FX Monthly Report- The Brazilian Real

October 2024

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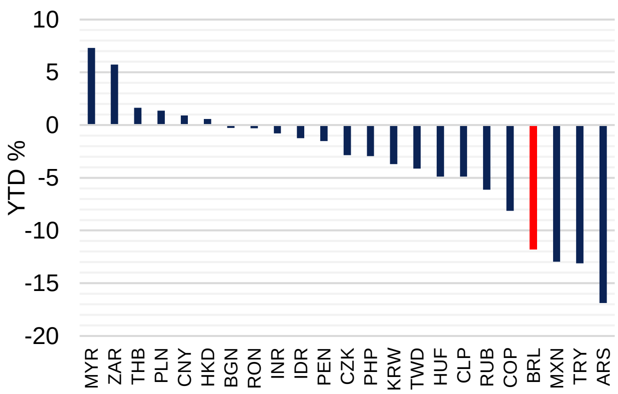
Brazil Focus

Despite a recent boost in emerging market currencies, Brazilian real (BRL) continued to weaken in recent months. A combination of strong US economic performance and ongoing fiscal expansion in Brazil led markets to lower Brazil's valuation over the dollar to 5.40. In September, this narrative shifted with the Fed initiating a rate-cutting cycle, starting with a 50 basis point reduction. A day later, the Brazilian Central Bank (BCB) increased its key Selic interest rate for the first time since March 2022, moving it from 10.50% to 10.75%. This positions Brazil as an outlier in a global context where major economies are reducing interest rates. Relative to other economies, Brazilian inflation forecasts are on the rise, bolstered by a resilient economy and fiscal responsibility. Throughout this year, annual inflation rates have consistently stayed above 4.0%, surpassing the central bank's target of 3.0%.

BRL vs Emerging Currencies Performance YTD

Brazilian Real has been one of the worst EM performers so far this year.



Source: Bloomberg

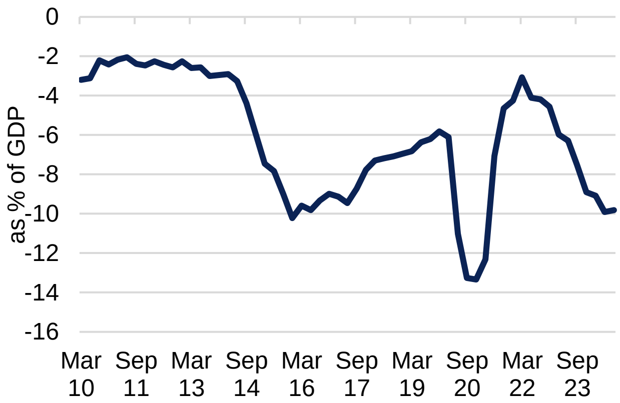
However, the BCB's action had little impact on the BRL's valuation, as the strengthening USD capped BRL gains. We anticipate that the divergence in Brazil's monetary policy compared to the Fed will play a significant role in shaping the USDBRL price trend through 2025. In our view, the BCB is likely to front-load the hikes in Q4 through Q1 2025 in an effort to tackle inflation efficiently before gradually reducing the pace of hikes in response to easing cycles in Western economies. There are a few reasons for this.

Firstly, the current economic environment shows that the nation remains strong. In the second quarter, the country's GDP grew more than expected at 3.3% YoY, leading the BCB to raise its 2024 growth forecast to 3.2% this year, up from June's estimate of 2.3%. Additionally, the nation's unemployment rate has fallen to 6.6% as of August, reaching its lowest level since 2015. This economic optimism was further boosted when Moody's upgraded Brazil's credit rating from Ba2 to Ba1.

Secondly, the high fiscal spending Brazil has engaged in over the past few years is weighing on investors' confidence that the ballooning deficit could be resolved. High fiscal spending tends to stimulate growth through the multiplier effect, meaning that every dollar the government spends can generate more than a dollar of economic activity. To address the primary deficit and alleviate investor concerns about excessive spending, Brazil has announced a reduction in its spending freeze to BRL13.3 billion. Despite intentions to balance the budget this year, it's improbable that the government will succeed in this aim.

Brazil's Fiscal Deficit as % of GDP

Brazil's growing fiscal spending has resulting in growing deficit.



