

The economic reopening and its positive narrative

June 05th, 2020

Executive Summary

Summary of the main estimates for 2020 and 2021

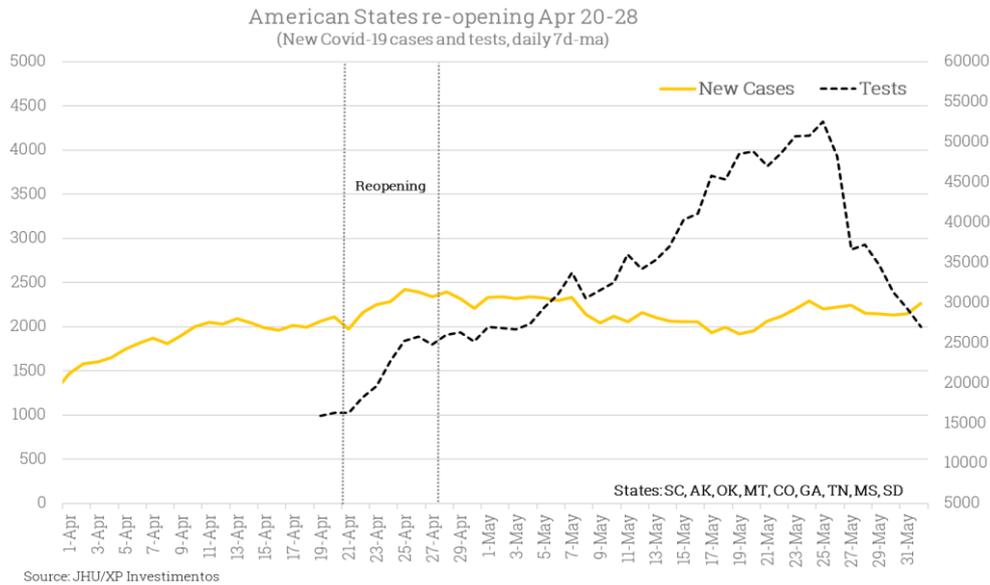
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Source: IBGE, BCB, Bloomberg. Estimativas (E): XP Investimentos

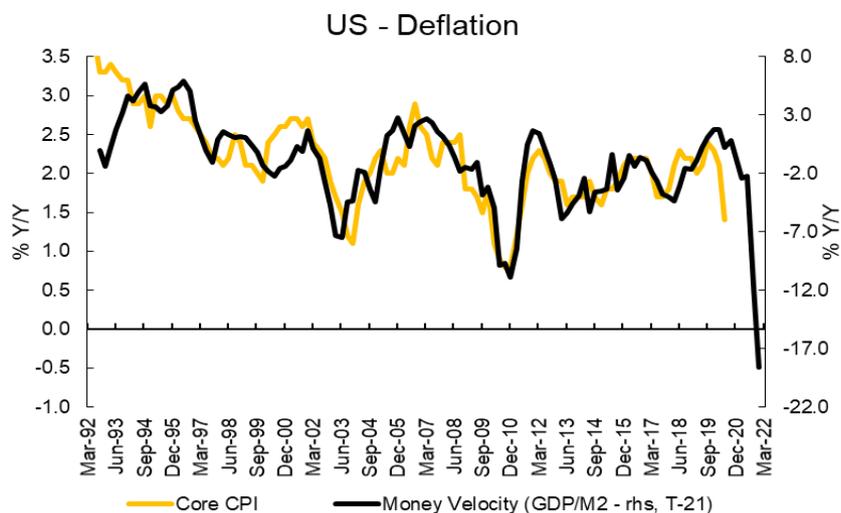
- The month of May was characterized by the continuity of the positive trend observed on the back of the reopening of the main global economies. The perception that the worst of the coronavirus pandemic is now behind us contributed to the favorable dynamics, in addition to factors including renewed fiscal and monetary stimulus and the resumption of economic activity in China.
- Despite the optimistic wave, our guess is that high volatility will resume as economic impacts of the pandemic become clearer, and US Presidential elections get closer. Until then, the "risk on" is likely to continue, especially with the US dollar weakening against emerging market currencies.
- In Brazil, we maintain our forecast of 5.50 R\$ / US\$ by year end, especially given the scenario of fiscal uncertainty that will likely growth stronger in the coming quarters.
- We also maintain our 2020 GDP forecast at -6.0%, despite short-term data signaling that the worst phase of output deterioration may be behind us (in April).
- Similar to the trend observed in developed economies, the Brazilian labor market registered a sharp deterioration in May, marked by a greatest hit on informal workers and a significant reduction in the labor force.
- With household consumption retraction and labor market deterioration, our forecast for 2020 IPCA remains at 0.7%.
- Finally, on the monetary front, we maintain our view that the Central Bank is likely to reduce the Selic rate to 2.25% at the June meeting. Moreover, we believe that there is room for further reduction, despite the signaling in the last Copom minutes that the next cut may be the last one.

