FX Monthly Report

March 2022

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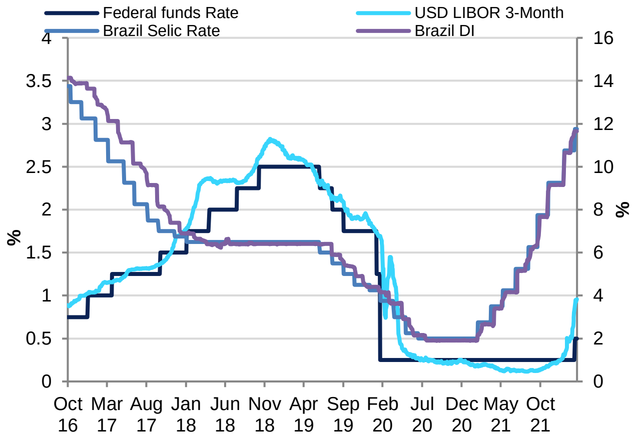
Brazil Focus

Fed Funds Rate vs 3-month LIBOR vs Selic Rate vs Brazil DI

The divergence in rates is evident and we expect the Selic rate to rise through 12.5%.



Source: Bloomberg

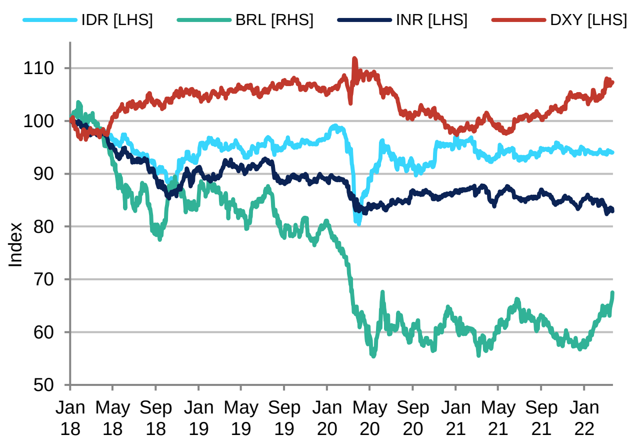
The Brazilian real has gained 12.91% so far this year and is one of the best-performing currencies in Q1 2022. It is the best performing emerging market currency, beating LATAM counterpart Colombian Peso, which has gained 8.84% as of March 3rd. In our opinion, this is partly due to the higher rate environment of the BRL compared to other economies. Investors are likely looking at the yield as preferential and benefit from the mismatch between monetary policy across developing and developed countries. We would expect to see some of these countries that have increased rates aggressively in the last 12 months could start to reduce rates as inflation starts to cool, assuming inflation starts to cool. This would happen at a time when the Fed is raising rates. The hunt for return is likely to keep the BRL bid in the near term; however, the economic data for Brazil may not be all it seems.

Inflation data in Brazil should be higher than it is due to reduced gasoline VAT and the decision by the country not to raise prices. This is keeping gasoline prices artificially low; this impacts the profitability of Petrobas. The latest rally in oil prices because of the conflict in Ukraine has put further pressure on inflation in Brazil. The Senate has tabled a bid to reduce oil prices at the pump due to oil prices, however Petrobas increased prices by 24.9% at the beginning of March. These price hikes could be 50% in some states, if the court injunctions are overthrown, some sectors will pass this on to the consumer adding to inflation. Rio and Espitito Santo are likely to be hardest hit as their entire supply by Petrobas expired, therefore the new contracts will be settled at higher prices. We expect the energy prices to continue to rally in the long run due to the change in fundamentals. One of the measures suggested is a stabilisation fund for fuel prices. The Economic Minister Paulo Guedes is against the stabilisation fund but favours changes to the ICMS calculation. Brazil has cut import taxes on ethanol and six food basket items until December, according to the Economy Ministry this will impact taxed by 1bn reasis. Jair Bolsonaro has indicated that the reduction in tax should lower prices at the pump in 0.20 reasis per litre.

The IBGE inflation IPCA Y/Y inflation was 10.76% in February; this is expected to be 10.68% in March. A very moderate increase considering the inflationary pressures in the market. The inflation report for January suggests that prices for housing and utilities accelerated by 14.45%, food and non-alcoholic beverages by 8.04%, and clothes and footwear reached 11.58% during that period. However, this data's key is that transportation and fuel prices increased but at a slower pace. Transportation prices eased in January to 20.41% from 21.03%, and fuel costs rise slowed to 44.1% from 49.02% the month prior. We expect inflation to beat in March as fuel prices continue to rise; the supreme court has said they cannot rule on whether lower taxes on fuel are constitutional in an election year. Petrobas are very far behind the curve, and we expect oil prices to push higher in the coming weeks; Petrobas cannot continue in the lower gasoline price environment which is why they hiked prices recently. They will have to increase their prices. While this will help revenue on a state basis, we expect the BCB to raise rates further.

