Santander

ECONOMICS

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Brazil – Inflation and Monetary Policy

Even Better than the Real Thing

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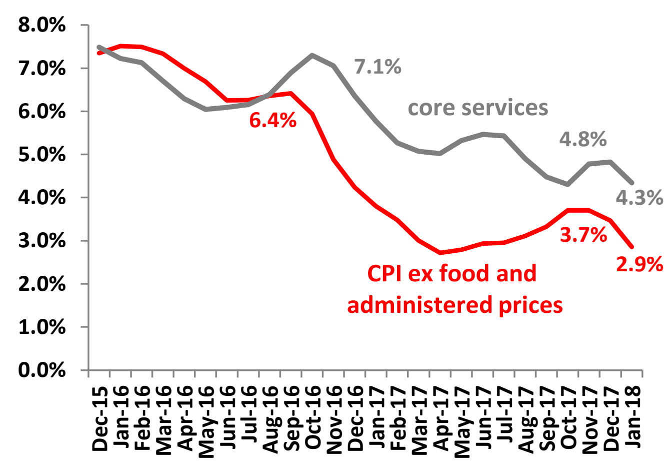
- **Inflation surprised to the downside in January and will probably show a much better performance in 1Q18 than what was embedded in consensus forecasts at the end of last year, in our view.**
- **We further believe that the services component is evolving toward a more benign dynamic than initially expected and prospects related to agricultural production in 2018 also suggest food inflation will be lower.**
- **For these reasons we are revising our 2018 IPCA forecast from 3.8% to 3.5%. For 2019, we maintain our 4% projection.**
- **Moreover, in our view, the minutes of last Copom meeting were more dovish than expected. While the communiqué released just after the decision one week ago suggested the end of the easing cycle, the document containing a more detailed description of the discussions shows there have been dissenting opinions against such signaling.**
- **In fact, the BCB clearly stated that "the persistence of core measures within comfortable and low levels, with increasing risk of favorable contamination of future inflation trajectory, would open room for an additional rate cut".**
- **Considering the fact that core inflation has already surprised to the downside in January and will probably maintain a favorable performance in February, we are revising our call for the next Copom meeting to be held on March 21.**
- **We now expect the Selic rate to be reduced from 6.75% p.a. to 6.5% p.a., remaining at this level until the end of the year. For 2019 we maintain our 8.5% forecast.**

IPCA – Selected Core Measures (% 3 months annualized)



Monthly IPCA - Forecasts and Actual by Dec-17

	BCB	Consensus	Likely*
Jan-18	0.53%	0.42%	0.29%
Feb-18	0.47%	0.43%	0.27%
Acum:	1.00%	0.85%	0.56%
Difference from likely:	-0.44%	-0.29%	

IPCA 2018 Forecasts

	BCB	Consensus	Likely*
by Dec/17	4.2%	4.0%	3.8%
Latest	4.2%	3.8%	3.5%

Source: IBGE and BCB

* Actual for January and Santander's latest estimate for February

(1) Inflation: Another leg down

Latest inflation figure (January's IPCA at 0.29%) came in substantially lower than our and consensus forecasts (0.44%). This result sustained the YoY reading at 2.9%, below the 3% lower bound of the target (4.5% +/- 1.5 p.p.). Although the main surprise in the headline index came from food and beverage prices, inflation from components more sensitive to economic activity and core measures improved after a not so benign performance in 4Q17 (see chart on previous page).

It seems services inflation will be better than initially forecasted and prospects for a good harvest, once again in 2018, suggests food inflation rebound, after contracting 5% in 2017, will not be so intense.

Therefore, we are revising downward our forecast for the IPCA in 2018, from 3.8% to 3.5%.

(2) Surprisingly Dovish Copom Minutes

The minutes of the last Monetary Policy Committee (Copom) meeting were also more dovish than expected. While the communiqué released just after the decision (one week ago) suggested the end of the easing cycle, the document containing a more detailed description of the discussions shows there have been dissenting opinions against such signaling.

Making a long story short, the Committee appears to believe that the inflation outlook and the balance of risks are favorable and consistent with a Selic at 6.75% p.a.: "All members of the Copom believe that**, as long as the outlook evolves in line with Copom´s baseline scen**ario, it is appropriate to indicate the interruption of the monetary policy easing cycle" (paragraph 23).

(3) Three Billboards for an Additional Easing

However, in our view, an excessive emphasis (thorough repetition) has been put on the behavior of core inflation as a condition for another interest rate reduction in the meeting to be held on March 21.

- Paragraph 10, about risk factors: "the propagation, thorough inertia, of low inflation readings could translate into **a below expected future trajectory**".
- Paragraph 17, about inflation outlook: "the persistence of core measures at low levels constitute a **downside risk for the inflation outlook"**.
- Paragraph 22, about monetary policy next steps: "the persistence of core inflation at low or comfortable levels, coupled with increasing risks of propagation, **would open room for an additional easing**".

The illustrations of the first page are self-explanatory.

- Core inflation has already surprised to the downside, and will likely do so again in February.
- Consensus expectations are already falling.
- The BCB's own 4.2% inflation forecast will likely be revised (substantially) down.

(4) More Than This

Considering such a (in our view) strong case for the base rate to go below 6.50% p.a., we believe that it would be fair to discuss the possibility of an even longer and deeper easing cycle, than the one we have just incorporated. The main factors behind our call of just one (and last) additional adjustment of the Selic are:

- The BCB has mostly emphasized the conditionality's related to monetary policy next steps. It could, at some point, change its assessment on neutral interest rate and the stance of monetary policy, but in our view, it would require more meaningful changes, which are not embedded in our base case scenario.
- There is no urgency regarding economic activity, which is recovering in a decent pace.
- We believe the exchange rate will weaken during the year (towards BRL3.50/USD) as a consequence of a more volatile and uncertain, although still not violent, external scenario.

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