Brazil | Inflation (finally) starts to decline

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After trending up for a longer-than-expected time, annual inflation declined from 10.71% YoY in January to 10.36% YoY in February. We expect it to continue to lose steam going forward, in line with smaller adjustments in administered prices and the effects of the contraction in domestic demand. Anyway, inflation will likely converge to within the target range only 2017.

Inflation was somewhat lower than expected

Inflation reached 10.36% YoY / 0.90% MoM in February, significantly lower than in January (10.71% YoY / 1.27% MoM) and somewhat lower than expected (BBVA: 10.47% YoY / 1.0% MoM). The decrease in comparison to January was mostly due to a moderation in the increases in food, housing and transport prices (respectively 1.1% MoM, -0.2% MoM and 0.6% MoM, in comparison to 2.3% MoM, 0.8% MoM and 1.8% MoM in January). The deceleration in these groups of products/services offset the seasonally-driven surge in education costs (5.9% MoM). In comparison to the same period in 2015, when monthly inflation reached 1.22% MoM, inflation eased mostly due to lower adjustments in administered prices (0.39% MoM vs. 2.37% MoM in February 2015). The latter is therefore the main reason behind the decline in annual inflation in February, which was the first significant one since the end of 2014 (in September 2015 inflation dropped non-significantly to 9.49% YoY from 9.53% in August 2015). Finally, it is worth to mention that service inflation continued to decline in February, to 7.9% YoY from 8.1% YoY, suggesting that the current economic activity tone is already having an impact on prices.

Pressure on monetary policy should lessen somewhat as inflation starts to trend downward

We expect administered prices to continue to be adjusted significantly this year (by around 9% YoY precisely), although not as much as in 2015 (18% YoY). That moderation, as well as the effect of the sharp contraction in domestic demand and the lagged impact of last year's monetary tightening, should allow annual inflation to trend downwards from now on. More precisely, we forecast annual inflation to be around 9.6% YoY in March, 8.6% YoY in June, 8.1% YoY in September and the close the year close to 6.8% YoY. Even though relevant, that deceleration will not be enough to make inflation to converge to within the 2.5%-6.5% target range. Diminishing inflation should take some pressure off the BCB, which could soon stop discussing the need to tight monetary again and start to consider easing monetary conditions. Anyway, in our view the most likely is that the monetary authority will leave the Selic rate unchanged at 14.25% over 2016 and only announce interest rate cuts at the beginning of the next year, when inflation will likely converge to within the target range.