Emerging Insight

Brazil – Inflation to continue to move down in '24

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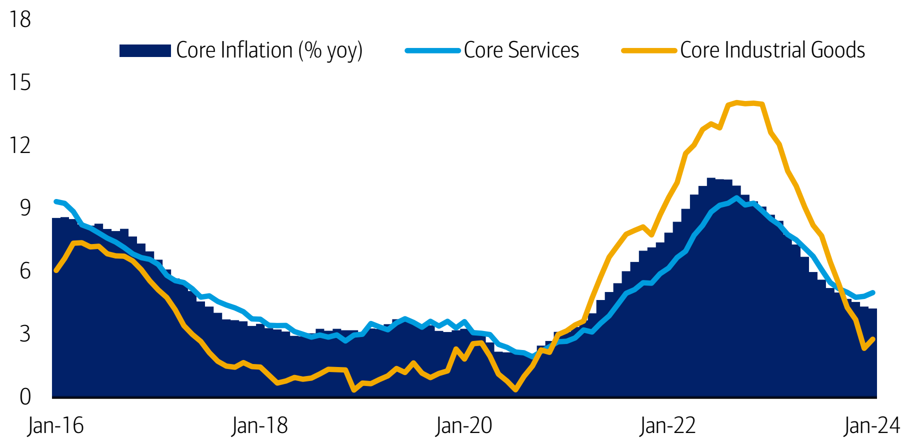
GEM Fixed Income Strategy & Economics
Global

Key takeaways

- Brazil started its hiking cycle ahead of the world and LatAm, and is now benefiting from a well behaved inflation.
- Recent IPCA prints have risen concerns, mainly due to services' prices. However, we still expect deceleration for '24.
- Our IPCA forecast remains at 3.7% in YE24. For Selic, we continue to expect 9.50% (terminal rate) in Jul24.

By David Beker and Natacha Perez

Chart of the Day: Despite IPCA deceleration, services prices remain sticky.
We expect headline and underlying inflation to still present a tamed behavior this year



Source: BofA Global Research, IBGE

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Brazil in Focus

Inflation will continue to decelerate in 2024

After the pandemic recovery period, several countries began to face inflationary pressures with activity resumption, leading Central Banks to adopt a contractionary monetary policy. Within this context, Brazil started its hiking cycle in Mar21, ahead of the rest of the world and even its LatAm peers. Due to this more restrictive monetary policy stance, currently, prices in the country have been showing a benign behavior, which allowed the Brazilian Central Bank (BCB) to start its easing cycle in 2023.

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However, recently, the breakdown of the latest IPCA releases has risen some concerns for market analysts and the BCB, due to core services inflation uptick. Activity in the sector has remained strong, driven mainly by a heated labor market and higher wages pressures. Yet, we don't see this increase changing our IPCA forecast of 3.7%yoy for YE24 (from 4.6%yoy in YE23), as we expect employment measures to slightly deteriorate and the output gap to remain negative this year. We also believe this upward pressure reinforces BCB's cautious stance and the pace of 50bp clips for the next 3 meetings, as Selic should reach the terminal rate of 9.50% in Jul24

Recent services prices print rose concerns…

Brazil stood out compared to its LatAm peers as it hiked more and faster than its LatAm peers (Exhibit 1). The first decision to increase rates happened in March 2021, when the IPCA was at 5.20% yoy. With a more restrictive monetary policy stance adopted by the BCB, inflation gradually showed better signs, reaching the inflation tolerance band in 2023 (3.25%+1.5%), after two years of misses.

Despite this context, more recently, price concerns have begun to re-emerge, especially after January IPCA surprised the market to the upside. Though we continue to believe that inflation remains well behaved and these worries should not change the monetary authority's guidance, the breakdown of the latest prints - namely, core services (Exhibit 2) - has drawn the attention of analysts and the BCB (For more, see: [Brazil Watch: Copom minutes: eyes wide open](#)).

