Macro Brazil

June 14, 2024

Copom Cockpit: end of cycle

- The Brazilian Central Bank's Monetary Policy Committee (Copom) will meet again on June 18 and 19, after weeks of intense volatility in the markets – fueled, along with other reasons, by the dissent in the previous decision. The BRL reached its weakest levels of 2024, decoupling from peer currencies. Our broad measure of country risk – which is based on asset prices and their relative performance – went up again after reaching post-pandemic lows earlier this year. It's reasonable to state that the domestic uncertainties mentioned in the committee's latest communications remain elevated and might even have increased, particularly with regard to the perception of the risks of changes to the main parameters of the fiscal framework approved last year.
- On the data evolution side, despite recent releases of inflation with a benign composition, the breakdown of May's IPCA showed that core services inflation accelerated again at the margin. In addition, inflation expectations reported in the Focus survey rose significantly. Economic activity remains resilient, with robust GDP and labor market figures standing out.
- Under these conditions (especially the deterioration in expectations), even if exchange-rate performance improves, we see that the committee will unanimously decide to maintain the current interest rate level of 10.50% pa at its next meeting.
- In its communication, we expect the Copom to indicate that increased uncertainty requires additional caution in the conduct of monetary policy, with the committee members unanimously opting to communicate that monetary policy should remain at a contractionary stance for as long as necessary until not only the disinflation process is consolidated, but also the anchoring of expectations around their targets.
- The balance of risks for inflation should continue to be described as symmetrical, despite elevated risks, amidst a more uncertain international outlook and fiscal convergence paths.
- Regarding the Copom's inflation forecasts, estimates will likely rise to 4.0% and 3.5% for 2024 and 2025 (from 3.8% and 3.3%, respectively).

1 – Inflation forecasts

When compared to forecasts presented in the May's 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 4.0% from 3.8% for 2024 and to 3.5% from 3.3% for 2025.

Since the last Copom meeting, inflation expectations reported by the Focus survey increased to 3.90% from 3.72% for 2024, rose 14 bps to 3.78% for 2025, and advanced 10 bps to 3.60% for 2026, thus above the target for the entire horizon. Forecasts for the Selic rate reached 10.25% for 2024 (from 9.63% previously), 9.25% for 2025 (from 9.00%), and 9.00% for 2026 (from 8.75%).

The tables below summarize the estimates based on our model, which attempts to replicate the BCB's small-scale model, and changes in the Focus survey since the last committee meeting. The exchange rate (at BRL 5.35/USD) considers the Central Bank's standard of using the average of the last 10 working days.

Focus forecasts *(%, year-end)*						
	2024		2025		2026	
	Copom (May)	Current*	Copom (May)	Current*	Copom (May)	Current*
IPCA	3.72	3.90	3.64	3.78	3.50	3.60
GDP growth	2.05	2.09	2.00	2.00	2.00	2.00
Selic rate	9.63	10.25	9.00	9.25	8.75	9.00
Exchange rate (BRL/USD)	5.00	5.05	5.05	5.09	5.10	5.10

*considering the latest Focus report.

Source: BCB, Itaú.

IPCA forecasts (%) according to "Central Bank model"*				
Period	January Meeting	March Meeting	May Meeting	June Meeting (forecast)
2024	3.5%	3.5%	3.8%	4.0%
2023	3.2%	3.2%	3.3%	3.5%
Exogenous variables				
Exchange Rate (R$/US$)	4.95	4.95	5.15	5.35
Selic Interest Rate (%) 2024	9.00%	9.00%	9.63%	10.25%
Selic Interest Rate (%) 2025	8.50%	8.50%	9.00%	9.25%
Inflation Expectations (Focus) 2024	3.81%	3.79%	3.72%	3.90%
Inflation Expectations (Focus) 2025	3.50%	3.52%	3.64%	3.78%
Inflation Expectations (Focus) 2026	3.50%	3.50%	3.50%	3.60%

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

2 – Asset prices

Since the last Copom meeting and until the publication of this report, 10-year US Treasury yields declined to 4.24% from 4.49%. Brent crude fell slightly to $83/bbl from $84/bbl, while agricultural and industrial commodity prices remained broadly stable. The exchange rate, currently at 5.36, depreciated significantly from the 5.09 reais per dollar seen at the May's meeting. Country risk measured by the 5-year CDS rose to 157bps from 138bps.

Asset prices		
	Last Copom (May)	Current*
UST 10Y	4.49	4.24
Oil price (Brent)	84	83
Agricultural commodities**	693	697
CRB RIND Index***	556	552
CDS 5Y	138	157
Exchange rate (BRL/USD)	5.09	5.36

*considering closing prices on June 13.
**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 labor market continue showing strength, while core services inflation remains at higher levels.

