Macro Monthly Letter

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The right amount of economic slowdown?

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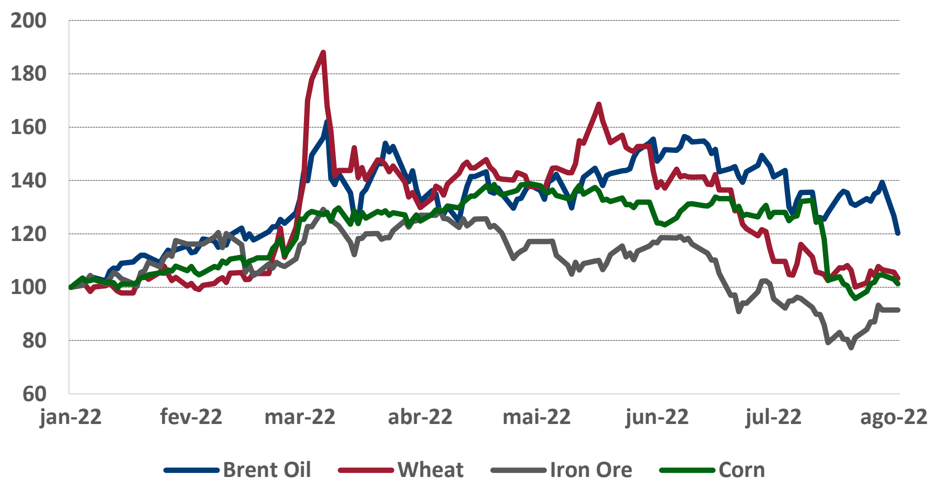
The inflation outlook is improving thanks to the reversal of several factors that were pressuring the prices of regulated items, food and industrial goods earlier in the year. First, the prices of energy and agricultural commodities, among others, have turned down after rising sharply in February with the start of the Russia-Ukraine war. For example, both Brent crude and wheat are back where they were before the war (Figure 1). Second, increased mobility is improving the logistics of production and distribution via a reduction in shipping costs and delivery times. Third, various indicators are pointing to a slowdown in the main developed economies, including the United States, China and the eurozone countries.

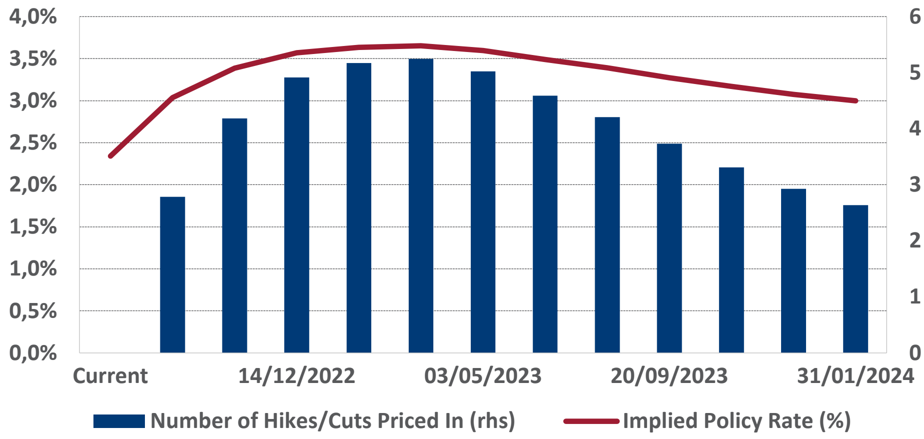
Figure 1 - Commodities Prices (01/jan/2020 = 100)



Source: Bloomberg, BOCOM BBM

In the US, the slowdown has come in the wake of post-Covid fiscal and monetary normalization. The FOMC raised the fed funds rate by 75 basis points for the second time at its last meeting. The rate is now 2.25%-2.5% and is expected to reach 3.6% by the end of this year (Figure 2). If on one hand this adjustment could be sufficient to bring inflation back into the target range, with a moderate impact on economic activity (as priced in by the stock market), on the other hand the generalized rise in prices throughout the economy, including services, and the extremely tight labor market could make convergence toward the target slower than expected, leading to an even more restrictive interest rate and far more severe impacts on economic activity.