The reopening

- *The month of May was marked by the continuity of the positive trend observed on the back of the reopening of the main global economies, as described in our previous letter. The perception that the worst of the coronavirus pandemic is now behind us contributed to the reduction in volatility and improvement in asset prices. However, it was not the only factor, and other drivers should also be highlighted as playing a key role on this favourable dynamics.*
- *These include: i) a stronger and faster than expected output recovery in several countries; ii) the resumption of economic activity in China; iii) the (so far) stable curve observed in many regions that resumed activities ahead of expected; iv) renewed fiscal and monetary stimulus; v) optimism towards the development of a vaccine by 2021; vi) liquidity measures adopted by the FED, which reduced the financial distress in different markets (credit, currency).*
- *On the faster than expected resumption of activity, available data on urban mobility signal to a positive scenario in regions where the number of cases is under control. In China, for example, where industrial output was already at pre-crisis levels in April, posted significant growth in household consumption in the past few week, including retail sales on malls reaching almost 90% of levels normally observed in June.*
- *The third factor mentioned behind the “risk on” market behaviour is the positive trend observed in the number of coronavirus cases in areas that relaxed social isolation policies prior to the “flattening of the curve” – as exemplified by more than a few US states and some European countries. However, is it still early to conclude that the situation is indeed under control on these areas, given the relevant lag existent throughout the cycle of the disease: transmission, symptoms and hospitalization. The scientific knowledge on coronavirus still carries high levels of uncertainty, including the real drivers behind the fall in the number of cases.*
- *In this sense, it is likely that the change in peoples’ behaviour, with some level of voluntary social distancing, will play a key role on avoiding the resurgence of new cases and the worsening of the curve after reopening. It will be crucial to observe carefully places that have chosen this approach in the coming weeks/month, such as New York, to understand where/how we will be on the reopening phase.*



- In terms of monetary and fiscal stimulus, this month's highlight was the proposal of a EUR 500 billion recovery fund by the EU. The proposal was lead by France and Germany, signalling an important behavioural change for the survival of the European bloc in the post-pandemic world. The fund would be an important first step towards fiscal policy coordination among EU members – an extremely positive movement to strengthen the Euro. Nonetheless, challenges remain before all member states agree to this “renewed unity”, especially more hawkish countries such as Sweden, Austria, Netherlands and Denmark.*
- Meanwhile in the US, the FED should keep its approach of using all the available tools to support (and effectively push) economic output, while standing by its strong position of not jumping into negative interest rates territory. The challenge we see, however, is that as mentioned in our earlier letter there's a high probability that the country will go through a deflation period in the coming months, even if short lived. Deflation coupled with nominal interest rates at zero would imply that the real interest rate would grow in a recessionary context – a situation that any Central Bank would want to avoid.*
- In this sense, although it seems unlikely that the FED will alter its speech in before 2021, we do not discard the possibility that short-term Treasuries will once again price this scenario.*



