

# The Fed's Big Change

Sep 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	1.7	2.6
SELIC rate (% p.y., end of period)	6.50	4.50	2.00	3.00
FX (USDBRL, end of the period)	3.87	4.03	5.2	4.9

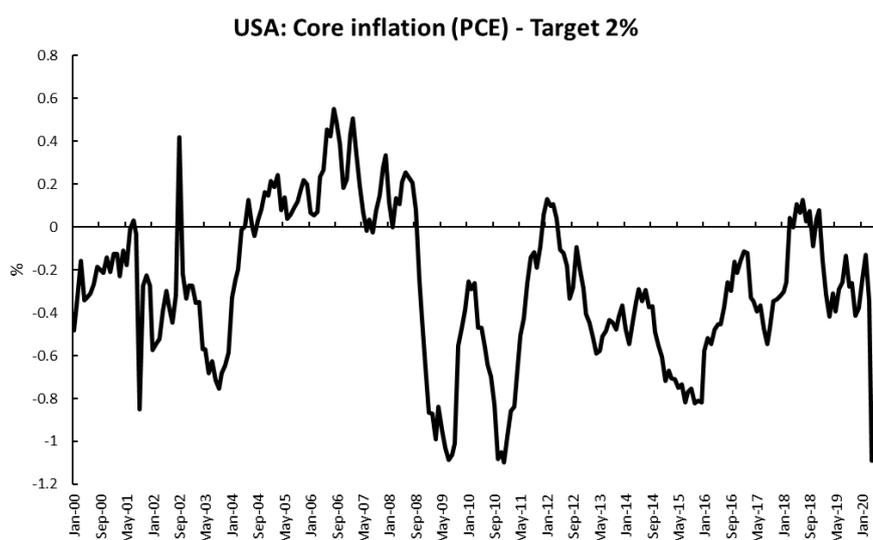
Source: IBGE, BCB, Bloomberg. Estimates (E): XP Investimentos.

- The Fed announces a historic revision of the monetary policy framework.
- We revised the IPCA estimates from 1.4% to 1.7% in 2020 and from 2.7% to 2.6% in 2021, due to the sharp rise in food prices.
- In Brazil, asset prices suffered during the month with concerns regarding compliance with the Expenditure Cap.

August was marked by a strong rally in the U.S. stock indices driven by the technology sector, with NASDAQ rising about 11.0%. Treasuries with longer maturities (10 and 30 years) had an increase in rates and the dollar presented another month of depreciation against the main currencies, a subject well discussed in the July report. In addition, the sharp rise in commodity prices over the month was a highlight, with returns close to 10% in various segments (food, industrial and metals). Emerging markets lagged and had mixed performance.

The main reason for what may be the start of a "reflation" move in the markets (high commodity prices and the long tip slope of the interest rate) is the change in the Fed's monetary policy framework. Although widely expected by the markets, it is a historical fact that will be seen in as a reference point in a few years. During his speech at the Kansas City Fed's economics symposium, Powell announced that from now on, the Fed will adopt a flexible average inflation target and the automatic correlation of the unemployment and inflation rate will also be abandoned— a low unemployment rate will no longer be seen as a risk to inflation. This is an extremely relevant change because it suggests that the interest rates in the U.S. will remain close to zero ("Zero Lower Bound") for a long period.

The big question for the coming months is whether this change in the institution's framework will be sufficient to generate inflation, especially in a scenario where few monetary policy instruments have remained (Quantitative Easing and negative interest rates?). This is one of the reasons for Fed directors to advocate in recent events for further fiscal policy assistance in order to support the resumption of economic growth. Over the past 20 years, the Fed has failed to achieve its goal of inflation around 2.0%, which can be seen from the difference between the core inflation and the 2.0% target.



