Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY PREVIEW

A WARRANTED HAWKISH RESPONSE AMID A WORSENING POLICY TRADEOFF

Mauricio Oreng*
mauricio.oreng@santander.com.br
+5511 3553 5404

- On Wednesday (October 27), the Brazil Central Bank (BCB) is scheduled to announce its monetary policy decision: we expect a 150bps hike in the Selic rate to 7.75% (revised up from 100bps last Friday). We anticipate a hawkish tone in the statement, probably accompanied by signs of a hike of 150 bps in December, as the BCB may seek to anticipate the benefits from the tough stance.
- In our view, the news regarding the latest fiscal policy initiatives, implying changes in the budget framework, have likely tilted the balance of risks even further to the upside. And now, with the rising trend in inflation expectations apparently gaining renewed steam, the baseline scenario itself is also deteriorating markedly.
- We expect a double-digit terminal Selic rate for the cycle (preliminarily penciling in 10.5%) in 1Q22. Amid increased policy uncertainty, we continue to see risks skewed to the upside as per this call.
- The deterioration in inflation conditions, outlook and balance of risks typically takes place along with a tightening in financial conditions and worsening GDP growth expectations. In our view, this worse tradeoff evidences the importance of structural (fiscal, macro) reforms to curb government expenses and boost productivity/investment. Unfortunately, monetary policy will be unable to help on this front in the near future.

Background on the Recent BCB's Policy Path

In the last Copom meeting[1], held on September 21-22, the BCB continued to hike the Selic rate by 100 bps (reaching 6.25%) and signaled the same pace for the subsequent meeting. According to the official communication back then "at the present stage of the tightening cycle, this pace is the most appropriate to guarantee inflation convergence to the target at the relevant horizon and, simultaneously, allowing the Committee to obtain more information regarding the state of the economy and the persistence of shocks."

The Copom minutes[2] complemented the message, with the authority clarifying that the level of terminal rate dominates the speed of hikes when it comes to achieving the center target for inflation in 2022. The BCB claimed that "simulations with interest rate hikes that assume different terminal rates suggest that the current pace of adjustment is sufficient to reach a significantly restrictive level and to ensure the convergence of inflation to the target in 2022, even considering the asymmetry of the balance of risks."

In the inflation report[3], BCB studies (or boxes) showed that the authority saw most of this year's inflation surprise associated with energy price shocks and believed an eventual persistence in inflation of industrial goods will hinge more on the future evolution of costs and shocks, rather than on the lagged CPI pass through of a repressed upstream inflation. The BCB also saw well-anchored inflation expectations in the long run and only a small deviation for the shorter policy horizon.

In recent speeches (as of mid-October), BCB officials clarified that there was no "commitment" to the pace of hikes (100bps), yet the final policy message continued to indicate this pace as part of the (baseline) flight plan.

All of that is history now: following the latest fiscal policy decisions[4], we believe the baseline scenario and balance of risks changed quite markedly since the last policy meeting. In our view, the BCB is probably willing to take an even more hawkish stance amid evidence that the fiscal framework could be undergoing changes that can impact the inflation outlook (most importantly) as well as signs that the global supply shocks remain in place, further feeding a cost push inflation that can make industrial costs more persistent than the BCB had been looking for (a bit less important but still noteworthy).

Scenario Evolution Since the Last Meeting

The main key change since the last Copom meeting (September 21-22) was the discussions about social programs and budget for 2022. The key focus was on the proposal to accommodate a higher level of government transfers (and other expenses) across 2022 within the constitutional spending cap. The idea was to do it by means of changes in the framework, theoretically opening a space of nearly BRL100 billion in additional expenses for 2022.

Since the last meeting, current inflation conditions continued to deteriorate, as supply constraints remain at work, and (what likely started off as) a cost push inflation has already produced a marked deterioration in underlying (or cyclical, demand-led) inflation gauges. Not only has the headline IPCA now reached (even if temporarily) double-digits, but also some key underlying inflation measures are running at an interval of 7-9% in annualized terms. The spreading of inflation pressures is particularly visible now in (core) services, where the pass through is supported by the recovery in urban mobility and reopening in economic activities.