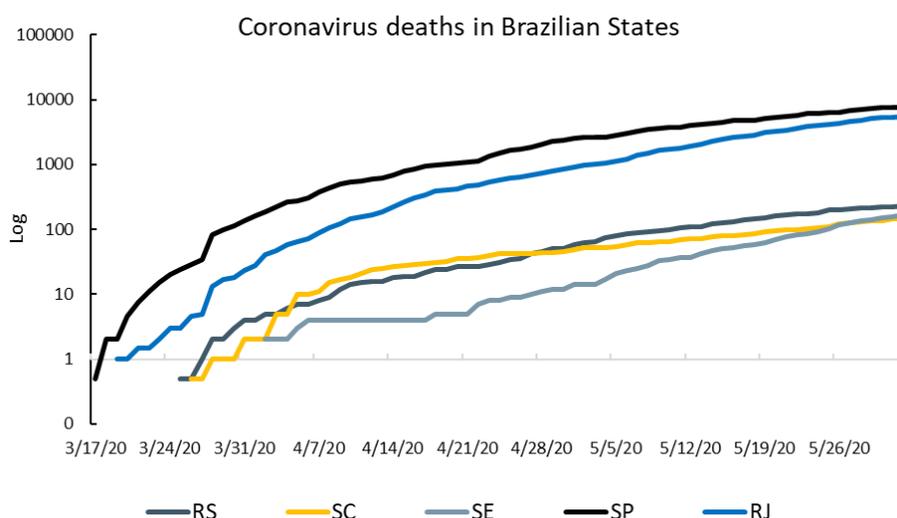
- *Despite the positive news on the progress of potential vaccines, we remain sceptic that anything will be largely available for global usage before the first half of 2021 – what would already mean a considerable advance. In this sense, it is more likely that society will have to learn to coexist with the virus still for a considerable amount of time.*
- *In our earlier letter, we mentioned the strong dichotomy observed between asset prices and the brutal economic recession, marked by the large deterioration in labour markets around the globe. In addition to the factors abovementioned, we understand the considerable liquidity sponsored by the FED and the US Treasury will play a key role in the dynamics observed.*
- *In a recent interview, the US investor Stanley Druckenmiller detailed this liquidity effect in a very comprehensive manner:*

“... So, in March and April alone, the Fed net of Treasury issuance, to pay for the new spending, created a trillion in QE more than Treasury issuance. So, it’s the biggest liquidity injection relative to history I’ve ever seen... The problem is as you look forward, because the Treasury deficits are not only still gonna be there, they’re just rolling out aggressively now the financing of them, the Fed front ran this with their actions of a month or two ago and so what the Fed bought was a trillion more than treasury issued. What’s going to happen now is Treasury issuance has caught up with the Fed and if they stick to the schedule they’ve outlined, the net difference between those two actually goes to zero in May and net borrowing by Treasury relative to Fed purchases in June very minor, pretty much flat through September. And then liquidity shrinks as far as the eye can see as the Treasury borrowing crowds out not only the private economy but even overwhelms Fed purchases... That leads me to believe... the risk for reward for equities is maybe as bad as I’ve seen it in my career here.”

- *Therefore, we should see a strong reduction on the liquidity observed by 3Q2020, when the economic impacts of the pandemic will be clearer and stronger (companies that won’t be able to survive, effective unemployment, household income loss, and change in consumption/investment behaviour by companies and householders), and presidential elections will be closer. This will be an interesting period for markets and our guess is that high volatility levels will be back. Until then, the “risk on” approach should reign, especially with the weakening of the US dollar against emerging market currencies.*
- *The main risks for the scenario detailed above are a potential worsening in the number of coronavirus cases through a second wave, which would imply new mobility restrictions, or the strengthening of US X China geopolitical and commercial tensions that presented considerable deterioration in the past month (Hong Kong, Taiwan and trade of agricultural products).*

