A silhouette of a construction site at sunset. In the center, a large concrete bucket is suspended by a crane. To the left, a worker stands on a horizontal beam. To the right, two workers are positioned on a vertical structure. The background shows a grid of scaffolding and rebar against a dark, orange-tinted sky.

The Next Phase

July 2020

Summary

Summary of the main estimates for 2020 and 2021

	2018	2019	2020 (E)	2021 (E)
GDP growth (%)	1.3	1.1	-6.0	2.5
IPCA (CPI, 12m, %)	3.75	4.31	0.9	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

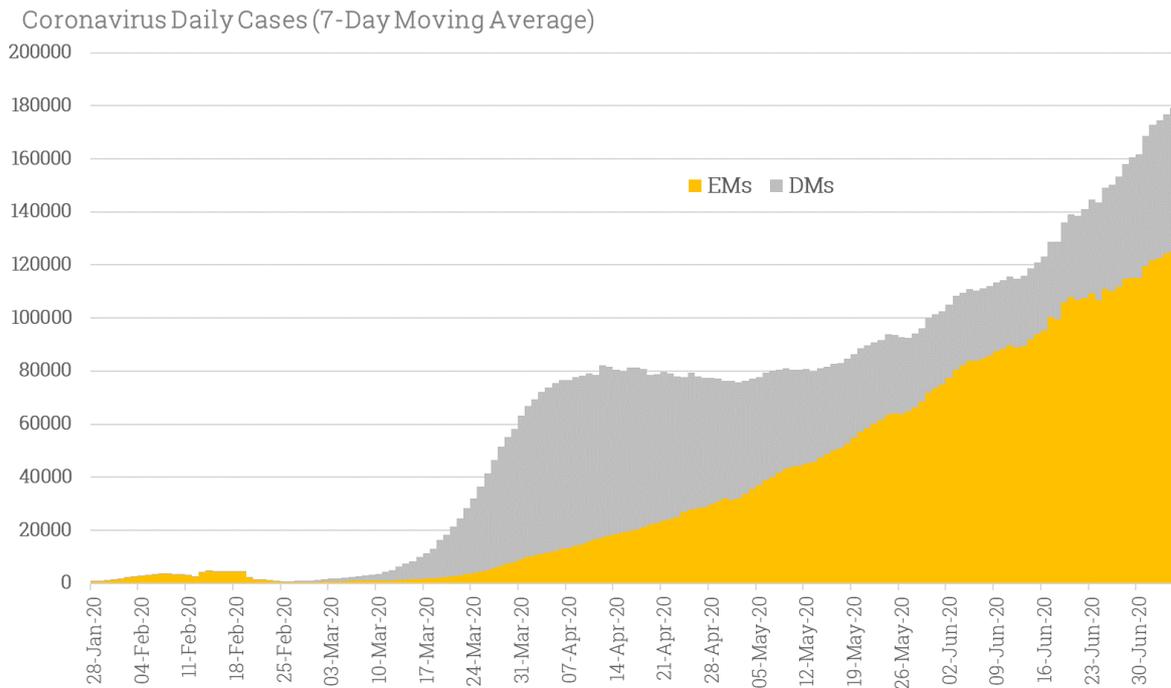
Source: IBGE, BCB, Bloomberg. Estimates (E): XP Investimentos

- After leaving what seems to have been the worst of the pandemic behind, all eyes turn to the expected recovery in the second half of the year.
- The end of fiscal, monetary, and labor market stimuli will likely set the tone.
- Meanwhile, the still increasing trend observed in the number of new coronavirus cases, especially in Brazil and the US, still restricts optimism on asset markets.
- We revised our inflation (IPCA) and currency forecasts for 2020 and 2021.