The conjunction of fiscal decisions (very important), higher underlying inflation for cyclical items (important) and stubborn supply shocks (a bit less important) continued to impact inflation expectations: since the last meeting, in terms of asset-based measures, inflation breakeven rates (BEIRs) rose by 0.5-0.9 pp for maturities of 1, 2, 5 and 10 years. In terms of survey-based measures, economists' forecasts for 18 months ahead (adjusted for the weights of calendar-year horizons, equally split between 2022 and 2023 as of 4Q21) remain

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[1] **Santander Brazil Monetary Policy - *"Scanning the Scene as It Moves at Cruise Speed"* –** September 23, 2021 - Available on: https://bit.ly/Std-COPOM-sep21

[2] **Santander Brazil Monetary Policy - *"Going Farther, Not Necessarily Faster"* –** September 28, 2021 – Available on: https://bit.ly/Std-Copom-min-set21

[3] **Santander Brazil Monetary Policy - *"Hindsight and Outlook"* –** September 30, 2021 - Available on: https://bit.ly/Std-InflaReport-3Q21

[4] **Santander Brazil Macro Compass - *"Changes in the Fiscal Framework to Trigger a Bolder Move by the Copom"* –** October 22, 2021 - Available on: https://bit.ly/Std-macrocomp-102221; details in the Fiscal Policy section.

stuck 0.5 pp above the calendar-adjusted mid-target. What's more, median 2022 IPCA forecast increased by 30bps to 4.40% (mid-target: 3.50%) since the last Copom, and the previously "frozen-at -target" estimates for longer horizons also started to move in a bad direction (+2bps for 2023, to 3.27%, and +2bps for 2024, to 3.02%).

It is important to note that this deterioration in the inflation outlook, mainly via expectations, implies a worse monetary policy tradeoff. Financial conditions are getting tighter, with a continued shift higher in the term structure of interest rates, a spike in the FX rate, and falling stock prices. Of particular importance is the fact that we estimate the real ex-ante short-term interest rate[5] is averaging at 4.2% in October (up to October 22), the highest reading since mid-2017. The series has now reached the same level as our asset-based proxy[6] for the structural interest rate, suggesting a neutral monetary policy stance for the month.

We note that the real ex-ante rate reached a level of 5.5% by October 22, topping our hypothesis for the neutral level of interest rate (4.0% in real terms). This means that November will probably see a contractionary policy stance already, implying that the signs of a tight monetary policy by the BCB are already moving down the policy pipeline (in its way through the economy), as economists expect the BCB to reach a terminal Selic of 9.75% in the cycle and the market likely projects an even more aggressive tightening[7].

For now, the policy tightening is more easily seen in GDP expectations rather than on actual economic data. The latter has been showing mixed results (better services and employment on the recovery of urban mobility and the reopening of activities, contrasting with slowing retail and manufacturing, on the heels of a spending reshuffle, supply constraints and rising costs/prices). On the expectations front, however, there has been a notable decline in median GDP forecasts for all the horizons since the last Copom meeting. And this is probably evidence that not only are the expectations about the cycle going down, but also that the expected path of Brazil's sustainable growth rate (potential GDP) is maybe being downgraded.

What to Expect from this Meeting, the Next One and Beyond?

After last week's fiscal announcements, we changed our forecast for the October 26-27 Copom meeting to a 150bps hike to 7.75%. We previously expected another move of 100bps, which we thought to be the "cruise speed" in the absence of shocks (like the one seen last week).

Since the BCB already saw fiscal discussions imparting upside risks for the inflation path—entailing the need for a tighter policy stance than in the baseline scenario—it seems like the recent fiscal policy developments will raise even further the concerns (and the tone). In addition to the worse balance of risks, our preliminary calculations point to a possible increase in the BCB's 2022 IPCA projection to nearly 4.0-4.1% (up 0.3-0.4 pp from the previous estimate, presented in the 3Q21 inflation report). The fact that 2023 estimates have started to move, even if just a mere couple of basis points for now, imply that the risk of "fiscal spillovers" have become increasingly important, and will now require a bolder policy reaction.

We believe that the Copom will raise concerns on the current inflationary environment and outlook, reaffirming its commitment to reaching the center of the inflation target for the relevant horizon. Although the BCB's "rule of thumb" indicates that 2022 and 2023 would have similar weights at this point in the calendar, we believe that the Copom will continue to indicate a slightly greater focus on the 2022 horizon, given the risks of further deterioration (in expectations) also for 2023. This belief follows recent communications from BCB officials. All in all, we believe that the BCB will seek to reinforce the signal that it will do whatever is necessary to bring inflation (expectations) down to 3.50% in 2022, and keep it at 3.25% for 2023.