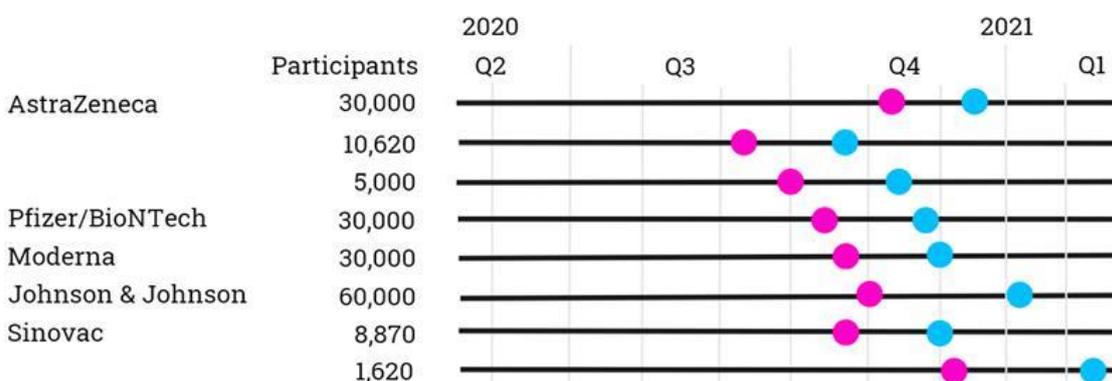
Source: BEA, XP Investimentos.

Our assessment is that we are in a transition period for the economy and the markets will have difficult navigation in the next 3 to 6 months. The first pillar was to change the Fed's framework which will be important for what will happen in asset prices. The second factor should be the announcement of the first test results of vaccines that are in the third phase of the approval process, with the possibility of release for emergency use in the USA. We believe that it will be the beginning of a new phase, with a gradual resumption of activity (although with a lot of volatility) and reduction in uncertainty. In addition, we will have the U.S. elections in November and the continuation of the discussion on a new fiscal stimulus package in the U.S..

**Race for Results**

Vaccine phase III clinical trial timelines

Estimated readout forecast: ● Interim analysis ● Results on primary goal



Source: Airfinity, August 29 report

With Trump showing resumed strength in most recent polls, the approaching US elections will likely be a tight run. Although the result will impact asset prices in the US, it is unlikely that either Republicans or Democrats opt for reducing fiscal stimuli in the short term. Nonetheless, the high fiscal deficit and FED’s QE policy remain the “other part of the puzzle”, adding to the U.S. dollar depreciation, which as discussed in our previous letter, will positively weigh on commodity prices (gold among them), both in developed countries ex-U.S. and in some emerging markets. Which emerging markets will benefit from this scenario? The countries who best managed to control the spread of the coronavirus, reducing its effects on the economy, and may leave the pandemic in a better fiscal position.

