From: Daniel Sabba [redacted]
To: "'Jeffrey Epstein'" <jeevacation@gmail.com>
Subject: FW: Faria: Brazil Daily Update
Sent: Wednesday, June 24, 2015 9:39:46 PM

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From: Isin Sumengen-Ziel (DEUTSCHE BANK AG, LO) [redacted]
Sent: Wednesday, June 24, 2015 04:49 PM Eastern Standard Time
To:
Subject: Faria: Brazil Daily Update

Thursday highlights:
FIPE is due to release the third June preview of São Paulo's inflation index, and we expect 0.55%. IBGE will release its employment report (PME) for May and we expect the unemployment rate to climb to 6.6% from 6.4% in April, reflecting the steep deceleration in job creation and deepening recession. The National Monetary Council (CMN) could decide on the TJLP rate for 3Q15. We expect the CMN to raise the TJLP by 50bps to 6.50%, repeating the previous two decisions, in line with the government's intention to curb subsidized lending. The CMN will also announce the inflation target for 2017, and although we expect the government to keep the 4.5% target, the local press has been discussing the possibility of a slight reduction in the target to 4.25%, or perhaps narrowing the tolerance band (currently plus or minus 2% around the center target), which would be a positive measure aimed at taming inflation expectations in our view. During the week, the government could release the federal tax receipts for May, and we expect BRL94bn, down from BRL109bn in April due to seasonal factors and also reflecting weak economic activity.

Inflation Report suggests further monetary tightening, but not too much
According to the quarterly Inflation Report published on Wednesday, the BCB's passive inflation forecast for 2015 climbed to 9.0% from 7.9%. Despite the sharp increase in the 2015 forecast, the IPCA forecast for 2016 fell slightly to 4.8% from 4.9% (we expected 4.7%). The "reference scenario" (passive forecast) now shows inflation converging to the 4.5% target in 2Q17. These forecasts assumed an exchange rate of BRL3.10/USD (vs. BRL3.15/USD in March) and a SELIC rate of 13.75% (vs. 12.75%) throughout the forecasting period. The BCB estimated administered price inflation of 13.7% (vs. 11.0%) for 2015 and 5.3% for 2016, and revised its 2015 GDP forecast to -1.1% from -0.5%. In the "market scenario" based on macro parameters provided by the Focus survey (assuming a weaker FX and lower interest rates), the 2015 forecast rose to 9.1% from 7.9%, the 2016 forecast was unchanged at 5.1%, and the 2Q17 forecast was 4.8%.
As we expected, the Inflation Report indicated clearly that the tightening cycle is not over yet. On page 75, the authorities wrote that "for the COPOM, the progress obtained in the fight against inflation – as exemplified by the benign signals coming from the medium- and long-term expectations – are still insufficient." However, since the official forecasts are close to the target in 4Q16 and reach the target in 2Q17, we believe we the cycle is close to an end. While the BCB's assumption that the fiscal targets will be fully met in 2015 and 2016 are overly optimistic, in our view, the GDP contraction forecast of 1.1% is optimistic as well, and a wider output gap would make inflation converge to the target faster. Moreover, a decline in inflation expectations caused by the BCB's hawkish stance could also contribute to further lower the official inflation forecasts (as they are an input of the model). We also call attention to the Inflation Report's "box" on inflation persistence claiming that a shock in administered prices (which has been the main driver of inflation this year) is relatively short-lived, thus reinforcing the BCB's opinion that the current market consensus forecast of 5.5% inflation for 2016 is too high.
All in all, we believe the BCB will deliver at least 50bps more, but no more than 75bps in hikes. We continue to expect a final 50bp hike in July, although we cannot rule out a scenario where the COPOM hikes by 50bps in July and finishes the cycle with a 25bp hike in September. Furthermore, the forecasts presented in the "market scenario" suggest that, once the BCB pauses, it will probably stay put for several months before cutting rates again.

Business confidence in the industrial sector fell further in June
According to preliminary data released by FGV, its business confidence index fell 4.7% MoM to 68.2 in May, reaching an all-time low. The current conditions index fell 5.4% to 70.6, and the expectations index fell 4.2% to 65.8. Capacity utilization fell further to 78.7% from 79.0%, the lowest level since April 2009. In our opinion, given the overall deterioration in this year's economic outlook, expectations of negative GDP growth, and turbulent political environment, business confidence will remain depressed for a while despite the potentially positive effect of the FX depreciation.

FX outflows persist in June
The FX market posted a net outflow of USD2.6bn in the first three weeks of June. The commercial market posted a small surplus of USD0.8bn (as export-related inflows fell 15% from May) and the financial market had a deficit of USD3.8bn (projecting a smaller deficit than in May, as financial inflows rose 29%).

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