Speed-wise, as for the subsequent decision (December 7-8), we believe that the Copom will continue to indicate a new increase of 150 bps, as the BCB may seek to anticipate the benefits from the hard tone and

[5] This series is the 1-year nominal swap interest rate deflated by economists', median 12-month ahead IPCA forecasts.
[6] This proxy is based on the 5y5y forwards on the real yields curve (NTN-Bs) deducted by a constant historical term premium of 100bps.
[7] Depending on the viewer's risk premium assumption.

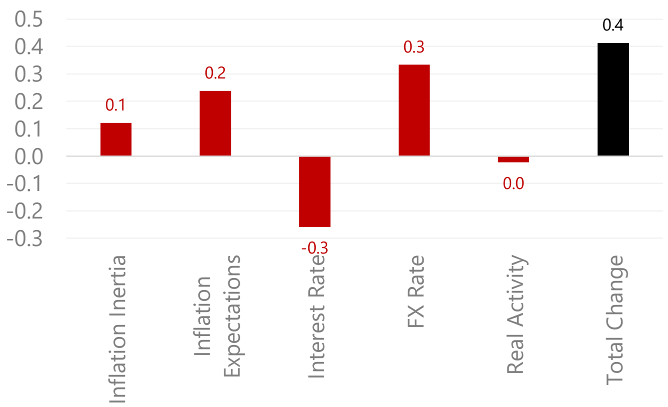
stance, with Selic rate likely ending the year at 9.25%. But the authority should buy itself some degree of freedom to eventually speed up the pace further if necessary.

Budget-wise, we have been saying[8] that signs of de-anchoring for 2023 would play a key role in an eventually stronger response by the BCB, as the authority seeks to avoid inflation consolidating above the mid-target. With these risks having (at least partly) materialized, we now expect the Copom to consider an even bolder flight plan, with Selic rate in double-digit territory: for now, we project the Selic hiking cycle to end at 10.50% sometime in 1Q22. But we recognize that the odds remain skewed to the upside.

Finally, just some food for thought, the deterioration in inflation conditions, outlook and balance of risks takes place along with a tightening in financial conditions and worsening GDP growth expectations. In our view, this worsening policy tradeoff evidences the importance of structural (fiscal, macro) reforms to curb government expenses and boost productivity/investment. Monetary policy will be unable to help in the near future.

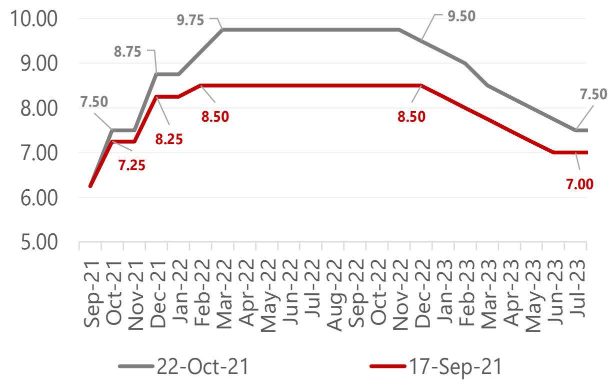
Refer to a summary of the Copom dataset and a few interesting graphs in the next pages.

Figure 1.A. – Contributions for the change in BCB model forecasts (IPCA 2022, pp)



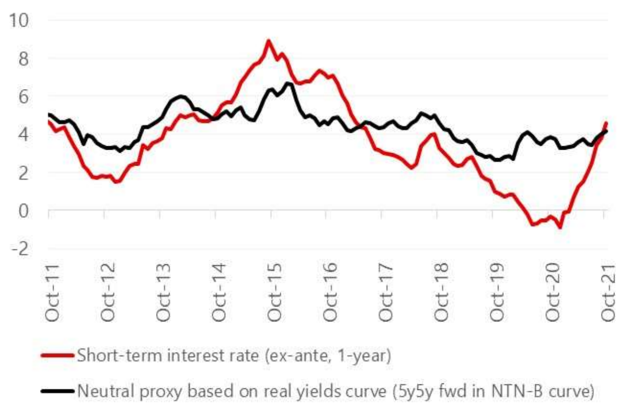
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: Based on the model elasticities published by the authority

Figure 1.B. – Median Selic Rate Expectations (% p.a., monthly path)



Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: As of the most recent BCB Focus report: October 22, 2021.