**Domestic scenario**

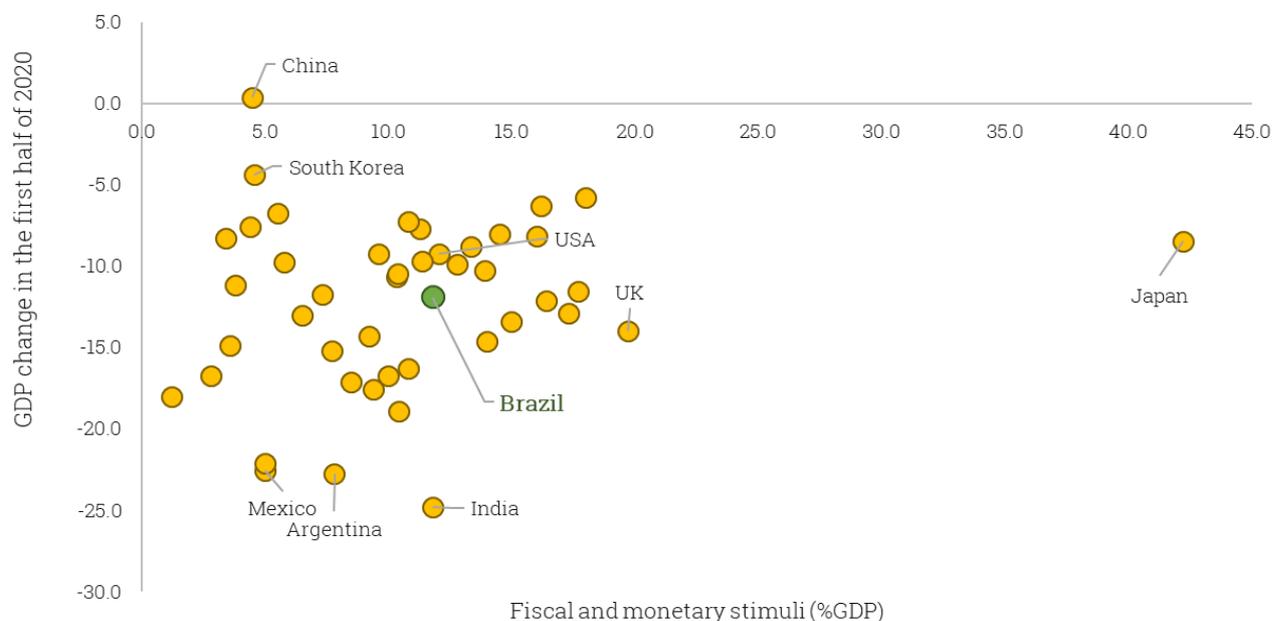
In Brazil, we have experienced a typical “risk-off” month, with the Ibovespa posting a 3.4% decline, future interest rates climbing and the Brazilian real depreciating approximately 5% against the U.S. dollar. We highlight three main drivers behind the worse performance of Brazilian assets compared to its emerging market peers: i) uncertainty around the fiscal impact of social transfer programs, namely the extension of the emergency aid and the development of a new permanent program, Renda Brasil; ii) the (related) discussions around the sustainability of the spending ceiling; iii) rumors about Minister Paulo Guedes’ future in the Bolsonaro administration.

In this context, it’s worth noticing that Brazil was one of the emerging countries with the largest spending on fiscal and monetary stimuli, so far totaling more than 8% of GDP, despite the already concerning fiscal situation before the pandemic crisis.

## 2020 GDP vs Economic stimuli - 45 countries

Source: OCDE and Elgin, C., Basbug, G., Yalaman, A. (2020)

By: XP Investimentos



Throughout the past month, the extension of the R\$ 600 emergency aid was largely discussed amongst politicians and in the Brazilian press. As the program's elevated cost (amounting to approximately R\$ 50bn per month), allied to questions about its efficiency (e.g. large number of frauds revealed) increased concerns among market players, the government opted for a reduced value on the program's extension. The R\$300 emergency aid, therefore, will be extended until December this year, following Congress approval.

