Santander
Macroeconomic Research

BRAZIL MACRO

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MONETARY POLICY PREVIEW

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

RAISING THE TONE

- On Wednesday (June 16), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We expect the stimulus removal to proceed, with another Selic hike of 75bps to 4.25%. This is broadly in line with analyst consensus and is the most likely outcome priced into the yield curve (~70% probability, with a perceived ~30% probability for a 100-bp move, as of June 10).
- Since the last Copom meeting (in May), the evolution of the BCB's baseline scenario features a stronger-than-expected cyclical recovery in economic activity, as well as more intense, persistent, and widespread price pressures than initially forecasted.
- We believe these elements will be mirrored in both the scenario assessment and inflation projections presented in the Copom statement: despite the continued BRL rally since the last meeting, we believe the BCB models will point to a higher bar (in terms of policy tightening necessary) to bring IPCA inflation back to the center of the target for the key policy horizon - i.e. 2022. In our view, this will be accompanied by a discontinuation of the "partial normalization" language.
- For the subsequent meeting (i.e., August), we believe the BCB will signal its intention to proceed with a similar pace of adjustment of 75 basis points.
- Our scenario projects a Selic rate of 6.50% at the end of this year (neutral level, according to BCB estimates). We then expect a hike in January 2022, taking the Selic to what we see as its possible terminal level for this cycle (7.00%). That level is consistent with what we see as preliminary evidence of a neutral interest rate of around 4% in real terms.

Context Surrounding the June Copom Meeting

Since the last BCB policy meeting in May, the evolution of the Copom dataset has featured a stronger-than-expected cyclical recovery in economic activity, as well as more intense, persistent, and widespread price pressures than initially expected. Although much of the ongoing inflationary pressures are being driven by temporary factors, we believe their impressive magnitude indicates the need to do more (in terms of policy tightening) to curb the secondary effects in progress.

These second-round developments have been materializing via hikes in other (cyclical or policy-sensitive) components of the consumer basket and via recent (yet for now moderate) gains in inflation expectations for the relevant 2022 policy horizon. In a nutshell, we believe the evolution of macro conditions and the outlook since the last Copom meeting supports the case for a still rapid pace of tightening and probably a complete removal of the stimulus, at the end of this process.

Despite some important GDP contributions from segments of the economy with low cyclicality or high volatility in 1Q21 (agriculture, on the supply side; inventories, on the demand side), the latest GDP report indicated that the economy is recovering more rapidly than expected to activity levels seen before the pandemic. Moreover, even with the looming risks of further delays in the COVID-19 immunization process, our expectation (as well as the market's) is that there will be a reopening that will support a further recovery in 2H21. Recent gains in terms of trade could also provide some additional support to the economy, in our view. Altogether, we believe these developments will probably result in a continued reduction of economic slack (especially in the labor market), with a broader reopening of services in general prompting a decline in joblessness (especially for informal workers, who account for the bulk of the unemployed).

The inflation picture continues to darken, as previously mentioned. We see this deterioration stemming from intensifying supply shocks (higher agricultural and other materials prices, a spike in electricity costs, global industrial supply disruptions). Perhaps reflecting the magnitude and the non-linear nature of these shocks, as well as some die-hard pressure for budgetary stimulus in Brazil, inflation pressures are becoming more disseminated across the CPI basket, as shown by several recent indicators of underlying inflation (notably May's IPCA report).

Even before the recent upturn in short-term GDP forecasts, we were already looking for IPCA inflation above the upper target for 2021, and slightly above the center target for 2022. And that was already true under the assumption of Selic rate hikes beyond the consensus of analysts. Thus, a natural conclusion is that future upward revisions to our own activity forecasts may prompt us to revise higher our own inflation estimates. The recent deterioration in the IPCA's composition adds even more pressure to the numbers.

We still see a deteriorating balance of risks for inflation ahead. In the short term, this is due to additional risks from the impact of weather-related events on electricity costs; in the medium and long term, our main concern continues to be the lack of clear signs of a permanent solution for Brazil's spending problem. Although some on the Street see considerable room for optimism in short-term developments on the budget front, we continue to see the country constrained by a fiscal straitjacket, with suffocating mandatory expenses still posing a major threat for debt sustainability in the medium term (in our view, the latter should be taken as the key "policy horizon" for fiscal policy purposes).

What to Expect from the Upcoming Rate-Setting Meeting?

