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Single Digit Selic in 1H2017?

João Mauricio Rosal, *Chief Economist, PhD*
joao.rosal@bgcpartners.com

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- *The huge budget for rate cuts and limited risks to the easing cycle calls for stronger action by BCB.*
- *Accordingly, we believe the Central Bank will overcome its excessive conservatism this time around and opt for 125pbs cut.*
- *Moreover, it may also signal that single digit rates may be observed already in 1S2017, entailing a possible cut of 125bps in May's meeting as well.*

1. Our COPOM Call

◇ **Our Call**: We believe the Central Bank (CB) shall cut the Selic by 125bps this coming Wednesday. As a matter of fact, we understand it could dare further, however, based upon the conservatism shown till the moment, we feel more comfortable in expecting a more contrived move this time around.
In addition, it is not unlikely the CB hints that it may pursue a single digit rate already in 1H2017. In this respect, any move shall depend on the CB's risk assessment with regards to short-term risks, in particular, to the outcome of social security reform, which revolves around subjective judgments as well as information that only those in Brasilia may hold.

◇ **The Size of the Budget**. The incoming data continued to underscore that the economy is stuck in a depression and that signs of recovery are mixed, at best. As matter of example, the Central bank's GDP tracker shrunk 0.26%momsa in January, while industrial production tanked 0.7%mom in February. To put it mildly, this is rather disappointing for an economy with an output gap estimated at about 3-4% below potential.
On the inflation front, CPI inflation is already on target, having reached 4.57% in March. Moreover, the average month-on-month annualized rate in the 1Q2017 has reached a dismal 3.8%, while the 2018E expected inflation is at 4.5%. Hence, if one sums all that up with the state of the economy, it is not difficult to see that any type of taylor rule should advocate a rate at about 200bps below neutral, currently standing at 9.6% by market metrics (real rate of 5.1% plus inflation target).
Therefore, when we take the aforementioned figures into consideration, along with the fact that the fiscal policy is on the contraction mode and subsidized credit has collapsed, we understand there is still a huge budget of cuts ahead of us, of about 450bps.

◇ **Risks**. As usual, risks abound, but as far as the intervening period between this week's meeting and the one in May is concerned, we reckon two of them call for special attention. On the local front, a negative outcome for social security reform may lead to a meaningful market dislocation, particularly in face of the fact that local assets look a bit pricey relative to the uncertainties concerning the reform.
On the global camp, besides the usual worries concerning international financial conditions, the first round of French Presidential election scheduled to April 23 can potentially send waves of shocks across the globe. However, from our vantage point, their possible impact seem less worrying relative to those on the local front.

◇ **Net/Net**: Be all that as it may, while the realization of the aforementioned negative outcomes may indeed shorten the length of the easing cycle, we understand that a 125bps cut in this Wednesday's meeting wouldn't lead the Central Bank into any radical u-turn, should any of these events occur. In the meantime, on the margin, the move could entail a more expedient recovery of the economy, which has already taken far too long, with many negative feedback loops, in particular, over fiscal policy outlook.

João Mauricio Rosal, *PhD*
joao.rosal@bgcpartners.com
+55 11 3077-2351

2. Forecast

Variable	2016	2017E	2018E
GDP (yoy %)	-3.5	0.3	2.5
Selic Rate (%)	13.25	8.00	7.5
Fx Rate (BRL per USD)	3.20	3.25	3.30
CPI (yoy %)	6.3	4.0	4.3
Gross Debt to GDP (%)	73.0	77.2	83.2
Primary Surplus (% GDP)	-2.1	-2.0	-1.0
Trade Balance (% GDP)	2.0	1.5	1.5
Current Account (%GDP)	-1.2	-1.5	-2.0
Foreign Reserves (xUSD Gross Liabilities)	1.1	1.1	1.1

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+55 11 3077-2351

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João Mauricio Rosal, *PhD*
joao.rosal@bgcpartners.com
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