Special Report

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Considerations on Our Exchange Rate Revision to R$ 5.40 in 2024

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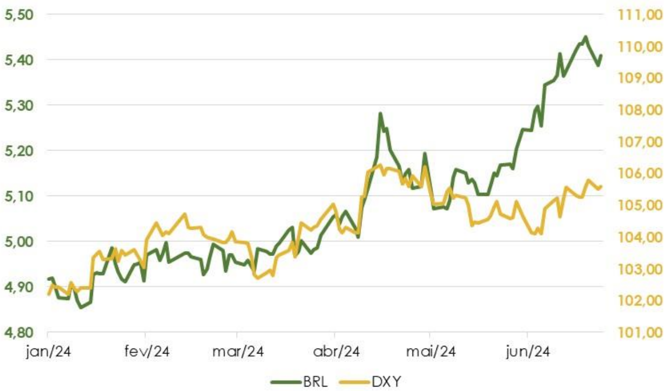
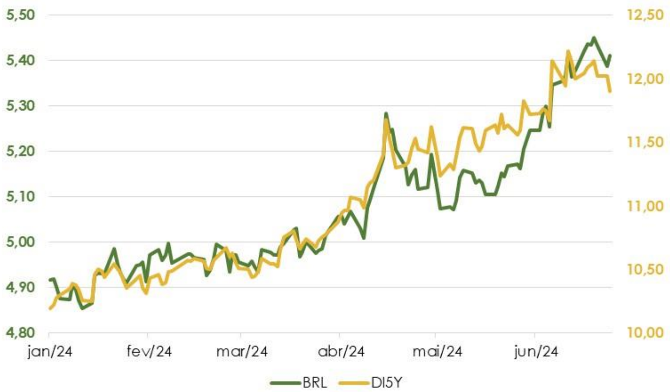
Internal and external factors should contribute to the BRL remaining depreciated for the rest of this year. The postponement of the Fed Funds rate cuts to December – which favors the interest rate differential between the US and major advanced countries – helps keep the dollar strong. Thus, a scenario with few factors for a significant weakening of the DXY is expected in the coming months. Here, the balance of payments has been harmed by the decline in the trade balance of goods and services, with a notable dynamic of strong physical import volume. All of this, combined with worsening financial flows on several fronts, are elements that should hinder the performance of the Brazilian currency compared to its peers. Additionally, there is a scenario of greater domestic risk aversion, possibly explained by the noise and controversial political signals from the government in the fiscal sphere over the last two months. **Given all these elements, we have revised our exchange rate projection from R$ 5.20 to R$ 5.40 in 2024**. The current account deficit is expected to reach 2.0% of GDP this year (excluding crypto asset imports), or about 3% of GDP compared to the current statistic of a 1.8% deficit in the last 12 months. This represents a considerable worsening of the current account transactions in the balance of payments from now until the end of the year, even excluding crypto assets.

Chart 1: BRL vs DXY



Source: Bloomberg, Buysidebrazil

Chart 2: BRL vs 5-Year Pre-DI



Source: Bloomberg, Buysidebrazil

DXY Tends to Remain Strong

Although the Central Bank of Brazil reiterates that there is no mechanical relationship between US and Brazilian monetary policies, the spillover effects from upside surprises in US activity and inflation data on emerging market currencies became evident in the first quarter of this year. However, since mid-May, domestic uncertainties have been more prevalent in the movement of the Brazilian currency, considering that the US dollar (DXY) recorded some decline. Therefore, all else being equal, a bearish impact on the BRL via the external scenario would require a more significant weakening of the DXY. In this sense, we do not foresee such a movement for now, as we identify: 1) some resilience of the US economy (still strong labor market and loose financial conditions); and 2) a favorable interest rate differential for the US compared to other advanced countries. In the chart below, we created an index of the 2-year interest rate differential of the United States with the countries belonging to the DXY basket (using the same weighting). We found a significant correlation between the US currency and the interest rate differential calculated since 2021.

