Sucden Financial

FX Monthly Report

May 2023

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Published by:
Sucden Financial Limited
May 2023

Research Desk
research@sucfin.com

Press Enquiries
press@sucfin.com

Authors:

Daria Efanova
Head of Research

Daniel Henson
Head of FX

Nimit Khamar
FX Desk Broker

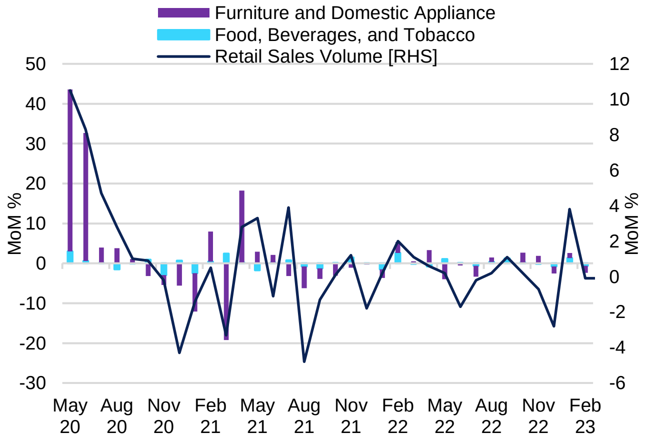
Chris Husillos
FX Desk Broker

USDBRL Pair Focus

The Brazilian economy, in line with the rest of global economies, is seeing signs of slowing growth based on softening global demand. Manufacturing PMI is now at 44.30, but robust service sector performance boosted the composite reading to 51.80, suggesting that while the economy is slowing, overall consumption in the region remains robust. While retail sales also continue to soften, with y/y growth at 1.00%, they remain in line with the 2-year average, suggesting the consumer sector is healthy. Likewise, overseas demand remains relatively robust, highlighting the strong underlying fundamentals in Brazil. The export volume index continued to remain elevated, with the April figure at $336bn, up $35bn from the same time last year. Higher soft agricultural prices are likely to prop up the agricultural part of the economy in Q2'23. China's reopening theme could see commodity prices, and in particular, oil, shoot higher, driving the growth in producer price performance. In recent days, Chinese policymakers have discussed cancelling grain purchases from the US in favour of cheaper Brazilian alternatives, which could help support shipments out of the country. Still, growth for 2023 is also set to recede sharply to 0.8%, down from 3.0% in 2022.

Retail Sales Volume by Category

Retail sales are seen softening in recent months, but still remain in line with the longer-term average.

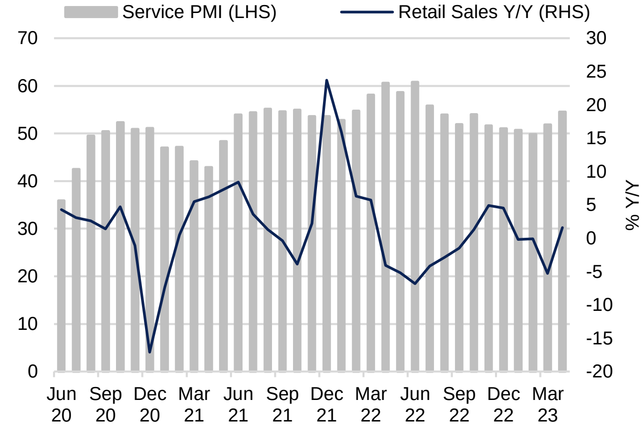


Source: IBGE

Despite softer inflation growth, wages remain upwardly sticky, with real income usually paid for the main job continuing to climb to BRL2,799 in March 2023. This further underscores the availability and propensity of households to spend, supporting retail and other consumer spending habits in Q2 '23. In particular, President Lula increased the country's minimum wage as his administration sought to increase social spending while keeping the growth of public debt under control. Lula signed a provisional measure adjusting the country's minimum wage to BRL1,320 per month, up from the BRL1,302 that had been set at the end of last year.

Service PMI vs Retail Sales YoY

Overall, the service sector in Brazil remains robust.

