August's IPCA: Headline Improving, Core Gauges Still High

Daniel Karp*
daniel.karp@santander.com.br
+55 11 3553 9828

Felipe Kotinda*
felipe.kotinda@santander.com.br
+55 11 3553 8071

- **The IPCA fell 0.36% MoM, an upward surprise compared to our forecast (-0.46%) and market consensus (-0.40%). Despite the upward surprise, the headline trend fell to -0.6% 3mma-saar (from 3.9%) and the YoY change fell to 8.7% (from 10.1%), significantly affected by the tax cut but also by some preliminary relief for other items.**
- **Compared to our forecast, upward surprises came in industrial goods and regulated prices. On the other side, services—stickier and more related to core gauges—surprised on the downside, as did food-at-home.**
- **Although IPCA surprised upward, we believe the reading consolidates that the peak of headline inflation is past us in YoY terms (a movement that was boosted by the tax cut measures).**
- **Regarding the "quality" of the number, we are seeing early signs of improvement at the margin, but levels of core gauges and diffusion are still historically high.**
- **Moreover, risks related to stickier prices (more related to core gauges) are still in place—particularly because of the new round of income aid and because of the likely income-effect from the tax cut measures, as both can support demand in the short-term and sustain prices.**

The IPCA fell 0.36% MoM, an upward surprise compared to our forecast (-0.46%) and market consensus (-0.40%). Despite the upward surprise, the headline trend fell to -0.6% 3mma-saar (from 3.9%), and the YoY change fell to 8.7% (from 10.1%), significantly affected by the tax cut but also by some preliminary relief for other items. This result marks the first time since August 2021 that the IPCA is running below two-digits in YoY terms.

Industrial goods accounted for most of the upward surprise (+8 bps of contribution to the headline forecast error). Perfumes, a highly volatile item, made up half of this surprise and makes the surprise less relevant for the inflation outlook. The other half was in apparel, which can be more relevant, as this group is not so volatile and is probably still suffering from cost pressures from the economic shocks suffered since the pandemic. Regulated prices also surprised upward (+8 bps), still affected by the noise generated by tax cuts. On the other side, food-at-home surprised to the downside (contributing -7 bps to the headline forecast error)—we have been waiting for more significant relief in this group for a while, so this surprise is positive. Finally, services saw a small downward surprise (-3 bps of contribution to the headline forecast error).

In terms of annual changes, industrial goods decelerated to 12.6% YoY (from 12.8%), but its trend is running below that, at 7.5% 3mma-saar, suggesting further deceleration ahead. We highlight that tax cuts in ethanol prices are influencing part of this deceleration. Indeed, industrial goods' core gauge (which excludes ethanol) accelerated a bit in trend terms, to 14.8% 3mma-saar (from 13.7%), and is still running a bit above the YoY change, which is at 14.1%. Regulated prices keep falling sharply on the back of the tax cuts affecting electrical energy, gasoline and communication; the YoY change is 1.5% YoY (from 5.1%), with the trend at -23.8% 3mma-saar. Food-at-home grew 15.6% YoY, a bit lower than the 17.5% rise of July, while its trend is running just a tad below that, 15.0% 3mma-saar. Finally, services stood basically stable at 8.8% YoY (from 8.9%), but its trend saw a sharper deceleration, to 9.7% 3mma-saar (from 12.2%), suggesting some early moderation of services inflation, although it is still running high. Additionally, services core inflation is a bit worse: 9.3% YoY (from 9.2%) with the trend still considerably above that, at 11.2% 3mma-saar (just a small deceleration from 11.7%).

Broad core gauges improved a bit more at the margin. The average of the five main cores was unchanged at 10.4% YoY, but its trend fell to 9.5% 3mma-saar (from 10.5% previously). The diffusion index had been falling for the past three prints, but this time it stood still at 68.4% s.a. Despite the marginal improvements, both measures are still hovering at high levels, far from the compatible with the BCB's target for headline inflation.

