

July IPCA-15: Underlying Inflation Deteriorates Further; Services' Core Reaches 6% 3mma-saar

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- July's IPCA-15 registered a 0.72% MoM change (8.59% YoY), quite above the market's median expectation of 0.65% and our call of 0.61%.
- The main upside surprise came in services, the group the Brazil Central Bank (BCB) is watching closely to decide what monetary policy steps will be taken next. Notably, the services core gauge accelerated to 6% 3mma-saar.
- Qualitative measures deteriorated further at the margin, reinforcing our view of an unfavorable inflation outlook for the short term (and our call for a 100-bp Selic hike in the next Copom meeting): the average of core measures rose to 7.4% 3mma-saar.
- We are revising our IPCA 2021 high-frequency tracking to 7.3% (from 7.0%), while our IPCA 2022 tracking moved to 4.1% (from 4.0%). Risks are still tilted to the upside, in our view.

Shocks Are Spreading, and Underlying Inflation Are on a Risky Trajectory

July's IPCA-15 registered a 0.72% MoM change (8.59% YoY), quite above the market's median expectation of 0.65% and our call of 0.61%. The headline accelerated further, to 10.1% 3mma-saar, showing that the upward pressure at the margin remains strong.

The main upside surprise came in services, the group that the BCB is watching closely to decide what monetary policy steps will be taken next. Although a significant part of the surprise in services came in the volatile item of airline tickets (contributing +5 bps to the headline forecast error), this was not the only surprise. When we exclude this item (and some others), we see that the core services gauge is accelerating considerably, passing from 4.5% to 6.0% in 3mma-saar terms. Particularly, food-service accelerated to 10.5% in 3mma-saar terms, and inertial services (such as residential rents) and services more linked to the job market dynamics (such as housekeepers) also accelerated at the margin. As the economy reopens on the back of falling COVID-19 cases, this upward trend in the services sector should only pick up.

Moreover, industrial goods remained at 12.0% 3mma-saar, and its core accelerated from 8.7% to 10.3% 3mma-saar. Even food-at-home surprised a bit to the upside, with the 3mma-saar measure still running below the year-over-year number though still accelerating to 8%; also, the food-at-home core gauge reinforced the upward trend, running at 10.1% 3mma-saar. It is also worth highlighting the recent frost that hit Brazil, which poses upside risks for food inflation in the short term.

Qualitative measures deteriorated further at the margin, reinforcing our view of an unfavorable short-term inflation outlook (and our call for a 100-bp Selic hike in the next Copom meeting). The average of the main core measures accelerated from the already high level of 6.2%, to 7.4% in 3mma-saar terms, and it has been hovering above 4.5% for nine months. This amounts to evidence of spreading primary shocks (commodities, exchange rate, supply chain disruption, etc.) to general prices and the persistency of these high levels is risky. Also on that note, the diffusion index—a leading indicator of annual inflation—remain a high 64.8% (seasonally

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adjusted)—a reading we see as compatible with the IPCA reaching around 8.0% YoY a few months from now. The diffusion is also another sign of these spreading shocks.

Forecasts Moving Further and Further from BCB's Targets

Our worries regarding the inflation outlook keep piling up. First, because we see a large backlog of price increases at the wholesale level that continue to flow through to consumers, and second because we are seeing more evidence of inflation spreading to general prices, which could worsen with a stronger economic recovery once the pandemic starts to fade (particularly in services). The recent frost that hit Brazil is another short-term upside risk.

We are revising our IPCA 2021 high-frequency tracking to 7.3% (from 7.0%), while our IPCA 2022 tracking moved to 4.1% (from 4.0%). For IPCA 2021, both food and services inflation were the drivers of the revision. For IPCA 2022, we incorporated a stronger impact from the inertia wrought by higher IPCA 2021 inflation. Risks are still tilted to the upside. It is worth remembering that the BCB's target is 3.75% for 2021 ($\pm 1.50\%$ tolerance interval) and 3.50% for 2022 (same tolerance interval), and our forecasts are above the targets for both years.