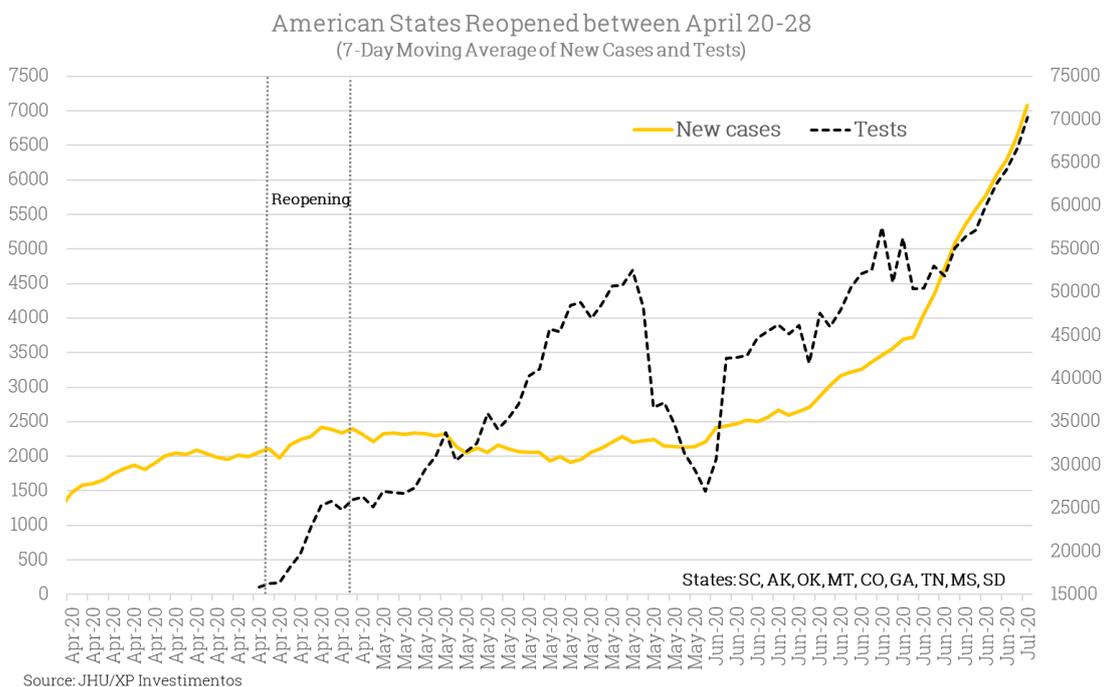
In June, asset prices remained on “risk on” mode, in line with the process observed in our previous letter: fast recovery of economic output lead by the relaxation/end of social isolation policies, strong rebound of the Chinese economy, expectations of a wide ranging vaccine in 2021, and monetary and fiscal stimuli worldwide. However, volatility remained slightly higher and asset price performance was more modest than in May. The US Dollar depreciated against strong currencies but appreciated against emerging market ones. Metal and energy commodities, in turn, presented positive growth this month.

One of the reasons behind the uneven dollar performance is the difference between emerging and developed markets on the progress of coronavirus cases. So far, Europe and Asia have had better success in containing the virus, while emerging countries face numerous challenges in stabilizing the contagion curve. Meanwhile, in the US, some states that started the reopening process between April and May faced an increase in the number of cases and hospitalizations, which lead many regions to put the reopening plans on hold. The challenge of a safe transition “back to normal” will be one of the main factors driving the US economic recovery and, therefore, the performance of the dollar over the coming months.

The graphs below illustrate the development of the coronavirus pandemic observed in June: still rising cases in emerging countries, and the US states that reopened in April, also facing a sharp increase in the number of cases.



Source: JHU / XP Investimentos



Source: JHU/XP Investimentos

It is important to note that, despite the increase in the number of hospitalizations, the number of fatalities per day remains lower than those observed throughout the first wave in New York and Europe. This may be partially explained by the relatively higher contagion rate now affecting younger individuals, a group that so far has registered cases with less severity. Another likely driver is the change in standard medical protocols, which have become more effective in combating the virus, in addition to reducing the hospitalization period.

