29 March 2012
www.btgpactual.com/research

1Q12 Inflation Report

Pledge and plan

Eduardo Loyo ● eduardo.loyo@btgpactual.com ● +55 21 3262 9707
Claudio Ferraz ● claudio.ferraz@btgpactual.com ● +55 21 3262 9758

The quarterly *Inflation Report* released today by the Central Bank of Brazil contained precious little news about the likely future trajectory of the Selic rate. The report does reiterate the intention already expressed (with great clarity) in the minutes of the March Copom meeting to bring the Selic rate to levels slightly above its historical lows – i.e., to 9% – and to hold it there. Since that message came out a couple of weeks ago, some media reports started putting numbers to the length of the intended holding period for the Selic rate, on the basis of information provided by unnamed government sources, stretching as far as 2 years out. These accounts raised questions as to whether the *Inflation Report* might officially make a more explicit 'low for longer' pledge. It did not.

If there is anything in the report with a bearing on how long rates would be able to stay at 9%, it points instead to the eventual need for rate hikes. Here we refer to the report's conditional inflation forecasts, acknowledging however that, just as the hawkish signal they seemed to convey in the December 2011 *Inflation Report* has since been belied by subsequent Copom communication and decisions, they may no longer provide a very reliable indication of the possibilities envisaged by the Central Bank for the future path of monetary policy.

What the conditional forecasts point to is that inflation would be around the target midpoint this year and then accelerate again to levels like 5.2-5.3% by the end of next year (the forecasts differ by a mere 10bps between the reference and the market scenarios, as the underlying assumptions are themselves reasonably close). This happens in spite of the Selic rate ending next year above the 9% mark: in the reference scenario, it would have been kept at 9.75% throughout, while in the market scenario it is assumed to climb back to 10% between March and June 2013. Such results would typically imply the Central Bank's recognition that some of the recent rate cuts will need to be reversed. But the usual implication may not automatically hold if the monetary authority, as it has been repeatedly declaring, works with a strong downward bias in the balance of risks around these forecasts, or else if it contemplates tightening monetary conditions through tools other than base rate hikes. As Deputy Governor Carlos Hamilton Araújo stressed again in today's press conference, the downward bias to the balance of risks means that the Central Bank finds it more likely that, going forward, inflation forecasts will be revised lower rather than higher.

We note in the forecasts some improvement with respect to the numbers reported in December. First, the forecasts for end-2012 have been revised downward by 30bps, thus bringing the market scenario precisely in line with the 4.5% midpoint. This revision, however, results mainly from 40bps having been shaved off the 1Q12 forecast, now that everyone already knows the readings for January and February and there is a considerable amount of preliminary information about March. With regard to 1Q12 inflation, last December's *Inflation Report* was actually more *pessimistic* than market consensus at the time – if only by some 10bps – and now the assumed quarterly figure is closely in line with the lowered consensus. For the remaining quarters of 2012, the revisions between the December and March reports have been small and approximately balance each other out, and these quarterly forecasts remain consistently more optimistic than market consensus. The discrepancy between the official and market forecasts is as large as 30bps for 2Q12 alone, meaning that the corresponding yearly projections are due for a considerable realignment, one way or another, as the results for the next quarter become known.

As one drops the 1Q12 quarterly reading from the trailing 12-month window – i.e., from 1Q13 onwards – the new report actually points to *higher* annual inflation than last December's version, further illustrating the dependence of the downward 2012 revision on the favorable surprise brought by the first quarter. The saving grace with respect to the longer term is that, with the forecasting horizon now extended by one further quarter, we now see a 10bps decline in inflation as we enter 2014, compared to the end-2013 readings. This is indeed not a large reversal and still leaves inflation clearly above the target midpoint, but at least it reveals that the Central Bank's forecasting methods do not foresee inflation indefinitely diverging under the assumed monetary conditions.

