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PREVIEW – MONETARY POLICY

COPOM: Kick-Starting the Hiking Season

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

- On Wednesday (March 17), the Brazilian Central Bank (BCB) will announce its monetary policy decision. We anticipate the start of a tightening process, with a Selic rate hike of 0.5 p.p. to 2.50% (in line with analyst consensus), although we recognize the potential for a bolder move (as partly priced in by the market).
- In its statement, we expect the Copom to signal further adjustments to be made at the next policy meetings, with the speed and size of the cycle hinging on the evolution of the inflation outlook and balance of risks and especially on key elements such as pandemic, commodities, activity, fiscal risks, and underlying inflation.
- At least for now, the consensus scenario for the Selic rate (pace of 50 bps per meeting, in a “budget” of ~250 bps in total hikes in 2021) is consistent with inflation expectations at the mid-target for 2022 (the main policy horizon). Yet we admit that the upwardly skewed balance of risks (mainly based on rising fiscal risks) and possibly a higher neutral rate, which could make the authority choose a bolder pace and/or a bigger budget.
- Either way, we see upside risks to our Selic rate forecast (currently at 4.00% for YE2021).

Overview

On Wednesday (March 17), the Brazilian Central Bank will announce its monetary policy decision. We anticipate the start of a tightening process, with a Selic rate hike of 0.5 p.p. to 2.50%, in line with analyst consensus. The yield curve is pricing in a high probability of a 75-bp move.

At the last Copom[1] meeting, the BCB signaled a bias toward the withdrawal of monetary stimulus through a sooner-than-expected abandonment of the forward guidance (of stable interest rates). Additionally, the tone of the statement and the minutes showed that the committee was already considering a timely removal of stimulus via interest rates. If the current level of the policy rate is considerably expansionary—i.e., below the structural level—the degree of stimulus might enlarge further, even if involuntarily, given a potential increase in the neutral level of interest rate. The latter may rise as result of pressures on global yields and, most importantly, a continued increase in fiscal risk at the local level.

Just as an example, we calculate that in March the key short-term interest rate for economic activity—the *ex-ante* real rate for one year, obtained via the one-year nominal swap rate deflated by the 12-month forward median IPCA forecasts—rose about 140 bps from December, in terms of monthly averages. For the same period, we calculate that the 5y5y forward in the real yield curve, adjusted for a historical term premium—which we view as a market proxy for the neutral level of interest rates—rose by nearly 150 bps. If those are minimally reliable proxies for the short-term interest rate and its neutral level, then the evidence suggests that the recent tightening in the BCB communication still may not have removed any stimulus.

[1] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).

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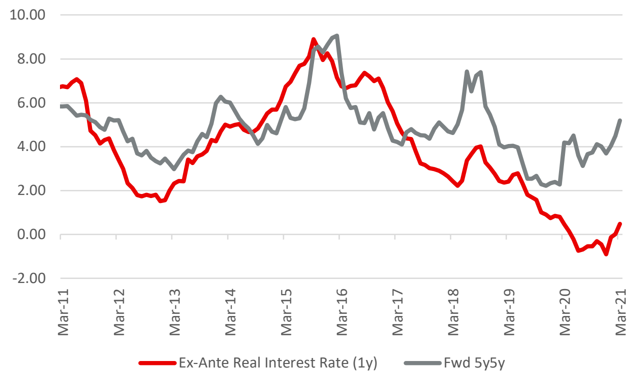
Figure 1.A. – Real Yields: Short Term vs. Long Term (monthly average, % p.a.)



Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: Long rate is adjusted for a constant historical term premium of 200bps.

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

Sources: Brazilian Central Bank, Bloomberg, Santander.

A Possible Scenario Assessment by the Copom

We believe the evolution of the economic environment since the last Copom meeting reinforces expectations for the kick-off of an interest rate adjustment cycle. Activity was steady in 4Q20, albeit with great asymmetry between sectors (industry going strong, with no idleness; services still lagging, with wide slack). The Copom may continue to see dwindling economic slack (or a closing output gap), owing to the positive GDP data out recently for 4Q20 and the (apparently) encouraging reading for the IBC-Br—the authority's monthly GDP proxy—in January. That report showed the last data point already catching up with the pre-crisis level (as of February 2020), which in our view should be seen by the BCB as a partial erosion of economic slack. That view by the BCB may also be strengthened by the solid payroll readings of late (per CAGED).

