

GOING 100 AND SUGGESTING A TIGHT POLICY STANCE

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

- On Wednesday (August 4), the Brazilian Central Bank (BCB) is scheduled to announce its next monetary policy decision.
- We expect that not only will the Copom proceed with the withdrawal of monetary stimulus, but that it also will start moving at an even faster pace, in response to an increase in inflationary risks and in view of stronger signs of greater persistence and spreading of (upward) inflationary shocks. We forecast an increase in the policy rate (Selic) of 1.00 p.p., to 5.25%.
- In conjunction with the decision, we believe that the BCB will again raise the tone of the statement, abandoning the neutral Selic guidance for the end of the cycle (given at its last meeting, in June) and reinforcing its commitment to bringing inflation (and expectations) back to the mid-target for the relevant policy horizon. Implicitly, this will mean that interest rate will need to rise above the neutral level and reach a contractionary territory.
- We project a 7.00% Selic at the end of the year (and throughout 2022 and 2023), with risks slightly skewed to the upside (i.e., meaning a greater likelihood of a terminal Selic of 7.50% than of 6.50%).



Context Around the Meeting

On Wednesday (August 4), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We expect that not only will the Copom proceed with the withdrawal of monetary stimulus, but that it also will start moving at an even faster pace, in response to an increase in inflationary risks and in view of stronger signs of greater persistence and spreading of (upward) inflationary shocks.

We forecast an increase in the policy rate (Selic) of 100bps, to 5.25%. Analysts' expectations and asset prices suggest to us that this decision is already widely expected by the market, especially after the release of the July IPCA-15 numbers about a week ago.

In conjunction with the decision, we believe that the BCB will again raise the tone of the statement, abandoning the neutral Selic guidance for the end of the cycle (given at the previous meeting) and reinforcing its commitment to bringing inflation (and expectations) back to the mid-target for the relevant policy horizon. Implicitly, this will mean that interest rate will need to rise above the neutral level and reach a contractionary territory.

In the minutes of its last meeting (June 15-16), the committee highlights having considered, on that occasion, the option of raising the interest rate more quickly (than the implemented decision of 75bps). Such a strategy allegedly would have allowed the BCB to accumulate more information on the behavior of inertial prices (e.g., services) and inflation expectations, which were apparently emerging as a likely focus of the committee's concerns.

In this regard, what has happened since that meeting is a deterioration in the overall inflation picture, according to the most recent data. This worsening has occurred mainly in the composition of inflation trends, with services showing sequential annualized numbers above 4% QoQ-saar, and the average of core inflation gauges running above 7%, using the same criterion. In our view, this deterioration in underlying inflation raises the probability of greater inflationary persistence from recent shocks, increasing the risks that the mid-point target for IPCA inflation will not be achieved in the relevant horizon.

In addition to increasingly clear signs that primary shocks are spreading to the rest of the IPCA basket, inflation expectations remain about 20-30bps above the center target for the relevant horizons (mainly 2022, which has a weight of 75% in the composition of the "relevant horizon" as of 3Q21). It is important to note that the virtual stability of IPCA estimates for 2022 since the June meeting occurs only under analysts' assumption that the Copom will speed up the pace and magnitude of the adjustment, with an expected increase of 100bps in August and the Selic at 7.00% at the end of the year. Thus, possible signs that the Copom may adjust interest rates less quickly and less steeply could, in our view, increase the probability of further upward revisions in inflation expectations ahead.

The ongoing improvement in the pandemic situation in Brazil (with a drop in new cases, hospitalizations, and deaths, as well as good progress in the vaccine rollout) increases the likelihood that economic activities will resume with no further setbacks, in our opinion. Added to this picture are the recent gains in terms of trade (expected to spread to some extent across the economy) and the renewal of fiscal stimuli, so that the BCB's expectation of a significant recovery in activity in 2H21 is increasingly plausible, in our view, and with fewer downside risks lurking around the corner.

These factors imply a reduced need for monetary accommodation in the current situation, in our opinion, especially given an upwardly skewed balance of risks for inflation, owing to the fiscal risks that are still present. The upshot is that we believe at this juncture that a faster pace of interest rate hikes is appropriate, in addition to a slightly contractionary terminal rate – considering the BCB's neutral interest rate estimate/assumption. We project a 7.00% Selic at the end of the year (and throughout 2022 and 2023)¹, with risks slightly skewed to the upside (i.e., meaning greater likelihood of a terminal Selic of 7.50% than of 6.50%).

¹ Our hypothesis is that the neutral rate increase to 4% in real terms (from 3%) in the wake of the increased fiscal risks following the pandemic. This implies an "equilibrium" Selic rate of 7.00% in nominal terms, given the convergence of the inflation target to 3% expected for the long run.