Figure 2.A. – Real Yields: Short Term vs. Long Term (monthly average, % p.a.)



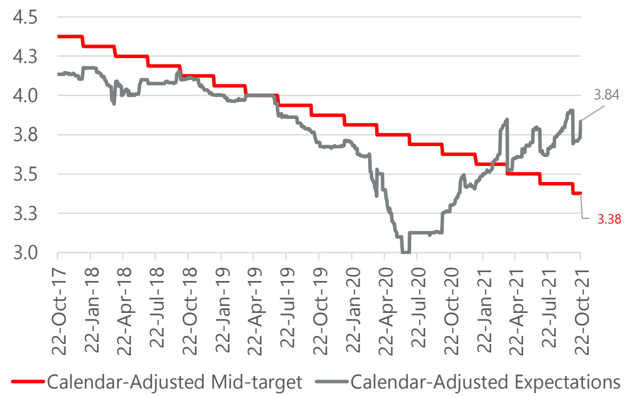
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: Based on historical averages, the neutral rate proxy based on long nominal yields is adjusted by a constant term premium of 200bps, with the neutral rate proxy based on real yields adjusted by a premium of 100bps.
Note 2: Average data for October 2021 up to the 22nd.

Figure 2.B. – Proxy for the Degree of Stimulus (gap between long and short-term real rates)

Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: To calculate the stimulus, we compared the short-term rate presented in the left-hand graph with the neutral rate proxy.
Note 2: Average data for October 2021 up to the 22nd.

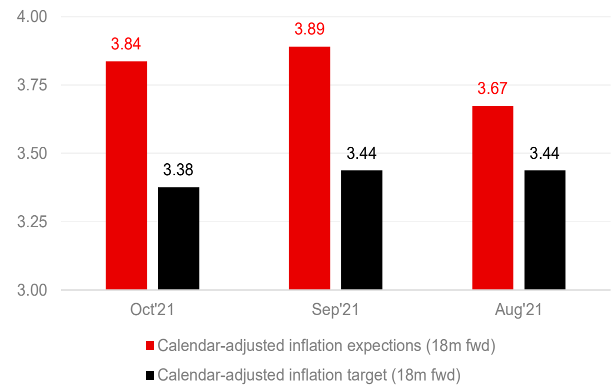
[8] **Santander Brazil - Macroeconomic Scenario: *"Signs of Normality in Public Health, Evidence of Risks in Fiscal Policy"* –** October 21, 2021- Available on: https://bit.ly/Std-scenreview-oct21; details in the Monetary Policy section.

Figure 3.A. – Calendar-Adjusted Expectations vs. Target (18 months ahead)



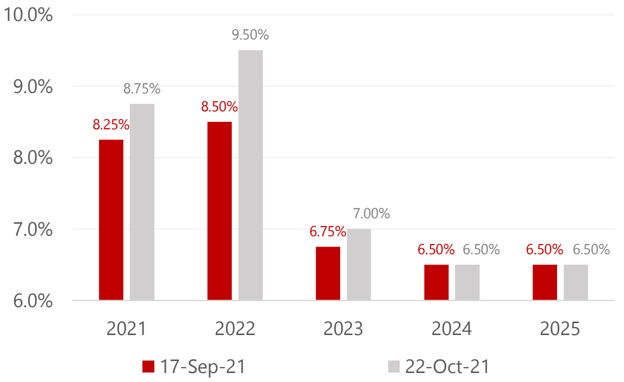
Sources: Brazilian Central Bank, Santander.
Note: IPCA expectations and target adjusted for the weight of each policy horizon. For October 2021, this means 50% for 2022, and 50% for 2023.

