

The Dollar Cycle

Aug 2020

Summary

Summary of the main estimates for 2020 and 2021

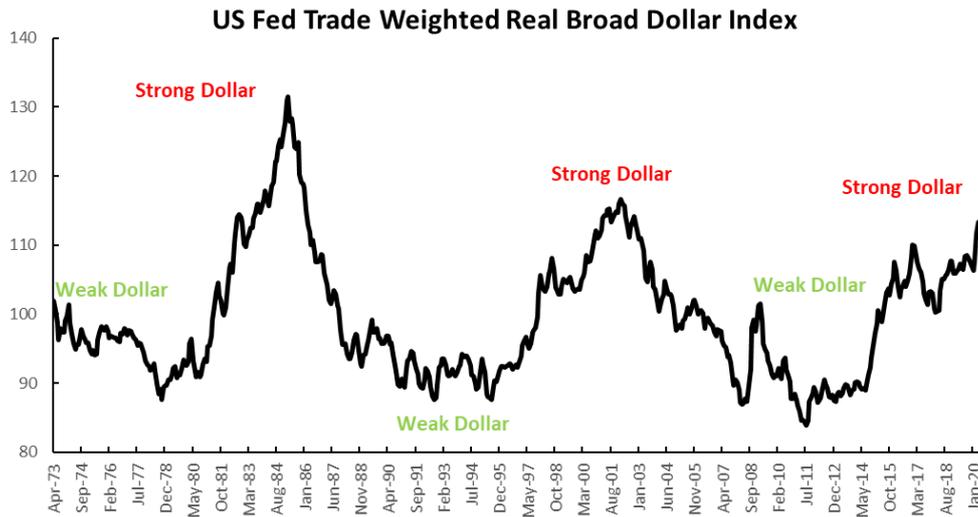
	2018	2019	2020 (E)	2021 (E)
GDP growth (%)	1.3	1.1	-4.8	3.0
IPCA (CPI, 12m, %)	3.75	4.31	1.1	3.0
SELIC rate (% p.y., end of period)	6.50	4.50	2.00	3.00
FX (BRL/USD, end of period)	3.87	4.03	5.2	4.9

Source: IBGE, BCB, Bloomberg. Estimates (E): XP Investimentos.

- We revised our 2020 and 2021 GDP forecast from -6.0% to -4.8%, and from 2.5% to 3.0%, respectively
- The BCB reduced the SELIC rate to 2%, but left the door open for further cuts, albeit with low probability.
- The depreciation of the US dollar against the developed currencies and the increase in the gold prices were the highlights of the month.

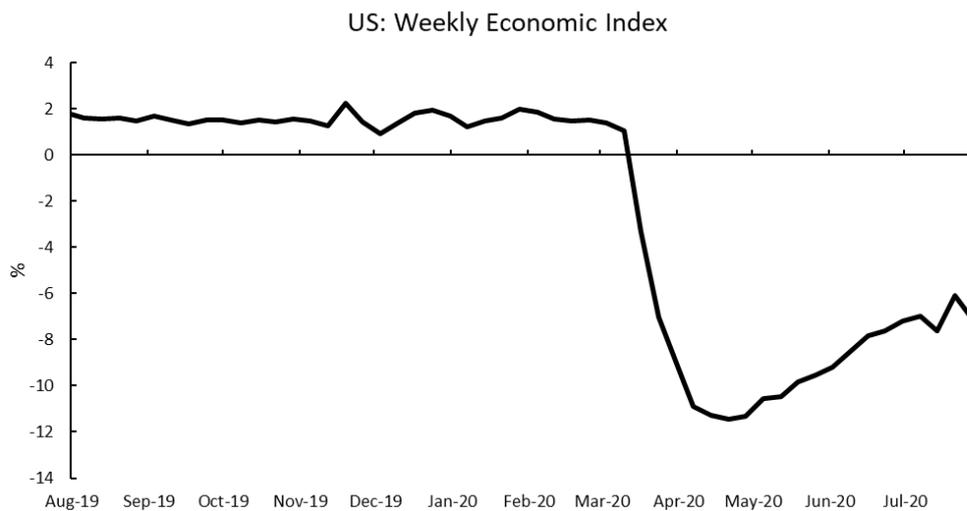
July was another month of "risk-on" for asset prices, with emphasis on the strong depreciation of the US dollar in relation to the developed currencies and the sharp rise in gold prices. A weaker dollar is usually associated with a positive environment for emerging markets and rising commodity prices. In the previous letter, we mentioned that the US dollar trend will be a key variable in the second half of the year and today we will discuss the factors driving this movement.