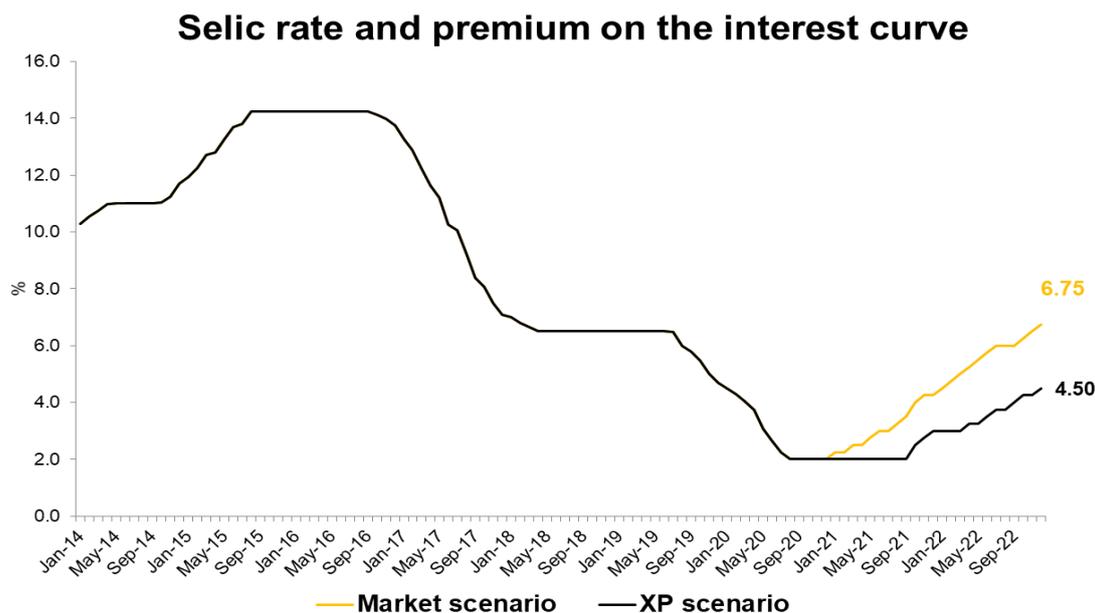
By the same token, uncertainties about the maintenance of the spending ceiling also drove the market's attention in August, especially given the attempts of increased expending through "extraordinary credits" approved to be used on emergency spending this year, which would be destined to "non-emergency" allocation such as (already planned) infrastructure works. Following continuous statements by the TCU that such an approach would not be allowed by the Court, both Congress and the Executive opted for a joint public statement highlighting the importance of the spending ceiling.

The new social program, Renda Brasil, in turn, was not included in the budgetary proposal for 2021 sent by the government to Congress (PLOA). With a mere R\$112bn available for discretionary spending (including financing for a new energy state company and for parliamentary amendments), the 2021 budget proposal illustrated the almost inexistent fiscal space left for any unplanned expenditures, given the ceiling restrictions. Nonetheless, it also portrayed relevant transparency and pragmatism with regards to the trajectory expected for revenue and mandatory spending. Renda Brasil will likely be included in the “Federative Pact Constitutional Amendment Proposal”, to be presented later this month.

In this context, we acknowledge the concerning current fiscal situation. However, we remain optimistic that the spending ceiling will not be breached in 2021. The Federative Pact PEC also aims to allow the triggers included in the ceiling legislation (however, not materially possible due to flaws in the existing law), namely civil servants payroll and new mandatory expenditures, in addition to clearer thresholds for such triggers. Additionally, the detachment, disengagement, and elimination of mandatory minimum spending also to be proposed by the PEC will likely create some room to accommodate Renda Brasil without breaching the ceiling.