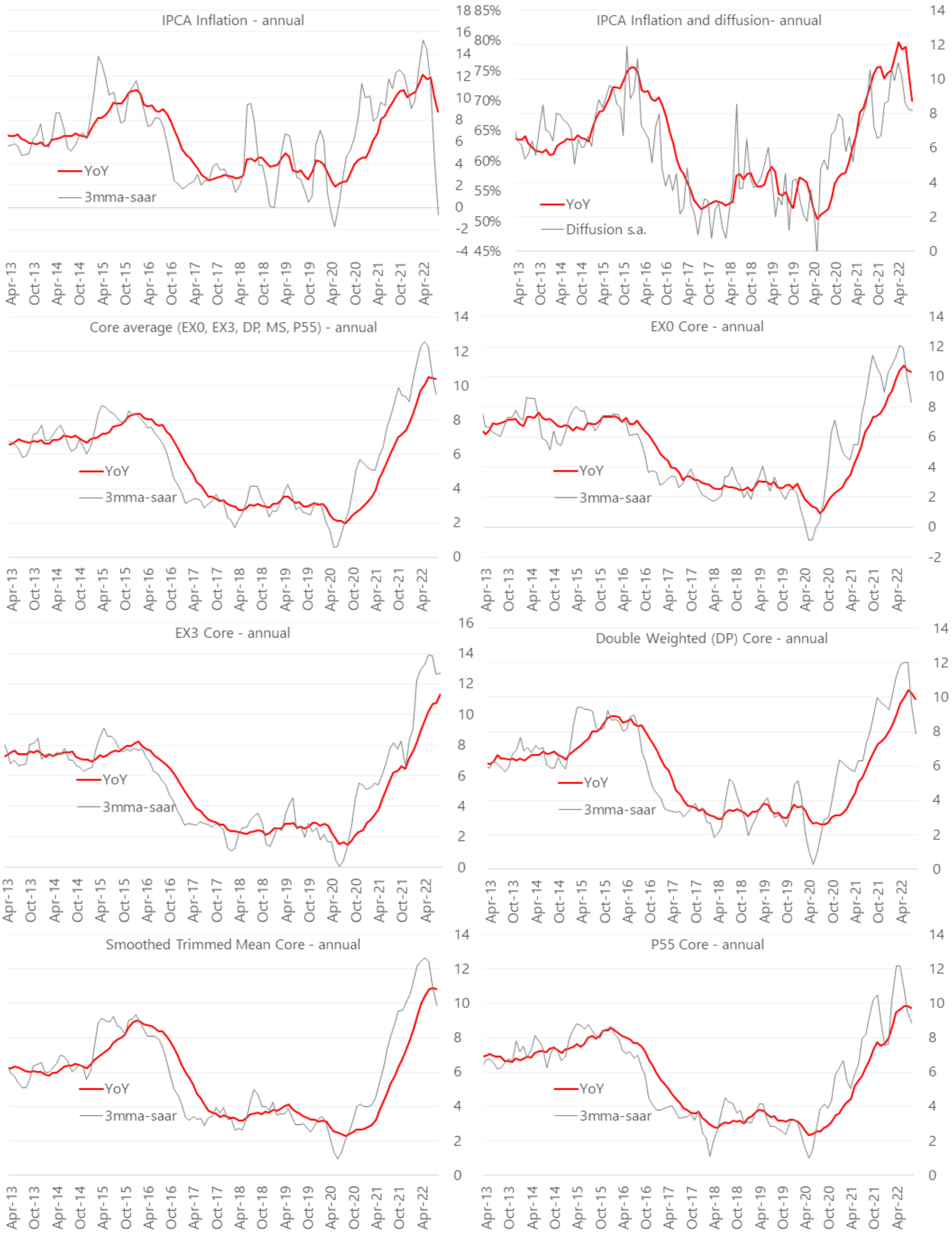
All in all, although IPCA surprised upward, we believe the reading consolidates that the peak of headline inflation is past us in YoY terms (a movement that was boosted by the tax cut measures). Regarding the "quality" of the number, we are seeing preliminary signs of improvement at the margin, but levels of core gauges and diffusion are still historically high. Moreover, risks related to stickier prices (more related to core gauges) are still at place—particularly because of the new round of income aid and because of the likely income-effect coming from the tax cut measures, as both can support short-term demand (while the economy is already running with no spare capacity) and sustain prices. Our IPCA 2022 forecast is at 6.3%, but the high-frequency tracking was revised to 6.2% after this release. For IPCA 2023, we continue to forecast 5.3%. We see downward risks (particularly for 2022) coming from volatile prices, but we remain cautious about the composition of inflation, as services inflation, core gauges and inertial prices as whole can remain high for a while.

Figure 1. August's IPCA Details (%)

	MoM			YoY		3MMA-saar	
	Aug-22	Santander	Desv.	Jul-22	Aug-22	Jul-22	Aug-22
IPCA	-0.36	-0.46	0.10	10.1	8.7	3.9	-0.6
Administered	-2.55	-2.88	0.08	5.1	1.5	-15.5	-23.8
Free	0.39	0.42	-0.02	11.9	11.4	11.6	9.9
Food-at-home	0.01	0.44	-0.07	17.5	15.6	17.2	15.0
Industrial goods	0.82	0.48	0.08	12.8	12.6	8.7	7.5
Services	0.28	0.37	-0.03	8.9	8.8	12.2	9.7
EX3 Core	1.10	0.85	0.09	10.8	11.3	11.6	9.9
Average of cores	0.66	-	-	10.4	10.4	10.5	9.5