Domestic scenario

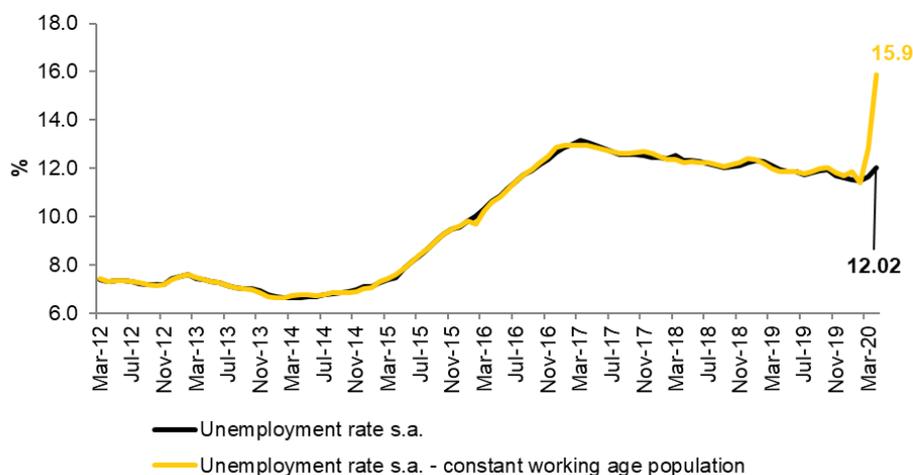
- In Brazil, we understand that an exchange rate close to R\$ 6.00 / US\$ already priced a great deal of the expected output fall and fiscal deterioration, in addition to a good part of the political risk. Throughout May, the improvement of the external scenario, the easing of the domestic political risks and the expectation of a gradual economic reopening corrected much of the overshooting observed in the previous months, with the exchange rate returning to around 5.00 R\$ / US\$ in early June. Nonetheless, we still believe that the exchange rate will end the year at 5.50 R\$ / US\$, especially given the scenario of fiscal uncertainty that will likely growth stronger in the coming quarters.
- In the political scenario, the government's approach in trying to forge alliances with the Congress spectrum know as "centrão" also contributed to easing tensions. For the coming months, it will be important to follow discussions on temporary fiscal measures, such as the potential extension of the financial aid package for informal workers ("Coronavoucher"). Given the strong recession and rising unemployment, the pressure to create permanent expenses will increase, which could compromise the spending ceiling in 2021. Either way, we believe that this risk will gain relevance in the last four months of this year, contributing to rising fiscal uncertainty and our expected exchange rate of R\$ 5.50 / US\$ at the end of this year.
- The optimism observed towards reopening is related to the trend illustrated by the first chart presented in this letter, where one can see the impact in regions that resumed activities prior to the expected and, until now, have not registered any significant increase in the number of coronavirus cases. In Brazil, the curve begins to show signs that some states are approaching the peak of cases and from now on we expect the decline to be very slow, similar to the trajectory observed above, but without the acceleration in the number of cases.



Source: Health departments, XP Inc.

