CAPITAL ECONOMICS

FX MARKETS UPDATE

We think the Brazilian real's rally will reverse soon

- **We expect the Brazilian real to reverse its gains against the US dollar by the end of the year as Brazil's central bank eases policy and risk sentiment deteriorates.**
- Although it has fallen a bit over the past few weeks, the Brazilian real has risen nearly 10% against the US dollar since the start of the year, among the strongest gains among major currencies. In part, we think this is due to the real's high "carry" (i.e. short-term yield) against a backdrop of strong appetite for risk in global markets. (See Chart 1.) On the domestic front, optimism about Brazil's fiscal sustainability also seems to have helped push down measures of risk premia there and boosted the real. (See Chart 2.)
- **What's more, the real has benefitted from a widening trade surplus, which hit a record high in June**. This has been driven by exports, which have been helped by an exceptionally strong harvest. And while we don't expect this export boom to last, we do think some of the real's appreciation over the past year or so is warranted in light of the sharp improvement in Brazil's commodity terms of trade since the onset of the pandemic. (See Chart 3.)
- **That said, there are three reasons why we expect the real to weaken against the greenback by year-end**.
- **First, we think the real's high carry is set to fall**. Last week's central bank meeting minutes signalled that policymakers intend to start the easing cycle in August. While we don't think that the bank will cut rates quite as quickly as investors currently discount (see Chart 4), the bigger picture is that yields associated with the real and other high carry emerging market (EM) currencies are set to fall as the EM central bank easing cycle broadens while developed market (DM) central banks keep policy rates elevated.
- **Second, and more important, we expect risk sentiment to worsen both globally and domestically in the latter half of the year**. We continue to think global economic resilience will give way to recessions in major economies including the US, while suggests to us "risky" assets – and high carry currencies – will struggle over the second half of this year. In Brazil in particular, a failure to fully implement the new fiscal framework could push up risk premia of Brazilian assets. And even if it is adopted, the resulting fiscal tightening will probably put further downward pressure on growth in the near-term. In either case, measures of risk premia in Brazil – such as dollar bond spreads – seem low relative to the current fading growth prospects there and globally. (See Chart 5.)
- **Third, by our estimates the real's appreciation has erased much of its undervaluation and leaves scope for renewed weakness in the near-term**. In general, we find a currency's valuation to be a helpful tool when it reaches extremes. The real (and the Colombian peso, the best performing major currency this year) appeared significantly undervalued six months ago, which suggested to us that downside in the currency would be limited even if risk sentiment deteriorated. Today, although the real still appears somewhat undervalued relative to its terms of trade (see Chart 3 again), our other estimates of the real's valuation – e.g., the real effective exchange rate (REER) relative to its medium term average (see Chart 6) – do not indicate that the currency is *significantly* undervalued. (See Chart 6.)
- **The upshot is that we are sticking by our forecast for the real to weaken to 5.25/$ by the end of the year, before strengthening a bit next year as the global economy exits recession and risk appetite recovers**. For context, the scale of this depreciation in the real is in line with the our forecasts for other EM currencies and smaller than the sharp falls we expect in the Mexican peso and most currencies of Emerging Europe. See the latest details underpinning our forecast for the real and other major currencies in our latest *Outlooks* on the *Latin America* and *FX Markets* services.

Jonathan Petersen, Senior Markets Economist, jonathan.petersen@capitaleconomics.com

Chart 1: Changes In EM Currencies Vs USD & Average 3m Forward-Implied Yields (Since 31st Dec. 2022, %)

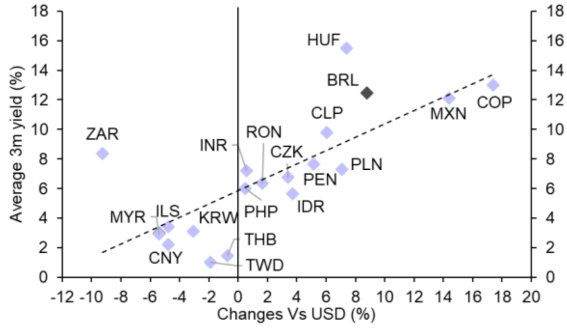


Chart 2: USD/BRL, 3m Implied Volatility, & Stripped Spread Of JPM EMBI Brazil Index

