

12

Dec/23

Itaú PrivateBank



Read time
6 min



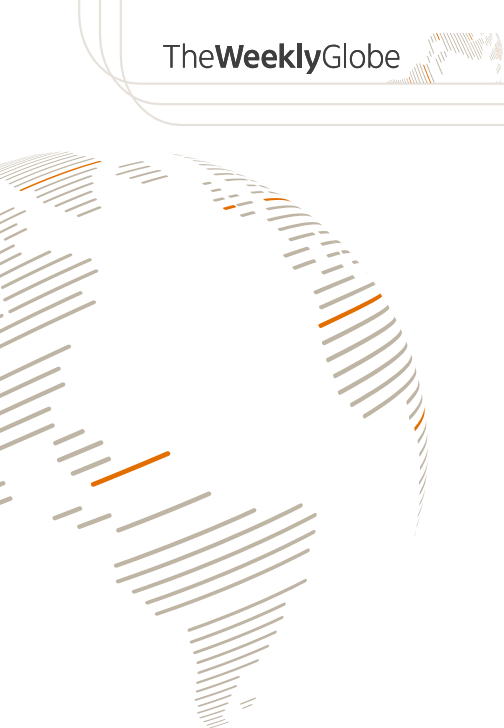
The Weekly Globe

What Can We Expect for the Brazilian Real in 2024?



Eduardo Coccaro
Strategy Analyst

eduardo.coccaro@itau-unibanco.com.br



Summary

This year, we have seen the Brazilian real appreciate against the dollar, after finishing 2022 in the range of USD/BRL 5.28. Nevertheless, our currency is being traded at a historically depreciated level. In this article, we will delve into the sensitivity of the exchange rate to the interest rate differential and what we can expect ahead.

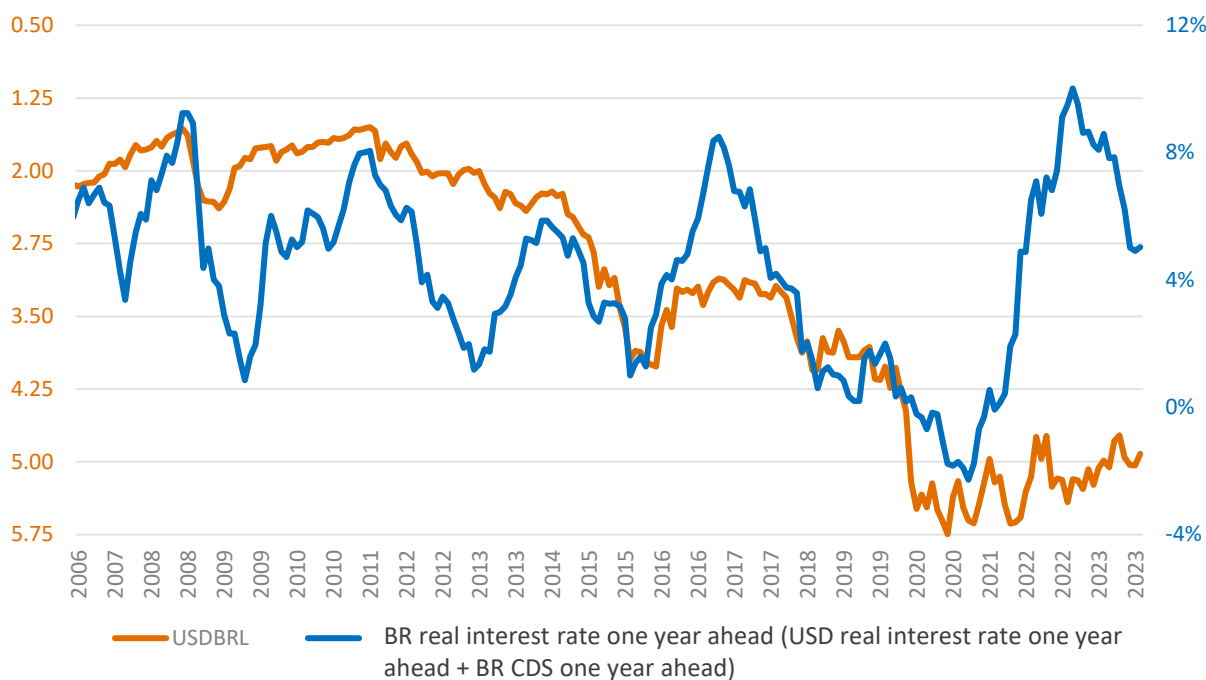
As our readers have seen, we have defended a positive bias for the Brazilian real throughout 2023. Among the factors that should sustain an eventual appreciation of our currency are its imbalance with the broad commodity index over the last four years, as well as its sensitivity to risk appetite in the international market, which has recently improved following disinflationary signs in the US economy. However, uncertainties in the local scenario, as well as possible surprises coming from the outside should not be ruled out and may weigh on an eventual recovery. Therefore, it is possible to say that the new year will begin with a positive asymmetry in appreciation for the Brazilian real. In this article, we will also focus on one more supporting point for an upward trajectory of the Brazilian currency: the real interest rate differential.