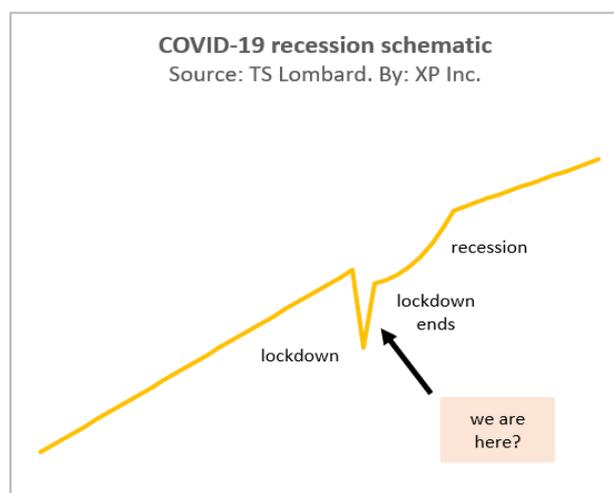
In this context, the behavior of the US currency in the short term remains uncertain and will be highly relevant in the second half of this year. The arguments behind a stronger dollar are based on the expectations of either a substantial global economic recovery driven by the US, or on an alternative scenario marked by higher risk aversion brought by a coronavirus second wave worldwide.

On the other end, in addition to the abovementioned challenge of normalization in certain states, the Fed's extremely stimulative monetary policy (QE to infinity and beyond) weights towards a weaker dollar, as well as the rise in uncertainty brought by the domestic political scenario, as the Presidential election approaches.

Regarding the monetary policy front, Fed maintained its strong rhetoric of doing "all it takes" to support the economy, keeping the US base interest rate at zero, and the asset purchase program ongoing. In the last FOMC minutes, the members discussed alternatives for the next monetary policy decisions, including the adoption of "forward guidance" within the inflation target regime - which is perhaps the most effective way to achieve the Fed's objectives. The adoption of a cap on the forward yield curve (Yield Curve Control) was discussed, but the directors signaled that it may not be adopted.

Therefore, in the very short term, we are still facing the positive narrative of the reopening and optimism with a lower than expected drop in activity in the second quarter of 2020. The second half of 2020, on the other hand, starts with numerous questions about the side effects of the rapid and deep recession that we are going through. The labor market, for example, which is marked by lagged effects, remains strongly influenced by fiscal stimulus adopted by governments. Only after the complete reopening will it be possible to assess with certainty the real speed of recovery from the crisis and how long it will take for the world to return to the pre-virus level.

Finally, part of the liquidity injected by Central Banks through the purchase of government bonds will be withdrawn by National Treasuries, which are running high fiscal deficits and issuing new bonds to finance higher expenditures. It is not yet clear what the net impact of this process will be on asset prices.



Domestic scenario

In June, the Ibovespa rose sharply (+ 8.8%), the nominal yield curve retreated and local currency depreciated 2.6% against the U.S. dollar. The main highlight was the Central Bank's decision to reduce the Selic rate by 75bps, to 2.25% pa., in line with market expectations, but leaving the "door open" for another "residual" cut. In the Quarterly Inflation Report (RTI), IPCA projections were in line with expectations in all scenarios, showing the IPCA of 2021 around 3.0%. For 2022, in the scenario with a constant Selic rate of 3.00%, IPCA is still at the inflation target, reinforcing our perspective that the Central Bank will keep interest rates at a low and stable level for a prolonged period.

In a recent event, BCB's director Fabio Kanczuk stated that, despite the RTI base scenario showing the 2021 IPCA below target (3.75%), the dynamics actually expected by the BCB includes other factors such as a lower GDP retraction and the effects of emergency programs on the demand, in such a way that it "already sees inflation very close to the target". This statement is relevant and signals that the Copom is likely to end the easing cycle. We believe that the BCB will still make a final cut of 25bps at the August meeting, taking the Selic rate to 2.00% pa. Our expectation is that the Selic will be maintained at this level until the second half of 2021, when the normalization cycle should start.