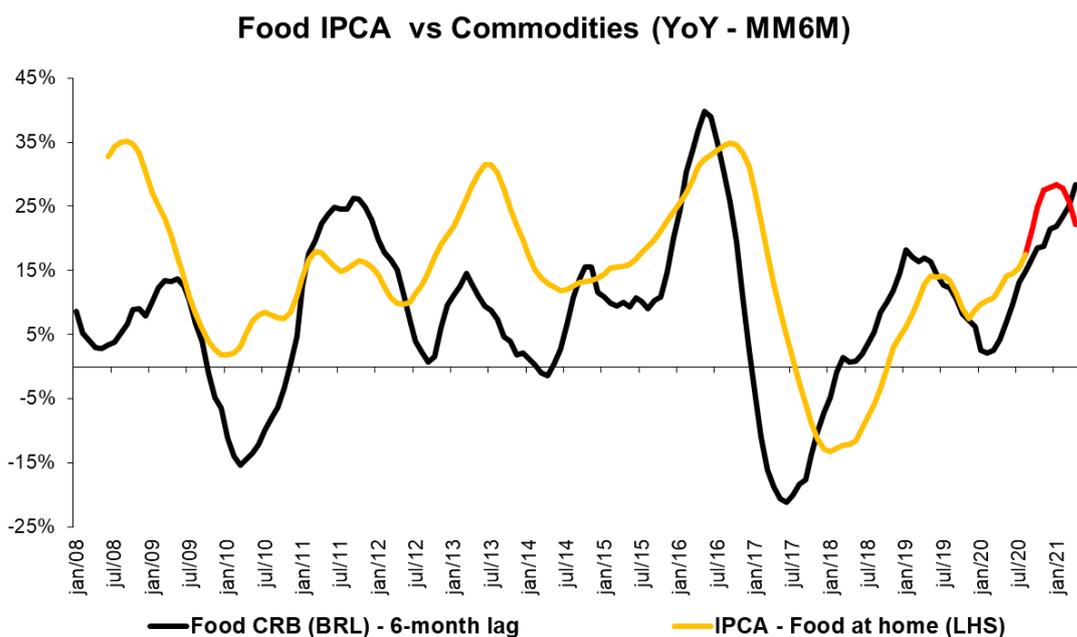
The government also sent another positive signal by presenting the proposal for an Administrative Reform -- a long-lasting claim by the Speaker of the Lower House, Rodrigo Maia. The proposal changes the structure of civil service in Brazil, reducing an important part of mandatory expenditures; nonetheless, it doesn't have fiscal impacts in the short term, as the new legislation, if approved, will only be applied to future civil servants.

The future interest rate market still prices a considerable deterioration in the country's fiscal situation in the coming years, with a projected SELIC rate at almost 7% by the end of 2020. We remain certain that the belly still carries a significant premium, but we also expect the reduction process to be slow, given the political challenges for the approval of the proposed reforms -- namely, the tax, administrative and federative reforms.



Finally, there was no change in the rhetoric of the Central Bank directors since the last COPOM meeting, when the committee introduced a “forward guidance” approach. The SELIC rate is likely to remain stable at 2% until, at least, the second half of 2021. The words of the President of the Brazilian Central Bank Roberto Campos Neto, clearly summarize the current situation: “At the moment, the Central Bank is a passenger, while the pilot is the fiscal policy. The fiscal policy remains our helm in the present situation”.

Regarding inflation, the August IPCA came slightly below expectations (0.24%), but with core measures running close to zero while food at home accelerated. Since July, several prices of agricultural commodities have accelerated sharply (rice, soybeans, corn, beef, etc.), which is the reason for several articles and inquiries about the rise in food prices. There is no single reason for this recent increase, but a combination of supply and demand factors for each category, such as emergency aid, bad harvest, climate, exchange rate depreciation, and exports to China. Considering these shocks, we revised our 2020 IPCA forecast from 1.4% to 1.7%, and from 2.7% to 2.6% in 2021. It is important to note that practically the entire review was concentrated on food at home. We have not changed our expectation of well-behaved core inflation with a smooth acceleration throughout 2021.