GDP grew by 0.8% qoq/sa in 1Q24, slightly above our estimate and the median of market expectations (both +0.7%), with resilient consumption and a recovery of investment. Household consumption was underpinned by a resilient labor market and rising income (due to the extra payments of *'precatórios'*, court-ordered debts, combined with the increase in social benefits linked to the minimum wage rise). Regarding the economic indicators for April, industrial production contracted by 0.5% in the month (+8.4% y/y), interrupting a sequence of two consecutive months of growth. The drop in industrial production in April was driven by the mining and quarrying segment, which fell 3.4% against the previous month, while the manufacturing industry was higher than expected, advancing 0.3% m/m. Meanwhile, the service sector real revenue rose 0.5% m/m seasonally adjusted (5.6% y/y), slightly above our forecast (0.4% m/m; 5.4% y/y) and exceeding the median of market expectations (0.2% m/m; 4.3% y/y). Despite the positive monthly change in services, it's worth noting the fall in professional services and services offered to households, which have a higher weight in GDP and therefore indicate some moderation in economic activity in the 2nd quarter. Finally, expanded retail sales disappointed in April, falling 1.0% in the seasonally adjusted monthly comparison (+4.9% y/y), below our forecast (+0.2% m/m) and the median of market expectations (+0.3% m/m).

As for inflation, the IPCA for May slightly exceeded market expectations, coming in at 0.46% compared to the 0.42% consensus expectation. The data revealed a renewed acceleration in core services inflation, particularly in labor-intensive services which remain under strain. We anticipate a further uptick in this category throughout the year, driven by the tight labor market. The recent uptick in core services inflation marks a pause in the previous trend of improvement observed up to the May IPCA-15, which reported lower-than-expected figures with a favorable breakdown.

Release Date	Indicator	Result	Consensus
10-May-24	IPCA (Apr/24) - MoM	0.38%	0.35%
14-May-24	IBGE Services Sector Volume (Mar/24) - MoM	0.4%	0.2%
15-May-24	IBC-Br (Mar/24) - MoM	-0.34%	-0.25%
28-May-24	IPCA-15 (May/24) - MoM	0.44%	0.47%
29-May-24	IGP-M (May/24) - MoM	0.89%	0.83%
29-May-24	Primary fiscal result (Feb/24) - BRL bn	6.7	15.0
29-May-24	Unemployment rate (Apr/24)	7.5%	7.7%
29-May-24	Formal job creation (Apr/24) - Thousands	240	210
04-Jun-24	GDP (1Q24) - QoQ	0.80%	0.70%
05-Jun-24	Industrial production (Apr/24) - MoM	-0.5%	-0.4%
11-Jun-24	IPCA (May/24) - MoM	0.46%	0.42%
12-Jun-24	IBGE Services Sector Volume (Apr/24) - MoM	0.5%	0.2%
13-Jun-24	Core Retail Sales (Apr/24) - MoM	0.9%	1.7%
14-Jun-24	IBC-Br (Apr/24) - MoM	0.01%	0.30%

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

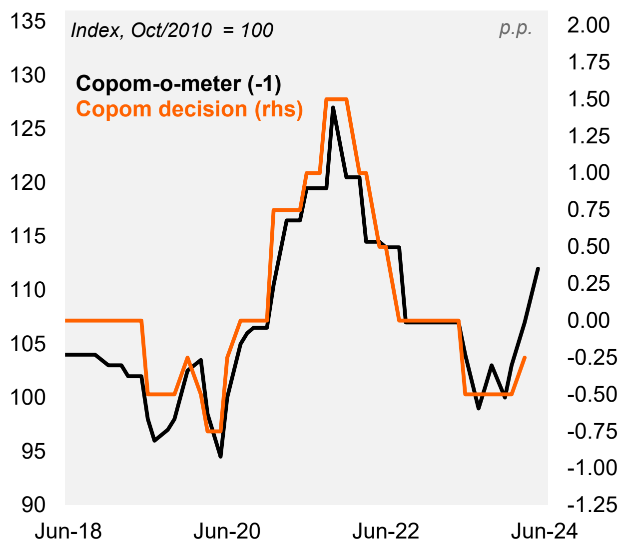
4 – Communication changes, Copom-o-Meter, and algorithm for reading meeting minutes

At its last monetary policy meeting, on May 7 and 8, the Copom reduced the pace of interest rate cuts, opting for a 25 bp cut. Among the members of the committee, there was dissent in the decision, with four of the nine directors, those who joined the Copom most recently, preferring a larger reduction, of 50 bp.