However, we believe there is evidence of a loss of impetus in some key segments of the economy in December and January—notably in retail—reflecting the phasing out of the fiscal stimulus (i.e., government transfers to unemployed or partly employed households) in a context of a weak job market, especially when it comes to informal jobs, accounting for nearly half of total employment in Brazil. Importantly, the economy—particularly tertiary activities—may take another hit from the broad-based tightening in urban mobility in Brazil, in the wake of measures recently adopted by a number of regional governments amid alarming levels of ICU occupation rates (and a still gradual COVID-19 vaccination process). In other words, we believe a further weakening of labor conditions can be expected, with unemployment poised to reach new record highs in 1H21.

Inflation continues to rise, reflecting a series of shocks that, although temporary, are proving far more persistent and intense than we expected. With the escalation of production costs in local currency, because of a combination of high commodity prices and a depreciated FX rate, the numbers show a certain spreading of price pressures for industrial goods, even though services prices remain relatively contained. The underlying inflation trend measures seem to be softening, but remain at high levels (i.e. north of the upper end of the inflation target: 5.0% for 2022). We project inflation above the target for 2021, and around the center target for 2022, but already accounting for Selic rate hikes (up to 4% in 2021, for now).

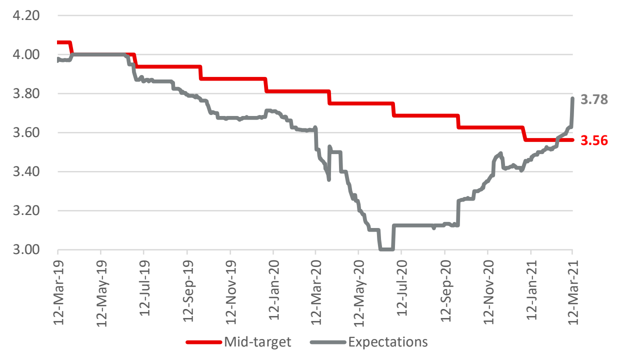
So far, the inflationary shocks are producing only limited effects on inflation expectations. While median IPCA projections for 2021 jumped by a full 115 bps (to 4.60%) since the last policy meeting, the number for 2022 remains (at least as far as we can see) anchored at the center target (3.50%). Our calculations show that while expectations for the next 18 months (a focal period for monetary policy, given the usual policy lags), adjusted for the weights attributed by the BCB for each policy horizon (25% for 2021; 75% for 2022), have risen 30 bps to 3.78% since the last Copom. While this indicator has crossed above the 3.56% mark for the calendar-adjusted target, it is not too far from the mid-target and might automatically move back to it in April, if the BCB manages to keep median 2022 IPCA projections on hold. But it is important to note that the maintenance of IPCA projections at the target for next year reflects expectations of less monetary stimulus for the short run—

given that the same inflation outcome for 2022 is now expected to be reached via a Selic rate about 75-100 bps higher than at the previous meeting.

If analysts' projections for inflation remains tame for the medium term, the same cannot be said about market-implied inflation expectations, which continue to incorporate risks. Since the last Copom meeting, inflation breakeven rates rose 0.5 p.p. to 0.9 p.p. for the key horizons, now standing at around 5% for the yield curve segment of 2 years and beyond. In our view, this is in line with the building of premium in most Brazilian asset classes, and is probably a reflection of worsening expectations on the fiscal side, prompting market participants to price in greater potential for a disruptive scenario in the area of fiscal policy. Remember: fiscal policy is the key element in the BCB's balance of risk, making inflation risks skewed to the upside for the key horizons.

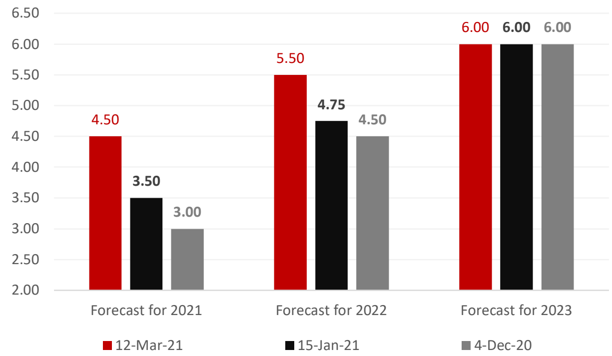
Speaking of which, since the last meeting the key debate on the fiscal side has been on the extension of COVID-19 stimulus (with transfers at values well below the gigantic budgetary impulse implemented in 2020, but above the constitutional spending cap), alongside measures of future expenditure restraint. The discussions in Congress generated a great deal of volatility in asset prices and economic expectations. After some zigzagging and, at the end, a watering down of the effects of the proposed budget curbs, we think authorities have been able to avoid a disruption in the fiscal regime. Yet some analysts (like ourselves) have begun to perceive high and rising execution risk for the long (but necessary) process of fiscal consolidation ahead (see link below[2]). Thus, we believe the fiscal debate should have kept an even stronger upward bias in the balance of risks for inflation, based on the BCB's view.