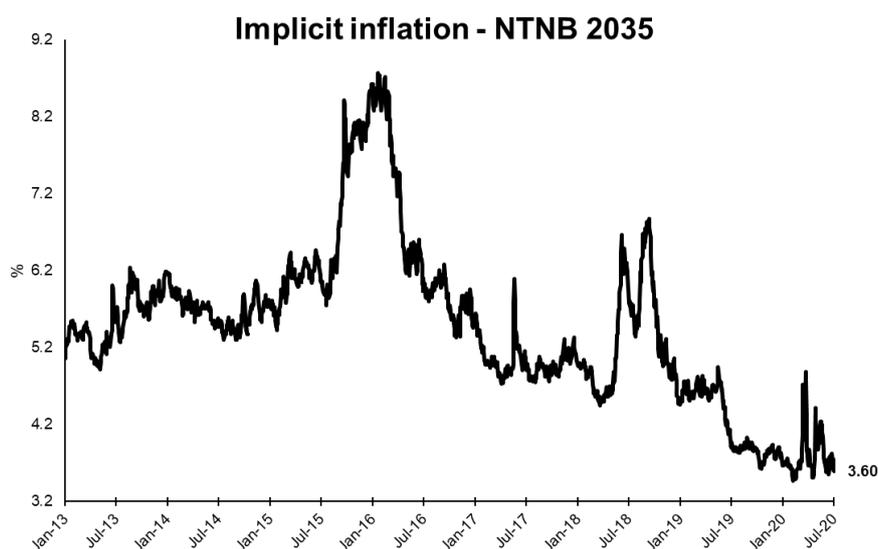
The scenario faced by the BCB is complex, pointing to a cautious approach from now on. Looking at inflation and activity projections, there's still room for further cuts, especially if we consider that there is no such thing as a minimum threshold above zero, after which further cuts would become counterproductive and, leading to worsening financial conditions (see discussion on the ELB in the previous month) . On the other hand, the fiscal risk is increasing and the pressure to create permanent expenses will increase in the coming months as discussions on the 2021 budget approach amidst the recession and the worsening of unemployment.

The government announced the extension of the emergency aid programme (popularly known as "coronavoucher"), totaling R\$ 1,200 to be provided throughout three months. The announcement, which corresponds to an additional R\$ 100 billion expenditures for 2020, came within our expectations, as well as the government's primary result, which reached 3.9% of GDP (accumulated in 12 months) in May, and should end 2020 at 12% of GDP - bringing gross debt to 92% of GDP.

However, we remain alert on increased discussions over a potential new minimum income program (Renda Brasil) to replace “Bolsa Família”. Without clarity on where would the budget for come from (whether it would be from existing wealth distribution programs or new mandatory expenditure) in order to ensure fiscal sustainability, this adds up to our concerns over the uncertainty of the temporary nature of emergency measures. In this context, something that raised our attention in June was the discussion brought by the President of the Lower House, Rodrigo Maia, over possibly extending the War Budget to 2021 and revising the spending ceiling.

Nonetheless, for now, we maintain our projection of GDP debt growth to 94% in 2021, resulting from a government's primary deficit of 4.1% of GDP.

Meanwhile, markets seem so far complacent with the growing fiscal risk. Long-term implicit inflation is around 3.6% on NTN-2035, practically at the inflation target if we consider the historical risk premium. It's worth noting that the Monetary Policy Committee (CMN) reduced the 2023 inflation target to 3.25%, in line with expectations, and may reduce it to 3.0% in 2024 – closer to other emerging markets.