Since we are analyzing the potential for appreciation of the Brazilian real versus the US dollar, we are going to begin with the inflation-adjusted interest rate differential between Brazil and the United States, using the benchmark rate established by the monetary authority and the inflation consensus one year ahead for both countries. In this way, by discounting the effect of inflation, we can evaluate the extra return offered to investors who decide to invest in the Brazilian risk-free rate. In theory, when that additional return increases, the attractiveness of Brazilian fixed income should also increase, which raises demand for the national currency and leads to its appreciation.

However, there is one detail missing in the above equation. In general, investors tend to demand a risk premium for assets from emerging countries, including sovereign bonds. That is where the use of credit default swaps (CDS) comes in. These work like insurance policies on third-party obligations; the buyer pays a certain amount to protect themselves against default and other risks. The greater the amount demanded, the greater the risk associated with the creditor in question by the market.

When we correct our interest rate differential for this country risk, we can see a clearer long-term relationship with the dollar-real exchange rate. The graph on the next page shows this relationship by inserting this differential adjusted against the exchange rate. As we can see, despite a real interest rate differential above the long-term average, the Brazilian real is at a depreciated level. Judging by this factor, there is ample room for the appreciation of our currency.

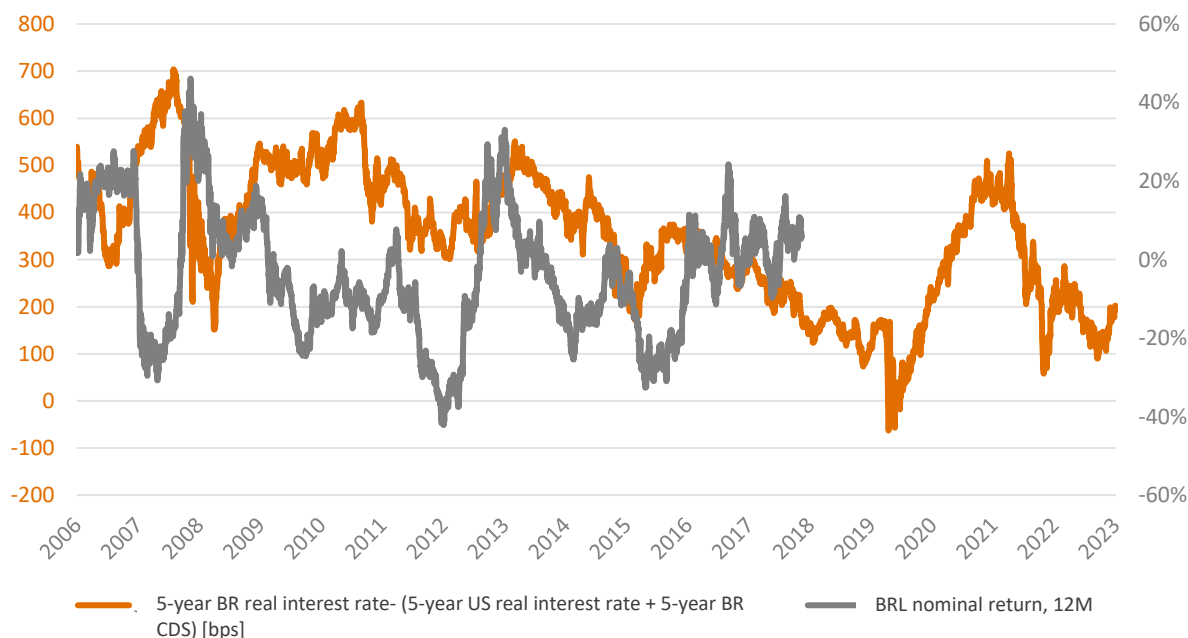
Real Interest Rate 1 Year Ahead, Brazil vs. US



