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MONETARY POLICY PREVIEW

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Copom: Keeping the Pace (and the Signal?)

- On Wednesday (May 5), the Brazilian Central Bank (BCB) announces its monetary policy decision. We expect the removal of monetary stimulus to proceed with another Selic rate hike of 0.75 p.p. to 3.50%. This is broadly in line with the consensus view and the most likely outcome priced into the yield curve (~80% probability).
- We believe the Copom will likely increase the emphasis on the data dependency for the speed and depth of the tightening cycle, even if the BCB sticks to the language of "partial normalization" (i.e., keeping the intention to retain a little stimulus at the end of the process),. This ensures flexibility to change the flight plan if necessary, given a sea of uncertainties in the macro scenario (both domestically and abroad) and mounting upside risks for inflation.
- For the subsequent meeting (i.e., June), it is possible that the BCB will signal a will to proceed with the adjustment at a pace of hikes of 50 or 75 basis points per meeting.
- Our scenario projects a Selic rate of 5.50% at the end of this year, with a slight upward bias. For the end of 2022, we continue to project interest rate at 6.00%.

The Context Around the Copom Meeting

Despite the removal of the "extraordinary" monetary stimulus started in March (at a faster rate than the consensus had expected, at the time), the current level of the policy rate is still considerably expansionary—i.e., below the structural level. This degree of stimulus may have become even greater involuntarily (from the BCB's standpoint) due to a probable recent increase in the neutral rate, following mainly a continued increase in the fiscal risks.

The evolution of the scenario since the last Copom[1] meeting shows a continued recovery of economic activity in 1Q21 up to February, which surprised our own baseline forecasts (previously, we had been projecting a sequential GDP contraction for 1Q21). However, after the recent aggravation of the pandemic (with sharp increases in infections, hospitalizations and casualties) and the resulting additional restrictions on urban mobility, there was a clear and steep reduction in the level of economic activity in March, especially in the tertiary sector. According to preliminary results from our proprietary indicators (see links below[2] [3]), gains in April have not been enough to fully compensate for this March contraction. Shutdowns in dynamic industrial segments given the lack of inputs on a global scale (amid strains in the supply chains) have added to the adverse shocks to activity in late 1Q21 and early 2Q21. As an upshot, we project a further weakening of the labor market (including formal job creation) in the coming months, which should further increase the economic slack (particularly in the service sector).

[1] The Copom is the monetary policy committee of the Brazilian Central Bank.
[2] **Santander Brasil - Atividade: "IGet: Um discreto começo do 2T21"** ***(Portuguese only)*** **-** April 22, 2021 - http://bit.ly/Std-igetprev-abr21
[3] **Santander Brasil - Atividade: "IGet Serviços: Um fraco começo de trimestre"** ***(Portuguese only)*** **-** April 20, 2021 - https://tinyurl.com/m9cfhzye

Current inflation is still exhibiting upward pressures emanating from supply shocks that show no signs of cooling (e.g., rising agricultural prices and breakdowns in productive chains in manufacturing). Thus, although temporary, inflationary shocks are increasingly persistent and more intense than we expected. Trend underlying inflation remains at still high levels on a sequential basis (around 5% annualized), with year-over-year readings still around the center target for 2022 (3.5%). We project headline inflation above the upper target for 2021, and slightly above the mid-target for 2022, which already takes into account the expected adjustments in the Selic rate ahead.

As per inflationary expectations, we note a recent decline in asset-based measures (break-even inflation), even for shorter-term horizons (i.e., 1 or 2 years). As for analyst projections for the relevant policy horizon (18 months ahead), there was a slight increase of +0.1 p.p. to 3.6% (center target: 3.5%), possibly reflecting a combination between a greater expected inflationary inertia for the coming year and a possible perception that the greater fiscal risks could keep spilling over into inflation (e.g., via FX rate).

Financial conditions have evolved in a mixed way since the last meeting. On the one hand, a favorable global backdrop has materialized in the short term amid expectations of a world economic recovery due to fiscal stimulus (mainly in the US) and the strong progress of vaccinations in advanced countries, coupled with a still accommodative stance by the major central banks (notably the Federal Reserve). Some asset classes in Brazil benefited from the greater risk appetite and higher raw material prices, such as the stock market and the exchange rate. The latter has appreciated from an average of ~5.70 in the previous meeting to below 5.50 in the past few days. On the other hand, we continue to see domestic uncertainties, especially with regard to rising inflation fears and an increasingly cloudy medium term fiscal outlook. The prospect of a withdrawal of most (if not all) of the current monetary stimulus add to this picture. Those factors have continued to put even more pressure on both the short and long end of the yield curve.