Policy Signals for the Future

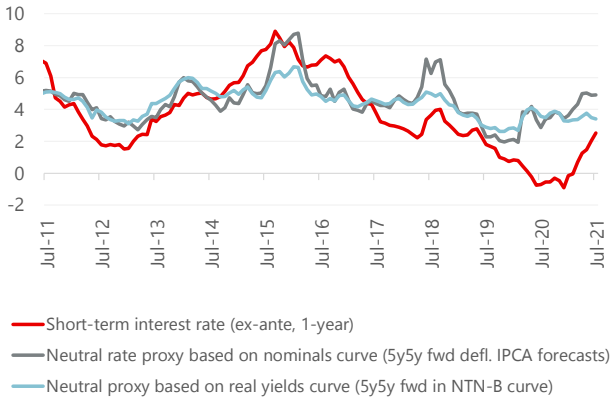
In terms of future guidance regarding the Copom's total adjustment, we believe that the Copom is likely to abandon the signal given at its last meeting, which pointed to a neutral Selic (i.e., 6.50%) at the end of the adjustment process. We estimate that the BCB's inflation models will indicate the need for a higher Selic (than the level suggested at the last meeting) to ensure the achievement of the mid-target in 2022 (3.50%). Therefore, we believe that the BCB will seek to reinforce the message that it will do whatever is necessary to bring inflation (and expectations) back down to the center target in 2022. In this context, we think it is possible that the authority may mention the need for a slightly contractionary level of interest rates at the end of the cycle.

As for the speed of the adjustment (the next decision is scheduled for September 21-22), we doubt whether the BCB will continue to explicitly point to a more likely outcome for the following Copom meetings (i.e., should the BCB scenario be confirmed before the next one), as it has been doing in recent months. While we believe that transparency (especially regarding the conditions for monetary policy decisions) is welcome, increased uncertainty in the current context may make the authority less clear about the next step. In any case, if the Copom does choose to signal the next step, we believe that the scenario to be indicated will more likely be another increase of 100bps (to 6.25%).

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

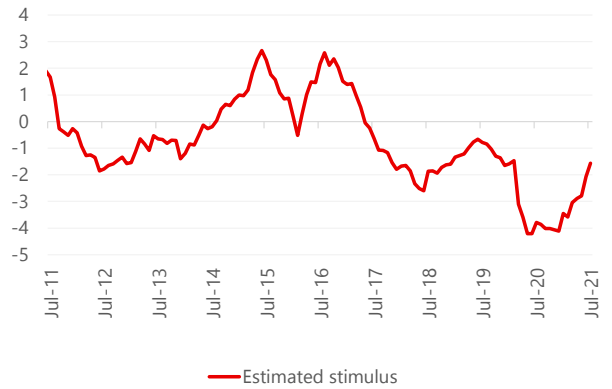


Figure 1.A. – Real Yields: Short Term vs. Long Term (monthly average, % p.a.)



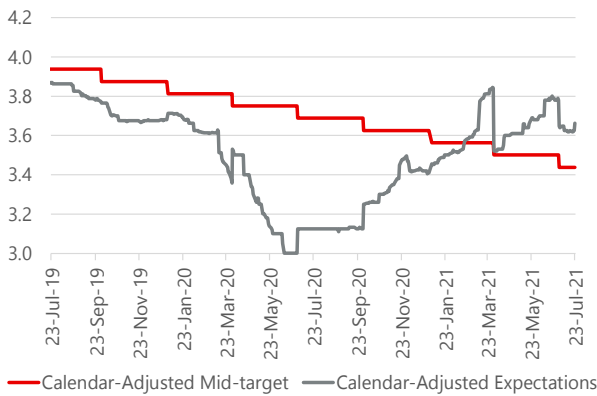
Sources: Brazilian Central Bank, Bloomberg, Santander.
 Note 1: The neutral rate proxy based on long nominal yields is adjusted by a constant term premium of 200bps, with the neutral rate proxy based on real yields adjusted by a premium of 100bps. All based on past data.
 Note 2: Average data for July 2021 based on data up to July 23.

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



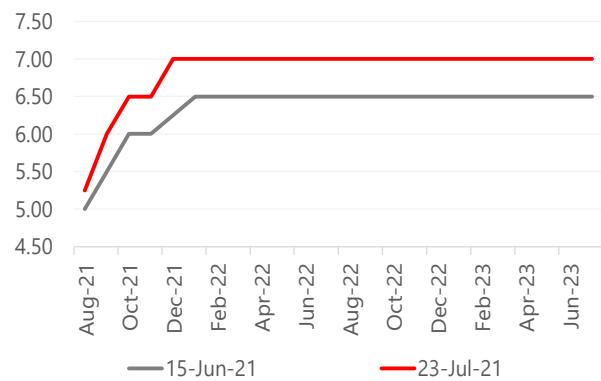
Sources: Brazilian Central Bank, Bloomberg, Santander.
 Note 1: To calculate the stimulus, we compared the short-term rate presented in the left-hand graph with the average of the neutral rate proxies presented in the same chart.
 Note 2: Average data for July 2021 based on data up to July 23.

