Currency Strategy
Latin America

HSBC
Global Research

LatAm FX Focus

Brazil: Aiming for a competitive BRL

- **While the BRL has recently outperformed relative to its EM FX peers…**
- **…we believe the BCB's reduced swaps roll-overs and economic headwinds will set a floor in USD-BRL**
- **We believe a weaker BRL is necessary to restore industrial competitiveness and rebalance Brazil's faltering economy**

Headwinds limit BRL upside

Despite many factors working against it, the BRL has managed to outperform many of its peers. We cite two primary factors that have contributed to this price action:

1. Reduced long USD FX positioning of both foreign and local investors, and
2. The BCB's hawkish stance on monetary policy which has made the BRL more expensive to short, and more attractive to be long, at least from a carry perspective.

In this report, we examine the contributing factors to the BRL's recent price action and highlight the headwinds that might limit, or even reverse the recent BRL rebound. We also discuss the reasoning behind the BCB's monetary policy stance, and what effect it might have on the currency going forward.

The latest economic data suggest that Brazil's recession may be deeper than many had expected. We thus see the BCB continuing with its policy goal of maintaining a competitive BRL in an effort to rebalance its faltering economy. We believe this will involve further unwinding of its short USD forward positions by allowing greater swaps maturities (effectively buying USDs back), particularly should the BRL strengthen further. This should help to set a floor in USD-BRL.

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BRL relative outperformance

With a challenging domestic and international backdrop, we believe the BRL has more room to weaken over the medium term. And yet, over the last two months the BRL has been on a better footing, made possible by:

a consolidation of the USD's broad rally and a reduction in long USD positions vs the BRL,

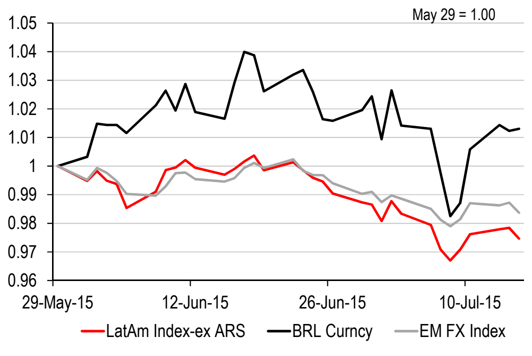
an increasingly hawkish central bank, hiking rates to 13.75%,

hopes that the fiscal adjustment efforts will provide more policy orthodoxy,

the abundance of global liquidity and investors' search for yield.

The BRL managed to outperform most of its peers in the recent EM FX sell-off (see Chart 1), even with commodity prices falling and the BCB implying it will purchase USD4.1bn at the end of this month, based on its swaps roll-over rate. Chart 1 shows the relative performance of the BRL vs the USD compared to an index of both EM currencies and LatAm currencies, all since the end of May. The BRL has gained modestly while the other indices have fallen vs the USD.

Chart 1: BRL outperformance vs EM FX and LatAm FX



Source: Bloomberg

Solving the Puzzle

Given that the underlying conditions for the BRL have not improved markedly, we look for explanations elsewhere. We believe that much of the good price action in BRL can be mainly explained by items 1. and 2. on the list above. Risks remain latent. Among them, our concerns on growth are on the rise, in particular about the prospects for a recovery in 2016. Ironically, part of our concerns stem from the hawkish stance on monetary policy. It may be the case that one factor which is supporting the BRL now, will come back to hurt it later.

Positioning explains a lot

The market has been very long USDs all year-long, and at current BRL rates, the marginal USD buyer has become scarcer. The BCB's hawkish stance has made it even more expensive to short the BRL.

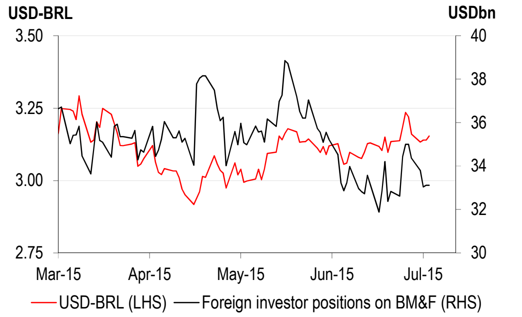
Foreign investors trim their USD longs

Foreign investors trimmed their long USD positions in recent weeks, although still remain long around USD32bn (black line in Chart 2). Since the peak in early June, foreign investors' long USD positions have been reduced from USD39bn to USD33bn.