Much of the anticipation (frustrated so far) of a clearer 'low for longer' pledge draws inspiration from the Federal Reserve's recent signaling policy. The analogy may sound obviously stretched for an economy which is nowhere near the *zero* lower bound for the nominal interest rate, but it might apply if the authorities cannot muster the political will to reform the existing remuneration scheme of savings accounts (which earn a yearly tax exempt minimum return of 6.17%, and thus place well above zero the lower bound on the returns of other local assets). The true problem with the analogy lies elsewhere: its motivation in zero lower bound cases, such as the US and Japan before it, is to convince market players that the central bank is committed to remain more dovish than its own historical patterns of behavior would suggest, so as to lower the term structure of nominal interest rates and to further reduce ex ante real rates by *buoying up* inflation expectations. In the case of Brazil, contrariwise, the most immediate communication challenge before the Central Bank is to contain the progressive increase of inflation expectations, especially the one observed for longer horizons, which has in turn been predicated on the notion that moderate but sustained upward deviations from the target midpoint *will* be accommodated. As a matter of fact, reversal of this deterioration would be instrumental in bringing the Central Bank's own inflation forecasts – for which private expectations are an important input – closer in line with the target midpoint for next year and beyond.

Another aspect in which, contrary to the expectations of some, the *Inflation Report* did not bring any news was the forecast for 2012 GDP growth, which the Central Bank kept at 3.5%. Although the downside risks to GDP growth seem to have increased since late last year, the Central Bank may have considered (in line with its own historical pattern of behavior) that it is still too soon after that forecast's original release for a revision. At this juncture, avoiding an immediate downgrade of 2012 GDP also contributes to the broader official agenda of spurring animal spirits in the economy.

All things considered, we remain persuaded that the Selic rate will go to 9% in April and stay there at least for the remainder of 2012. On its trajectory for next year it is exceedingly hard to have clarity now, as it will depend on the Central Bank's degree of tolerance towards deviations of its own quantitative inflation forecasts from the target midpoint, on the further evolution of these forecasts themselves in light of new data, and on the interplay between macroprudential regulation and the base rate. Although the Central Bank has refrained from pledging to keep the Selic rate at 9% for any specific amount of time, it may indeed be planning to remain on the sidelines for quite long once it reaches that level next month.

Analysts

Eduardo Loyo
eduardo.loyo@btgpactual.com
+55 21 3262 9707

Danilo Igliori
danilo.igliori@btgpactual.com
+55 21 3262 9059

Claudio Ferraz
claudio.ferraz@btgpactual.com
+55 21 3262 9758

Julia Guerreiro
julia.guerreiro@btgpactual.com
+55 21 3262 8883

Andre Batista
andre.batista@btgpactual.com
+55 21 3262 9843

Marcelo Castello Branco
marcelo.castello@btgpactual.com
+55 21 3262 8774

Bernardo Mota
bernardo.mota@btgpactual.com
+55 21 3262 9660

Required Disclosure

This report has been prepared by Banco BTG Pactual S.A.

The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results.

Additional information will be made available upon request.

Analyst Certification

Each research analyst primarily responsible for the content of this investment research report, in whole or in part, certifies that:

(i) all of the views expressed accurately reflect his or her personal views about those securities or issuers, and such recommendations were elaborated independently, including in relation to Banco BTG Pactual S.A. and/or its affiliates, as the case may be;

(ii) no part of his or her compensation was, is, or will be, directly or indirectly, related to any specific recommendations or views contained herein or linked to the price of any of the securities discussed herein.

Research analysts contributing to this report who are employed by a non-US Broker dealer are not registered/qualified as research analysts with FINRA and therefore are not subject to the restrictions contained in the FINRA rules on communications with a subject company, public appearances, and trading securities held by a research analyst account.

Part of the analyst compensation comes from the profits of Banco BTG Pactual S.A. as a whole and/or its affiliates and, consequently, revenues arisen from transactions held by Banco BTG Pactual S.A. and/or its affiliates.

Where applicable, the analyst responsible for this report and certified pursuant to Brazilian regulations will be identified in bold on the first page of this report.

Global Disclaimer