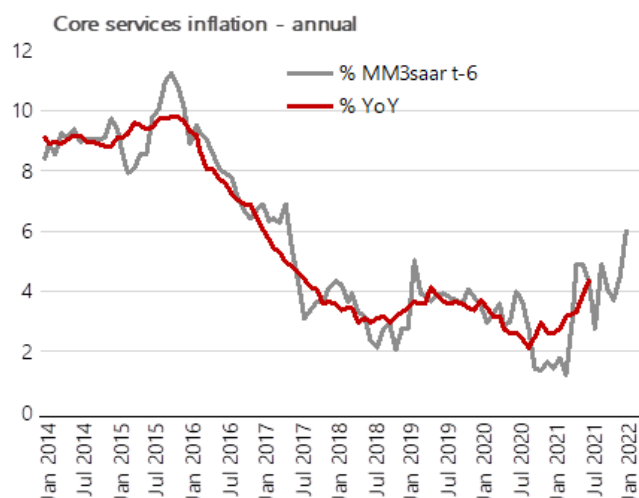
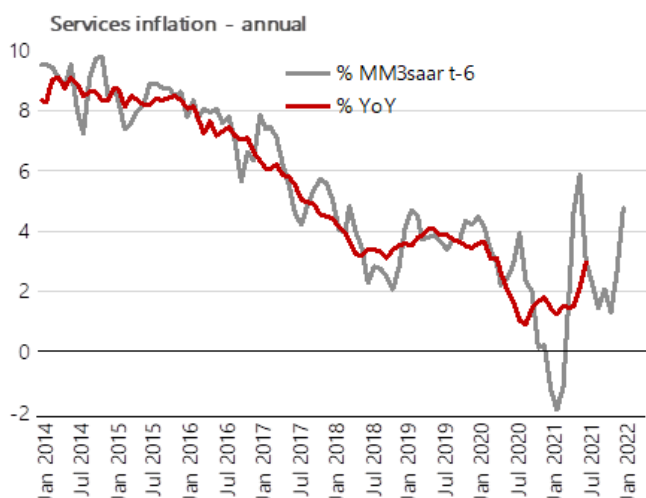
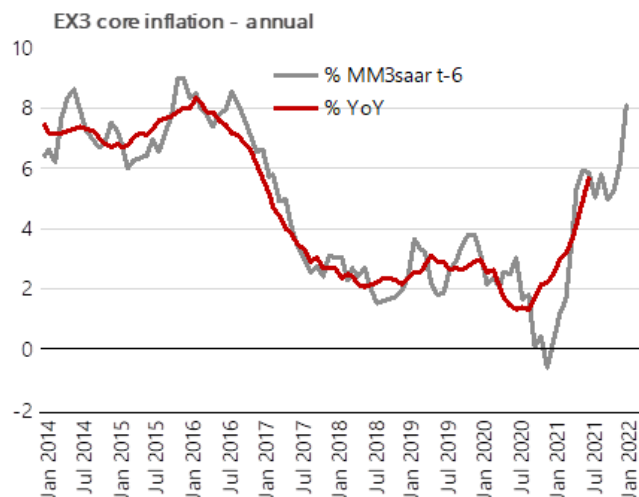
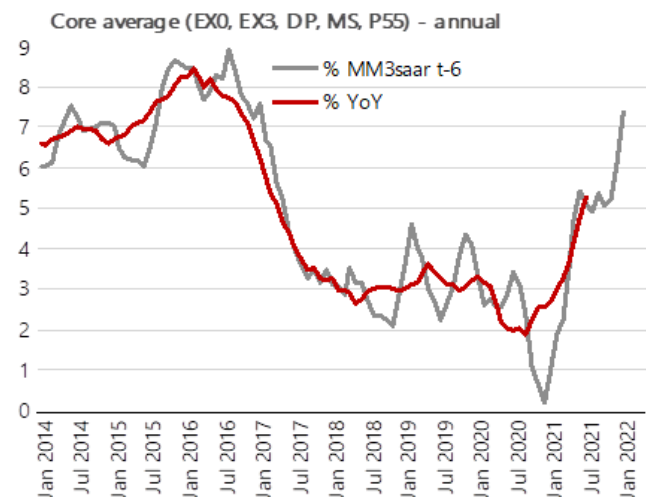
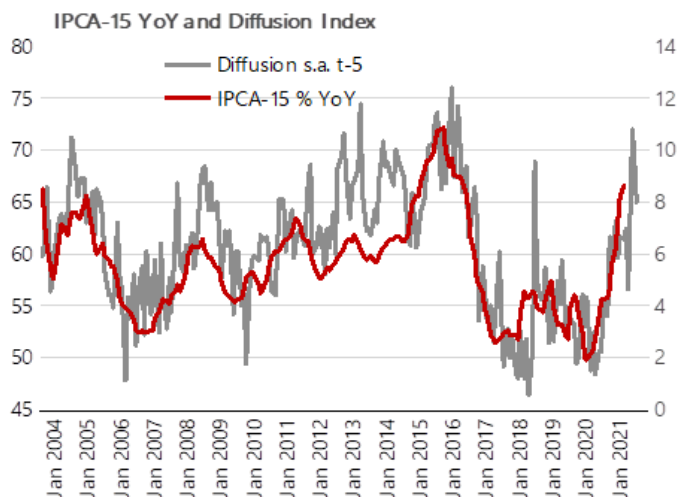
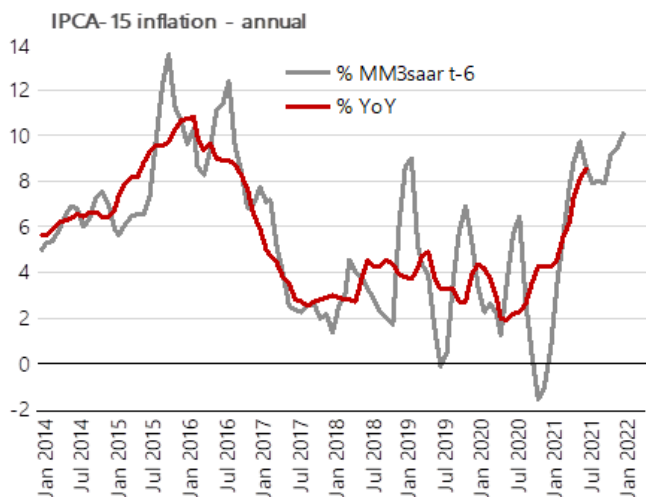
Figure 1. IPCA-15 by Group and Forecasting Errors