Chart 3: DXY vs. Interest Rate Differential of the Countries in its Basket

Source: Bloomberg, Buysidebrazil

This means that the greater the interest rate differential between these countries, the stronger the index tends to be – whose composition is predominantly influenced by the euro. Thus, the European Central Bank's decision to cut rates this month, and the expectation of cuts in other countries that comprise the DXY over the second half of the year, contribute to maintaining this differential at a high level. On the other hand, there was a hawkish revision of the Dots (in the Fed's Summary of Economic Projections, SEP) in the last FOMC, which indicates only one cut in 2024, corroborating our expectation of the start of monetary easing only in December in the US. We believe in some reversal of this movement after Fed Funds cuts in 2025. For this reason, we foresee that the BRL should benefit next year from the USD weakening, closing at R$5.30 in December.

Record High Volume of Imports

The value of imports in the physical trade balance (MDIC) showed a strong rise in value in recent months, despite the significant price drop this year. This occurred because the imported quantum grew 11.5% from January to May compared to the same period last year, indicating an increase of approximately 17% for the year if the current level is maintained going forward. This vector is undoubtedly the main cause of the abrupt reduction in the seasonally adjusted trade balance in the second quarter of the year.

Chart 4: Imports in Quantum with Seasonal Adjustment – MDIC (index)

Source: MDIC, Buysidebrazil

Chart 5: Import Prices - MDIC (index)

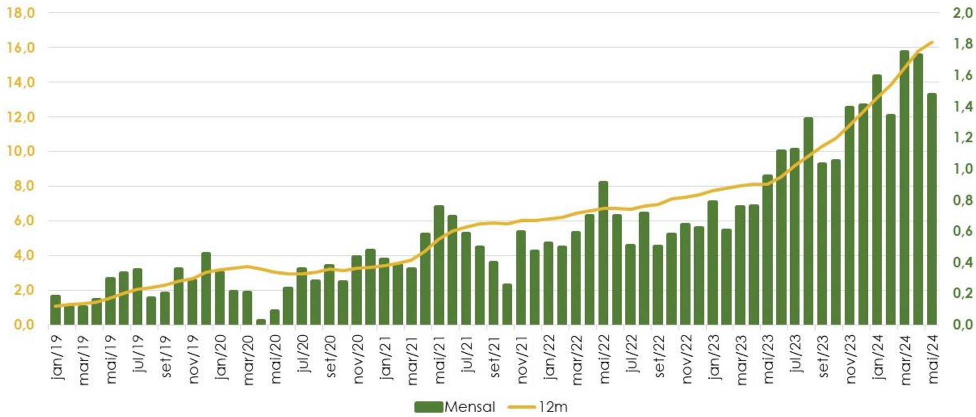
Source: MDIC, Buysidebrazil

On the contrary, imports have shown a significant increase in volume, in line with recent labor market data, which show very strong incomes and sustained consumption. Additionally, investments showed a significant recovery in the first quarter and will probably continue this way in the second quarter and may also be driving imports.

Another relevant point comes from the fact that low-value imports and crypto assets, although not accounted for by MDIC, have generated increasingly larger outflows of foreign currency.

As for low-value imports, although they have shown some stability – around US$ 10 billion accumulated over 12 months this year – they are at a much higher level than the values recorded until 2020. Crypto asset imports have consistently grown and have already accumulated more than US$ 16 billion in the last 12 months.

Chart 6: Crypto Asset Imports (US$ billions)



Source: BCB, Buysidebrazil

Price Effect Has Hurt Exports

At the same time, international prices of significant products in Brazil's export agenda have dropped substantially since the beginning of the year – iron ore, soybeans, and corn have decreased by 23%, 13%, and 25% YTD, respectively. Oil prices, however, did not follow this trend, but Brazilian production, reported by the ANP, has shown lower-than-expected figures. At that time, the expectation was for continuous growth, which would support even more robust balances for the oil trade balance (after the record surplus of US$ 21 billion in 2023) and offset expectations of smaller crops. Thus, exports are declining due to the price effect, but there is also a significant slowdown in the quantum exported in the second quarter of this year.