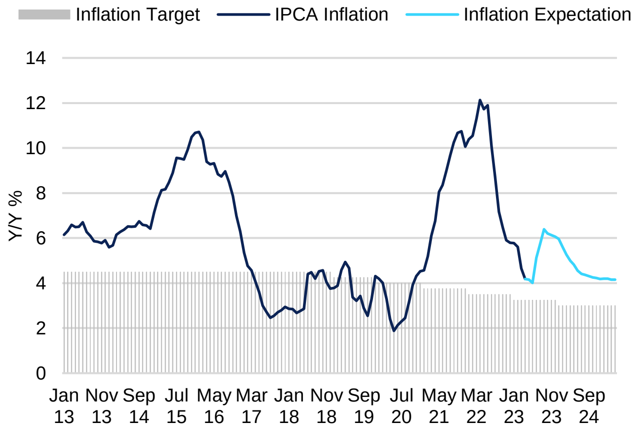


Source: S&P Global, IBGE

The big risk for this year will be Lula's approach to policy support. The government is increasing the size of welfare programmes beyond strict budget limits to address social issues, breaking the fiscal ceiling by BRL145-176bn. However, this new wave of spending could put Brazil's debt on an even more unsustainable path and reignite inflation. With the tax on fuel now reinstated, that could support inflation higher for longer. Congress is preparing to debate a bill to shore up public finances, a plan which Lula is also counting on to allow for looser monetary policy. The legislation was initially welcomed by markets, but questions remain on how the government will raise revenues as forecast. In the meantime, uncertainty associated with public debt growth alongside the existing fiscal framework may lead to a more benign disinflation process.

Brazil IPCA Inflation vs Expectations vs Target

Inflation is set to accelerate slightly in Q3'23 as tax reduction impacts ease.

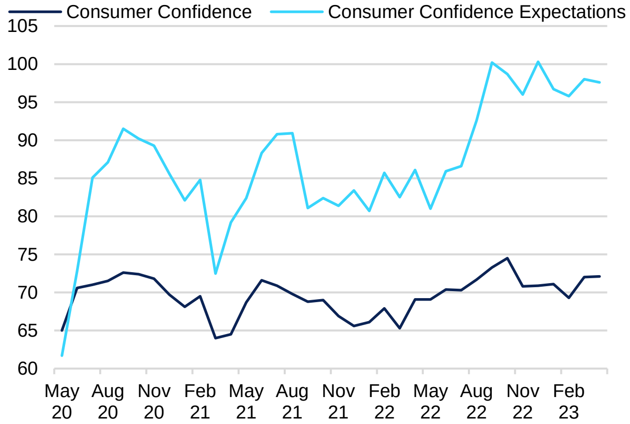


Source: BCB

Indeed, the inflation story differs from that of the US and Europe, as it has already halved from the peak of 12%, while developed countries have only begun to soften in the latter part of 2022. Data shows continued weakness in pricing pressures, and a recent decline to 4.18% y/y pointed to a sharper-than-expected reduction; this highlights the slowest pace of growth in over two years. Indeed, inflation in Brazil has been coming down at a faster rate than in the US or Europe - this makes the government target of 3.5% more likely. However, core inflation is still running hot and causes additional worries. PPI remains negative m/m, and the y/y figure just flipped into the lows of 2.32%, losses not seen since the 2010s, and we expect the PPI to remain low in the meantime.

Consumer Confidence vs Expectations

Lula's presidency did little so far to alter consumer sentiment.