	MoM			YoY	
	Jul-21	Santander	Contr.	Jun-21	Jul-21
IPCA-15	0.72	0.61	0.11	8.1	8.6
Food and beverage	0.49	0.43	0.01	12.1	12.8
Food-at-home	0.47	0.41	0.01	14.5	15.3
Food service	0.52	0.48	0.00	6.6	7.2
Housing	2.14	1.86	0.04	8.2	10.0
Electrical energy	4.79	4.85	0.00	12.8	16.9
Household articles	0.81	0.85	0.00	12.3	12.5
Apparel	0.58	0.81	-0.01	2.9	4.5
Transportation	1.07	0.67	0.08	15.3	15.3
Airline tickets	35.64	18.00	0.05	0.4	42.1
Gasoline	0.50	0.80	-0.02	45.9	40.3
Health and personal care	-0.24	-0.04	-0.03	4.3	3.6
Personal spending	0.36	0.27	0.01	1.7	2.3
Education	0.12	0.03	0.01	-1.1	-0.9
Communication	-0.04	0.02	0.00	2.3	1.8
Administered	0.90	0.96	-0.02	13.3	12.9
Free	0.65	0.48	0.13	6.4	7.1
Food-at-home	0.47	0.41	0.01	14.5	15.3
Industrial goods	0.69	0.58	0.02	8.3	9.0
Services	0.71	0.45	0.09	2.2	2.9
EX3 Core	0.65	0.51	0.14	4.9	5.6
Average of cores	0.60	-	-	4.8	5.3

Sources: IBGE and Santander.