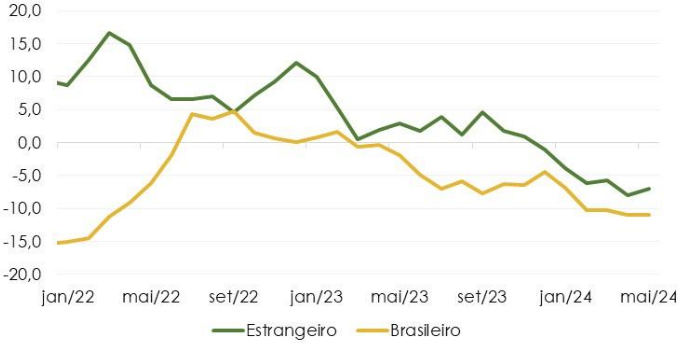
Foreign Exchange Flow Expected to Be Negative in 2024

The worsening trade balance is being accompanied by greater internalization of resources by exporters. In 2023, the differential between contracted and physical balance was US$ 49.9 billion for the year. In 2024, this accumulated balance is practically zeroed, which implies an improvement in the contracted trade flow. However, in the most recent Inflation Report, the Central Bank addressed this issue (in the boxes Foreign Exchange Contracts and Current Transactions: The Exchange Gap and Exporters' Accounts Abroad) concluding that the amount not internalized is used by exporters for expense payments. In other words, there is no accumulation abroad that would indicate a future inflow, which could positively impact the exchange rate.

On the other hand, the contracted financial flow is deepening its deficit – a trend that should continue in the coming months, mainly considering that seasonality indicates the largest outflows occur in the last quarter (more specifically in December). In April, the financial segment recorded US$ -11.2 billion, while the largest outflow for the month since 2010 was US$ 6.8 billion (in 2020, the pandemic context). For the year, there have already been US$ -26.3 billion in contracted financial exchange, while from January to June last year the accumulated amount was US$ -14.1 billion.

Other significant drivers for the more intense outflow in contracted financial exchange in recent months are Brazilians' portfolio investments abroad and the outflow of foreign investments from the Brazilian stock market. Additionally, we highlight higher spending on services in the Balance of Payments. There was recently a methodological change that deepened the transport deficit due to freight, but this year, other services have also gained prominence – such as telecommunications, computing and information services, intellectual property services, and cultural, personal, and recreational services. Thus, the "other services" account (excluding transport, travel, and equipment rental) already accumulates a deficit of US$ 5.6 billion in 2024, against an outflow of US$ 2.0 billion in the same period of 2023 and US$ -11 billion over 12 months.

Chart 7: Portfolio Investments Accumulated Over 12 Months (US$ billions)



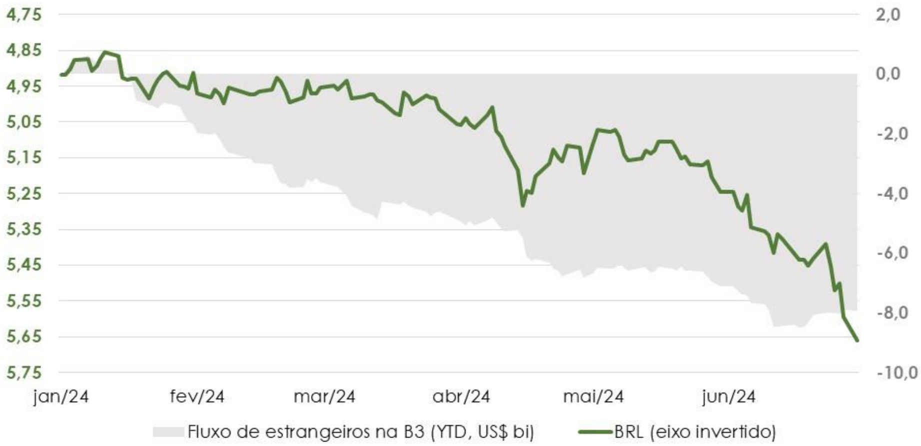
Source: BCB, Buysidebrazil

Chart 8: Other Services Accumulated Over 12 Months (US$ billions)

Source: BCB, Buysidebrazil

In turn, foreign investments in fixed income in the country are expected to be modest this year - until May, there was a net inflow of only US$ 2.8 billion, despite the high interest rate differential. Although net borrowing by companies remains positive (with an effective rollover rate of 145% for the year), daily data on foreigners in the Brazilian stock market show increasing domestic risk aversion, impacting the exchange rate and other Brazilian assets.