Regarding the scenario assessment, we believe that the BCB will continue to recognize a consistent recovery in economic activity, raising the tone of the current growth assessment as well as of the activity outlook (the latter assuming an acceleration in the vaccination process against COVID-19 in 2H21).

On the inflation side, the acceleration of both headline and core IPCA will likely be highlighted, in our view, prompting more caution among the members of the board. We believe this recognition can go hand in hand with maintaining the policy line that these are mostly temporary price pressures, even though we think the BCB will need to do even more to ensure that these pressures on inflation will not linger into the medium term (and therefore be temporary, *de facto*).

In the meantime, in the discussion of the balance of risks, we think the possible worsening of the country's hydrological conditions[1] may be addressed by the BCB, with this potentially adverse supply shock implying an additional upside risk for inflation. We also believe that the fiscal debate will be maintained with few changes, and with the BCB still seeing the budget outlook supporting an upward asymmetry in the balance of risks. In other words, with reforms to permanently reign in government spending still needed, we are assuming that the positive (but one-off) surprises in this year's fiscal performance (up to April) will not have a material influence on the BCB's perceptions of inflationary risks, and even less so on its policy conduct.

Finally, in terms of monetary policy signals, we believe that the BCB will abandon indications that it is considering "partial normalization" of the interest rate. With the evolution of data, we believe the official inflation simulations will point to the need for an even tighter monetary stance to reach the mid-point inflation target (3.50%) for 2022. Despite the stronger exchange rate expected to be used in the forecasts (probably departing from *USD/BRL* ~5.10, compared to an initial point of 5.40 at the previous meeting), we believe FX is likely to have greater influence for the 2021 horizon, but less so for next year. For the key horizon, 2022, the higher inflation inertia (from 2021), the rising expectations (for 2022), and the stronger economy (meaning a narrowing of the output gap) will probably dominate the recent dynamics of the forecasts, in our view. Thus, with consensus now expecting the Selic at 5.75% (vs. 5.50% previously) for YE21 and 6.50% (vs. 6.25% previously) for YE22, we think BCB estimates will probably land at (or close to) mid-target next year, but with a higher level of interest rate. Furthermore, in our view the balance of risks deteriorated further with the record-high PPI numbers seen in key economies (Brazil included) and with the increased risk for electricity costs. This makes the balance of risks even more skewed to the upside.

For the subsequent meeting (August), we believe the BCB will signal the continuation of the adjustment at a pace of 75 basis points (to 5.00%). Importantly, if this occurs, it will maintain a welcome transparency in BCB decisions, also with this early indication of the flight plan for the short term (alongside its conditioners).

Looking Further Ahead

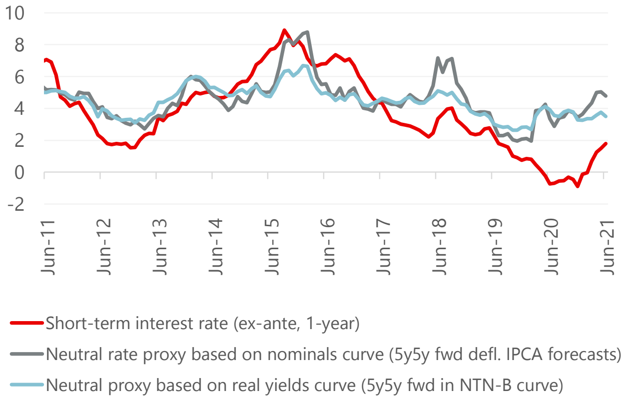
Amid mounting inflationary surprises to the upside, on the heels of higher cost pressures (and risks of even more down the pike), and amid a sea of budget stimulus (expected to fade much more slowly than initially thought) as well as a faster cyclical economic recovery, we see rising chances of a more hawkish response by the BCB at the June Copom meeting.

Our scenario projects a Selic rate of 6.50% at the end of this year. For the end of 2022, we continue to project the Selic at 7.00%, with a hike of 50 bps in January (and the BCB staying put for the whole year). Our Selic rate forecast is consistent with what we see as preliminary evidence of a neutral rate in the realm of 4% in real terms.