Figure 3.B. – Median Selic Rate Expectations (% p.a., monthly path)



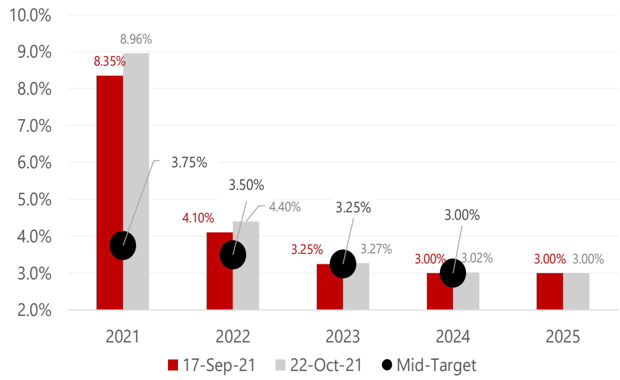
Sources: Brazilian Central Bank, Santander.
Note: IPCA expectations and target adjusted for the weight of each policy horizon. For October 2021, this means 50% for 2022, and 50% for 2023.

Figure 4.A. – Median Selic Rate Expectations (% p.a., annual)



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report: October 22, 2021.

Figure 4.B. – Median IPCA Expectations (% p.a., annual)



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report: October 22, 2021.

Figure 5.A. – A Proxy for the Copom Dataset, Part 1

ECONOMIC TOPICS	*LAST DATA*		*THIS TIME*	*LAST MEETING*	*SECOND LAST*
Key Decision Variables	*When?*		*Oct'21*	*Sep'21*	*Aug'21*
INFLATION					
Forecasts (% p.a.) - BCB's Focus report					
Calendar-Weighted Forecast (~18 months)	22-Oct-21	↓	3.84	3.89	3.67
Calendar-Weighted Target (~18 months)	22-Oct-21	↓	*3.38*	*3.44*	*3.44*
Forecast for a year ahead (12 months)	22-Oct-21	↓	4.90	4.93	4.47
Forecast for 2021 - target: 3.75%	22-Oct-21	↑	8.96	8.35	6.79
Forecast for 2022 - target: 3.50%	22-Oct-21	↑	4.40	4.10	3.81
Forecast for 2023 - target: 3.25%	22-Oct-21	↑	3.27	3.25	3.25
Forecast for 2024 - target: 3.00%	22-Oct-21	↑	3.02	3.00	3.00
Forecast for 2025 - target: 3.0% (?)	22-Oct-21	→	3.00	3.00	3.00
Breakeven inflation rates (% p.a.)					
1-year	22-Oct-21	↑	5.3	4.8	4.3
2-year	22-Oct-21	↑	5.3	4.8	4.4
5-year	22-Oct-21	↓	6.3	7.2	8.7
10-year	22-Oct-21	↑	6.4	5.5	4.9
Actual CPI data					
Headline (% YoY)	Sep-21	↑	10.2	9.7	9.0
Headline (% QoQ, saar)	Sep-21	↑	13.6	11.5	11.3
Core IPCA X3 (% YoY)	Sep-21	↑	6.4	6.2	5.6
Core IPCA X3 (% QoQ, saar)	Sep-21	↓	7.4	7.7	7.4
New cores average (% YoY)	Sep-21	↑	6.5	6.1	5.5
New cores average (% QoQ, saar)	Sep-21	↑	8.9	8.1	7.8
Diffusion index (sa)	Sep-21	↓	67.1%	74.2%	71.2%
Diffusion index ex-food (sa)	Sep-21	↓	67.1%	72.7%	71.1%
MONETARY POLICY					
Selic rate (% p.a.)					
Current level	22-Oct-21	↑	6.25	5.25	4.25
Forecast for 2021	22-Oct-21	↑	8.75	8.25	7.00
Forecast for 2022	22-Oct-21	↑	9.50	8.50	7.00
Forecast for 2023	22-Oct-21	↑	7.00	6.75	6.50
Forecast for 2024	22-Oct-21	→	6.50	6.50	6.50
Forecast for 2025	22-Oct-21	→	6.50	6.50	6.50
Yield curve (% p.a.)					
1-year OIS swaps (pré-DI)	22-Oct-21	↑	10.7	8.6	7.6
2-year OIS swaps (pré-DI)	22-Oct-21	↑	11.3	9.3	8.4
Ex-ante real interest rate (% p.a.)					
1-year (OIS swaps vs. inflation forecast)	22-Oct-21	↑	5.5	3.5	3.0

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.
Last update: October 25, 2021.