Figure 2.A. – Calendar-Adjusted Expectations vs. Calendar-Adjusted Target (18 months ahead)



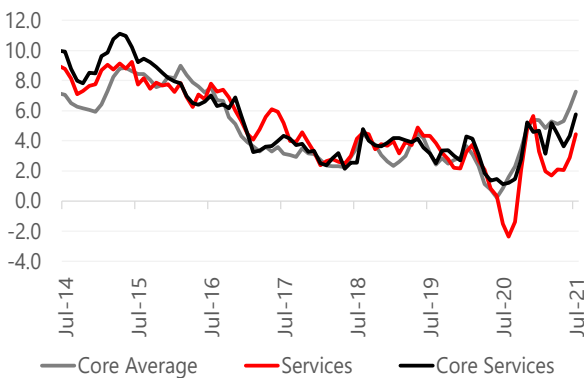
Sources: Brazilian Central Bank, Santander.
 Note: Expectations and target adjusted for the weight of each policy horizon. For July 2021, this means 75% for 2022 and 25% for 2023.

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



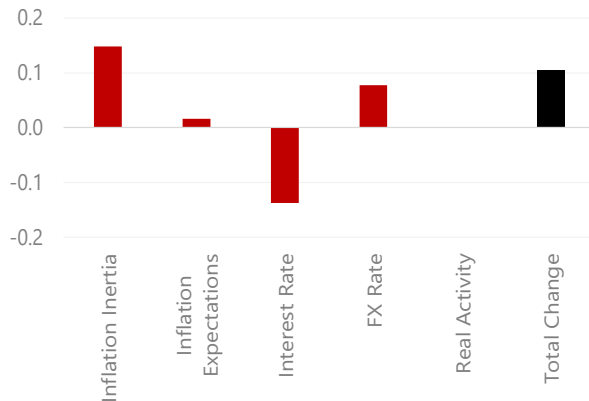
Sources: Brazilian Central Bank, Santander.
 Note: As of the BCB Focus report.

Figure 3.A. – Underlying Inflation Trends (IPCA-15) - % QoQ-saar



Sources: IBGE, Santander.
 Note: Average core measure includes DP, MS, EX0, EX3, P55.

Figure 3.B. – What to Expect for BCB Forecast for 2022 (Change from Previous)



Sources: Brazilian Central Bank, Santander.
 Note: At the June 15-16 meeting, BCB simulated IPCA at 3.5% for 2022.



Figure 4.A. – A Proxy for the Copom Dataset, Part 1

ECONOMIC TOPICS	LAST DATA		THIS TIME	LAST MEETING	SECOND LAST
Key Decision Variables	When?		Aug'21	Jun'21	May'21
INFLATION					
Forecasts (% p.a.) - BCB's Focus report					
Calendar-Weighted Forecast (~ 18 months)	23-Jul-21	↓	3.66	3.78	3.61
Calendar-Weighted Target (~ 18 months)	23-Jul-21	↓	3.44	3.50	3.50
Forecast for a year ahead (12 months)	23-Jul-21	↑	4.44	4.31	4.04
Forecast for 2021 - target: 3.75%	23-Jul-21	↑	6.56	5.82	5.04
Forecast for 2022 - target: 3.50%	23-Jul-21	↑	3.80	3.78	3.61
Forecast for 2023 - target: 3.25%	23-Jul-21	→	3.25	3.25	3.25
Forecast for 2024 - target: 3.00%	23-Jul-21	↓	3.00	3.25	3.25
Forecast for 2025 - target: ?????	23-Jul-21	↓	3.00	3.25	3.25
Breakeven inflation rates (% p.a.)					
1-year	23-Jul-21	↑	5.6	4.8	4.0
2-year	23-Jul-21	↓	5.0	5.0	4.9
5-year	23-Jul-21	↑	4.9	4.8	5.0
10-year	23-Jul-21	↑	5.3	5.2	5.2
Actual CPI data					
Headline (% YoY)	Jun-21	↑	8.3	8.1	6.8
Headline (% QoQ, saar)	Jun-21	↓	9.1	9.7	8.5
Core IPCA X3 (% YoY)	Jun-21	↑	5.1	4.5	3.8
Core IPCA X3 (% QoQ, saar)	Jun-21	↑	6.7	6.0	5.5
New cores average (% YoY)	Jun-21	↑	5.0	4.6	3.9
New cores average (% QoQ, saar)	Jun-21	↑	6.8	6.3	5.2
Diffusion index (sa)	Jun-21	↓	68.4%	68.5%	65.3%
Diffusion index ex-food (sa)	Jun-21	↑	65.3%	64.8%	62.1%
MONETARY POLICY					
Selic rate (% p.a.)					
Current level	23-Jul-21	↑	4.25	3.50	2.75
Forecast for 2021	23-Jul-21	↑	7.00	6.25	5.50
Forecast for 2022	23-Jul-21	↑	7.00	6.50	6.25
Forecast for 2023	23-Jul-21	→	6.50	6.50	6.50
Forecast for 2024	23-Jul-21	→	6.50	6.50	6.50
Forecast for 2025	23-Jul-21	→	6.50	6.50	6.50
Yield curve (% p.a.)					
1-year OIS swaps (pré-DI)	23-Jul-21	↑	7.1	6.3	5.4
2-year OIS swaps (pré-DI)	23-Jul-21	↑	7.5	7.4	6.9
Ex-ante real interest rate (% p.a.)					
1-year (OIS swaps vs. inflation forecast)	23-Jul-21	↑	2.5	1.9	1.3