Exhibit 1: LatAm started earlier the hiking cycle
Policy rate hikes since January 2020

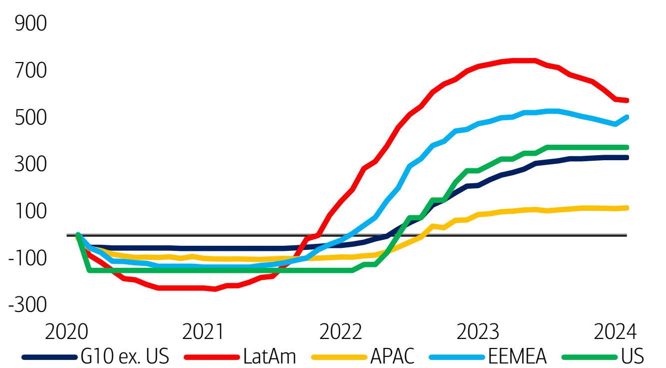

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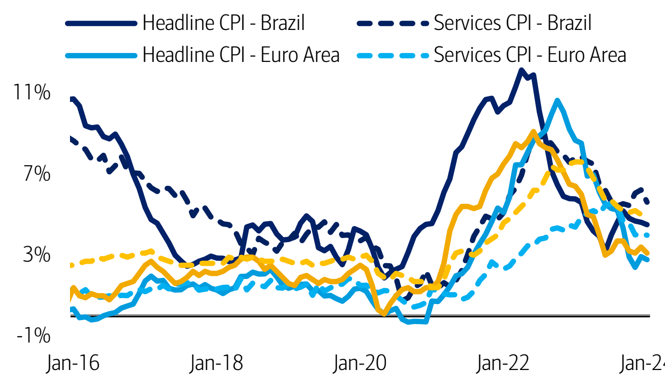
Exhibit 2: Services prices remain sticky
Headline and services Inflation (%yoy)



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… But we see the sector cooling down in '24

The recovery of services was seen as a natural movement, especially because it is a labor-intensive sector and, therefore, was deeply impacted by social distancing. However, even though the post-pandemic recovery period has already passed, activity in the sector continues to post relatively strong prints.

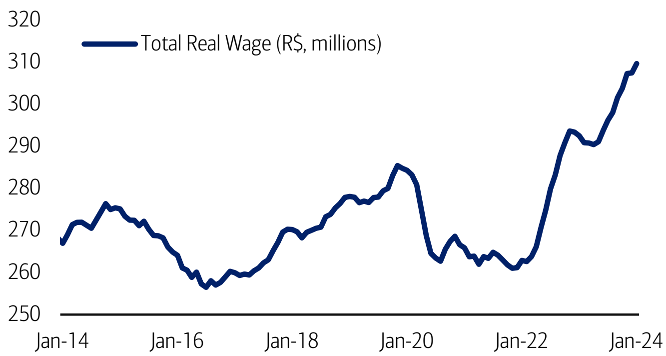
According to Brazilian Institute of Geography and Statistics (IBGE) statistics, the volume of services grew 37.9% between Apr20 (when COVID-19 restriction measures were more impactful) and Dec23 in the seasonally adjusted series. In the last year, the same index grew by 2.3%. In comparison, the seasonally adjusted retail sales volume index increased 27.8% in the same period and was up 1.7% in 2023.

In this sense, this backdrop seems to be pointing towards a change on consumer preferences, opting for services rather than goods. One of the reasons for this movement can be attributed to the heated labor market and increased pressures for higher wages (Exhibit 3) in the last year, which enabled households to consume more services, which are typically associated with higher incomes. Wages are also the main costs of the sector, meaning that rising remunerations translate into higher final prices

In addition, when we compare inflation evolution between sectors, we notice that, proportionally, retail prices rose more than services in recent years (Exhibit 4). According to the implicit deflators of the series, core and broad retail prices rose by 36.2% and 36.7% between Jan20 and Dec23, respectively; while services' prices went up by 17.1% in the same period. This relative cheapening of service prices may have been another reason for a demand increase in the services sector, to the detriment of consumer goods.

Nonetheless, we don't expect this strong performance to remain throughout 2024. First, the labor market is expected to deteriorate this year, as we foresee unemployment rate to end at 8.0% in 2024 (from 7.4% in 2023). A slightly weaker activity and lower pressures for wage negotiations should also contribute to the deceleration in the sector. Besides that, another point to be highlighted is that we expect the output gap to remain negative this year, i.e., with the economy operating below its potential level.