In a rather complex environment for monetary policy, we see inflationary risks skewed to the upside due to ongoing supply shocks, as well as lingering fiscal risks. We believe the BCB perceives the need to unwind monetary stimulus in a timelier manner so as to avoid the potential for second-round inflationary pressures. The BCB has the time and the instruments to bring inflation back to the mid-target in the medium-term, even considering a still uncertain contribution from the exchange rate (as a transmission channel). We see it pressured not only by the narrower interest-rate differential, but mainly by the deterioration in the outlook for government debt. In our view, lingering fiscal uncertainty will continue to adversely impact monetary policy in the coming months.

What to Expect from the Next Rate Setting Meeting

As per the monetary policy decision, our view is a further increase in the Selic policy rate of 0.75 p.p. to 3.50%, which is broadly in line with consensus and the most likely outcome priced into the yield curve (~80% probability). At the previous meeting, the Copom raised the rate by 0.75 p.p. to 2.75%, which began the process of removing the "extraordinary" degree of stimulus (see link below[4]).

In terms of policy signaling, we believe the Copom will likely reaffirm the data dependency of the next steps, meaning no pre-commitment with the speed or depth of the tightening cycle. That could happen even if the BCB continues to point to a process of "partial normalization" of interest rates (i.e., indicating a willingness to maintain some stimulus at the end of the adjustment). For the subsequent policy meeting (June), it is possible that the BCB signals a continuation of the interest rate adjustment at a pace of 50 or 75 basis points.

Regarding the scenario assessment in the statement, we believe the BCB will continue to recognize the recovery in economic activity, while noting downside risks to the economy due to mobility restrictions after the strong relapse of COVID-19. The pace of recovery before the worsening of the pandemic could be seen as a sign of a lesser need for extraordinary monetary stimuli, with the BCB probably maintaining a constructive view for the speed of economic recovery in 2H21, based on an expected acceleration of the vaccination program and economic reopening.

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

On the inflation side, the central bank is likely to remain cautious as the Copom may continue to highlight the accelerating IPCA and high underlying measures. But we believe the authority should retain the assessment that these are mostly temporary pressures, still largely concentrated in volatile items. It is likely that the BCB will recognize an even greater intensity and persistence of recent inflationary shocks, reaffirming the need for the removal of stimulus to avert contagion for inflation expectations for the relevant policy horizon (2022, at this juncture).

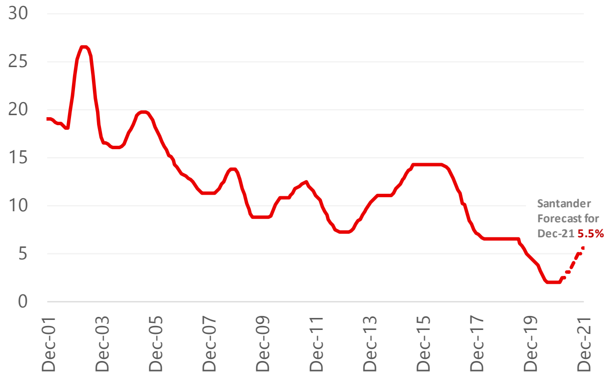
In our view, the medium-term fiscal situation remains worrisome, despite the recent solution by the Executive branch and Congress to adjust the legislation to ensure the implementation of the 2021 budget. In our view, the fiscal outlook has worsened a little further since the last Copom meeting, and we believe the BCB should at least maintain (if not increase) its recognition of the fiscal risks. Thus, we project a continued upward bias in the balance of risks for inflation.

Looking Further Ahead

Amid persistent inflationary surprises to the upside, largely reflecting higher (and still rising) costs in BRL terms, and increasing risks for an orderly structural budget adjustment, we see higher chances of a more hawkish response by the BCB. Our scenario projects a Selic rate of 5.50% at the end of this year, with a slight upward bias. For the end of 2022, we continue to project the Selic at 6.00%. For 2023, our number is 7.00% (consistent with a neutral rate of 4% in real terms).

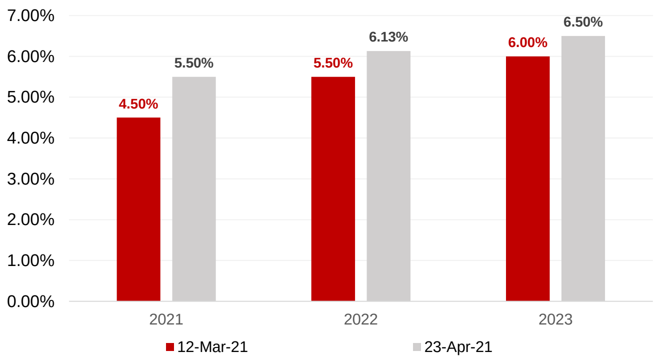
Please refer to a summary of the Copom dataset in the following pages.

Figure 1.A. – Nominal Selic Rate (monthly average, % p.a.)



Sources: Brazilian Central Bank, Santander.