… while local funds are following suit

to FINRA regulations.**Local Brazilian funds have also been reducing their long USD positions**. From a peak of USD34.5bn in January 2015, long USD positions among local funds have

Chart 2: Foreign investors reduce their long USD positions



Source: BM&F Bovespa, Bloomberg, HSBC

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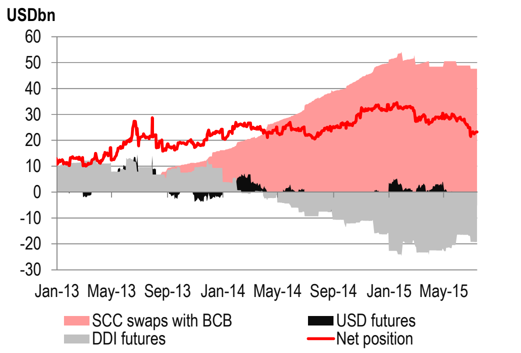
fallen by USD11.2bn to USD23.3bn as of 10 July. These funds have been unwinding their long USD positions amidst stable market conditions too, suggesting the decision is strategic.

Chart 3: Local funds' USD-BRL positions



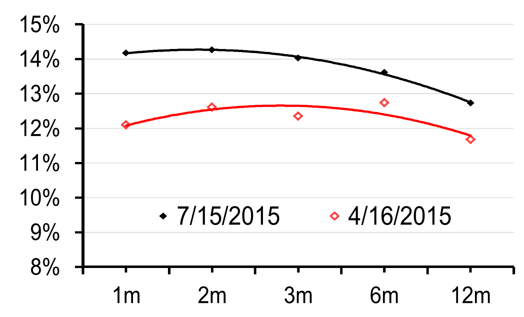
Source: Bloomberg, HSBC

The data is consistent with the BCB's gradual reduction of the swaps intervention, which the authorities have said was possible due to a reduction in USD hedging demand in the system. Partly, the system was already very long USDs, but we also think that the rising cost of being short BRL has motivated this reduction in positions among locals.

Blame the carry

The biggest change among BRL inputs has been the rapid increase in interest rate differentials thanks to the BCB's delivery of 275bps of rate hikes since October 2014, 200bps of which have come this year. The return of the superior carry in BRL has positive direct and indirect implications for the currency, which dissuade overly bearish BRL positions despite still weak fundamentals.

Chart 4: BRL yield curve shifts higher



Source: Bloomberg

Direct Impact

The more direct impact is that it significantly increases the cost of selling BRL. With BRL valuations having improved so much in the last two years, the risk-reward of bearish BRL positions is less attractive. We ourselves have maintained our USD-BRL forecast (to end the year at 3.20), which now reflects a more neutral stance for the rest of 2015. For next year, we are pencilling in a slower pace of depreciation, though we see risks rising to our view (see more below).

We do not see evidence that investors are enthusiastically putting on long BRL carry trades. Simply, they are reducing some of their existing short BRL positions.

Indirect Impact

The global backdrop has helped as well. The stability of the EUR-USD and unresolved expectations on Fed lift off has provided an impetus for yield searching. Brazilian assets have benefited in this environment from the availability of liquidity globally, as investors have been lured back to higher yielding Brazilian assets.

Overall, FX flows have been better than we had expected. The current account has stabilized in nominal terms, and in May improved to -4.4% of GDP from -4.5% in April and -4.6% in March. The capital account has also seen some modest upside surprises, with net financial flows of USD1.3bn year-to-date. It is worth noting that net FDI too has been more resilient than expected, recovering from a low of USD3bn in February to USD6.6bn in May.

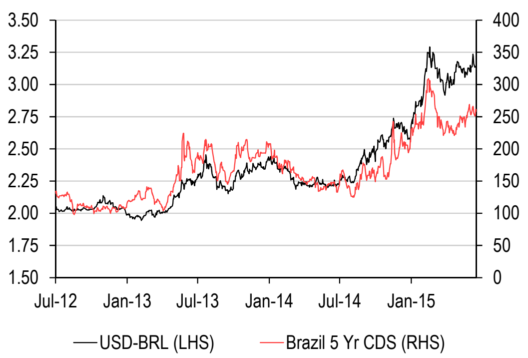
Not out of the woods yet

Despite the somewhat surprising BRL outperformance in recent months, several economic headwinds still remain that suggest this trend may not continue. **The latest economic data show that the recession might be deeper than many had expected.**

Fiscal results falling behind

The latest headlines have been dominated by speculation that the government may reduce the 2015 fiscal target (from 1.2% of GDP) to reflect lower-than-expected tax revenues. Brazilian CDS prices have widened out in recent weeks, and based on recent history, this suggests that USD-BRL should move higher too (see Chart 5 below, where CDS spreads and USD-BRL have tended to move together).