The DXY, the US dollar index against a basket of foreign currencies (mainly the euro), fell about 4.0% in the month, the biggest monthly depreciation in the past decade. The rapid movement sparked discussions about a sharp change in the trend of the world's reserve currency and even raised questions about the possibility of the dollar losing this status. Firstly, putting it in a long-term perspective (chart below), it is clear that the recent movement is small, and the dollar is still in its strong cycle. Generally, strong dollar cycles are associated with low global growth and it is usual to experience "mini-cycles" of appreciation/depreciation during these long trending periods.



Source: Fed, Bloomberg. By: XP Investimentos.

In June, we stated that the number of cases and hospitalizations caused by Covid-19 was on the rise in several American states, among which many were delaying the reopening process or even reversing some of the easing measures. The result was a marginal slowdown in the high-frequency activity data that all analysts follow closely. The New York Fed, for instance, created a weekly activity index for the United States, through which this slowdown in recovery can be clearly observed in July:

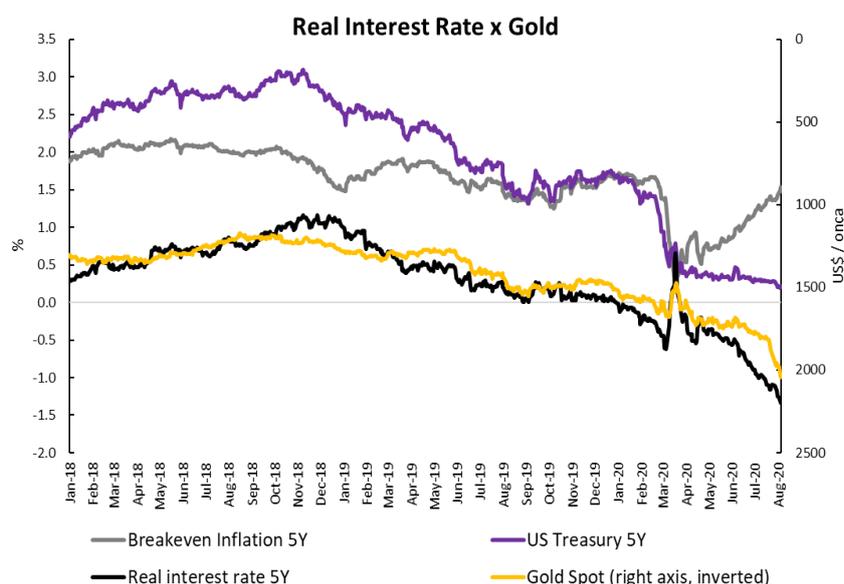


Source: NY Fed. By: XP Investimentos.

On the other hand, Europe’s reopening process is more under control, with the second wave much smaller than the first in most countries. This “momentum” is one of the reasons behind the better performance of the euro against the US dollar, a movement that ends up fuelling the weakening of the dollar against other currencies.

Other factors also contributed to the depreciation seen in the US dollar. The unprecedented level of liquidity injected by the FED, in addition to the swap lines with other currencies (extended until March 2021), played an important role in reducing market stress, contributing to the normalization. In addition to committing to rates below zero for an extended period, the FED also implemented the greatest and fastest expansion of its balance sheet, effectively monetizing the largest part of the fiscal expansion by the US Treasury. The result was the strong fall in real interest rates, and the increase in inflation expectations (once nominal rates remained practically stable in the past months). Real interest rates have a negative correlation with the price of gold (Keynes), considered a “currency with zero nominal interest rate”, which explains the commodity’s 30% rise in 2020. The graph below illustrates this dynamic, with inflation expectations on the rise, falling real interest rates, and increasing prices of gold since March.

It is still early to affirm whether we are just going through a “mini appreciating cycle” of the US dollar, or if the partial monetization of the US deficit will be enough to kick start a new “weak dollar” phase in the world. Nonetheless, given high expectations towards new cycles of FED’s balance sheet’s enlargement (QE to infinity and beyond), the maintenance of low-interest rates for an extended period, and other factors impacting the US balance of payments, we consider likely there to be an inflection of the current dollar cycle throughout the second half of this year, and more so in 2021.



Source: NY Fed. By: XP Investimentos.

In August, the focus will be on the likely agreement between Republicans and Democrats over a new fiscal stimulus package (around US\$ 1.5 trillion), avoiding what is called the “fiscal cliff”- what would lead to a strong negative impact on household consumption once the emergency aid expired. We also note that the equation virus vs economy is changing, with most countries/regions implementing selective restrictions where the number of Covid-19 cases starts to increase. It looks unlikely that cities will again experience complete lockdowns, reducing the negative impact of potential new contagion waves on economic output.

