

## Brazil Central Bank Tempts Fate on Rates and Traders Follow Suit

### Swap rates defy rise in global yields after BCB guidance

Officials signal one more hike is enough to control inflation By Davison Santana and Josue Leonel

(Bloomberg) -- Brazilian swap rates are swimming against the tide, defying a surge in yields across the globe, as traders buy into the central bank's forecast that inflation will ease toward target with just one more rate hike.

Investors have halved the amount of rate increases priced into the curve for the rest of this year since the central bank meeting on March 16, when officials signaled an end to its yearlong aggressive tightening cycle in May. More importantly, long-term swap rates also fell, indicating traders expect inflation to slow, even without the rate hikes many had forecast.

The drop in Brazil's swap rates goes against the move seen elsewhere in emerging markets, with yields rising across the board following the U.S. bond rout. Treasury yields surged recently with traders pricing in more tightening in the world's biggest economy amid concern about rising prices.

"BCB has raised rates almost 1,000 basis points in two years, so they are certainly willing to fight inflation," said Brendan McKenna, a currency strategist at Wells Fargo in New York. "There is little they can do to defend against external shocks, but at some point policy makers have to wait for the effects of tighter policy to materialize."

Brazil's policy makers defied analyst expectations when it said that a final 100 basis-point rate hike in May would be enough to bring inflation back toward the 3.25% target next year. The last central bank weekly Focus survey shows economists see consumer prices running at 3.8% next year.

"The central bank was being held hostage of the Focus survey forecasts and now it decided to follow its own views," said Tony Volpon, chief strategist at Wealth High Governance and a former central bank director.

Traders quickly bought into the central bank's guidance and adjusted their position, with the swap rates curve now pricing in 35 basis points in hikes after the one-point move in May. Two weeks ago, that premium to cover for the risk the cycle needs to be extended was of more than 100 basis points.

The more dovish central bank stance suggests officials want to avoid overkill after their decision to cut rates to a record low of 2% a couple of years ago opened room for a sharp increase in inflation. At that time, officials delivered all the rate cuts that were priced in the swap curve, also meeting economists' expectations.

The move lower in Brazil's swap rates happened even as equivalents in Mexico, Colombia and Chile edged higher due to the rise in U.S. yields. That underscores the Brazilian central bank's credibility, as often times dovish remarks by policy makers are negatively received by traders, who instead of adjusting bets to the softer guidance, push rates higher on the view that the policy response won't be enough to control rampant inflation.

The Brazilian real also proved resilient, holding onto its world-beating advance this year even as rates may not climb as much as previously expected. The already high carry return is probably enough to keep attracting foreign capital, especially as the Russia-Ukraine war steers investors away from emerging economies that are directly affected by the conflict.