Figure 1.B. – Selic Rate Expectations (median, year-end, % p.a.)



Sources: Brazilian Central Bank, Santander.

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

	THIS TIME	LAST MEETING	SECOND LAST
	May'21	Mar'21	Jan'21
INFLATION			
Forecasts (% p.a.) - BCB's Focus report			
Calendar-Weighted Forecast (~18 months)	3.60	3.78	3.48
Calendar-Weighted Target (~18 months)	*3.50*	*3.56*	*3.56*
Forecast for a year ahead (12 months)	4.01	4.18	3.46
Forecast for 2021 - target: 3.75%	5.01	4.66	3.45
Forecast for 2022 - target: 3.50%	3.60	3.50	3.50
Forecast for 2023 - target: 3.25%	3.25	3.25	3.25
Forecast for 2024 - target: ??????	3.25	3.24	3.22
Forecast for 2025 - target: ??????	3.25	3.20	3.00
Breakeven inflation rates (% p.a.)			
1-year	4.4	5.7	4.7
2-year	4.7	4.8	4.3
5-year	4.8	4.9	4.2
10-year	5.2	5.0	4.4
Actual CPI data			
Headline (% YoY)	6.1	5.2	4.6
Headline (% QoQ, saar)	7.7	8.8	8.9
Core IPCA X3 (% YoY)	3.4	3.1	2.9
Core IPCA X3 (% QoQ, saar)	5.8	5.6	5.4
New cores average (% YoY)	3.5	3.2	3.0
New cores average (% QoQ, saar)	4.9	5.0	5.3
Diffusion index (sa)	58.9%	64.7%	61.8%
Diffusion index ex-food (sa)	58.1%	60.2%	60.5%
MONETARY POLICY			
Selic rate (% p.a.)			
Current level	2.75	2.00	2.00
Forecast for 2021 (Focus)	5.50	4.50	3.50
Forecast for 2022 (Focus)	6.13	5.75	4.75
Forecast for 2023 (Focus)	6.50	6.00	6.00
Forecast for 2024 (Focus)	6.50	6.00	6.00
Yield curve (% p.a.)			
1-year OIS swaps (pré-DI)	5.2	4.7	3.3
2-year OIS swaps (pré-DI)	6.5	6.2	5.0
Ex-ante real interest rate (% p.a.)			
1-year (OIS swaps vs. inflation forecast)	1.1	0.5	-0.1

Sources: IBGE, FGV, Brazilian Central Bank, Bloomberg, Santander.
Last update: April 28, 2021; market data updated up to April 26, 2021; expectations data up to April 23, 2021.

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

	THIS TIME	LAST MEETING	SECOND LAST
	May'21	Mar'21	Jan'21
REAL ACTIVITY			
GDP forecasts (% p.a.) - BCB's Focus report			
Forecast for 2021	3.09	3.25	3.49
Forecast for 2022	2.34	2.39	2.50
Forecast for 2023	2.50	2.50	2.50
Forecast for 2024	2.50	2.50	2.50
Actual activity data			
IBC-Br (% QoQ, saar)	13.1	12.9	15.3
Industrial production (% QoQ, saar)	7.7	13.8	21.4
Retail sales (% QoQ, saar)	-9.2	-3.3	12.5
Services volume (% QoQ, saar)	15.9	19.4	26.6
Unemployment rate (% 3m, SA)	14.6	14.5	14.5
Real average wage (% YoY, 3m)	2.2	2.8	4.0
Real wage bill (% YoY, 3m)	-6.9	-6.5	-5.9
Caged payrolls (thousands, SA, 3m)	224	291	341
Economic confidence (2011=100)	0.0	79.1	79.2
EXTERNAL SECTOR			
FX rate (USD/BRL)			
Current level	5.44	5.59	5.31
Actual: 5-day average (previous week)	5.50	5.68	5.33
Forecast for 2021 (Focus)	5.40	5.30	5.00
Forecast for 2022 (Focus)	5.40	5.20	4.95
Forecast for 2023 (Focus)	5.17	5.00	4.90
Forecast for 2024 (Focus)	5.08	5.00	5.00
ASSET PRICES			
CRB Commodity Index	196.1	193.8	175.2
IC-Br (% YoY)	66.0	50.8	40.3
Brazil 5-year CDS (basis-points)	191	199	169
Ibovespa stock index (points)	120,530	114,160	120,349
DI Jan-22 (% p.a.)	4.62	4.21	3.35
DI Jan-23 (% p.a.)	6.18	5.97	5.04
NTN-F 2023 (% p.a.)	6.34	6.15	5.18
NTN-F 2027 (% p.a.)	8.47	8.18	7.03
NTN-B 2045 (% p.a.)	4.33	4.21	3.99
NTN-B 2055 (% p.a.)	4.43	4.32	4.04

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