Source: Bloomberg Finance LP

If we lengthen the investment horizon used by our hypothetical investors, considering an interest rate differential beyond twelve months, we can also deduce that there is room for the Brazilian real to appreciate. In the graph below, we use the 5-year CDS to adjust the longer-term interest rate differential for inflation-linked bonds:

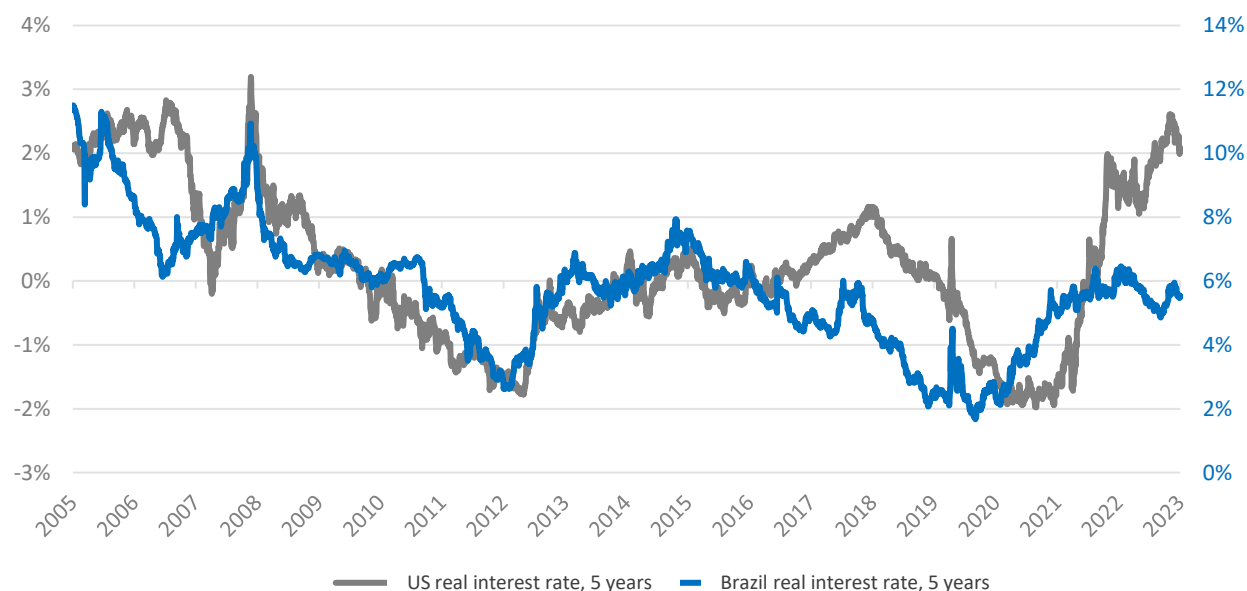
BRL Nominal Return and 5-Year Interest Rate Differential