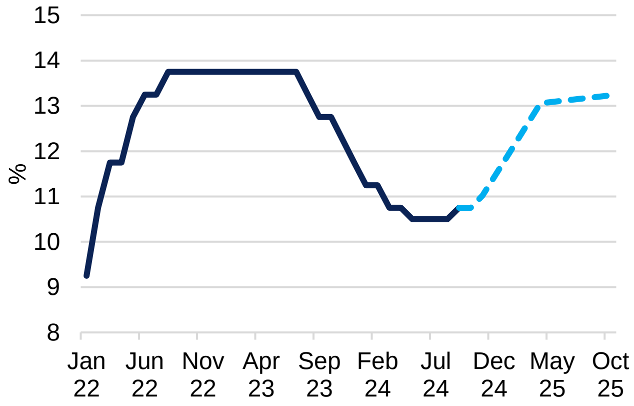
Source: Banco Central do Brazil

Among other major hurdles, Brazil is facing the worst drought on record. The impact on domestic production has been significant, with markets already downgrading their crop estimates for the following year. Given more than half of Brazil's power supply comes from hydro, the dry conditions prompted regulators to apply additional charges to electricity bills in response to a drop in reservoir levels. This indirectly leads to more persistent inflation, with housing costs rising 0.5% in the first half of September, lifted by a spike in energy prices. As a result, the government announced credits to help fight the wildfires, further adding to investors' unease regarding fiscal spending. With this in mind, we do not anticipate that aforementioned cuts in fiscal spending will reduce inflation. Instead, it is more likely that further monetary policy tightening will be key to softer pricing pressures.

Given a combination of these events, the economy is prone to overheat further unless the hikes take place in the near term. With the goal of managing growing inflation, the central bank is tasked with navigating a delicate balance. It must stay adaptable to fresh economic data while remaining consistent on its commitments about the timing and scale of the hikes. A firm approach from the BCB will encourage market confidence and, in turn, increase appetite for the BRL. Without this, the outlook on the upside will likely be driven by noise, resulting in BRL choppiness. Policymakers' tone will be crucial in guiding the credibility of future moves.

BCB Rate Hike Expectations

Forward swaps show market's expectation for consecutive hikes from the BCB until mid-2025.



Source: Banco Central do Brazil, Bloomberg

Due to start next year, the newly appointed Monetary Policy Director Gabriel Galipolo vowed to do whatever it takes to slow inflation to target, solidifying the market's outlook to more hawkish. With continued hikes from BCB, the carry trade with BRL should expand, creating tailwinds for local currency. However, the timing and scale of the hikes will be data dependent.

Desk Comments

GBP

GBPUSD price action continues to be driven by US data. After the Fed cut by 50bp, GBP traded to its highest level against the greenback at 1.3430 since 2022. Bank forecast models show plenty of upside potential in the pound, but Andrew Bailey commented on the BOE being a 'bit more aggressive' in its approach to cutting rates which has contributed to the GBP suffering its biggest weekly loss since early 2023, however, it must be noted that the decline against other G10 economies is not as perceptible.

On a positive note, the recent rhetoric has seen the UK housing market grow again after a faltering recovery at the start of the year. The average house price is now close to all-time highs set in 2022 after the cutting cycle has encouraged prospective homeowners to have the confidence to enter the market again.

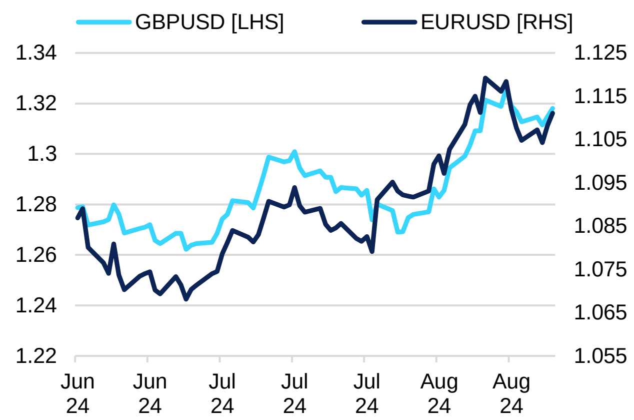
The latest set of economic data still demonstrates the UK economy has proved more resilient than expected this year. We continue to favour selling into EURGBP rallies and remain bullish GBP into year end.

EUR

EUR tried and failed to break the resistance above 1.12 handle, which led to a reversal of the gains from the previous month. A number of factors can be attributed to the rejection and subsequent sell off. The market has now fully priced a cut at its next meeting on Oct 17th. Lagarde then made comments vindicating the markets pricing of an October cut. In addition, further cuts are priced in as inflation fell below the ECBs 2% target in September. The balance of risk is now altering from overshooting the 2% target to the risk of undershooting due to weak growth and the policy being restrictive for too long.

GBP and EUR vs the Dollar

EURUSD has been gaining momentum in recent weeks.