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



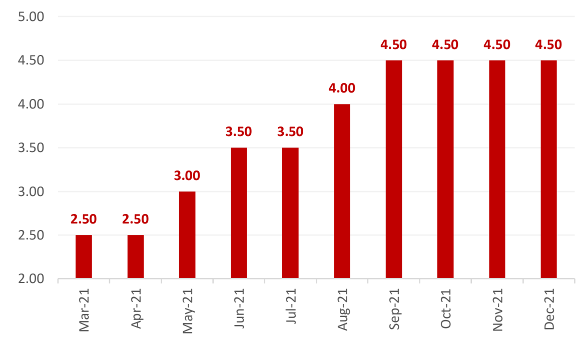
Sources: Brazilian Central Bank, Santander.
Note: IPCA expectations and target adjusted for the weight of each policy horizon. As of March 2021, this means 25% for 2021 and 75% for 2022.

Figure 2.B. – Median Selic Rate Expectations (% p.a., end of year)



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report, released on March 15, 2021.

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



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report, released on March 15, 2021.

[2] **Santander Brazil - Macro Compass: "Changing Gear In Monetary Policy" –** March 12, 2021- http://bit.ly/Sant-macrocomp-120321

Expected Policy Message

In view of this complex environment, with risks in both directions (but with a prevailing upward bias), the need to withdraw monetary stimuli should be seen by market observers as a way to prevent secondary effects from inflationary shocks (i.e., avoiding more persistent inflation ahead), even as the economy continues to face headwinds from the pandemic (and job market). Furthermore, *in time*, we believe that an increase in the Selic to levels potentially above the effective lower bound (ELB) for Brazil, 3% or 4%, may reduce excess vulnerability of the currency and help mitigate FX pressures that have contributed to intensify the inflationary impact of such a cost-push inflation, particularly in the case of raw materials. Lastly, according to the BCB, the committee's perception of dwindling economic slack is also an element suggesting a reduced need for extraordinary monetary stimulus.

In terms of policy signaling, we believe the BCB will probably point to a gradual process of (perhaps still allegedly “partial”) normalization of interest rates, possibly indicating its intention to keep a little stimulus at the end of the adjustment. Speed-wise, while asset prices are divided, reflecting expectations for moves between 50 bps and 75 bps, analysts are more inclined to the former, which could be a signal that a 50-bp move in March might not derail inflation forecasts from the target for 2022, the most relevant horizon now. But that option may also hinge on the BCB’s time impatience in terms of current pressures from the market and short-term inflation readings.

In any case, we believe the BCB is likely to indicate some data-dependency with respect to both the speed and depth of the adjustment, giving it some flexibility to adjust the flight plan if necessary, amid a sea of macro uncertainties. Bearing in mind an increase in risk for the materialization of an orderly process of structural budget adjustment in Congress, we see increasing potential for an even greater (and maybe faster) adjustment cycle in the Selic rate, amid continuous inflationary surprises from cost hikes, and also partly due to lax fiscal and monetary policies. **All in all, our forecasts of a 4.00% Selic for YE2021 and 4.50% for YE2022 are under revision.**

Refer to a summary of the Copom dataset in the next pages.

