May 6, 2024

Copom Cockpit: slowing down amid greater uncertainty

- The Brazilian Central Bank's Monetary Policy Committee (Copom) will meet again on May 7 and 8 against a backdrop of greater uncertainty, which elicits caution, both externally (postponement and reduced room for interest rate cuts in developed economies, albeit with a slightly better scenario at the margin) and domestically (in the form of a delayed and more uncertain convergence of the dynamics of public accounts).
- Recent data also suggest the need for a more cautious stance. Despite more benign inflation at the margin (with downside surprises in the latest IPCA and IPCA-15 consumer price indicators), underlying services measures remain high. Furthermore, unemployment and wage data continue to indicate a tight labor market. The exchange rate depreciated since the last meeting, with the deterioration in domestic fiscal fundamentals and the potential postponement of interest rate cuts in the US.
- Given these circumstances, we believe that the committee will decide to slow down the pace of rate cuts to 25 bps, taking the Selic rate to 10.50% pa. This path differs from the signal conveyed at the last meeting —consistent with another 50-bp reduction— but will not be at all surprising in light of the latest communications from committee members and the magnitude of changes seen since then. For the next meetings, we expect the Copom to maintain a signal of data-dependence, reaffirming that higher uncertainty requires caution in monetary policy decisions.
- The balance of risks for inflation should continue to be described as symmetric, with a possible indication of increased risks, given higher uncertainty in the international outlook and in the convergence of fiscal trajectories. Considering the current scenario, authorities may also choose to explicitly mention the tighter labor market.
- The Copom's inflation forecasts should rise to 3.9% for 2024 and 3.4% for 2025 (from 3.5% and 3.2%, respectively).

1 – Inflation forecasts

When compared to forecasts presented in the March 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 3.9% from 3.5% for 2024 and to 3.4% from 3.2% for 2025.

Since the last Copom meeting, inflation expectations reported by the Focus survey declined to 3.72% from 3.79% for 2024, while rising by 12 bps to 3.64% for 2025, and remaining unchanged at 3.50% for 2026, thus above the target for the entire horizon. Forecasts for the Selic rate reached 9.63% for 2024 (from 9.00% previously), 9.00% for 2025 (from 8.50%), and 8.75% for 2026 (from 8.50%).

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. Despite the recent appreciation, the exchange rate (at BRL 5.15/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 (Mar)	Current*	Copom (Mar)	Current*	Copom (Mar)	Current*
IPCA	3.79	3.72	3.52	3.64	3.50	3.50
GDP growth	1.80	2.05	2.00	2.00	2.00	2.00
Selic rate	9.00	9.63	8.50	9.00	8.50	8.75
Exchange rate (BRL/USD)	4.95	5.00	5.00	5.05	5.04	5.10

*considering the latest Focus report.

Source: BCB, Itaú.

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

Period	October meeting	December meeting	January meeting	March meeting	May meeting (forecast)
2024	3.6%	3.5%	3.5%	3.5%	3.9%
2023	3.2%	3.2%	3.2%	3.2%	3.4%
Exogenous variables					
Exchange Rate (R$/US$)	5.00	4.90	4.95	4.95	5.15
Selic Interest Rate (%) 2024	9.25%	9.25%	9.00%	9.00%	9.63%
Selic Interest Rate (%) 2025	8.75%	8.50%	8.50%	8.50%	9.00%
Inflation Expectations (Focus) 2024	3.90%	3.93%	3.81%	3.79%	3.72%
Inflation Expectations (Focus) 2025	3.50%	3.50%	3.50%	3.52%	3.64%

Source: Bloomberg, Central Bank of Brazil, Itaú.
* Model developed by Itaú replicating Copom's model.
** Considers the average of the last 10 working days.

2 – Asset prices

Since the last Copom meeting and until the publication of this report, 10-year US Treasury yields climbed to 4.51% from 4.27%. Brent crude fell to $83/bbl from $86/bbl (though with some volatility during this period). Agricultural and industrial commodity prices went up slightly. The exchange rate experienced great volatility between meetings, reaching 5.29 reais per US dollar and rebounding to 5.07 – still weaker than the 4.97 reais per dollar seen at the March meeting. Country risk measured by the 5-year CDS interrupted its downward trend and rose slightly to 139bps from 137bps.

Asset prices	Last Copom (Mar)	Current*
UST 10Y	4.27	4.51
Oil price (Brent)	86	83
Agricultural commodities**	661	688
CRB RIND Index***	544	556
CDS 5Y	137	139
Exchange rate (BRL/USD)	4.97	5.07

*considering closing prices on May 3rd.
**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 data released since the last Copom meeting. Overall, we see signs of strength in economic activity and in the labor market in early 2024, while core services inflation continues running at high levels.

Retail sales beat expectations in February, with the core measure advancing 1.0% (while consensus pointed to a decline of -1.5%), backing our view that court-ordered payments, or precatorios (disbursed to households at the beginning of the year), and the increase in the minimum monthly wage are boosting consumer spending. The services sector receded 0.9% in February (vs. consensus at 0.2%), dragged by transportation and professional services. Despite the decline in the headline index, the category of services provided to households – closely tied to consumption and relevant to our GDP estimate – advanced at the margin. As for industrial production, the index rose 0.9% mom/sa (-2.8% yoy), below market's estimates (+1.4% mom/sa). The lower-than-expected manufacturing result was partially offset by an upward revision in the indicator in the previous month. In 1Q24, industrial production expanded 0.3% qoq/sa, reflecting a breakdown of +1.0% for manufacturing and -3.9% for mining/extractive. The labor market remains tight, with fast creation of formal jobs, lower unemployment, and robust growth in the wage bill.

