Macro Brazil

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Copom Cockpit: start of the tightening cycle, with 25 bps

- The Brazilian Central Bank's Monetary Policy Committee (Copom) will meet again on September 17 and 18, after weeks of intense volatility and with fundamentals that justify the beginning of an interest rate tightening cycle, starting with a pace of 25 bps.
- The BRL remained under pressure, close to recent highs, reflecting the noise in the BCB's communication and the ongoing uncertainties about the direction of the public accounts. In addition, the most recent activity data indicate that the economy has been stronger than the BCB expected at the last meeting and inflation expectations remain unanchored.
- Simulating the model used by Copom, with the exchange rate at BRL 5.60/USD and considering the deterioration of expectations 12 months ahead since the last meeting, in addition to some revision of the output gap – which should not be large given the still limited signs of contagion of stronger activity to inflation in services – we find an inflation forecast in the relevant horizon above the target, at 3.4%. With this forecast, we estimate that the interest rate necessary to bring the IPCA back to the target would be at least 12.00%. In this context, the initial hike cycle will likely not be large, totaling 150 bps. We expect the Selic rate at 11.75% by the end of 2024, starting with a pace of 25 bps in September, followed by two hikes of 50 bps later this year and a final hike of 25 bps at the first meeting of next year.
- Under these conditions, the monetary authority will likely renew in the statement its promise of vigilance and a firm commitment to converge inflation to the target, with the committee members unanimously opting to signal the resumption of the interest rate hike cycle starting in September. In this context, most members should emphasize the upward asymmetry of the balance of risks, amid higher forecasts and risks for the inflation trajectory.

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 (5.60 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 previous 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 oscillate to 4.1% (from 4.2%) for 2024, and to increase to 3.7% (from 3.6%) for 2025, and remain stable at 3.3% for 2026 (also stable at 3.4% in the 12-month period until 1Q26, vs the July meeting).

Since the last Copom meeting, inflation expectations reported by the Focus survey advanced to 4.30% from 4.10% for 2024, while receding 0.04pp to 3.92% for 2025, and remaining unchanged at 3.60% for 2026 — thus above the target for the entire horizon. Forecasts for the Selic rate increased to 11.25% in 2024 (from 10.50%), to 10.25% in 2025 (from 9.50%), and to 9.50% in 2026 (from 9.00%).

IPCA forecasts (%) according to "Central Bank model"*					
Period	**March Meeting**	**May Meeting**	**June Meeting**	**July Meeting**	**September Meeting (forecast)**
2024	3.5%	3.8%	4.0%	4.2%	4.1%
2025	3.2%	3.3%	3.4%	3.6%	3.7%
2026 / 1Q26	--	--	--	3.3% / 3.4%	3.3% / 3.4%
Exogenous variables					
Exchange Rate (R$/US$)	4.95	5.15	5.30	5.55	5.60
Selic Interest Rate (%) 2024	9.00%	9.63%	10.50%	10.50%	11.25%
Selic Interest Rate (%) 2025	8.50%	9.00%	9.50%	9.50%	10.25%
Selic Interest Rate (%) 2026	8.50%	8.75%	9.00%	9.00%	9.50%
Inflation Expectations (Focus) 2024	3.79%	3.72%	3.96%	4.10%	4.30%
Inflation Expectations (Focus) 2025	3.52%	3.64%	3.80%	3.96%	3.92%
Inflation Expectations (Focus) 2026	3.50%	3.50%	3.60%	3.60%	3.60%

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

Focus forecasts *(%, year-end)*						
	2024		**2025**		**2026**	
	Copom (Jul)	**Current***	**Copom (Jul)**	**Current***	**Copom (Jul)**	**Current***
IPCA	4.10	4.30	3.96	3.92	3.60	3.60
GDP growth	2.19	2.68	1.94	1.90	2.00	2.00
Selic rate	10.50	11.25	9.50	10.25	9.00	9.50
Exchange rate (BRL/USD)	5.30	5.35	5.25	5.30	5.25	5.30

*considering the latest Focus report.
Source: BCB, Itaú.