Chart 9: BRL vs. foreign flow in the Brazilian stock market



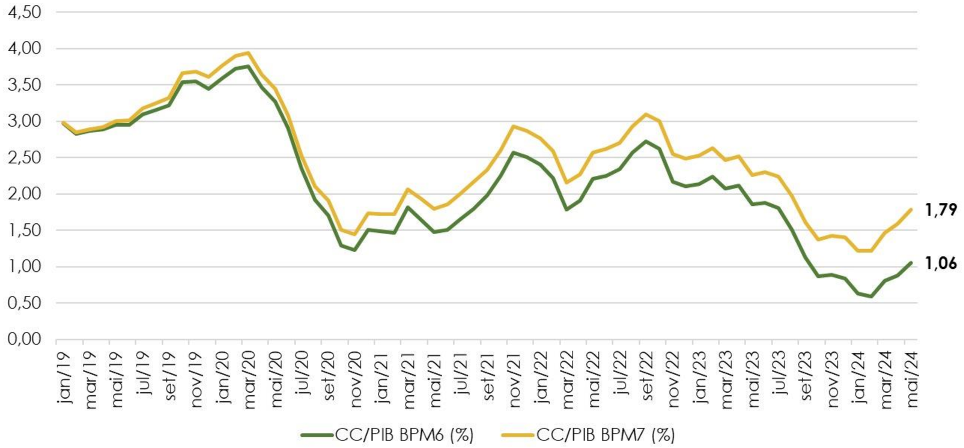
Source: B3, Bloomberg, Buysidebrazil

Contributing to this dynamic are also internal political and fiscal factors. The situation has become more turbulent in recent months due to factors such as (i) changes in the fiscal framework, (ii) the shift in the primary surplus target for 2025, (iii) signals of interventionism in Petrobras, (iv) recurrent questions regarding the actions and autonomy of the Central Bank by the government, (v) the withdrawal of the Provisional Measure that limited the offsetting of PIS/Cofins credits, and (vi) resistance from the presidential palace to fiscal adjustments via spending cuts. All of these factors have exacerbated the deterioration of domestic assets over the past two months, partially reversed by this week's announcement of mandatory spending cuts in 2025 and contingencies in 2024.

Therefore, the current account deficit is expected to deepen, without sufficient counterpart from the financial account to ensure currency appreciation.

It is worth mentioning, finally, that the current account of the balance of payments will be more deficit-prone due to worsened trade balance in goods and services, as well as increased interest expenses. However, despite lower year-on-year expenses for profit and dividend remittances, this level remains significant. Thus, our projections indicate a current account deficit closer to 3.0% of GDP (including crypto assets, consistent with the current 12-month cumulative GDP ratio of 1.8%). However, in its latest External Sector Note, the Central Bank announced a new methodology to be incorporated for crypto assets (BPM7). In this regard, crypto assets will no longer be part of the goods trade balance and will instead be included in the capital account of the balance of payments, thus no longer contributing to the external deficit. Below, we present a simulation of the historical current account deficit as a proportion of GDP, excluding imports of crypto assets:

Chart 10: Current account deficit as a proportion of GDP (actual and simulated, excluding crypto assets)



Source: BCB, Buysidebrazil

Considering that crypto asset operations for the remainder of this year follow the average monthly rate recorded until May — which is a relatively conservative assumption, given their recent accelerating trend — we would expect around US$ 19 billion in accumulated transactions by the end of 2024. Excluding this amount from the goods trade balance, we project a current account deficit of -2.0% of GDP, after incorporating the new methodology in the next release.

However, the negative exchange flow generated by crypto asset operations remains, but will no longer be accounted for in contracted imports and will instead be reflected in financial exchange sales. In other words, this change doesn't alter the dynamics of the total flow, and consequently, the currency.

Taking all these considerations into account and considering our more aligned fair value model (which uses DXY, country risk, commodities, and the 5-year DI rate), we believe the exchange rate should close the year at R$ 5.40. We anticipate some room for currency appreciation in 2025, particularly if there is an expected USD weakening due to potential Fed Funds rate cuts. However, this may not materialize if domestic risk premiums start rising again.

Our team

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