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Brazil: BRL Between the Short and the Long Run

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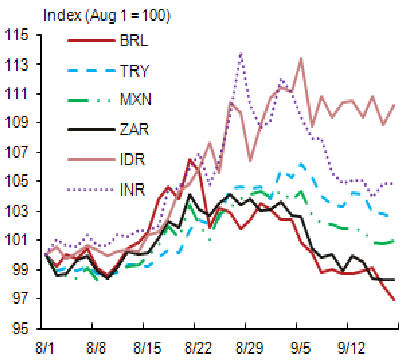
As we have argued recently (see "Where is BRL going?"), both global and domestic factors will likely call for a rebalancing of the Brazilian economy that will have a weaker real exchange rate as its main component. Thus, by our estimates, if constraints from the capital account determine the need to balance the current account by 2015, BRL would have to fall to somewhere near the 2.65 level by the end of that year.

Nonetheless, the Central Bank of Brazil's (BCB) intervention program (see "BRL Shock and Awe") has been very successful, leading to a 9% rally from the 2.45 lows. BRL is now no longer the EM underperformer (Figure 1).

Can the rally continue? Obviously there are various external risks, nonetheless current local positioning suggests that BRL can rally further from here. The combined long dollar position of local and foreign institutional investors (excluding banks and non-financial corporations) is now US$34.2 billion, still near levels seen in end of June (Figure 2).

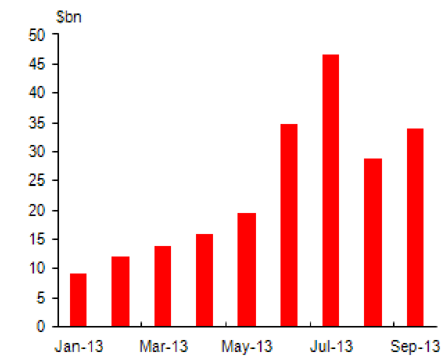
The BCB has made it clear that its intervention program is not dependent on the level of exchange rate and it plans to continue selling $500mn in currency swaps four times a week until the end of the year.

Fig. 1: EMFX performance



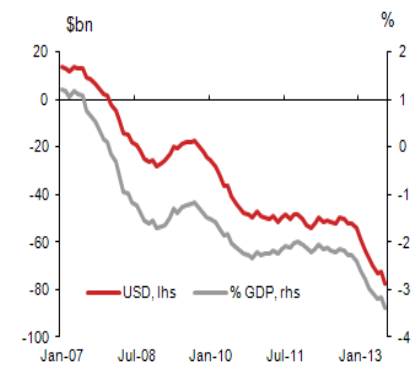
Source: Nomura, Bloomberg.

Fig. 2: Speculative long USD demand



Source: Nomura, Bloomberg, BM&F.

Fig. 3: Current account balance



Source: Nomura, Haver.

In a benign external environment, which in terms of our expectations for the beginning of tapering by the Fed is our base case, the current positioning could lead to an increasing supply/demand imbalance that could send BRL substantially stronger in the near term as short positions are liquidated.

We nonetheless believe that any such improvement would prove ephemeral. While liquidity and positioning will likely be the most potent determinants of short-term movements, ultimately it is balance of payment dynamics that determine the long-run value of a currency. BRL at current or stronger levels will likely lead to further worsening of the already rapidly deteriorating current account deficit (Figure 3).

We thus believe BRL is likely to strengthen from here in the short-run, which will be a further boost to our current receiver position (see "Receive offshore DI Jan 21").

Disclosure Appendix A-1

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