2 – Asset prices

Since the last Copom meeting and until the publication of this report, the 10-year US Treasury rate has fallen by 38 bps in response to the Fed signaling that the cycle of rate cuts will begin. The price of Brent crude oil fell sharply during the period, to USD 71 (from USD 81) per barrel, while the price of agricultural commodities increased slightly and that of industrial commodities remained stable. The exchange rate remained relatively stable, despite intense volatility since the last meeting, fluctuating between BRL 5.40 and BRL 5.70. This dynamic even led the Central Bank to intervene in the spot foreign exchange market on August 30 (US$1.5 billion auction). The perception of country risk measured by the 5-year CDS fell slightly (-2 bps to 156).

Asset prices		
	Last Copom (Jul)	Current*
UST 10Y	4.03	3.65
Oil price (Brent)	81	71
Agricultural commodities**	592	595
CRB RIND Index***	545	545
CDS 5Y	158	156
Exchange rate (BRL/USD)	5.65	5.66

*considering closing prices on September 11.
**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 set of indicators released between the last Copom meeting and the next one. In general, activity and labor market data continued to show signs that the Brazilian economy is growing above its potential. Current inflation, on the other hand, recorded better-than-expected performance and breakdown in August, but may still show greater pressure on underlying services by the end of the year.

On the activity front, GDP grew 1.4% qoq/sa (3.3% y/y) in 2Q24, above our estimate (+1.0% qoq/sa; 2.8% y/y) and the median of market expectations (+0.9% qoq/sa; 2.7% y/y). In general, the result included expansion of the public sector (government spending on the demand side and public administration on the supply side), in addition to resilient consumption and some recovery in investment (which has been at low levels). In our view, the increase in income (led by a resilient labor market), as well as the benign credit cycle and stronger capital market, have contributed to the GDP growth in the period.

In June, the industrial production increased 4.1% mom/sa, offsetting the impact of the floods in Rio Grande do Sul that had affected the industry in May. In July, industrial production fell by 1.4%, only partially offsetting the strong increase observed in the previous month. In the services sector, the PMS index of real revenue grew 1.7% mom/sa, above market expectations, while core retail sales fell by 1.0% (4.0% y/y), below expectations.

The labor market in July continued to show resilience, with the unemployment rate falling again. On inflation, the IPCA in July exceeded market expectations (result of 0.38% in the month, against the consensus at 0.35%), but the August result came in slightly below expectations, registering a drop of 0.02%, with many of the openings that showed pressure in the previous release, including core measures and services prices, falling in the monthly change.

Economic Indicators: Result vs. Consensus			
Release Date	Indicator	Result	Consensus
02-Aug-24	Industrial Production (Jun/24) - MoM	4.1%	2.7%
09-Aug-24	IPCA (Jul/24) - MoM	0.38%	0.35%
13-Aug-24	Core Retail Sales (Jun/24) - MoM	1.7%	0.8%
14-Aug-24	IBGE Services Sector Volume (Jun/24) - MoM	-1.0%	-0.2%
16-Aug-24	IBC-Br (Jun/24) - MoM	1.4%	0.5%
27-Aug-24	IPCA-15 (Aug/24) - MoM	0.19%	0.17%
28-Aug-24	Formal job creation (Jul/24) - Thousands	188	190
29-Aug-24	IGP-M (Aug/24) - MoM	0.29%	0.45%
30-Aug-24	Primary fiscal result (Jul/24) - BRL bn	-21.3	-6.9
30-Aug-24	Unemployment rate (Jul/24)	6.8%	6.8%
03-Sep-24	GDP (2Q24) - QoQ	1.4%	0.9%
04-Sep-24	Industrial Production (Jul/24) - MoM	-1.4%	-1.0%
10-Sep-24	IPCA (Aug/24) - MoM	-0.02%	0.01%
11-Sep-24	IBGE Services Sector Volume (Jul/24) - MoM	1.2%	0.0%
12-Sep-24	Core Retail Sales (Jul/24) - MoM	0.6%	0.5%
13-Sep-24	IBC-Br (Jul/24) - MoM	-	-

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 July 30 and 31, the Copom kept the Selic rate unchanged at 10.50%, for the third consecutive time, as widely expected by the market. The decision was once again unanimous, as in the previous meeting.