Chart 5: USD-BRL tends to move in tandem with CDS spreads



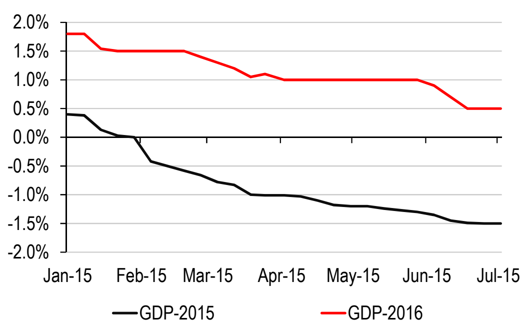
Source: Bloomberg, HSBC

A reduction of the fiscal target for 2015 could prove to be a less critical event for the market if the targets for 2016-2018 are maintained at high levels to ensure that debt-to-GDP dynamics stop rising. **However, confidence in the adjustment is unlikely to improve meaningfully unless tax revenues can improve.**

Growth ever more elusive

Our economists are again becoming more concerned about growth. Optimism over a potential rebound in 2016 is also waning. We have been arguing that 2015 was the important adjustment year for the BRL. But since the economy is expected to improve in 2016, the pressures on the currency to weaken should subside. Now that we are closer to 2016, we find that the prospects for growth are deteriorating, from hopes of a rebound to calls for another year of stagnation. **The latest BCB survey shows 2016 GDP expectations having fallen to 0.5% (from 1.8% at the beginning of the year,** Chart 6).

Chart 6: Consensus growth expectations deteriorate



Source: BCB Weekly Survey

Our economists recommend focusing on consumer indicators for signs of a bottom of the recession. While we had expected some of the improvements in overall macro-policy direction, with FX valuations and real wages to start to filter into sentiment by now, there are still too many uncertainties hurting business sentiment. These include uncertainty over the end of the hiking cycle, concerns of more tax hikes to come, and ongoing investigations into the "Car Wash" scandal. **The result is that the anticipated rebound is being pushed further out**.

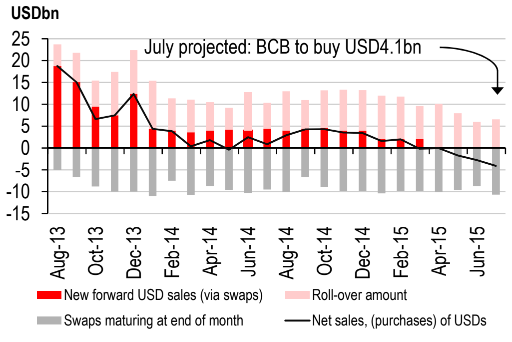
We have highlighted in the past the importance of growth as a driver for the BRL. Finance Minister Levy himself has stressed on a number of occasions the importance of stimulating supply rather than demand to kick start an economic rebound. **A weaker BRL is essential, in our view, to restore industrial competitiveness in order to increase productive capacity**. Indeed, there is evidence of some import substitution starting to take place already. But the sobering reality is that this type of adjustment takes a long time to materialize.

This is particularly true as fiscal and monetary policies are likely to remain restrictive for some time. **Thus the more that the prospects for an economic rebound falter, the weaker the BRL should remain, and for longer, to support a rebalancing of the economy**.

FX policy priority: preserve competitiveness

The BCB's position has been clear so far: offset any inflows by buying back USDs from the swap program and preserve competitiveness gains made in recent years. As bond flows have picked up in recent months, the BCB has been allowing a larger percentage of expiring swap contracts to expire. This is equivalent to buying USDs back at expiry – the first future contract. The BCB started buying back USDs in May and every month it has been increasing the amount it is buying back from USD1.7bn in May to USD2.8bn in June to an estimated USD4.1bn at the end of July (see Chart 7).

Chart 7: BCB rolling over less swap contracts



Source: BCB, HSBC

After this month, the BCB still has some USD108bn in outstanding swaps. We expect them to continue unwinding these short USD positions, and the pace of USD buying to increase should the BRL appreciate.

We do not believe the BCB is so much targeting a specific level for the BRL as adjusting to demand for hedges and strength of speculative flows. However, the net effect of these efforts is likely to put a floor in USD-BRL over the coming months, we believe, while the weak domestic backdrop will maintain downside risks to the BRL.

Conclusion

Short term drivers have helped to bring the BRL some support over recent weeks, including reduced long USD positioning, a more hawkish central bank and hopes that fiscal improvements can still be achieved.

However, we remain concerned that over the medium term the BRL will face downside pressures, due to weak growth, domestic politics (resistance to the fiscal tightening program as the labor market deteriorates) and a challenging FX flows environment where the current account deficit is still wide, and portfolio capital flows may turn negative.

Further, we believe that local authorities are keen to reduce their outstanding short USD positions, and also to maintain a competitive BRL. The combination of these goals points to a likely floor being established in USD-BRL.

Disclosure appendix

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