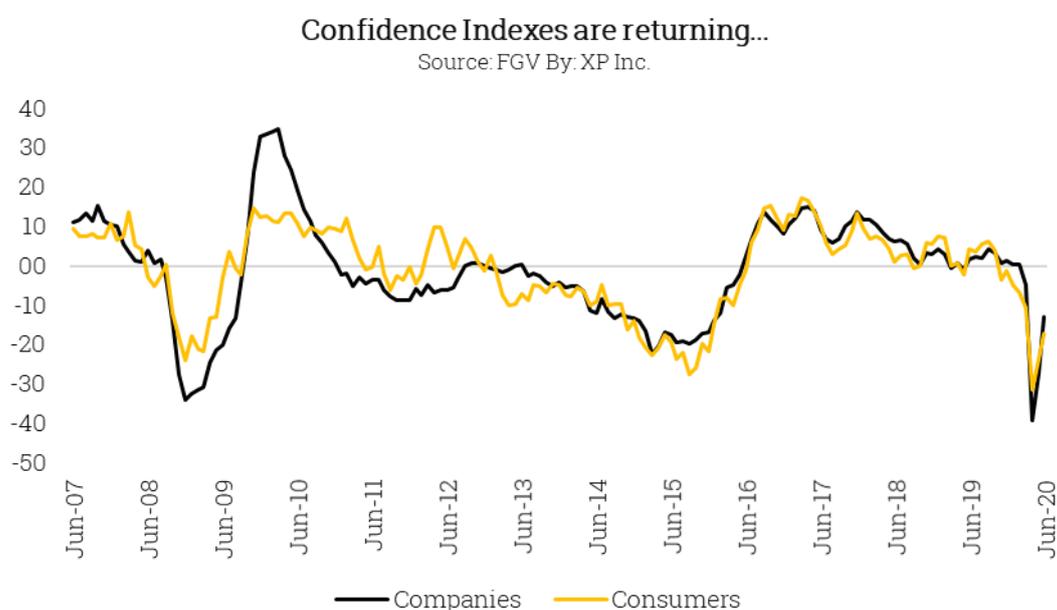


Given the above described scenario, we revised our projections for inflation and exchange rate. The 2020 IPCA was revised from 0.8% to 0.9%, led by higher inflation for gasoline and meat, but still well below market expectations. For 2021, our forecast fell from 3.2% to 3.0%, following a more appreciated exchange rate. On this, as detailed in our piece [“Preparing for the resumption: exchange rate”](#), we revised our exchange rate forecast in 2020 from R\$/US\$ 5.50 to R\$/US\$ 5.20.

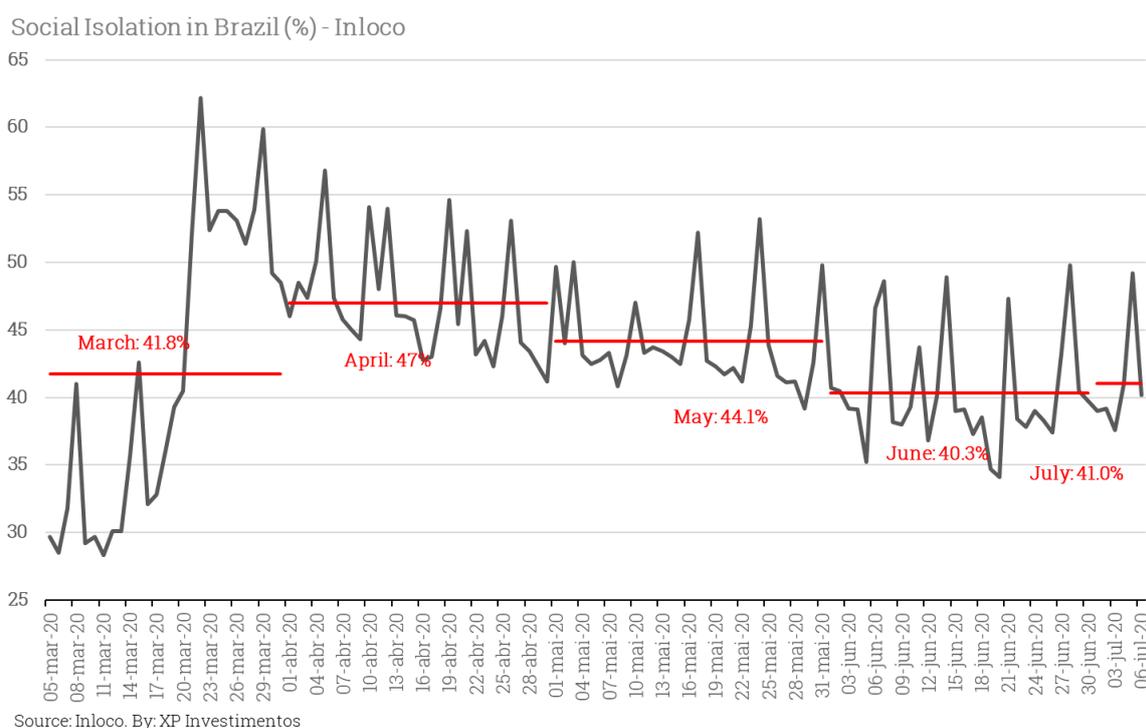
For 2021, we see a more positive scenario for emerging countries on the back of: i) the normalization of activity after a vaccine becomes widely available; ii) the maintenance of an highly expansionary monetary policies in developed countries; and iii) some recovery in commodity prices (oil as the main highlight). On the other hand, fiscal risks in Brazil should prevent a more relevant currency appreciation. We, therefore, revised our 2021 forecast from R\$/US\$ 5.50 to R\$/US\$ 4.90, which represents an appreciation of about 6.0% in relation to our 2020 forecast.