Source: Bloomberg Finance LP

In fact, the spread between inflation-linked bond yields in Brazil and in the US has been compressing lately. This is largely due to the increase in US yields, driven by the uncertainty caused by high inflation and the contractionary policy adopted by the Federal Reserve:

Evolution of the 5-Year Real Interest Rate



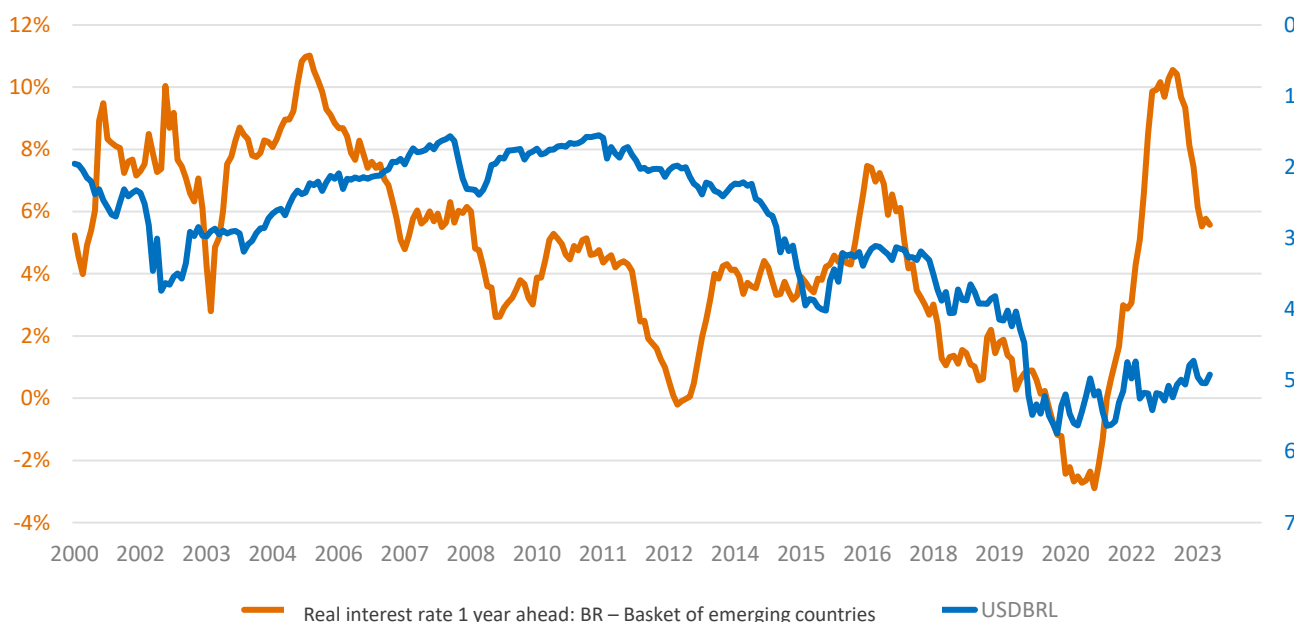
Source: Bloomberg Finance LP

An eventual convergence of US inflation to the Fed's target should make room for rate cuts (keeping in mind that more persistent inflation remains as one of our likely [scenarios](#)), which could translate in an increase in the longer-term real interest rate differential, exerting yet another positive force on the Brazilian real.

When comparing the real interest rate offered to investors in Brazil to the one offered in other emerging countries with a similar country risk, we can also observe another imbalance with the current exchange rate. Ultimately, investors tend to compare Brazilian assets with those offered in other emerging countries, using dollars to buy and sell securities denominated in local currency.

Therefore, the USD/BRL rate is, to some extent, a function of the attractiveness of Brazilian assets versus those in the rest of the emerging market universe. Looking to the real interest rate differential one year ahead between Brazil and a basket of emerging countries with a similar country risk (in the next graph), we notice once again that the Brazilian real is traded at a depreciated level.