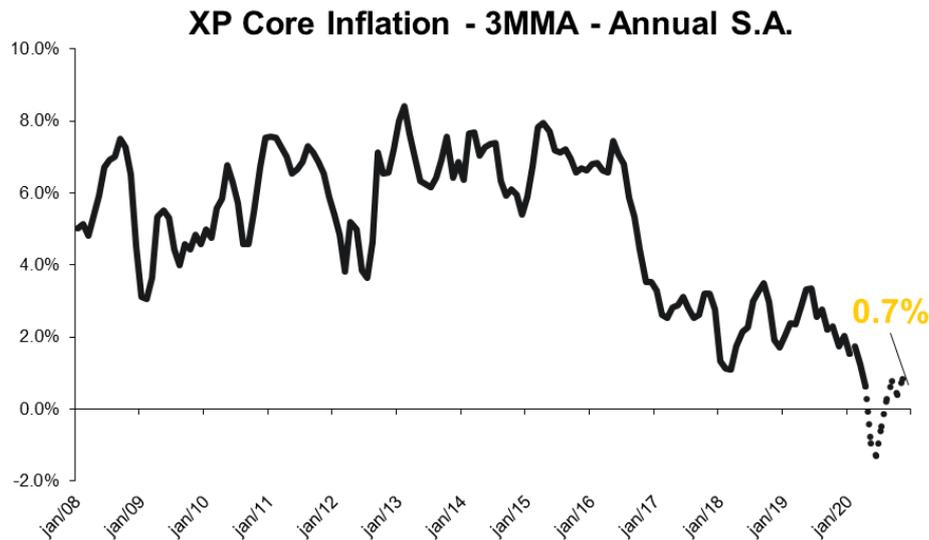
- In terms of economic activity, the first quarter brought a contraction of 1.5% QoQ of GDP, (slightly below our expectation), only partially reflecting the impacts of social isolation measures, which started in mid-March. We maintain our 2020 GDP forecast at -6.0%, despite short-term data showing that the worst phase of output deterioration is likely to have taken place in April, as illustrated by the slow recovery observed in May. Nonetheless, the complete reopening in most states may only take place in August, according to announcements made so far.
- The main highlights in terms of domestic activity indicators released in May were industrial production and labor market from April. Industrial output fell less than expected (18.8% YoY vs -28.3% YoY according to Bloomberg), bringing a positive bias to 2Q20. In turn, the labor market deterioration was similar to that observed in developed countries, marked by a sharp increase in unemployment and a large number of people leaving the labor force. An alternative tool to measure unemployment would be keeping the labor force constant, as portrayed below.

Unemployment rate s.a.



Source: IBGE, XP Inc.

- There are two relevant points about the trend observed in the labor market. 1) The government program that allows for suspension of employment contracts by guaranteeing limited unemployment benefits for affected workers is important to avoid a further increase in the number of unemployed, but given the limited scope of the program, unemployment is expected to increase gradually over the third quarter. 2) On the other hand, the wage bill will be sustained in the short term with the emergency aid of R\$ 600.00 (Coronavoucher), which may mitigate the income loss in the period. In this context, we believe aid programs will likely be extended.
- The retraction in household consumption and the well-weakened labor market are the main reasons for sustaining that inflation will likely remain at low levels for a long time. Our 2020 IPCA forecast remains at just 0.7% (and 3.2% in 2021), with a considerable deceleration in core inflation. We believe the exchange rate depreciation will have a limited pass-through effect throughout the second half of this year but may resume gradually in 2021, alongside economic activity resumption (we expect GDP to expand by 2.5% in 2021).



Source: IBGE, XP Inc.

- In this scenario, regarding monetary policy, we remain confident that the BCB will likely reduce the Selic rate to 2.25% at the June meeting. Moreover, although the Committee has signaled in its last minutes that the next cut may be the last one, we believe that there is a possibility of further cuts.
- In May, a large number of analysts and BCB directors debated on the existence of an “Effective Lower Bound” (ELB), which would be above zero in Brazil. According to the theory, when crossing the ELB, the exchange rate would suffer a strong depreciation and further cuts in the Selic rate would be counterproductive in tightening financial conditions. We believe there’s a lot of uncertainty about the existence and the level of an ELB in Brazil, which suggests that the BCB may continue to bring more gradual cuts (while cautioning for the behavior of other key variables) and keep the focus on the main BCB goal - the inflation target.
- The recent exchange rate appreciation and reduction observed in long term interest rates reinforce the easing in financial conditions and allow the BCB to keep the “door open” for further downgrades in the Selic after June. In this scenario, we believe the Selic upward cycle may start only in the fourth quarter of 2021.

Forecasts

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- Finally, given the elements mentioned in this letter, we believe that the domestic scenario remains uncertain, making expectations more diffused.*
- In early June 2020, the gradual recovery of Brazilian assets suggests that rock bottom may be behind us, and the outlook is now focused on the post-pandemic. However, the return to normality may be slower until there's good news on the medical front - either a flattening of the curve or the development of an effective a vaccine. Moreover, countercyclical policies adopted so far or to be implemented later this year may mitigate output deterioration, bringing instability to more assertive forecasts.*
- The projection of economic scenarios will remain for a long time contingent on normalization processes around the globe, and developments on the political and medical fronts.*

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