EM Currencies Indexed January 2018

BRL is the worst performing currency over the time period but is the best in 2022.



Source: Bloomberg, Sucden Financial

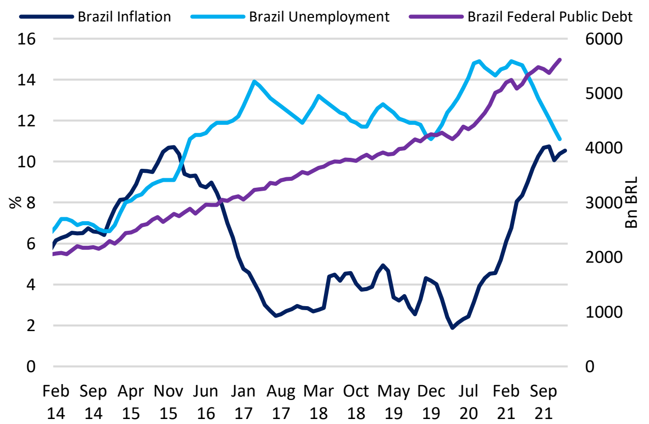
The recent rally in commodity prices suggests that the BCB will have to continue to raise rates, even though they wanted to pause. This will be the same for other central banks; the key relationship for the BCB is between the Selic rate and the BCOM energy subindex. At what point does the BCB stop raising rates? We saw rates reach 14% in 2015 and 2016, and this could be the benchmark; 12% is an essential level in the near term and would allow the BRL to firm without being detrimental to internal economics and aggregate demand. Inflationary pressures outside of higher commodity prices are coming from the supply-chain costs; the conflict in Russia is undoubtedly a threat to the shipping market, keeping rates elevated in the medium to long term, especially when you factor in China continued zero tolerance for COVID-19.

Underlying economic data for Brazil shows that GDP grew faster than expected in Q4, with Q/Q growth at 0.5% and Y/Y growth at 1.6%. GDP accumulated over four quarters reached 4.6% for Q4, up from 3.9% in Q3. While Brazil's external balances are in better health than in 2013, however, with rates expected to rise in the U.S., we could still see some outflows of capital from Brazil, although when you factor in the currency return and yield, assuming investors' appetite for risk is strong, there is value in Brazil. According to the IMF, the annual current account deficit is expected to be 0.5% of GDP in 2021, and it was 3.2% in 2013. 2022 higher commodity prices will boost the trade balance and revenue; however, the current account balance stood at -$8,146m in January. A threat to the economy is the fiscal situation, and government debt stands at 79.56% of GDP as of January 31st, 2022. This is a considerable decline since the start of 2021, when the debt was 88.1% of GDP; however, with the high inflationary environment, the government needs to reduce the debt percentage. Government yields have rallied, with the Brazilian 10yr at 11.70%. This is an attractive yield.

The election is already playing a pivotal role for the BRL; former President Lula and his running mate Sao Paulo Governor Geraldo Alckmin are ahead in the polls, with incumbent President Jair Bolsonaro second. The strength of these two candidates leaves little room for others, and this is evident from the polls; tertiary candidates are struggling to gain a footing in the race. Their lack of message and political clout may mean they struggle in the race, Lula will entice the votes and attention from centre to the left, while Bolsonaro's ability to gain popularity will mean there is little room for centre-right candidates, even though he is far right. Investors favour a Lula Presidency, as they have become marginally disillusioned by Bolsonaro and some of these policies. Lula's agenda will be moderate and favourable to markets, but his international image is also strong.

3-month Deposit Rates

Financing levels have dipped but we expect a strong recovery in Q1 2022.



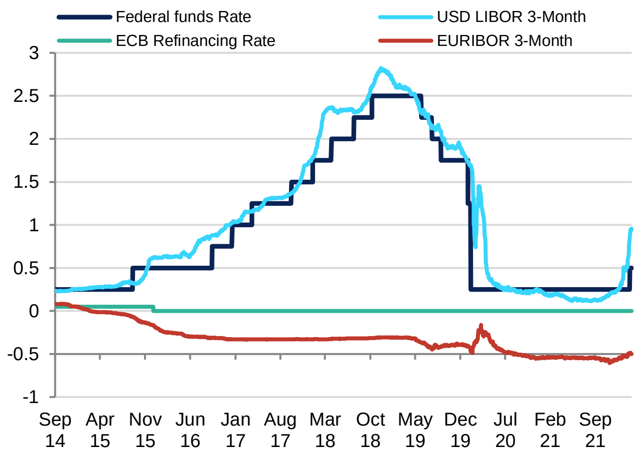
Source: Secretaria do Tesouro Nacional, Fundacao Getulio Vargas, IBGE