The activity indicators for the second quarter presented better results than expected, signaling that the “rock bottom” must have been lower than initially feared. Business and consumer confidence indexes recovered 83.8% and 81% from the pre-pandemic level, respectively. We maintain our forecast of a 6.0% GDP contraction in 2020 and a growth of 2.5% in 2021.

The projections reflect that there is still lots of uncertainty on the pace of economic recovery in Brazil. On the one hand, the worst moment is behind us and high frequency indicators point to a substantial recovery in the third quarter. On the other hand, the pandemic imposed a significant setback in the labor market (mainly informal), and the end of emergency aid in September helped to increase uncertainty about aggregate demand in the last quarter of this year.



On the pandemic front, the optimism about the reopening process continued in June, with the states of São Paulo and Rio de Janeiro showing improvement in the ICU occupancy rate. However, while capitals saw a “flattening” of the curve, there was a clear increase in the number of cases in the countryside/suburban areas. Therefore, our scenario remains the same as in previous months: the contagion curve will likely keep “running at high speed”, with a very slow decline in places that are closed for longer. We hope that the measures of social distancing and improved social awareness will be sufficient to avoid a strong acceleration in the number of cases. Cities are reopening gradually, marked by a slow (see graph below) resumption of activity – making the month of July decisive.



In conclusion, both in Brazil and around the world, the perception that the second quarter represented a “rock bottom” in terms of economic output, especially thanks to the government’s and central bank’s fiscal and monetary stimulus, is now reflected in indicators. From now on, uncertainty hangs over the progress of the disease in some central economies and in Brazil. Despite the small probability of the reintroduction of social isolation policies, this uncertainty contributes to the scenario of a gradual resumption of economic sectors such as trade and services. In addition, the withdrawal of credit, fiscal and monetary stimuli may reduce the strength of aggregate demand, as the labor market - with more lagged dynamics - will recover slowly. Therefore, it will be key to monitor these risks in July (observing other countries, given our delay in the pandemic timeline), as the pace and nature of the economic normalization will be marked by volatility and uncertainty, until we know a solution coming from science.

Disclaimer

This material was prepared by XP Investimentos CCTVM S.A. ("XP Investimentos" or "Company") and should not be considered as a research material for the purposes of article 1° of CVM Instruction 598/2018. All opinions, projections and estimates constitute the judgment of the author as of the date of transmission and these, plus any other information contained herein, are subject to change without prior notice. The Company does not support or oppose any political parties, political campaigns, candidates, or public officials. Furthermore, XP Investimentos is not permitted to give corporate funds, property or other resources to political parties or candidates and will not reimburse any shareholders, directors, officers, employees, and licensors for such contributions or expenditures. XP Investimentos and its affiliates, parents, shareholders, directors, officers, employees, and licensors will not be liable (individually, jointly, or severally) to you or any other person as a result of your access, reception, or use of the information contained in this communication.

Past performance is no guarantee of future results. Therefore, nothing in this report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances or otherwise constitutes a personal recommendation. This report is published solely for information purposes, it does not constitute an advertisement and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. This material (including any attachments) is confidential, may contain proprietary or privileged information and is intended for the named recipient(s) only.