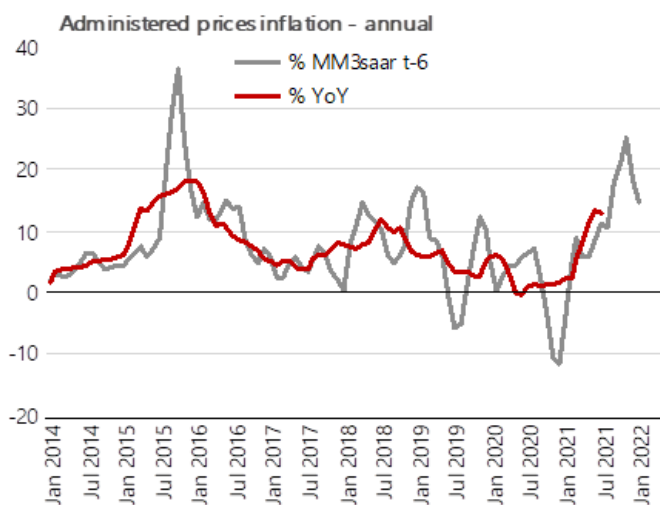
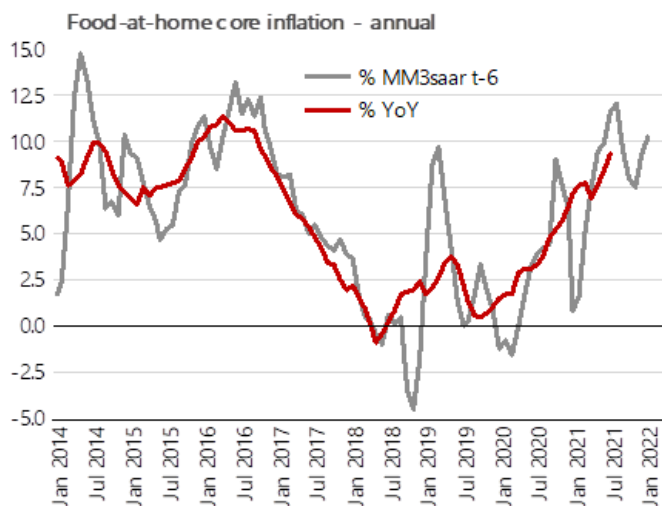
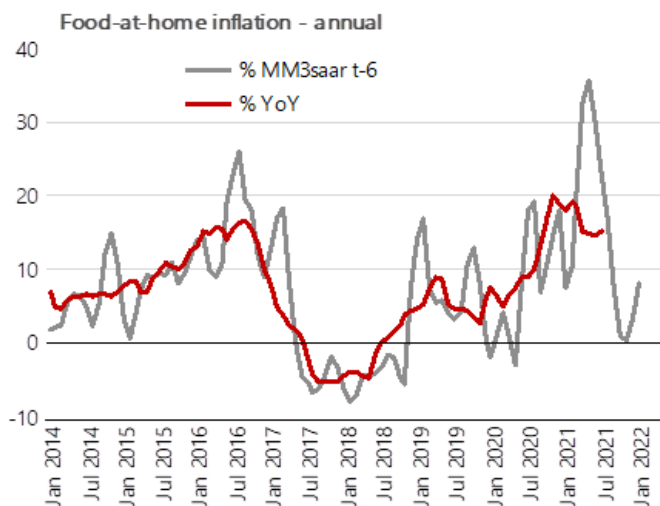
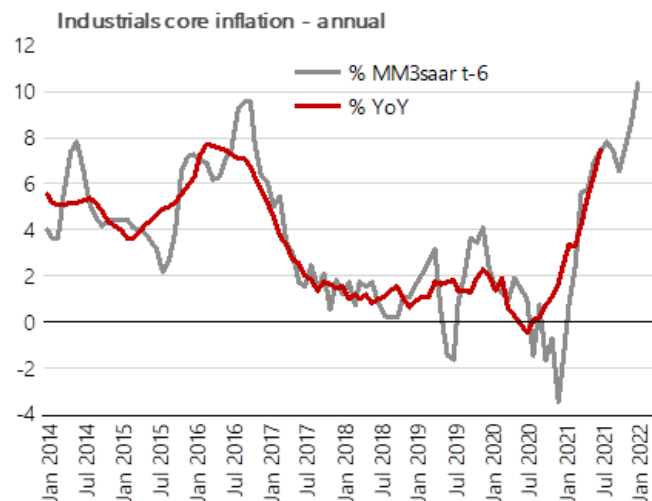
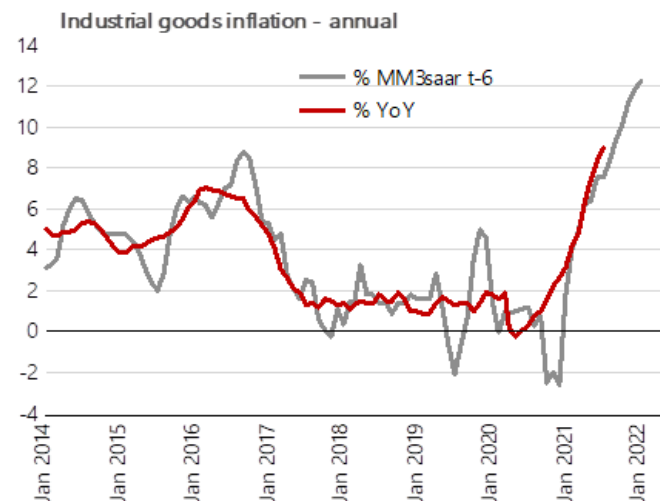
Figure 2. IPCA-15, Groups and Qualitative Measures



Sources for all charts: IBGE and Santander.



Figure 3. IPCA-15, Groups and Qualitative Measures continuation



Sources for all charts: IBGE and Santander.



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