Currency View

In the near term, headwinds mount against the Brazilian economy when you factor in high inflation, which certainly has room to rise when Petrobras increase fuel prices. Lowering tax would reduce government revenue, and with government debt high compared to 2013, this is not advised. However, despite the shaky economic data, investors are looking towards the yield from the 10yr or carry trade with Brazil expected to benefit from higher commodity prices. As we move through 2022, the presidential election will move further into focus, and as mentioned, a Lula presidency will be bullish the BRL, local stock markets and foreign investors' sentiment. We need regulations to remain steady domestically to see more FDI. The Fed increasing rates will cost the Brazilian economy, but they are in a better place than previous rate hike cycles. Brazil is a large holder of U.S. debt, and higher rates and a Ukrainian conflict-driven stronger USD will hurt repayments. Investor appetite for the BRL has increased; however, the economy is still on shaky ground, but the interest rate is expected to rise sharply in the near term. We expect the currency to rally back to 4.70, based on higher rates and election sentiment.

U.S., and Europe Monetary Policy Conditions

Financial Conditions in all countries have shown growing tightness in the first couple of months of 2022.



Source: Bloomberg

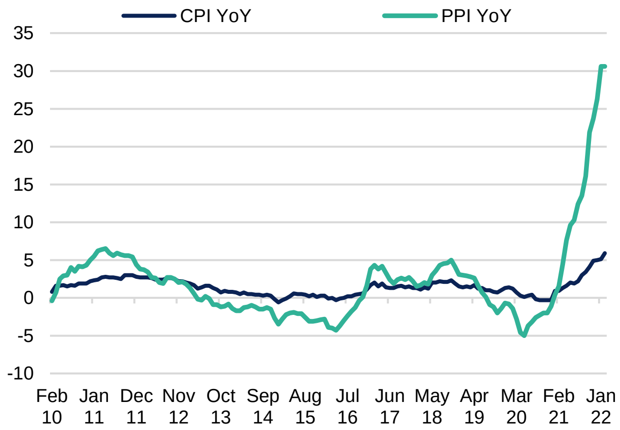
Desk Comments

Euro

Further signs of growth are needed before the ECB act. The labour market remains strong, but the war in Ukraine is causing global supply bottlenecks and further fuelling short-term inflation. Household real income will be the lowest in decades. The forecast is for inflation to get back to target relatively quickly. Germany is said to have agreed receiving Natural Gas from Qatar in an attempt to reduce Europe's dependence on Russian energy. Diversifying to renewable energy sources will also help. However, the ECB must be prepared for inflation spiking further, which may come in the form of energy sanctions in Europe or further escalation in Ukraine.

European Inflation

CPI inflation has a long way to go, and we expect the ECB to act. The market is underestimating rates in Europe.



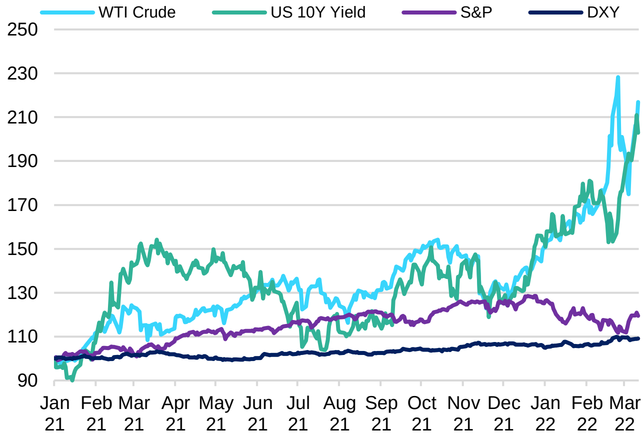
Source: Eurostat

USD

The Fed raised rates by 25 basis points this month and indicated rate hikes at all remaining meetings in 2022. In addition, the dot plots are indicating 2 more rate hikes than the market was pricing in prior to the meeting. The FED's outlook is evidently hawkish and FED Chair Powel has said controlling inflation is their top priority with 50 basis points hikes very much on the table. Markets have responded, we have seen large moves in the forward curve especially in 3month-24month period (please see swap forward table). It is our view the most hawkish scenario is priced in now and on the back of rate path indicated we should see USD range bound with slight upward bias for the next 3 months as GDP remains above potential and jobs market remains tight. The monetary tightening and as FED look to offload their large balance sheet will eventually see US growth Slow second half 2022 of this year which should see USD finish on the back foot towards the end of year. In the short-term geopolitics and rising commodity prices is also likely to support USD's cause but will also weigh on economic growth going forward.

Real Weekly Earnings vs Average Hourly Earnings vs CPI

WTI and the US 10yr yield have rallied strongly, with both outperforming the USD and S&P 500.