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

		THIS TIME	LAST MEETING	SECOND LAST	1y AGO
INFLATION					
Forecasts (% p.a.) - BCB's Focus report					
Calendar-Weighted Forecast (~18 months)	↑	3.78	3.48	3.42	3.51
Calendar-Weighted Target (~18 months)	→	*3.56*	*3.56*	*3.63*	*3.81*
Forecast for a year ahead (12 months)	↑	4.27	3.46	4.02	3.50
Forecast for 2021 - target: 3.75%	↑	4.60	3.45	3.34	3.60
Forecast for 2022 - target: 3.50%	→	3.50	3.50	3.50	3.50
Forecast for 2023 - target: 3.25%	→	3.25	3.25	3.25	3.50
Forecast for 2024 - target: ??????	↑	3.25	3.22	3.20	3.50
Forecast for 2025 - target: ??????	↑	3.24	3.00	-	-
Breakeven inflation rates (% p.a.)					
1-year	↑	5.6	4.7	4.9	2.3
2-year	↑	4.8	4.3	4.2	3.4
5-year	↑	5.0	4.2	4.2	4.3
10-year	↑	5.2	4.4	4.3	4.8
Actual CPI data					
Headline (% YoY)	↑	5.2	4.6	4.5	3.3
Headline (% QoQ, saar)	↓	8.7	8.8	11.3	1.6
Core IPCA X3 (% YoY)	↑	3.1	2.9	2.4	2.7
Core IPCA X3 (% QoQ, saar)	↑	5.8	5.4	5.8	1.9
New cores average (% YoY)	↑	3.2	3.0	2.8	2.9
New cores average (% QoQ, saar)	↓	5.1	5.3	5.7	2.0
Diffusion index (sa)	↑	66%	62%	66%	54%
Diffusion index ex-food (sa)	↓	60%	61%	64%	46%
MONETARY POLICY					
Selic rate (% p.a.)					
Current level	→	2.00	2.00	2.00	4.25
Forecast for 2021	↑	4.50	3.50	3.00	5.25
Forecast for 2022	↑	5.50	4.75	4.50	6.00
Forecast for 2023	→	6.00	6.00	6.00	6.25
Forecast for 2024	→	6.00	6.00	6.00	6.00
Yield curve (% p.a.)					
1-year OIS swaps (pré-DI)	↑	4.6	3.3	2.9	4.1
2-year OIS swaps (pré-DI)	↑	6.1	5.0	4.3	4.8
Ex-ante real interest rate (% p.a.)					
1-year (OIS swaps vs. inflation forecast)	↑	0.3	-0.1	-1.1	0.5

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.
Last update: March 15, 2021; market data updated up to March 12, 2021.

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

	THIS TIME	LAST MEETING	SECOND LAST	1y AGO
REAL ACTIVITY				
GDP forecasts (% p.a.) - BCB's Focus report				
Forecast for 2021	3.23	3.49	3.50	2.50
Forecast for 2022	2.39	2.50	2.50	2.50
Forecast for 2023	2.50	2.50	2.50	2.50
Forecast for 2024	2.50	2.50	2.50	2.50
Actual activity data				
IBC-Br (% QoQ, saar)	11.6	14.3	19.6	0.6
Industrial production (% QoQ, saar)	14.3	21.7	41.5	-2.0
Retail sales (% QoQ, saar)	-3.4	12.1	31.6	-0.8
Services volume (% QoQ, saar)	19.4	25.8	32.2	1.5
Unemployment rate (% 3m, SA)	14.5	14.4	14.3	11.6
Real average wage (% YoY, 3m)	2.7	4.0	5.7	0.4
Real wage bill (% YoY, 3m)	-6.5	-5.9	-5.3	2.5
Caged payrolls (thousands, SA, 3m)	320.7	342.1	324.7	79.8
Economic confidence (2011=100)	79.1	79.2	80.9	78.6
EXTERNAL SECTOR				
FX rate (USD/BRL)				
Current level	5.56	5.30	5.13	5.11
Actual: 5-day average (previous week)	5.68	5.33	5.22	4.76
Forecast for 2021	5.30	5.00	5.10	4.23
Forecast for 2022	5.20	4.95	5.00	4.20
Forecast for 2023	5.00	4.90	4.90	4.30
Forecast for 2024	5.00	5.00	5.00	4.40
Current account balance (USD Billions, 12m)				
Current level	-9.4	-12.5	-11.8	-52.8
Forecast for 2021	-13.1	-16.2	-14.3	-58.7
Forecast for 2022	-27.9	-29.8	-28.3	-61.1
Forecast for 2023	-15.5	-35.2	-35.0	-65.4
Forecast for 2024	-21.8	-41.8	-45.6	-64.9
ASSET PRICES				
CRB Commodity Index	193.8	175.2	159.9	140.8
IC-Br (% YoY)	51	40	28	3
Brazil 5-year CDS (basis-points)	199	169	153	263
Ibovespa stock index (points)	114,160.40	120,348.80	113,750.20	82,677.90
DI Jan-22 (% p.a.)	4.21	3.35	3.09	5.31
DI Jan-23 (% p.a.)	5.97	5.04	4.50	6.14
NTN-F 2023 (% p.a.)	6.15	5.18	4.62	5.90
NTN-F 2027 (% p.a.)	8.18	7.03	6.74	7.39
NTN-B 2045 (% p.a.)	4.21	3.99	3.98	4.11
NTN-B 2055 (% p.a.)	4.32	4.04	4.01	4.43

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.
Last update: March 15, 2021; market data updated up to March 12, 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 Vasquez*	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
Daniel Gewehr*	Head, Brazil	dhgewehr@santander.com.br	5511-3012-5787
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