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Traders Doubting Inflation Pledge as Debt Slumps: Brazil Credit
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By Ye Xie and Matthew Bristow

July 19 (Bloomberg) -- Traders are betting Brazilian policy makers will fail to bring inflation down to the government's target for a third straight year in 2012.

The yield gap between inflation-linked bonds and interest- rate futures, a gauge of investors' expectations for annual consumer price increases over the next two years, swelled to a two-month high of 5.69 percentage points yesterday, according to data compiled by Bloomberg. Central bank President Alexandre Tombini said he will reach Brazil's 4.5 percent inflation target in 2012 after conceding he wouldn't achieve it this year.

Rising wages in Latin America's biggest economy are prompting investors to boost bets the central bank will fail to deliver on its 2012 pledge after inflation surged to a six-year high of 6.71 percent in June. Central bankers led by Tombini will raise borrowing costs 25 basis points, or 0.25 percentage point, to 12.5 percent tomorrow, according to all 44 economists surveyed by Bloomberg.

"The market doesn't believe the central bank will meet the target," Marcelo Schmitt, a fixed-income portfolio manager in Sao Paulo at SulAmerica Investimentos, which has 20 billion reais ($12.7 billion) under management, said in a telephone interview. "People are more comfortable holding inflation- linked bonds again."

The two-year breakeven rate in the U.S., the world's biggest economy, was 1.65 percent, according to data compiled by Bloomberg. A similar gauge for Chile was 3.23 percent.

Inflation Outlook

Inflation-linked bonds, which allow investors to hedge against rising consumer prices, rallied in the past month, pushing down yields on notes due in May 2013 by 22 basis points to 6.63 percent, according to data compiled by Bloomberg. The yield on interest-rate futures due in July 2013 rose 20 basis points in the same period to 12.67 percent, while that of fixed- rate government bonds due in January 2013 increased 19 basis points to 12.77 percent.

Consumer prices will rise 6.3 percent this year and 5.2 percent in 2012, according to a central bank survey of economists published yesterday. In January, they forecast inflation would slow to 5.3 percent this year and 4.5 percent in 2012. Consumer prices rose at an annual rate of 5.9 percent in 2010.

The central bank targets inflation of 4.5 percent, plus or minus two percentage points. Brazil is the only major Latin America country where inflation is above the government's target, according to data compiled by Bloomberg.

'No Sign'

Rising wages and consumer spending are fueling cost-of- living increases. Average inflation-adjusted wages rose 4 percent in May from a year ago to 1,567 reais per month. The minimum wage will rise more

than 13 percent next year under a government formula. Sixty-six percent of Brazil's pension and welfare payments are linked to that wage. Retail sales rose 0.6 percent in May.

"The labor market shows, as yet, no sign of real adjustment," Paulo Vieira da Cunha, a former central bank director who is now a partner at Tandem Global Partners LLC, said in a telephone interview. "You have to have nominal demand converging more quickly to the real economy, and for that you need interest rate hikes."

The yield on interest-rate futures due in October rose to 12.42 percent, suggesting investors are split on whether the central bank will lift the benchmark rate in August, according to data compiled by Bloomberg. The bank has boosted the rate 150 basis points this year.

Inflation may quicken to 7 percent this year and end 2012 at 5 percent if policy makers don't raise borrowing costs in August after lifting them tomorrow, Vieira da Cunha said.

'Huge Unwinding'

"What I'm afraid of is that the central bank will pause after this meeting," Vieira da Cunha said.

The central bank declined to comment in an e-mailed statement.

Falling commodity prices will offset a pickup in core inflation, allowing the central bank to get price increases closer to the government's target, according to Neil Shearing, an emerging-markets economist at Capital Economics Ltd.

A central bank index of commodity prices has declined 7.5 percent since March after rising 41 percent in the previous 12 months.

"Global inflationary pressures should start to recede next year," Shearing said in a telephone interview from London.
"You're going to get a huge unwinding of the commodity price shock, which has been the principal driver of inflation in Brazil."

The real rose 0.2 percent to 1.5709 per U.S. dollar at 8 a.m. New York time.

The extra yield investors demand to own Brazilian dollar bonds instead of U.S. Treasuries narrowed five basis points to 165, according to JPMorgan Chase & Co.

Default Swaps

The cost of protecting Brazilian bonds against default for five years rose three basis points to 120, according to data provider CMA, which is owned by CME Group Inc. and compiles prices quoted by dealers in the privately negotiated market.
Credit-default swaps pay the buyer face value in exchange for the underlying securities or the cash equivalent if a government or company fails to adhere to its debt agreements.

The yield on interest-rate futures contracts due in January fell one basis point to 12.46 percent.

Tombini, who replaced Henrique Meirelles as central bank president in January, repeated his goal of slowing consumer prices increases to 4.5 percent in 2012 at a Senate hearing on July 5. Inflation will peak in August and measures the central bank have taken to cool the economy will ensure inflation "converges" to its target, Tombini, 47, said.

'Danger'

Tombini headed the central bank's research department when Brazil created its inflation-targeting regime in 1999. The system has allowed the country to overcome crises, Tombini told lawmakers in March.

The central bank under Meirelles raised rates as high as 26.5 percent in 2003, when inflation reached 17.2 percent. Meirelles also boosted the rate 375 basis points in nine months to 19.75 percent in 2005. Inflation averaged 4.85 percent since the end of 2005.

The risk of missing the 4.5 percent inflation target for another year is that the central bank will lose credibility and erode inflation expectations, according to Alexandre Schwartsman, a former central bank board member.

"They are facing the danger of losing the battle for another year," Schwartsman, who is setting up his own consultancy firm, said in a telephone interview from Sao Paulo.
"It boils down to the question how seriously the central bank wants to bring inflation in line with the target. The move so far was too little too late."

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