Source: Bloomberg

GBP

BOE hiked 25bp as expected at the March meeting. The 8-1 vote, with Cunliffe voting for no change was a dovish surprise and a big contrast to the previous meeting. Much has changed since the previous decision. The escalation in Ukraine has pushed energy prices sharply higher, with growth and employment expectations skewed to the downside, the fear of stagflation in the near term exists. The inflationary pressures will likely squeeze household spending power in the near term but become disinflationary in the medium term, reducing the need for BOE to continue their current monetary policy of aggressive hikes. As such, we are now expecting 125bp increase by year end compared to 175bp previously. We expect GBPUSD to continue trading in a downtrend. 5- and 10-year gilts are relatively unchanged as the rhetoric is more a short-term adjustment than a longer-term change to economic recovery.

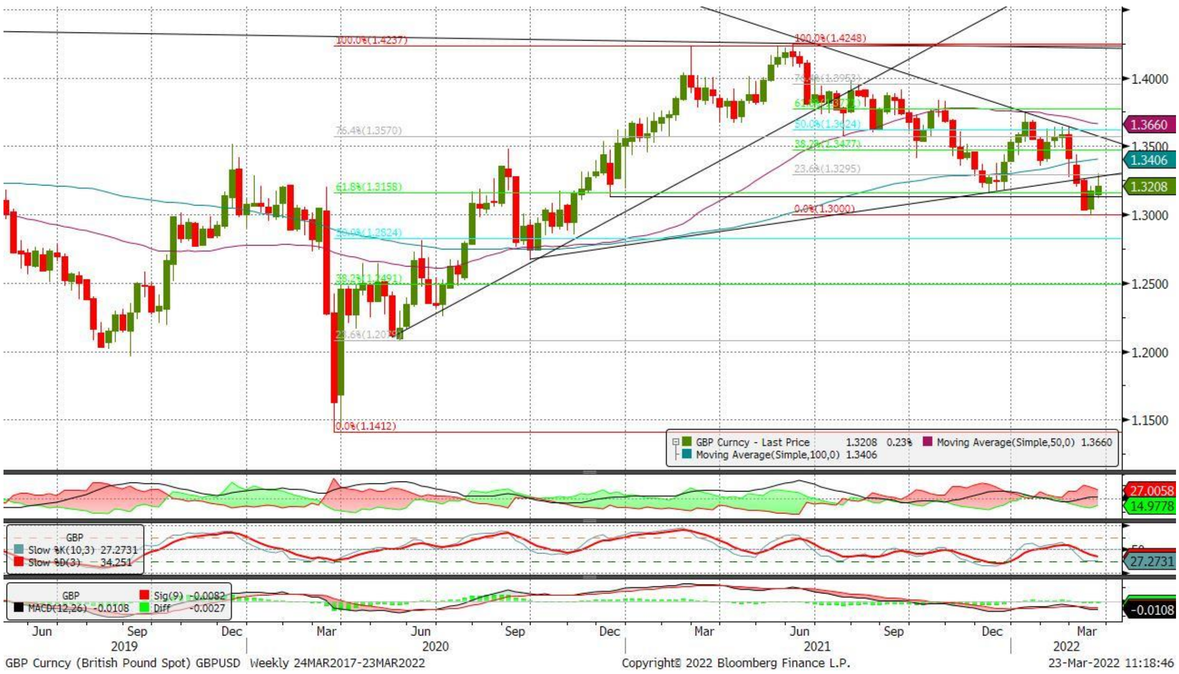
EUR and GBP Forward Swap Points

Spot-3month	COB 4th march	COB 21st March
3month – 1 year	-3.72	-5.68
3month -2 year	-19 pips	+20pips
2 year-5 year	-16	+89 pips mid
GBP	+95	+234
Term		
Spot-3month	COB 4th march	COB 21st March
3month – 1 year	+162 pips	+37.8
3month -2 year	+381 pips	+198 pips
2 year-5 year	+463	+468 pips mid
		+565

*All values are in pips.

Technical Analysis

GBPUSD



GBPUSD broke below support @ 1.3163 and tested psychological 1.30 level. We expect the cross to continue moving lower while down trend remains intact. On the downside, the break below supports no opens the door for a deeper correction down towards 1.2830 (50% fib), support beyond there is at 1.2681. On the upside, resistance is at 1.3358 and then down trend (white line), a break above could see the market test resistance at 1.3750.

EURUSD

EURUSD made fresh lows @1.0806 (levels last seen July 2020) after breaking below the broadening triangle. Our head and shoulders target set in July last year at 1.1072 has now been met. We expect the cross to continue trending lower and retesting recent lows around 1.08, a then trending towards our target levels around 1.0723-1.0691, support beyond there is at 1.0638. On the upside, a close above 1.1138 could lead to a pull back up towards down trend (green line), next resistance beyond there is at 1.1500.

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