As for inflation, the consumer price index IPCA decelerated in March, rising 0.16% (vs. consensus at 0.25%). The mid-month IPCA-15 also printed below expectations in April, but the surprise was concentrated in volatile items. However, the breakdown shows that underlying inflation measures remain under pressure, particularly from items related to the workforce and the job market.

Economic Indicators: Result vs. Consensus

Release Date	Indicator	Result	Consensus
26-Mar-24	IPCA-15 (Mar/24) - MoM	0.36%	0.30%
27-Mar-24	IGP-M (Mar/24) - MoM	-0.47%	-0.24%
27-Mar-24	Formal job creation (Feb/24) - Thousands	306	236
28-Mar-24	Unemployment rate (Feb/24)	7.7%	7.8%
03-Apr-24	Industrial production (Feb/24) - MoM	-0.3%	0.2%
05-Apr-24	Primary fiscal result (Feb/24) - BRL bn	-48.7	-49.0
10-Apr-24	IPCA (Mar/24) - MoM	0.16%	0.25%
11-Apr-24	Core Retail Sales (Feb/24) - MoM	1.0%	-1.5%
12-Apr-24	IBGE Services Sector Volume (Feb/24) - MoM	-0.9%	0.2%
17-Apr-24	IBC-Br (Feb/24) - MoM	0.40%	0.35%
26-Apr-24	IPCA-15 (Apr/24) - MoM	0.21%	0.29%
29-Apr-24	IGP-M (Apr/24) - MoM	0.31%	0.10%
30-Apr-24	Formal job creation (Mar/24) - Thousands	244	194
30-Apr-24	Unemployment rate (Mar/24)	7.9%	8.1%
03-May-24	Industrial production (Mar/24) - MoM	0.9%	1.4%
06-May-24	Primary fiscal result (Mar/24) - BRL bn	-	-

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 March 19 and 20, the Copom continued the easing pace (50 bps) and rightly chose to shorten its guidance given the increased uncertainty, signaling another 50-bp move only at the next meeting (and not in future meetings, as it had been doing). Notwithstanding these greater risks, the Copom also stated that its inflation and activity scenario has not changed materially and maintained its inflation forecast for 2025 (the main point of the relevant horizon) above the target, at 3.2%.

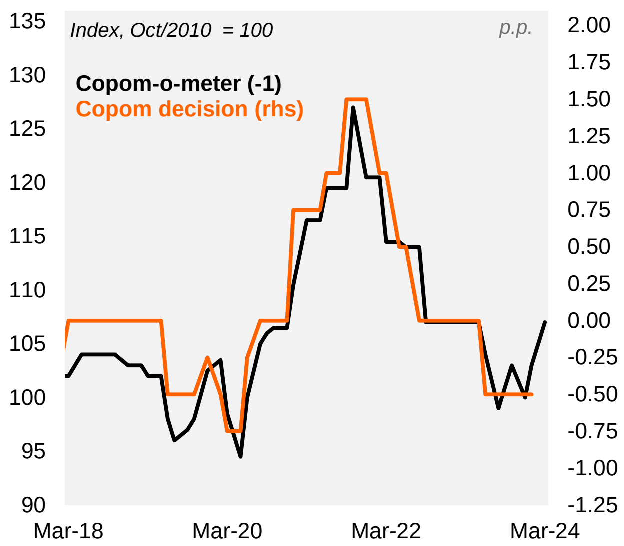
In the minutes of the last meeting, the Copom provided more details on why the guidance became shorter. The committee emphasized a cost/benefit analysis of this decision, in which the advantage of lower volatility was recently outweighed by the cost of inflexibility in a more uncertain environment — in terms of activity and inflation as well. The authorities stressed that the change in the guidance should not be confused with an indication of a change in the size of the easing cycle. However, in a critical section (paragraph 23), the Copom highlighted that upcoming data reports will be key to define the pace and, mainly, the terminal rate.

In public communications after the meeting, in a week marked by the depreciation of the Brazilian currency, increased geopolitical risks, and global risk aversion, the President of the Central Bank avoided making a commitment to a specific course of action, mentioning that monetary policy will adjust to the evolution of the scenario –possibly a reduction in the easing pace and in total rate cuts– depending on the level of uncertainty. Market players interpreted such statements as more hawkish, accelerating the repricing of the domestic yield curve in the direction of fewer interest rate cuts going forward.

Another Copom member emphasized that current inflation has improved, considering the IPCA reading in March, and that the Central Bank should act with caution and serenity while US Treasuries are repricing, even if it runs the risk of being a little further behind in the reaction function.

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, suggests a smaller budget for rate cuts, and creates space for a discussion about a slower pace or even a pause in the easing cycle.

Itaú Unibanco Copom-o-Meter



Source: BCB, Itaú

5 – Our view

The next meeting will happen against a backdrop of greater uncertainty, which elicits caution, both externally (postponement and reduced room for interest rate cuts in developed economies, albeit with a slightly better scenario at the margin) and domestically (in the form of a delayed and more uncertain convergence of the dynamics of public accounts).

Recent data also suggest the need for a more cautious stance. Despite more benign inflation at the margin (with downside surprises in the latest IPCA and IPCA-15 consumer price indicators), underlying services measures remain high. Furthermore, unemployment and wage data continue to indicate a tight labor market. The exchange rate depreciated since the last meeting, with the deterioration in domestic fiscal fundamentals and the potential postponement of interest rate cuts in the US.

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