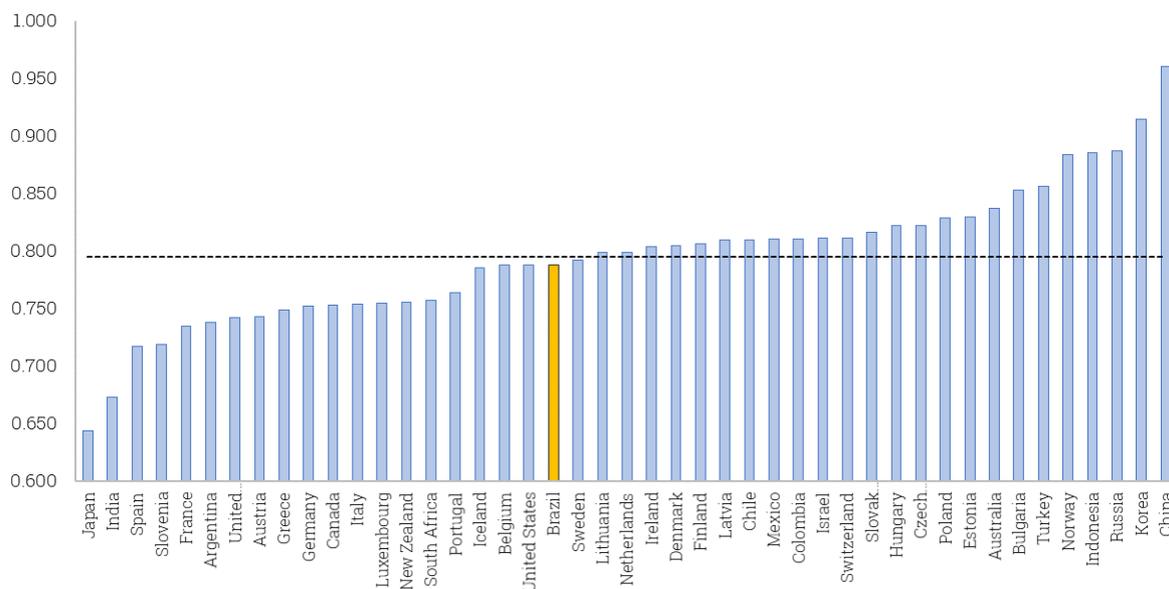
Source: Bloomberg, IBGE, XP Investimentos

In the first week of September, the Brazilian Institute of Geography and Statistics reported a drop of -9.7% q/q in the Brazilian economy in the second quarter of this year. Although the result came below our expectations (-8.0% q/q), the surprise was not big enough to change our 2020 GDP forecast (-4.8% y/y) nor the 2021 GDP forecast (+3.0% y/y). The biggest difference came from government consumption (-8.7% y/y vs -2.0% estimated), which underwent a methodological change in the quarter for international compatibility. Other economic segments, and especially those most impacted by the pandemic, came in line with our projections and illustrated that the worst moment is behind us. The highlight from the less negative result came from the Civil Construction sector (the segment with the greatest multiplier effect on the economy) and Other Services (labor intensive) with a decrease of -5.7% and -19.8% respectively. For the next quarters, we expect the 3Q20 GDP to increase by +6.8% and by +3.6% in the last quarter of this year. Industrial production (PIM) in July (+8.0% m/m) already indicated that the recovery is underway for the period. The biggest source of uncertainty will be the transition from 2020 to 2021, when emergency aid is depleted and the workforce resumes its search for jobs actively (mainly in the service sector, which is the most affected by the pandemic).

## Stimulus Effectiveness Indicator (GDP / Spending)

Source: OCDE and Elgin, C., Basbug, G., Yalaman, A. (2020)

By: XP Investimentos



As mentioned throughout the letter, the uncertainty scenario now turns to the 2021 horizon. Structural factors of the Brazilian economy will prevail once the health issues fade out. The progress of the reformist agenda can and should be a necessary trigger for the confidence of the economic agents to return. Combined with a significant income rebuild, a highly stimulative monetary policy will be essential so that aggregate demand in the medium term does not lose steam. However, fiscal and inflationary risks will always be a source for concern with regard to the pace at which the Brazilian economy will resume.

In fact, fiscal and monetary stimuli were quite expressive when compared internationally and mainly against our emerging peers. The effects of these injections will continue for the next quarters, but considering the activity drop in the first half of this year and the size of the expenditure to combat the pandemic, we are close to the world average (graph above). With a recession in economic activity of -11.9% in the period and stimulus around 11.8% of GDP, Brazil had stimulus effectiveness similar to the one observed in the U.S., but well below those observed in South Korea and China.

It is too early to understand the effectiveness of fiscal and monetary stimuli on each economy, even because the pandemic turmoil has not yet been resolved. However, it is increasingly evident (in an even more indebted world / country) that persisting with the reform agenda is the only way for the level of productivity of the Brazilian economy to be able to outline some greater and sustainable growth in the medium and long term.

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