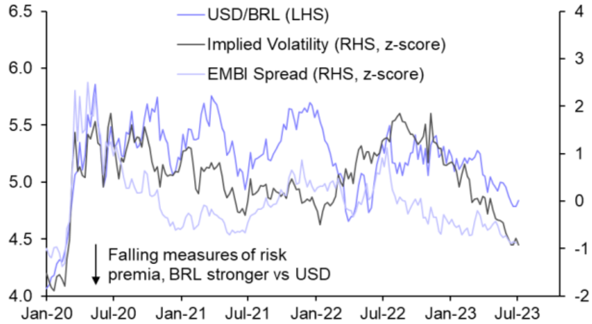


Chart 3: BRL Commodity Terms Of Trade (CToT, 2010 = 100) & BIS Broad BRL REER Index (2020 =100)

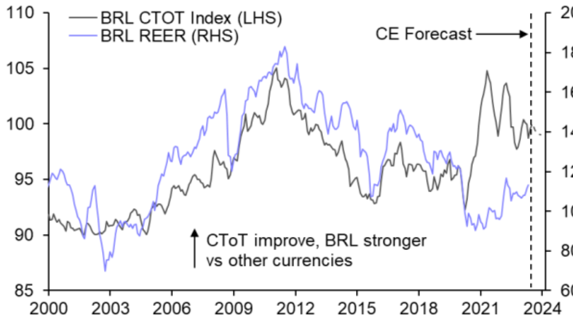


Chart 4: Brazil Selic Rate (%) With CE Forecast & Market-Implied Path

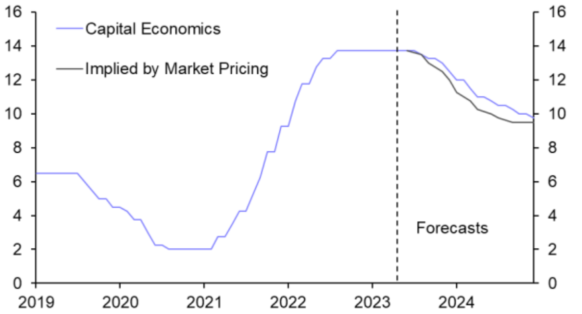


Chart 5: Brazil Composite Leading Indicator & Stripped Spread Of JPM EMBI Brazil Index

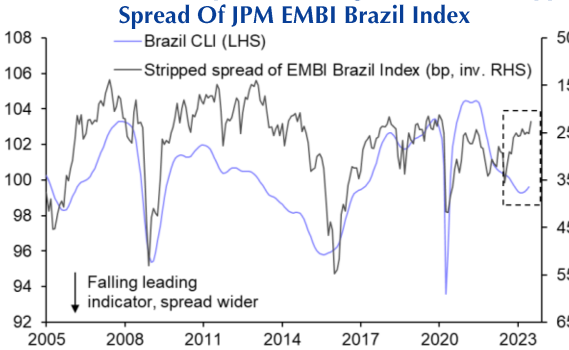
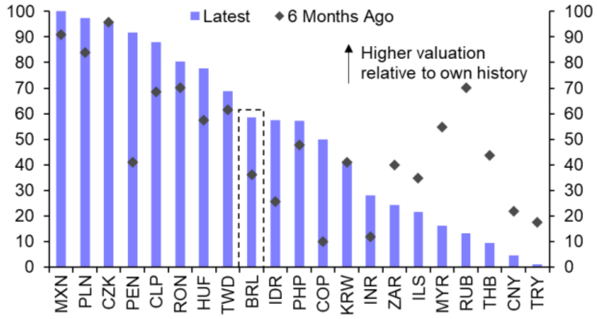


Chart 6: CE REER Valuation Score (Percentile Of Deviation From 7-Year Moving Average REER)



Sources: Refinitiv, Capital Economics