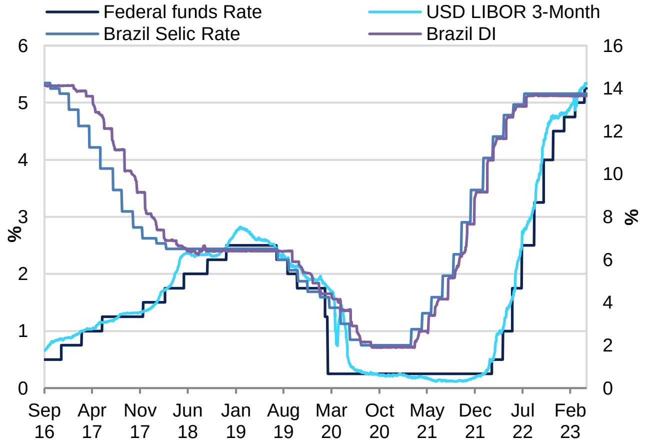


Source: Fundacao Getulio Vargas

Despite the central bank's chief Neto stating his refusal to cut rates, softer inflation stoked expectations that the BCB might be the first major bank to cut rates soon. The swap rates curve is already showing investor bets on a least 25bps cut to the benchmark rate in September. Inflation is poised to decline until the end of the quarter, especially given the round of tax reductions enacted last year. However, expectations are set to increase once again in the latter half of the year, with inflation growing to the 6.32% level in Q3'23. If these expectations materialise, this should reaffirm the policymakers' rhetoric of higher-for-longer rates for the majority of the year. The next central bank meeting is scheduled to take place on June 21st, and we expect rates to remain flat at 13.75%, the highest among the major developing economies. The BCB has kept the rates unchanged at current levels since August, hiking 11.75% since the end of 2020 and keeping the rate unchanged right through the election process. Brazil has done most of the damage before the Fed and the ECB, driven by historically high inflation. Even with the threat of inflation subsiding, abundant fiscal support is likely to keep rates elevated for longer.

Fed Funds Rate vs Selic Rate

Both rates are set to remain higher-for-longer as policymakers continue to tackle inflation.



Source: Bloomberg

The prospects of high terminal rates keep real an attractive investment, especially among the EMs. The Brazilian real was seen strengthening in recent weeks despite the outlook for lower interest rates as investors are growing optimistic that a new fiscal framework proposal is set to succeed in shoring up public finances. It combines fiscal adjustment with the preservation of the budget for social policies, setting the annual primary budget surplus target from -0.5% of GDP in 2023 to 1% of GDP in 2026. Brazil's fiscal framework sets a ceiling and a floor for the expansion of public expenditures, limiting it to 70% of the revenue growth or 50% when the government fails to meet its budget surplus targets. The fiscal plan signals the Lula administration's recognition of the importance of replacing the old spending cap with a credible, new fiscal anchor to contain macroeconomic uncertainties. By linking spending to revenues as opposed to inflation under the prior cap, the new rule is more pro-cyclical, taking a more holistic approach to fiscal consolidation by targeting primary balances instead of just spending. The authorities plan to pursue revenue efforts which they hope will yield 1.1%-1.5% of GDP. They expect most of this to come from the elimination of tax exemptions, dispelling the private sector's fear of tax increases.

The proposal is yet to reach Congress, but if passed, this could provide a strong upside for the real. The implementation of Lula's policies is all set to prolong the country's inflation. In the meantime, we expect higher interest rates as well as a positive fiscal outlook to be a tailwind for BRL. This, coupled with a pause in tightening from the Fed and a weaker dollar, is likely to keep USDBRL below the 5.00 level in the near term.

Desk Comments

GBP

BOE hiked 25bp in line with expectations this month. Inflation figures continue to print to the high side posting double digits for the 7th consecutive month, the BOE revised its inflation figures higher forecasting to reach its target rate of 2% by 2025, a year later than previously expected. Further 50bp rate hikes is now priced in by year end. In addition, the divergence to the USD rate path has helped GBP continue to trade bid in the past month, reaching a high of 1.2668.

However, we see the economy stagnating over the next few months. The economy unexpectantly shrank in recent months, leaving the UK behind other G7 nations. Households are turning more cautious as the result of strikes; increased borrowing costs are starting to erode the spending power of consumers. Retail sales -1% was well below forecast last month. Employment data is also to the weak side, with a small uptick in unemployment 3.9% vs 3.8% previously.

We don't foresee much change in GBP over the coming weeks. Vols are trading at yearly lows, sighting a lot of two-way flow so we expect a range of 1.2440 – 1.2650 to hold with little momentum of any directional breaks to either side in the short term.

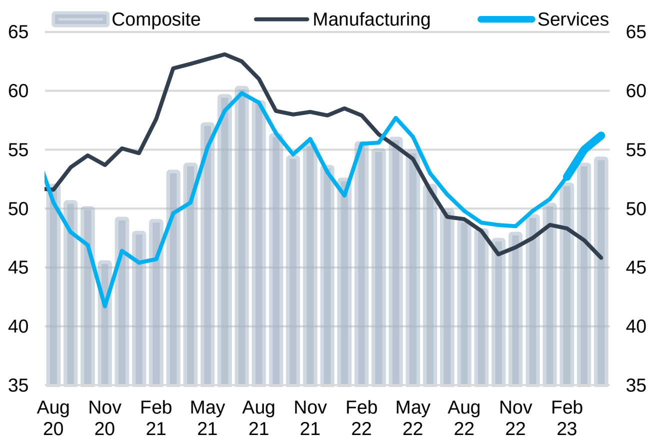
EUR

EUR has declined below 1.09 against the USD on the back of broad USD appreciation. However, the ECB path continues to diverge from the FED. More rate hikes are priced in this year as the European commission raised the inflation outlook. Moreover, the projections for consumer price growth were raised.