Interest Differential, Brazil vs. Emerging Markets



Source: Bloomberg Finance LP

Even when we take into account that the Central Bank of Brazil is at the forefront of interest rate cuts worldwide, it is important to remember that the interest rate priced by the market at the end of the current cycle should remain well above the one expected for other emerging countries, especially in East Asia.

It is worth mentioning that this outlook of a higher-valued exchange rate compared to the US dollar is shared by a good part of local fund managers, who have increased their short position (sold) in dollars and long position (purchased) in reais.

In short, the risk environment emerging for 2024 is conducive to a more positive bias towards the Brazilian real, although important points of attention remain on the radar. These include a deterioration in the local fiscal scenario that could weigh on Brazil's country risk, or more resilient inflation readings in the United States, which would sustain US fixed-income yields at a higher level for more time. Nevertheless, considering the historical sensitivity of the Brazilian currency to the interest rate differential, the current environment continues to indicate that the currency is being traded at a depreciated level, pending an eventual convergence.



Our Conclusions

- After closing 2022 in the range of USD/BRL 5.28, the Brazilian currency has been appreciating over the course of this year.
- The Brazilian real exhibits a historical sensitivity to the interest rate differential both in relation to the United States as well as to emerging peers.
- Considering the current spread, the Brazilian real appears to be traded at a depreciated level.
- A cut in US interest rates could lead to an eventual appreciation of the Brazilian currency.
- Even with interest rates priced in by the market, the real interest rate differential between Brazil and its emerging peers should remain high.
- Fiscal risks in Brazil and the possibility of more persistent inflation from the outside are potential factors that could postpone this possible appreciation of the Brazilian real.



This material has been prepared by Banco Itaú International. This document contains information obtained from sources deemed reliable by Banco Itaú International and reproduced in whole or in part, and in original or modified form. It is being provided for informational purposes only and is not intended as a recommendation or offer for a product, service, or legal opinion.

The information in this document is provided as an accommodation to the inquirer. Banco Itaú International does not guarantee the accuracy of the information in this material and are not liable for any direct or indirect damages that may result from the use of this material and its contents. This document and any information provided in connection therewith are provided on the condition that they are strictly confidential, and that no liability or responsibility whatsoever in connection herewith shall attach to Banco Itaú International or any of its officers, employees or agents.

Banco Itaú International does not guarantee that such information is current and has no obligation to update it in the future. Banco Itaú International reserves the right to change, amend or delete any part of the information herein contained, without prior notice.

This document does not take into account individual investment objectives, financial condition or investor needs. The information contained in the document should not, in any circumstance, by itself constitute ground for any investment decision. In addition, it does not exclude or replace its confirmation and the preliminary investigation that should be undertaken by any invest or before taking an investment decision. Neither the information nor any opinion expressed herein constitutes an offer or invitation to buy or sell any securities or investment products. Investors should seek independent financial, tax, legal and / or accounting advice, as appropriate, before making any investment decision based on the information contained herein. Investment decisions should only be made after understanding the risks involved, analyzing personal objectives and carefully reading sales material and other documents related to the desired investment.

The financial markets are subject to sudden and important variations, and the instruments and other financial products in the document can rapidly and in unforeseeable ways lose a substantial portion of their value, or even all their value. Certain financial products may involve major risks, to such extent that they may generate losses that exceed the invested amount. Past performance is not necessarily a guide to future performance. Estimates of future performance are based on assumptions that may not be realized.

Accounts maintained with Banco Itaú International are governed by the terms and conditions specific thereto under the jurisdiction of the United States of America.

This document and any information provided in connection herewith are strictly confidential and may not be reproduced, redistributed or the contents hereof or thereof communicated to any third person, without the express written consent Banco Itaú International. Neither Banco Itaú International nor any of its officers, employees or agents shall be liable for the representations herein.