Figure 5.B. – A Proxy for the Copom Dataset, Part 2

ECONOMIC TOPICS	*LAST DATA*		*THIS TIME*	*LAST MEETING*	*SECOND LAST*
Key Decision Variables	***When?***		***Oct'21***	***Sep'21***	***Aug'21***
REAL ACTIVITY					
GDP forecasts (% p.a.) - BCB's Focus report					
Forecast for 2021	22-Oct-21	↓	4.97	5.04	5.27
Forecast for 2022	22-Oct-21	↓	1.40	1.63	2.06
Forecast for 2023	22-Oct-21	↓	2.00	2.30	2.50
Forecast for 2024	22-Oct-21	↓	2.25	2.50	2.50
Forecast for 2025	22-Oct-21	↓	2.25	2.50	2.50
Actual activity data					
IBC-Br (% QoQ, saar)	Aug-21	↑	0.8	0.8	-1.8
Industrial production (% QoQ, saar)	Aug-21	↓	-4.7	-5.7	-11.4
Retail sales (% QoQ, saar)	Aug-21	↑	3.3	11.3	11.8
Services volume (% QoQ, saar)	Aug-21	↑	18.5	13.1	9.2
Unemployment rate (% 3m, SA)	Jul-21	↓	13.5	14.0	14.2
Real average wage (% YoY, 3m)	Jul-21	↓	-8.8	-6.6	-3.2
Real wage bill (% YoY, 3m)	Jul-21	↑	-1.0	-1.7	-2.5
Caged payrolls (thousands, SA, 3m)	Aug-21	↑	281	286	356
Economic confidence (2011=100)	Sep-21	↓	83.1	87.1	86.9
EXTERNAL SECTOR					
FX rate (USD/BRL)					
Current level	22-Oct-21	↑	5.65	5.29	5.17
Actual: 5-day average (previous week)	22-Oct-21	↑	5.60	5.29	5.17
USD/BRL (to be) used in simulations	22-Oct-21	↑	5.60	5.25	5.15
Forecast for 2021	22-Oct-21	↑	5.45	5.20	5.10
Forecast for 2022	22-Oct-21	↑	5.45	5.23	5.20
Forecast for 2023	22-Oct-21	↑	5.20	5.10	5.00
Forecast for 2024	22-Oct-21	→	5.10	5.10	5.00
Forecast for 2025	22-Oct-21	↓	5.12	5.15	5.00
ASSET PRICES					
IC-Br (% YoY)	Sep-21	↑	42.7	40.2	48.3
CRB Commodity Index	Oct-21	↑	237.7	221.8	213.5
Brazil 5-year CDS (basis-points)	22-Oct-21	↑	236	196	180
Ibovespa stock index (points)	22-Oct-21	↓	106,296	112,282	121,801
DI Jan-22 (% p.a.)	22-Oct-21	↑	8.15	7.13	6.35
DI Jan-23 (% p.a.)	22-Oct-21	↑	10.85	8.82	7.88
NTN-F 2023 (% p.a.)	22-Oct-21	↑	10.94	8.90	8.04
NTN-F 2027 (% p.a.)	22-Oct-21	↑	11.84	10.17	9.20
NTN-B 2040 (% p.a.)	22-Oct-21	↑	5.40	4.85	4.41
NTN-B 2055 (% p.a.)	22-Oct-21	↑	5.47	4.91	4.51

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.
Last update: October 25, 2021.

CONTACTS / IMPORTANT DISCLOSURES

Brazil Macro Research			
Ana Paula Vescovi*	Chief Economist	anavescovi@santander.com.br	5511-3553-8567
Mauricio Oreng*	Head of Macro Research	mauricio.oreng@santander.com.br	5511-3553-5404
Jankiel Santos*	Economist – External Sector	jankiel.santos@santander.com.br	5511-3012-5726
Ítalo Franca*	Economist – Fiscal Policy	italo.franca@santander.com.br	5511-3553-5235
Daniel Karp*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Tomas Urani*	Economist – Global Economics	tomas.urani@santander.com.br	5511-3553-9520
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Credit	felipe.kotinda@santander.com.br	5511-3553-8071
Gabriel Couto*	Economist – Special Projects	gabriel.couto@santander.com.br	5511-3553-8487
Gilmar Lima*	Economist – Modeling	gilmar.lima@santander.com.br	5511-3553-6327
Global Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Mike Moran	Head of Macro Research, US	mike.moran@santander.us	212-350-3500
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Equity Research			
Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Mariana Cahen Margulies*	Head, Brazil	mmargulies@santander.com.br	5511 3553 1684
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