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

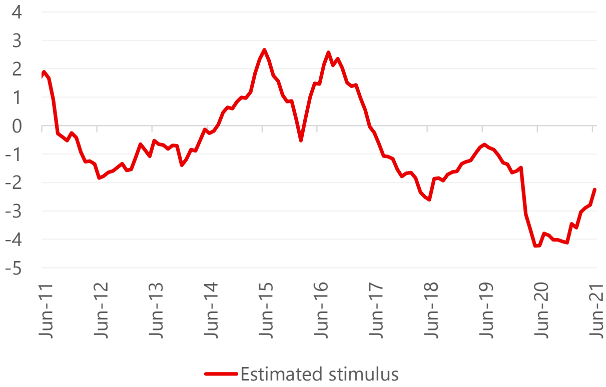
[1] The rainy season has just ended in Brazil with worryingly low levels in the reservoirs. Hydroelectric power plants account for ~65% of the country's electricity supply.

Figure 1.A. – Real Yields: Short Term vs. Long Term (monthly average, % p.a.)



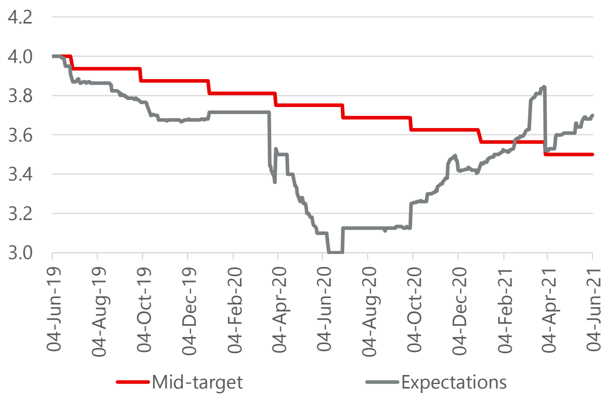
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: Based on historical averages, the neutral rate proxy based on long nominal yields is adjusted by a constant term premium of 200bps, with the neutral rate proxy based on real yields adjusted by a premium of 100bps.
Note 2: Average data for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

Figure 1.B – Proxy for the Degree of Stimulus (gap between long- and short-term real rates)



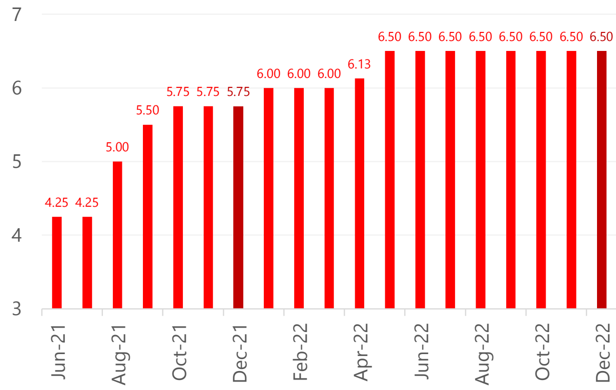
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: To calculate the stimulus, we compared the short-term rate presented in the left-hand graph with the average of the neutral rate proxies presented in the same chart.
Note 2: Average for June 2021 based on the first week of the month.

Figure 2.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 June 2021, this means 100% for 2022 (only horizon).

Figure 2.B – Median Selic Rate Expectations (% p.a., monthly path)



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report, released on June 4, 2021.