Finally, it is worth noticing the increasing optimism regarding progress towards a Covid-19 vaccine. There are currently 6 candidates going into the initial testing phase, with the possibility of an announcement of effectiveness (or not) until December. The group known as the “superforecasters”, of the Good Judgment Project, see a 37% chance that 25 million doses are distributed until March 2021, and 78% chance that this occurs until September 2021. Two months ago, the numbers were at 9% and 35%, respectively.

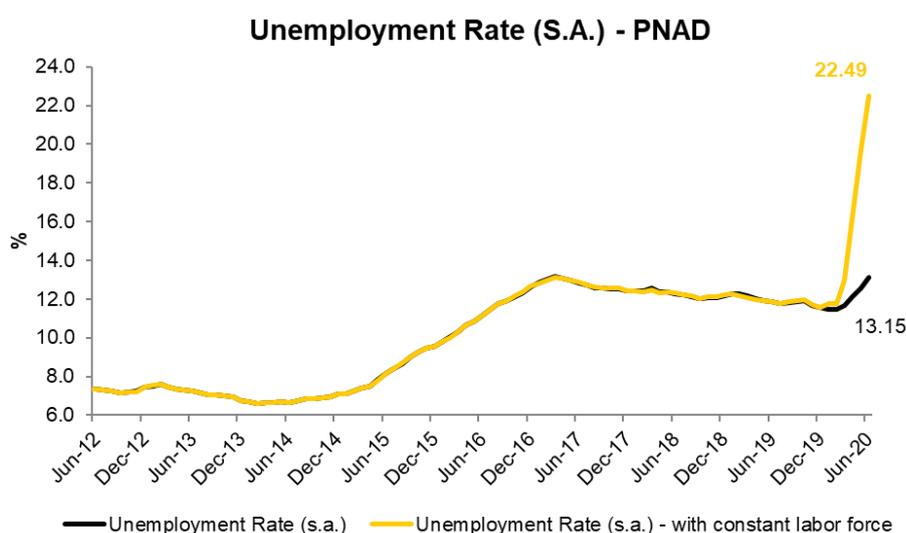
Domestic scenario

In Brazil, the Ibovespa index experienced a strong increase in July (+8.3%), with the nominal interest rate curve partially disinclining, while the Brazilian real appreciated 4.5% against the US dollar. The month’s highlight was the decision by the Monetary Policy Committee, which reduced the Selic rate by 25bps, reaching 2.00%, in line with market expectations, but leaving the “door open” for further cuts, despite having lifted the bar for an additional cut.

The news on the communique was the “forward guidance” type of language, in the following extract “the Copom doesn’t anticipate reductions in the level of monetary stimulus, unless inflation expectations, as well as projections in the base case inflation scenario, are sufficiently close to the inflation target in the relevant horizon for monetary policy, which now includes the calendar year of 2021, and to a lesser degree, 2022”. With inflation projected at 75bps below the target for 2021 and 10bps below for 2022 considering the trajectory observed in the “focus” report, we understand that the BCB is trying to limit the increase in the Selic rate to what is found to be the Focus survey or that, at least, has some margin to accommodate any positive surprises on the economic activity front.

In this context, we understand that the BCB shall keep the Selic rate at 2,00% in the next Copom meeting, in September. With the scenario for 2022 starting to become relevant for monetary policy, our understanding is that the maintenance of interest rates in 2,00% is in line with our macroeconomic scenario until the second half of 2021 when we expect that the normalization cycle raises the Selic rate to 3,00%.

What can change this scenario? The Central Bank emphasizes in the statement the importance of keeping the current fiscal regime (read “Government Expenditure Cap”) to anchor inflation expectations. As we stressed in the last letter, the fiscal risk is increasing and the pressure for the creation of permanent expenses will pile up in the coming months with the discussion of the 2021 budget, amid the economic recession and an increase in the unemployment rate, which reached 22.5% if adjusted to a steady workforce since January 2020 (people have stopped looking for jobs).



Source: IBGE. By: XP Investimentos.

Considering the uncertain scenario, we believe that the government will extend emergency aid until December, raising our primary deficit forecast for the end of 2020 to 15.1% of GDP, and the gross debt / GDP ratio to 96%. Despite the pronounced impact of the extension of aid on this year's accounts, we believe that today the greatest fiscal risk for the base scenario remains the extension of such anti-cyclical policies through 2021. This could be possible with the extension of the calamity decree and the “War Budget” for next year or, even other “creative accounting tools”, such as the use of extraordinary credits already approved for 2020 but not yet fully used (resources destined to fight the pandemic, for instance).