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.



Figure 4.B. – A Proxy for the Copom Dataset, Part 2

ECONOMIC TOPICS	LAST DATA		THIS TIME	LAST MEETING	SECOND LAST
Key Decision Variables	When?		Aug'21	Jun'21	May'21
REAL ACTIVITY					
GDP forecasts (% p.a.) - BCB's Focus report					
Forecast for 2021	23-Jul-21	↑	5.29	5.16	3.14
Forecast for 2022	23-Jul-21	↑	2.10	2.09	2.31
Forecast for 2023	23-Jul-21	→	2.50	2.50	2.50
Forecast for 2024	23-Jul-21	→	2.50	2.50	2.50
Forecast for 2025	23-Jul-21	→	2.50	2.50	2.50
Actual activity data					
IBC-Br (% QoQ, saar)	May-21	↓	-1.2	-1.2	4.8
Industrial production (% QoQ, saar)	May-21	↓	-12.9	-9.9	-1.6
Retail sales (% QoQ, saar)	May-21	↓	-8.9	-8.2	-14.0
Services volume (% QoQ, saar)	May-21	↑	1.7	9.4	10.8
Unemployment rate (% 3m, SA)	Apr-21	→	14.4	14.4	14.4
Real average wage (% YoY, 3m)	Apr-21	↓	-1.5	0.8	1.3
Real wage bill (% YoY, 3m)	Apr-21	↓	-5.4	-6.7	-7.4
Caged payrolls (thousands, SA, 3m)	May-21	↑	324	175	206
Economic confidence (2011=100)	Jun-21	↑	84.4	79.9	75.3
EXTERNAL SECTOR					
FX rate (USD/BRL)					
Current level	29-Jul-21	↑	5.07	5.05	5.36
Actual: 5-day average (previous week)	29-Jul-21	↑	5.15	5.07	5.40
Forecast for 2021	23-Jul-21	↓	5.09	5.11	5.40
Forecast for 2022	23-Jul-21	→	5.20	5.20	5.47
Forecast for 2023	23-Jul-21	↓	5.00	5.11	5.20
Forecast for 2024	23-Jul-21	→	5.00	5.00	5.08
Forecast for 2025	23-Jul-21	→	5.00	5.00	5.10
Current account balance (USD Billions, 12m)					
Current level	Jun-21	↑	-19.4	-21.8	-24.2
Forecast for 2021	23-Jul-21	↓	0.3	1.4	-5.0
Forecast for 2022	23-Jul-21	↑	-14.3	-18.8	-20.3
Forecast for 2023	23-Jul-21	→	-21.0	-21.0	-30.0
Forecast for 2024	23-Jul-21	↑	-27.0	-42.0	-26.7
Forecast for 2025	23-Jul-21	↑	-25.0	-42.6	-40.0
ASSET PRICES					
IC-Br (% YoY)	01-Jun-21	↑	51.0	48.9	65.4
CRB Commodity Index	Jul-21	↑	216.6	210.2	204.1
Brazil 5-year CDS (basis-points)	23-Jul-21	↑	173	164	192
Ibovespa stock index (points)	23-Jul-21	↓	125,053	129,260	119,564
DI Jan-22 (% p.a.)	23-Jul-21	↑	6.05	5.43	4.80
DI Jan-23 (% p.a.)	23-Jul-21	↑	7.47	7.01	6.50
NTN-F 2023 (% p.a.)	23-Jul-21	↑	7.57	7.14	6.65
NTN-F 2027 (% p.a.)	23-Jul-21	↑	8.75	8.50	8.69
NTN-B 2040 (% p.a.)	23-Jul-21	↑	4.23	4.19	4.35
NTN-B 2055 (% p.a.)	23-Jul-21	↑	4.37	4.33	4.56

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.



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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