Therefore, growth within the EU economic area continues to expand, GDP estimated to rise by 1.1 % this year thus avoiding a recession within the whole area.

Eurozone PMIs Performance

Service and manufacturing performance is set to diverge further in the coming months, with the former more resilient.



Source: Markit

The Labour market continues to strengthen. Unemployment levels 6.5% have steadily declined from a post pandemic high of 6.5% and earnings remain steady.

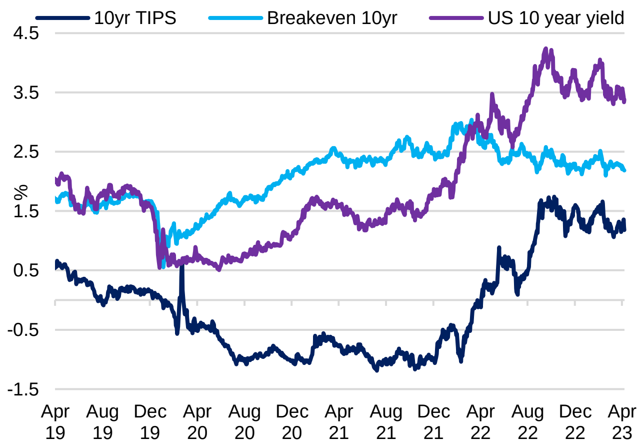
With volatility at year lows, the price action is likely to remain muted. As a result, we see range bound price action with a slight bullish bias.

USD

Dollar has seen a bounce in May benefiting from risk aversion as market reluctant to take on risky position amid debacle surrounding the US Debt ceiling. Following last Fed Rates announcement market now believe terminal rates have been reached. Timing of any potential cuts in the future is lacking consensus, earliest cuts could come as early as September, but we believe this to optimistic.

10yr TIPS vs 10yr Breakeven vs 10yr Yield

Yields have remained broadly rangebound in the coming weeks.



Source: Federal Reserve

Largest risk to USD currently is the highly unlikely but still the possibility of Default of Treasury debt for the first time in their history, as negotiations between the White house and the House of Representative likely to go to down to wire as very little progress currently been made (debt ceiling likely to be breached by 1st June).

Our expectations is for the dollar to appreciate once situation of the debt ceiling is behind us, as we have seen recent economic data showing the US economy slowing causing recessionary jitters and is likely to see flight to the safety of the dollar. Especially given similar situation is occurring in Europe with economic data surprising to the downside; unlike in the US, inflation is far from under control in Europe/UK and is likely to see both regions potentially facing a stagflation situation and weakening their respective currencies.

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Technical Analysis

GBPUSD

GBPUSD has risen steadily since March but failed to break above white downtrend and Resistance at 1.2680. Candlesticks show a bearish engulfing pattern and could indicate further pull back to the red uptrend. On the Downside, a break below red trendline could indicate a deeper pull back to the psychological 1.20 area and then support at 118 Area. On the upside a close above white trend line / 1.2680 resistance could pave the way for the cross to test 130 and then 76.4% fib level at 1.3328.

EURUSD

EURUSD has broken-down trend after a period of steady gains, and this could pave the way for a deeper correction down to 1.05. Support before then comes at 61.8% (1.0737) and 76.4% fib (1.0653) of the recent move up. If support @ 1.05 holds, we could see a period of consolidation in the range between 1.05 – 1.11. On the upside, closed above 200week MA / 1.1272 (61.8% fib) would be needed to see cross make next leg higher to 1.15 and then 1.1682.

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Sucden Financial

United Kingdom
Sucden Financial Limited
Plantation Place South
60 Great Tower Street
London
EC3R 5AZ

Tel: +44 (0)20 3207 5000
Email: info@sucfin.com

USA
Sucden Futures Inc.
156 West 56th Street
12th Floor
New York, NY 10019
United States

Tel: +1 212 859 0296
Email: ny@sucfin.com

Hong Kong
Sucden Financial (HK) Limited
Unit 1001, 10/F
Li Po Chun Chambers
189 Des Voeux Road Central
Hong Kong

Tel: +852 3665 6000
Email: hk@sucfin.com

sucdenfinancial.com