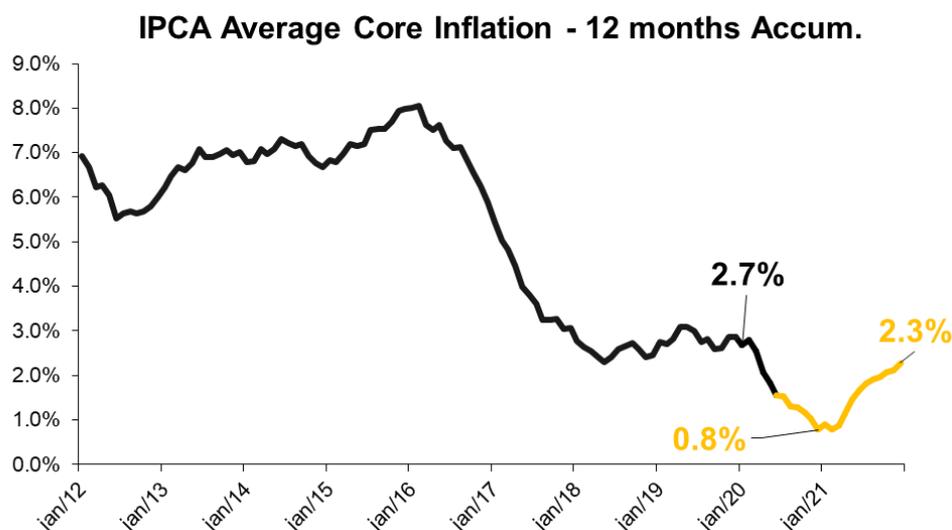
We cannot see reasons for the Congress and the Executive Power to decide on the subject before the last two months of the year, but we have already seen a lot of noise in the press. The emergency aid as designed has a significant impact on the income of low-income families, contributing positively to the president's popularity. However, it is an expense of R\$ 50 billion per month, and its maintenance in 2021 would be perceived as a permanent breach in the spending ceiling, with a certain negative impact on asset prices and deleterious side effects on expectations.

In the activity, we revised the GDP growth in 2020 from -6.0% to -4.8%, while for 2021 we changed from 2.5% to 3.0%, as detailed in the article "Why wait for a less negative drop?". Part of the revision was motivated by the reassessment of the performance of the economic activity in the second quarter, with the main indicators showing that the "rock bottom" was less profound than initially expected, a perception highlighted in the monthly report for June. Regarding the data breakdown, the agriculture sector is practically unscathed by the new coronavirus pandemic and is expected to grow + 2.6% in 2020. The industry sector, with greater recovery dynamics, is expected to retract -5.5% in 2020 and accelerate +5.9% in 2021. The service sector, which is most affected by social distance measures, is expected to recover gradually after a projected drop of 5.2% in 2020 and an increase of 2.2% in 2021.

	2Q20		2020
	YoY, %	QoQ, %	
Agriculture	2.3	1.1	2.6
Industry	-12.6	-12.2	-5.0
Extractive	3.1	-3.7	-0.7
Transformation	-18.3	-15.9	-6.6
Construction	-11.4	-4.7	-5.1
SIUP	-7.1	-6.6	-3.8
Services sector	-9.6	-8.1	-5.2
Retail sales	-12.7	-10.6	-6.7
Transport	-16.4	-13.0	-7.2
SIC	-4.3	-1.7	-2.0
Intermediation	2.0	0.3	1.5
Other services	-22.7	-18.9	-13.2
Real Estate	-3.0	-3.1	-0.9
Government	-2.0	-1.6	-1.1
Taxes	-11.3	-	-5.4
GDP	-9.8	-8.0	-4.8
Household Consumption	-9.5	-7.5	-5.3
Government Consumption	-0.4	-0.6	0.0
GFCF	-22.0	-20.2	-11.3
Export	-10.7	-6.8	-4.9
Import	-14.0	-11.3	-6.3

Source: XP Investimentos

Finally, we have marginally revised our 2020 IPCA forecast from 1.0% to 1.1% due to greater pressure on food prices, especially meat. For 2021 our forecast remains at 3.0%, but with well-behaved core metrics, close to the lower bound of the inflation target corridor. Despite the positive GDP revision, we recognize that the output gap will remain negative for a long period, allowing growth to resume without inflationary pressures on the demand side. As mentioned before, the labor market will remain weak over the next year, minimizing any inflation effect on wages. In this scenario, BCB may be able to maintain the Selic rate at a very stimulating level for a long time, starting the monetary policy normalizing process only at the end of 2021 (and with parsimony).



Source: IBGE. By: XP Investimentos.

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