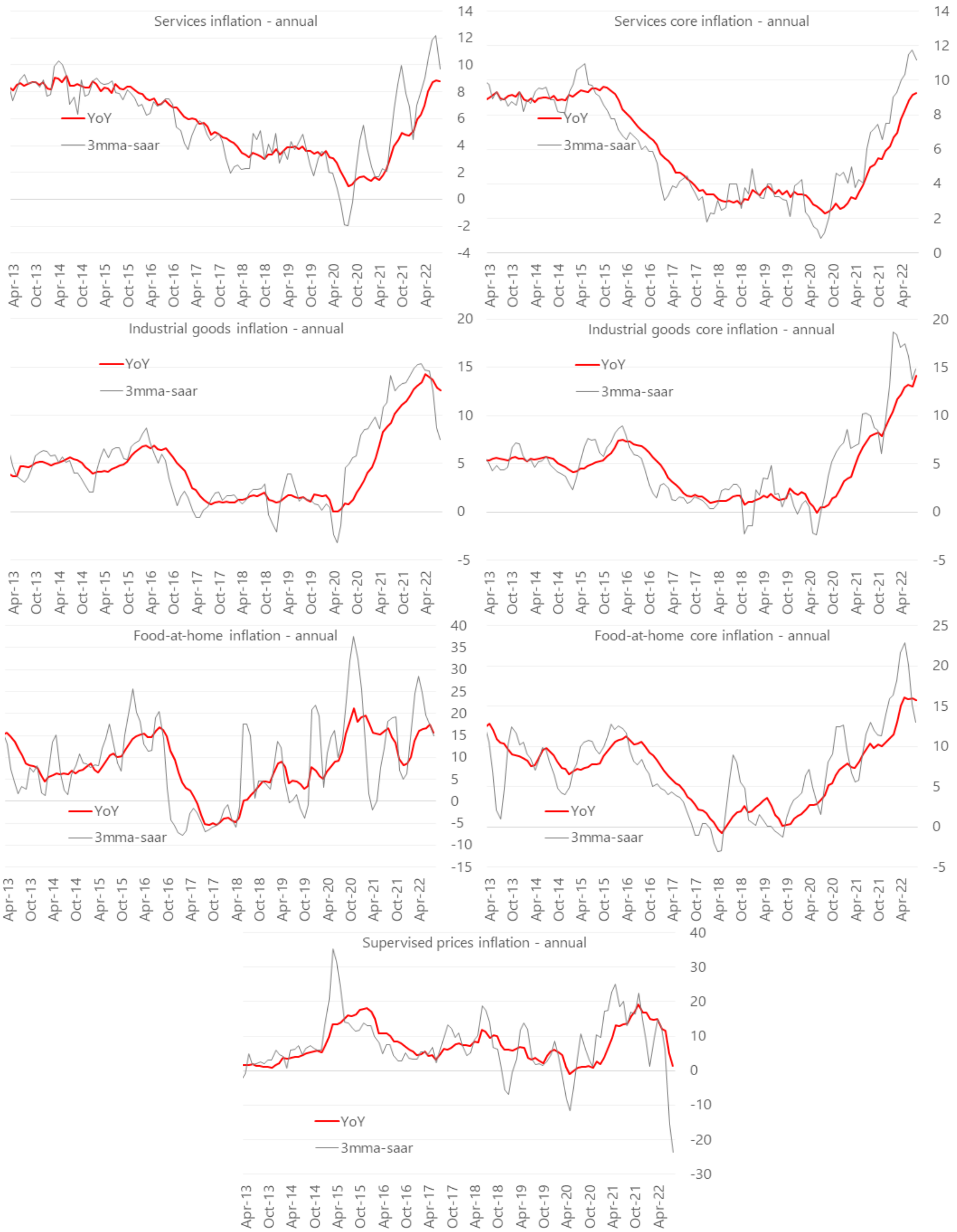
Sources: Brazilian Central Bank, IBGE, Santander.

Figure 2. IPCA, Groups and Qualitative Measures



Sources for all charts: IBGE and Santander.

Figure 3. IPCA, Groups and Qualitative Measures (continued)



Sources for all charts: IBGE and 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 – Commodities	felipe.kotinda@santander.com.br	5511-3553-8071
Gabriel Couto*	Economist – Special Projects	gabriel.couto@santander.com.br	5511-3553-8487
Fabiana Moreira*	Economist – Credit	fabiana.de.oliveira@santander.com.br	5511-3553-6120
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
Rodrigo Park *	Economist – Argentina	rpark@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
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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