VotorantimAsset

Monthly Economic Outlook

June | 2015

Monetary tightening cycle is coming to an end

With the first half of 2015 almost over, the conditions are ripening for the Central Bank to end its monetary tightening cycle. The expectations that are now being formed, however, are that the Selic rate will be left on hold for a long period, whether it end the cycle on 13.75% with one last hike of 50 basis points at the June meeting or, as we consider more likely, on 14%, with an additional rise of 25 bps at the July meeting, in order to conclude the process of inflation expectation convergence to the 4.5% official target in the years ahead.

Analysts' forecasts for the official consumer price index (IPCA) in the coming years are starting to converge to this value, according to the Central Bank's Focus report, but only for a relatively long-term horizon. In the last issue of the report in May, the median consensus forecast was 4.5% in 2019. For the nearer term, such as 2017 and 2018, the median consensus forecast has been falling since January: it is now 4.90% for 2017 and 4.70% for 2018.

The Central Bank's directors continue to insist they will do whatever it takes to ensure that inflation falls to 4.5% as early as 2016. The consensus forecast is 5.5% for 2016, according to Focus, similar to our own projection of 5.6%. Additional tightening of 250 bps would be needed to close the gap, all other things remaining constant. The Central Bank's March inflation report, on the other hand, projected 4.9% for end-2016. Thus according to the model used by the monetary authorities an additional rise of 100 bps would be needed for next year's IPCA to come close to the midpoint of the target range and the tightening cycle to be deemed over. The March Selic was 12.75%, but at that time analysts were forecasting lower inflation for 2015 (7.9%) than they are now (8.4%), implying that the official projection must have deteriorated fairly significantly. Given the higher inertial inflation to be combated in 2016, the monetary effort will have to be somewhat stronger than 100 bps.

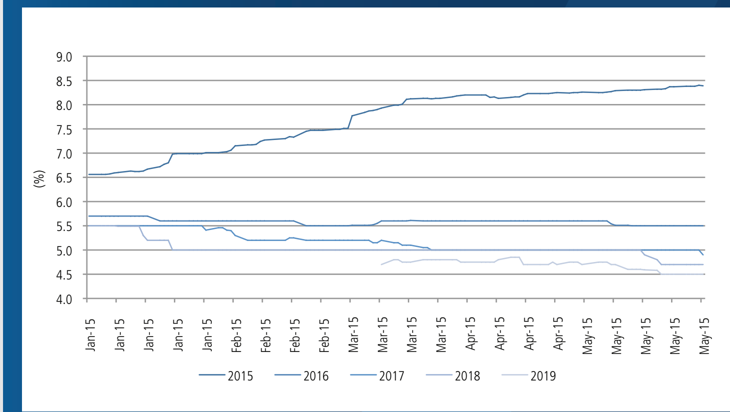
Because the social cost of monetary tightening is very high, we do not believe the Central Bank will insist on bringing market expectations according to the Focus report down to the midpoint of the target range in 2016. Instead, it will aim at its model's projection for that year. The result, in our view, will be a very gradual process of convergence to the target: according to our projections, the IPCA will decelerate year by year, coming in very close to the target in 2018. Even so the process is already very costly to economic activity, especially in conjunction with fiscal tightening.

GDP contracted 0.2% in the first quarter of 2015 compared with the previous quarter, according to IBGE. The statistics captured a less intense contraction than expected in the industrial sector. However, the consensus forecast based on coincident indicators, and above all on qualitative measures of business and consumer confidence, is that GDP will contract more sharply in the second quarter. For now we estimate a 1% contraction compared with the first quarter.

Furthermore, a resumption of economic growth in the second half of this year is now looking less likely in light of the current evolution of several key economic indicators. The rise already seen in the unemployment rate, sharply falling real incomes and the decelerating credit market will weigh on household consumption in the coming quarters. As for investment, the fact that confidence has not yet turned up, as evidenced by FGV's surveys, whose indices are fluctuating at similar levels to those seen during the 2008-09 crisis, means a rise in this activity is unlikely in the short term, possibly not until 2016. And given fiscal consolidation in the public sector, that leaves only the external sector to exert a positive effect on the domestic economy, although Brazil is a relatively closed economy to international trade. Thus the outlook for the second half is starting to point to economic stagnation following the contraction seen in the first half, so that the overall result for 2015 is set to be a GDP contraction of approximately 1%.

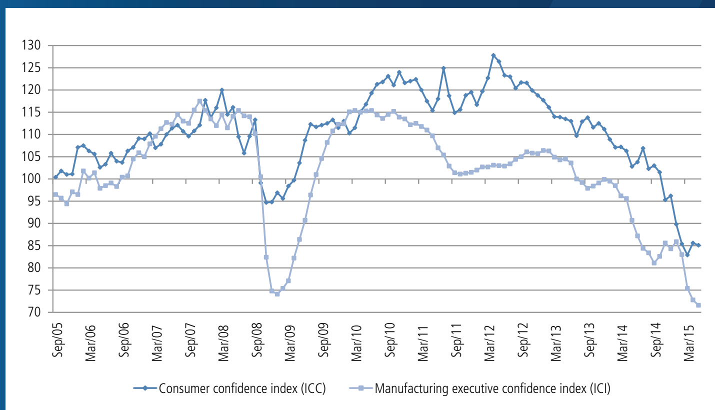
The local environment, however, has benefited from the US economy's uneven performance, with inflation still below the level deemed desirable by the Fed, which has therefore postponed the first interest-rate rise, so that at least this source of volatility for asset prices has not been created. Indeed, the Central Bank should take advantage of the Brazilian Real's relative stability to end the monetary tightening cycle before materialization of the alternative scenario in which exchange-rate pressure potentially hinders the convergence of inflation expectations to the target.

Inflation: median consensus forecast



Source: Central Bank of Brazil (Focus report)

Consumer & business confidence



Source: FGV