices and the Focus survey, where the median estimates for 2025 and 2026 surged, marking one of the sharpest increases in recent history, including on the critical date used as a reference for this week's Copom meeting. These concerning conditions require a more vigorous stance by the monetary authority.

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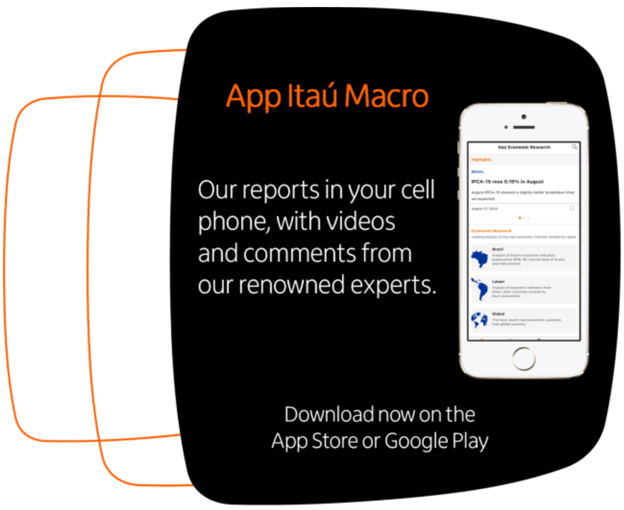

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