Figure 3.A – A Proxy for the Copom Dataset, Part 1

ECONOMIC TOPICS	*LAST DATA*		*THIS TIME*	*LAST MEETING*
Key Decision Variables	*When?*		*Jun'21*	*May'21*
INFLATION				
Forecasts (% p.a.) - BCB's Focus report				
Calendar-Weighted Forecast (~18 months)	04-Jun-21	↑	3.70	3.61
Calendar-Weighted Target (~18 months)	04-Jun-21	→	*3.50*	*3.50*
Forecast for a year ahead (12 months)	04-Jun-21	↑	4.16	4.04
Forecast for 2021 - target: 3.75%	04-Jun-21	↑	5.44	5.04
Forecast for 2022 - target: 3.50%	04-Jun-21	↑	3.70	3.61
Forecast for 2023 - target: 3.25%	04-Jun-21	→	3.25	3.25
Forecast for 2024 - target: ??????	04-Jun-21	→	3.25	3.25
Forecast for 2025 - target: ??????	04-Jun-21	→	3.25	3.25
Breakeven inflation rates (% p.a.)				
1-year	09-Jun-21	↑	4.9	4.0
2-year	09-Jun-21	↑	5.1	4.9
5-year	09-Jun-21	↓	4.8	5.0
10-year	09-Jun-21	↓	5.2	5.2
Actual CPI data				
Headline (% YoY)	May-21	↑	8.1	6.8
Headline (% QoQ, saar)	May-21	↑	9.7	8.6
Core IPCA X3 (% YoY)	May-21	↑	4.5	3.8
Core IPCA X3 (% QoQ, saar)	May-21	↑	6.0	5.5
New cores average (% YoY)	May-21	↑	4.6	3.9
New cores average (% QoQ, saar)	May-21	↑	6.3	5.2
Diffusion index (sa)	May-21	↑	68.2%	65.1%
Diffusion index ex-food (sa)	May-21	↑	64.3%	61.8%
MONETARY POLICY				
Selic rate (% p.a.)				
Current level	04-Jun-21	↑	3.50	2.75
Forecast for 2021 (Focus)	04-Jun-21	↑	5.75	5.50
Forecast for 2022 (Focus)	04-Jun-21	↑	6.50	6.25
Forecast for 2023 (Focus)	04-Jun-21	→	6.50	6.50
Forecast for 2024 (Focus)	04-Jun-21	→	6.50	6.50
Yield curve (% p.a.)				
1-year OIS swaps (pré-DI)	09-Jun-21	↑	6.1	5.4
2-year OIS swaps (pré-DI)	09-Jun-21	↑	7.1	6.9
Ex-ante real interest rate (% p.a.)				
1-year (OIS swaps vs. inflation forecast)	09-Jun-21	↑	1.9	1.3

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.
Last update: June 4, 2021 (consensus); June 9, 2021 (market data).

Figure 3.B. – A Proxy for the Copom Dataset, Part 2

ECONOMIC TOPICS	*LAST DATA*		*THIS TIME*	*LAST MEETING*
Key Decision Variables	*When?*		*Jun'21*	*May'21*
REAL ACTIVITY				
GDP forecasts (% p.a.) - BCB's Focus report				
Forecast for 2021	04-Jun-21	↑	4.36	3.14
Forecast for 2022	04-Jun-21	↓	2.30	2.31
Forecast for 2023	04-Jun-21	→	2.50	2.50
Forecast for 2024	04-Jun-21	→	2.50	2.50
Actual activity data				
IBC-Br (% QoQ, saar)	Mar-21	↑	9.5	11.1
Industrial production (% QoQ, saar)	Apr-21	↓	-9.7	-1.9
Retail sales (% QoQ, saar)	Apr-21	↓	-5.4	-13.9
Services volume (% QoQ, saar)	Mar-21	↑	11.6	16.5
Unemployment rate (% 3m, SA)	Mar-21	→	14.4	14.4
Real average wage (% YoY, 3m)	Mar-21	↑	0.8	1.3
Real wage bill (% YoY, 3m)	Mar-21	↓	-6.7	-7.4
Caged payrolls (thousands, SA, 3m)	Apr-21	↑	157	196
Economic confidence (2011=100)	May-21	↑	79.9	75.3
EXTERNAL SECTOR				
FX rate (USD/BRL)				
Current level	09-Jun-21	↓	5.06	5.36
Actual: 5-day average (previous week)	09-Jun-21	↓	5.05	5.40
Forecast for 2020 (Focus)	04-Jun-21	→	5.15	5.15
Forecast for 2021 (Focus)	04-Jun-21	↓	5.25	5.40
Forecast for 2022 (Focus)	04-Jun-21	↓	5.30	5.40
Forecast for 2023 (Focus)	04-Jun-21	↑	5.27	5.20
Forecast for 2024 (Focus)	04-Jun-21	↑	5.20	5.09
ASSET PRICES				
CRB Commodity Index	09-Jun-21	↑	211.2	204.1
IC-Br (% YoY)	May-21	↑	48.9	65.4
Brazil 5-year CDS (basis-points)	09-Jun-21	↓	161	192
Ibovespa stock index (points)	09-Jun-21	↑	129,907	119,564
DI Jan-22 (% p.a.)	09-Jun-21	↑	5.22	4.80
DI Jan-23 (% p.a.)	09-Jun-21	↑	6.82	6.50
NTN-F 2023 (% p.a.)	09-Jun-21	↑	6.97	6.65
NTN-F 2027 (% p.a.)	09-Jun-21	↓	8.41	8.69
NTN-B 2045 (% p.a.)	09-Jun-21	↓	4.17	4.48
NTN-B 2055 (% p.a.)	09-Jun-21	↓	4.26	4.56

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.
Last update: June 4, 2021 (consensus); June 9, 2021 (market data).

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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