Source: Bloomberg

Growth indicators have been mixed, but a loss of momentum has become more noticeable recently. Retail sales rose in August, marking the largest increase since April. However, despite this positive result, the broader trend in retail sales has been weakening. Both household confidence and retail sales have failed to strengthen as expected. While services inflation remains elevated, the ECB projects a slowdown heading into the new year. Geopolitical tensions could drive up energy prices, shipping, and transportation costs in the short term, potentially disrupting global trade and pushing prices higher. Inflation risks could also intensify if wages rise more than anticipated or if profit margins expand.

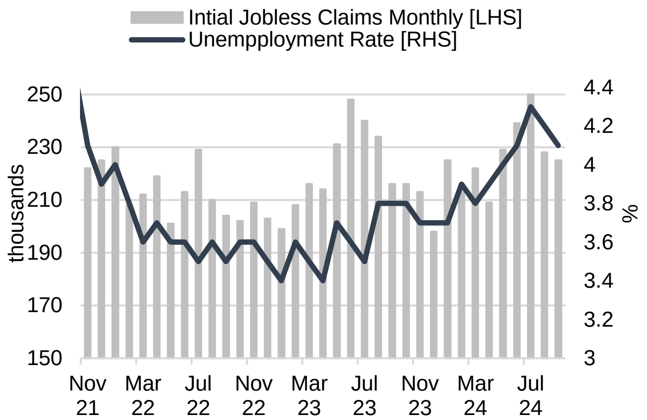
It is a difficult balancing act for central banks to ensure that inflation sustainability remains at target while avoiding the risk of excessively tight policies. We expect choppy trading over the next few weeks before another test of 1.12 level.

USD

After four consecutive weeks of USD weakness, the dollar index tested the 100 level multiple times after the Federal Reserve's 50-basis-point rate cut. However, it failed to break through and reversed by the end of September.

The USD remained resilient as the more aggressive cut in the October meet shifted the pricing of the short end of the curve but the medium to longer term pricing remained relatively unchanged which led to the USD failing to gain enough momentum to break key downside levels.

US Initial Jobless Claims vs Unemployment Rate
Labour market data has started to improve in recent months.



Source: Bureau of Labour Statistics, Department of Labour

The Fed has a dual mandate to lower inflation and defend the strength of the labour market. Fed governor Waller gave us insight into the FED thoughts by only mentioning inflation softening faster than initially thought as reason for pushing for 50bp. There was no mention of concerns to the jobs market. Chair Powell said the decision to cut by 50bp was timely, and a recalibration toward a more neutral setting. He cautioned against 50bp being the new pace and suggested a slower 25bp pace per meeting. This led to USD buying against G10 currencies. Subsequent data releases namely labour data came in a lot stronger than expected. Unemployment ticked lower 4.1% an outcome forecasted by only 2 out of 71 economists in the Bloomberg survey. The bar for the Fed to go more aggressively has now diminished. November meet moved from 35% chance of another 50bp cut to virtually nothing priced. In addition, month end USD demand and the resurfacing of geopolitical worries, which contributed to safe haven demand benefitted the USD and contributed to USD making gains.

We expect some choppy trading sessions ahead. Macro data is still driving the USD but with US elections on the horizon, we expect the added uncertainty to fuel further volatility. Vol levels have ticked higher, and we expect them to remain above one year average during first half of Q4.

Our Outlook

Our View: As we assess the path for BRL in the coming months, a number of factors will be key to watch out for. Changes in leadership at the institutional level, the potential for these leaders to influence policymakers, and increased public spending are causing worries for investors, likely to be translated into price swings in local assets. This is likely to keep Brazil's risk premium elevated at the margin. As a result, we anticipate a choppy path upward for BRL until the year's end.

Technical Analysis

GBPUSD

GBP/USD bounced off the previous symmetrical triangle resistance at 1.3030, reaching new highs at 1.3432. The pair has since retraced to the 1.3030 level. If this support holds, a retest of 1.3432 is anticipated, with potential for further upward momentum toward the channel resistance, now positioned at 1.3700. However, if momentum drives the pair below the triangle, the next target would be 1.2820, aligning with the 200-day moving average (200 DMA) and cluster support.

EURUSD

EUR/USD was rejected at the 1.1200 resistance level and sold off sharply, finding support around the 200-day moving average (200 DMA) just above 1.0920. Volatility has increased, and we anticipate more volatile swings between downside support at the 1.0750 trendline and the 1.1200 double top. A close above 1.1200 would open the door for further upside potential, with a target of 1.1500.

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