In the minutes, the committee provided a detailed discussion of the reason for the disagreement between the members and the breach of the forward guidance. According to the document, the majority of the committee considered that the expected scenario was not confirmed due to the additional unanchoring of expectations, the rise in inflation forecasts, the more adverse international outlook and more dynamic economic activity than expected. For this group, there was a change in the scenario compared to what was expected, which justified breaking the future guidance. Therefore, these members felt that a 25 bp reduction was more appropriate. On the other hand, the Copom members who voted to reduce the Selic rate by 50 b.p., although they also shared the perception of increased internal and external uncertainties, chose to follow the guidance from the previous meeting, fearing the reputational cost of not following the signal given at the previous meeting. According to the minutes, this minority reaffirmed its firm commitment to the target and to the required terminal interest rate so that the Committee's primary objective of converging inflation to the target is achieved. Both in the communiqué from the last meeting and in the minutes, the Copom kept the next steps in monetary policy open, reaffirming its commitment to convergence of inflation to the target, and thus making room for the end of the cycle of cuts, which began in June last year.

In order to try to anticipate the 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, suggests a pause in the easing cycle.

Itaú Unibanco Copom-o-Meter



Source: BCB, Itaú

5 – Our view

The Copom will meet again next Wednesday, after weeks of intense volatility in the markets – fueled, along with other reasons, by the dissent in the previous decision. The BRL reached its weakest levels of 2024, decoupling from peer currencies. Our broad measure of country risk – which is based on asset prices and their relative performance – went up again after reaching post-pandemic lows earlier this year. It’s reasonable to state that the domestic uncertainties mentioned in the committee’s latest communications remain elevated and might even have increased, particularly with regard to the perception of the risks of changes to the main parameters of the fiscal framework approved last year.

On the data evolution side, despite recent releases of inflation with a benign composition, the breakdown of May’s IPCA showed that core services inflation accelerated again at the margin. In addition, inflation expectations reported in the Focus survey rose significantly. Economic activity remains resilient, with robust GDP and labor market figures standing out.

Under these conditions (especially the deterioration in expectations), even if exchange-rate performance improves, we see that the committee will unanimously decide to maintain the current interest rate level of 10.50% pa.

In its communication, we expect the Copom to indicate that increased uncertainty requires additional caution in the conduct of monetary policy, with the committee members unanimously opting to communicate that monetary policy should remain at a contractionary stance for as long as necessary until not only the disinflation process is consolidated, but also the anchoring of expectations around their targets.

The balance of risks for inflation should continue to be described as symmetrical, despite elevated risks, amidst a more uncertain international outlook and fiscal convergence paths.

Macro Research – Itaú
Mario Mesquita – Chief Economist

To access our reports and forecast visit our website:
https://www.itau.com.br/itaubba-pt/macroeconomic-analysis

Relevant Information

1. This report has been prepared and released by the Macro Research Department of Itaú Unibanco S.A. (“Itaú Unibanco”). This report is not a product of the Equity Research Department of Itaú Unibanco or Itaú Corretora de Valores S.A. and shall not be construed as a research report (“relatório de análise”) for the purposes of Article 1 of the CVM Instruction NR. 20, dated 2021.
2. The exclusive purpose of this report is to provide macroeconomics information and it does not constitute and shall not be construed as an offer to buy or sell or a solicitation of an offer to buy or sell any financial product, or to participate in any particular trading strategy in any jurisdiction. The information herein is believed to be reliable as of the date on which this report was released and it has been obtained from public sources believed to be reliable. However, Itaú Unibanco does not make any explicit or implied representation or warranty as to the completeness, reliability or accuracy of such information, nor does this report intend to be a complete statement or summary of the markets or developments referred to herein. Itaú Unibanco has no obligation whatsoever to update, modify or amend this report and inform the reader accordingly.
3. The opinions contained herein reflect exclusively the personal views of the analyst responsible for this report and were prepared independently and autonomously, including in relation to Itaú Unibanco, Itaú Corretora de Valores S.A. and any other companies within their economic group.
4. This report may not be reproduced or redistributed to any other person, in whole or in part, for any purpose, without the prior written consent of Itaú Unibanco. Additional information on the financial products mentioned in this report may be available upon request. Itaú Unibanco and/or any other company within its economic group is not and shall not be liable for any investment decisions (or otherwise) based on the information provided herein.

Additional Note: This material does not take into consideration the objectives, financial situation or specific needs of any particular client. Clients must obtain financial, tax, legal, accounting, economic, credit and market advice on an individual basis, based on their personal characteristics and objectives, prior to making any decision based on the information contained herein. By accessing the material, you represent and confirm that you understand the risks related to the financial instruments described in this material and the laws in your jurisdiction relating to the provision and sale of financial service products. You acknowledge that this material contains proprietary information and you agree to keep this information confidential for your exclusive use.

For inquiries, suggestions, complaints, criticisms and compliments, talk to Itaú’s CSCC: 0800 728 0728. Or contact us through our portal https://www.itau.com.br/atenda-itau/para-voce/. If you are not satisfied with the proposed solution, please contact the Itaú Corporate Ombudsman: 0800 570 0011 (on weekdays from 9 AM to 6 PM) or our PO Box 67.600, São Paulo-SP, Zip Code 03162-971. Hearing impaired, every day, 24h, 0800 722 1722.