Exhibit 3: High levels of total disposable income
The strong labor market has been pressuring services prices



Source: IBGE

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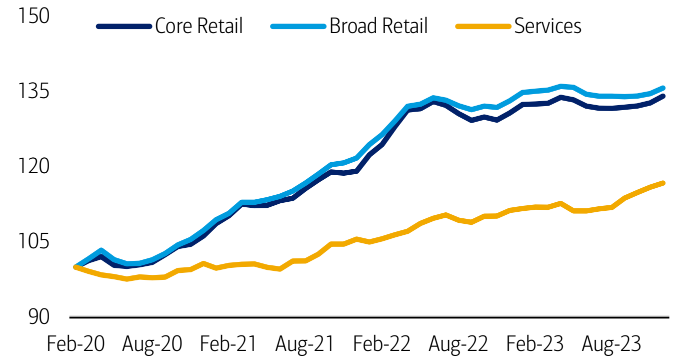
Exhibit 4: Goods are more expensive than pre-pandemic
Retail and Services implicit deflators (Feb20 = 100)



Source: IBGE

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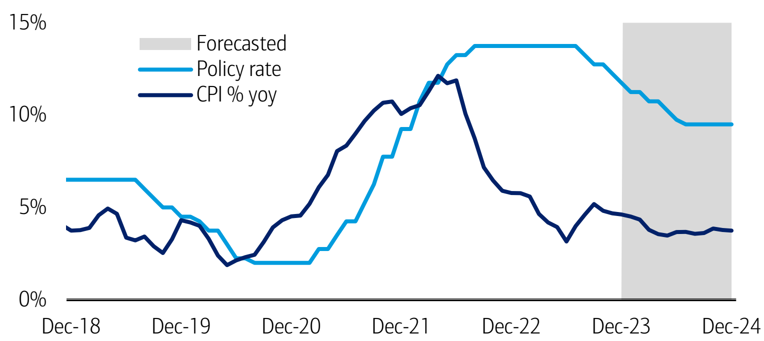
We maintain our IPCA forecast of 3.7% in YE24

All in, we expect services prices to continue to decelerate this year, reaching 4.5%yoy in YE24 (from 6.2%yoy in 2023). Though core services accelerated at the margin in Jan24 print (0.76% mom, from 0.51%), we still see room to inflation move down – as high real rates should continue to contain prices acceleration ahead.

Exhibit 5: IPCA should end 2024 at 3.7%
We expect a Selic rate of 9.5% (terminal rate) in YE24



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Therefore, we maintain our IPCA forecast at 3.7% in YE24 (from 4.6% in YE23), as inflation should still be impacted by the contractionary monetary policy and base effects from federal tax reoneration - leading to declining core components and regulated prices. On the interest rates side, we continue to expect BCB board members to keep the same magnitude of the easing pace during 1H24 and, then, deliver one last 25bp clip Sin July, taking Selic to a terminal rate of 9.50% (Exhibit 5).

News and Views

Brazil: Outstanding credit continues decelerating in yearly terms

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Total outstanding credit decelerated to 7.6% yoy in January (from 8.1% yoy in December) according to the Brazilian Central Bank (BCB). As has been since last year, the bulk of deceleration came mainly from non-earmarked loans (now at 4.6% yoy, from 5.5% yoy in December), particularly due to non-financial corporates (NFC). For overall earmarked loans, data slightly accelerated in the month, reaching 12.0% yoy (from 11.9% yoy previously). Regarding marginal data, originations rose 3.1% momsa at the margin, following two consecutive positive prints. On the other hand, broad credit growth, which includes debt securities, sovereign bonds and external debt, accelerated to 9.2% yoy (from 8.2% previously). Household debt fell to 48.0% (from 48.2% in November), while debt service ratio went to 26.1% in seasonally adjusted terms (from 26.6%). Besides that, Individuals book and Corporate NPL moved both up to 2.7% (vs 2.6%) and 4.0% (vs 3.9%), respectively.

- **To follow:** Though the picture should become less tight due to the lagged effects of the easing in monetary policy, the turning point is yet to be seen.

Mexico: Auto production increased 7.8% yoy in February

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Auto production in February increased 7.8% yoy (vs 9.9% a year ago, 9.6% a month ago), auto exports increased 22.6% yoy (vs 14.2% a year ago, 6.8% a month ago), and auto sales increased 11.1% yoy (vs 28.0% a year ago, 18.7% a month ago), according to AMIA. During the first two months of the year auto production increased 8.6% ytd (vs 6.1% a year ago), auto exports increased 14.6% ytd (vs 12.0% a year ago) while auto sales increased 14.8% ytd (vs 24.1% a year ago).

- **To follow**: Auto production is recovering, as it fell -9.9% yoy in December. This coincides with the deceleration in activity in the 4Q of last year and lines up with our view that growth will pick up and remain strong in the 1H of this year.

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