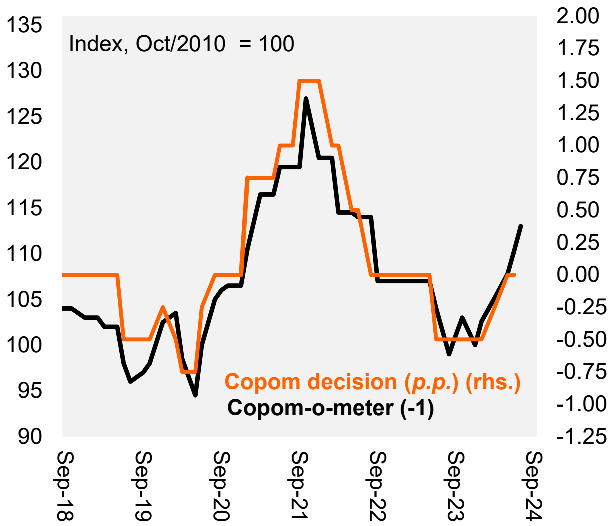
Although the authorities opted for an on-hold decision, the committee highlighted in the last minutes that it is ready to increase the Selic rate, if the upward trend in inflation forecasts and the unfavorable dynamics of the exchange rate persist. In the balance of risks, the committee maintained the assessment that in its inflation scenarios, risk factors remain in both directions. However, the authorities mentioned that during the discussions, all members agreed that there are more upside risks to inflation, with several members even emphasizing the asymmetry of the balance of risks. The monetary authority also continued to reinforce that it monitors the implications of fiscal policy on monetary policy and asset prices (i.e., the exchange rate).

In the weeks following the last Copom meeting, BCB directors signaled to the press that the committee will spare no effort to bring inflation to the target, reinforcing the tougher tone of the last minutes.

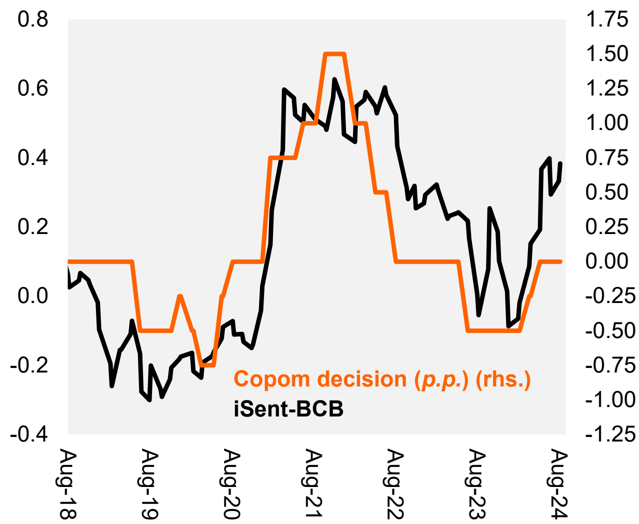
In order to try to anticipate Copom's decisions, we use the Copom-o-meter, an index that measures the degree of restriction or expansion implicit in the Central Bank's communication. Applying the methodology (based on scores attributed to relevant communication by the committee), we understand that the messages have a more hawkish tone, consistent with the signals of an increase in 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 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.

Copom-o-Meter and Itaú iSent Classifier



Source: BCB, Itaú Unibanco



Source: BCB, Itaú Unibanco

5 – Our view

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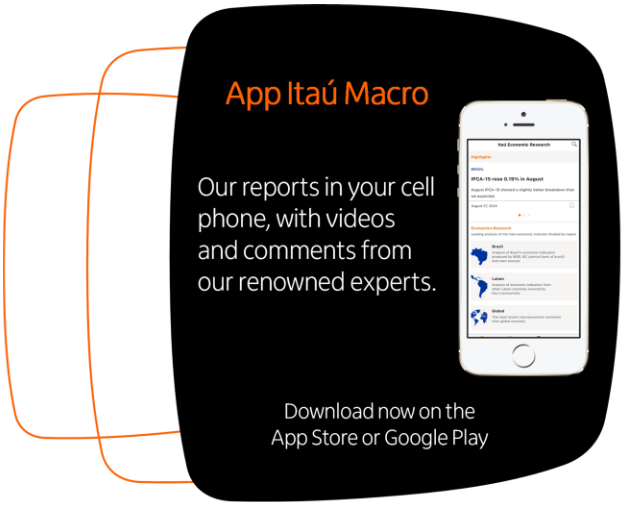

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