Figure 2 - Fed Funds: Hikes/Cuts Priced In and Implied Policy Rate

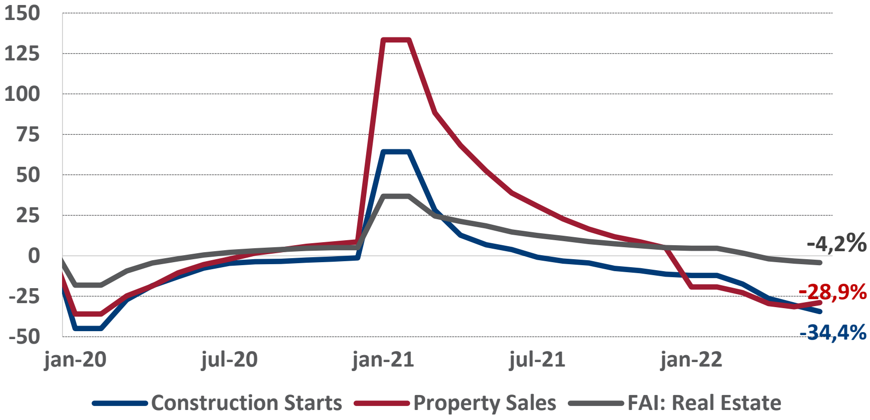


Source: Bloomberg, BOCOM BBM

The European Central Bank (ECB) also embarked on a monetary tightening cycle, raising its policy rates by 50 bps in July. This was its first rate hike since 2011, ending an eight-year period of negative rates. The hike was sharper than expected, and was accompanied by the approval of a transmission protection instrument (TPI) designed to ensure that the monetary policy stance is smoothly transmitted across all eurozone countries. According to a press release issued by the ECB, it will be able to counter risks to the transmission mechanism by making secondary-market purchases of securities issued in jurisdictions that are experiencing a deterioration in financing conditions not warranted by country-specific fundamentals.

In China, the end of mobility restrictions imposed to combat novel variants of SARS-CoV-2 boosted economic activity in the near term, and a degree of recovery was reported in the end of the second quarter. The many packages of measures announced by the Chinese government, such as infrastructure projects and tax cuts or deferrals, have not been particularly effective in terms of stimulating domestic consumption, owing to uncertainty about the continuation of the zero-Covid policy. The real estate sector is facing huge difficulties following the announcement that homebuyers plan to boycott mortgage payments on unfinished houses. The increase in risk for the sector has reduced sales and new constructions still further (Figure 3).

Figure 3 - China: Real Estate Sector (YTD YoY, %)



Source: CEIC, BOCOM BBM

In Brazil, the slowdown in the main developed economies and decelerating commodity prices (and demand) have significantly reduced inflationary pressures on notoriously volatile items. However, the elevated price adjustment diffusion of several items in IPCA, alongside core rates surpassing 10%, show that inflation will converge slowly to the target. In its latest decision, the Central Bank of Brazil raised its policy rate (Selic) by another 50 bps to 13.75% p.a. Although the post-meeting statement did not rule out continuation of the tightening cycle at the next meeting, it signaled that the "relevant monetary policy horizon" is now 2024 and emphasized that its 12-month inflation projection for the first quarter of 2024 is 3.5%.

In light of the above, we project 13.75% for the Selic at end-2022, and 11.75% at end-2023. With the ICMS cut and other tax breaks applying only to the current year, we have revised our inflation projections to 7.2% in 2022 and 5.6% in 2023. Continuing fiscal stimulus via sectoral tax breaks and expansion of the Auxílio Brasil cash transfer program, as well as the robust labor market recovery, have led us to revise GDP growth to 2.1% in 2022. For 2023, we project GDP growth of 0.1%, considering the lagging effects of monetary policy on economic activity. Other projections are shown in the table below.

ECONOMIC FORECASTS	2019	2020	2021	2022F	2023F
GDP Growth (%)	1,1%	-3,9%	4,6%	2,1%	0,1%
Inflation (%)	4,3%	4,5%	10,1%	7,2%	5,6%
Unemployment Rate (eoy ,%)	11,7%	13,9%	11,1%	9,0%	9,5%
Policy Rate (eoy, %)	4,5%	2,0%	9,3%	13,75%	11,75%
External Accounts					
Trade Balance (US$ bn)	48	32	36	68	45
Current Account Balance (US$ bn)	-65	-24	-28	-14	-40
Current Account Balance (% of GDP)	-2,8%	-0,9%	-1,8%	-0,8%	-2,6%
Fiscal Policy					
Central Government Primary Balance (% of GDP)	-1,2%	-10,0%	-0,4%	-0,6%	-0,6%
Government Gross Debt (% of GDP)	74,3%	88,8%	80,3%	78,2%	82,6%