BRAZIL MACRO

APRIL 1, 2021

SCENARIO REVIEW

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ANCHORING POWER IS DWINDLING

- On the fiscal front, we see declining "anchoring power" for the constitutional spending cap and believe the focus now will shift to the debt sustainability outlook. We see rising execution risks for the fiscal consolidation process. We estimate a primary deficit close to 3.2% of GDP in 2021 and a gradual improvement in (primary) fiscal performance afterward.
- We expect the aggravation of the pandemic and a more polarized political environment to keep market participants cautious about Brazilian assets. Despite the impact of a less expansionary monetary policy stance on the FX rate, we forecast a persistent risk premium in the Brazilian currency, with USD/BRL to end 2021 and 2022 at 5.25 and 5.55, respectively. We believe a combination of a weak currency and favorable terms of trade is likely to foster an unusually positive current account balance for 2021-2022: we continue to project USD17.6 billion and USD7.3 billion surpluses for 2021 and 2022, respectively.
- Despite the unfortunate (and tragic) resurgence of the pandemic in 1Q21, we see a more speedy vaccination process ahead, allowing a gradual relaxation of social distancing restrictions throughout the remainder of 2021. This supports our assumption of a broader reopening of the economy in 2H21 and a "normalization" toward the end of the year.
- We are slightly revising our 2021 GDP estimate to 3.0% from 2.9%. A higher carryover from the 4Q20 result and the surprisingly positive releases for activity at the start of 1Q21 reduce the likelihood of a sharp contraction in 1Q21, in our view, even with a probable contraction in March. However, we expect the tighter mobility restrictions caused by the pandemic to lead to a sharp contraction in 2Q21. The incorporation of a less expansionary monetary policy path motivated our downward revision for 2022 GDP to 2.0% from 2.3%.
- We expect a recovery in the labor force to lead to a higher unemployment rate in 1H21—we see it peaking just below 17%, before falling to ~15% by year-end. Looking at the recent divergence between CAGED and PNAD labor market surveys, we view the latter as describing more accurately the current job market conditions.
- Despite a still tepid recovery in demand, cost/supply-related shocks have pushed our 2021 IPCA forecast up further, to 5.0% (from to 3.6%). For 2022, although we still believe pandemic-related factors will probably fade, paving the way for a relatively benign scenario for inflation, we are incorporating a small spillover from 2020-2021 shocks to IPCA 2022, pushing it to 3.7% (from 3.2%).
- We raised (considerably) our Selic rate forecasts for the period 2021-23, reflecting a cyclical deterioration of the inflation conditions and a possibly structural worsening of the fiscal outlook. The latter has implications for monetary policy, leading to a higher neutral level of interest rates. We project the Selic rate at 5.50% for YE2021, 6.00% for YE2022, and 7.00% (terminal rate) for YE2023.

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE ATTACHED.
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Figure 1. Santander Macro Forecasts for Brazil – Summary

Macroeconomic variables		Previous		Current
GDP (%)	2021E	2.9	↑	3.0
	2022E	2.3	↓	2.0
	2023E	1.8	→	1.8
IPCA (%)	2021E	3.6	↑	5.0
	2022E	3.2	↑	3.7
	2023E	3.3	→	3.3
Selic Rate (% end of period)	2021E	4.00	↑	5.50
	2022E	4.50	↑	6.00
	2023E	6.00	↑	7.00
FX Rate - USDBRL (end of period)	2021E	5.20	↑	5.25
	2022E	5.40	↑	5.55
	2023E	5.20	→	5.20
Current Account Balance (% of GDP)	2021E	1.2	→	1.2
	2022E	0.5	→	0.5
	2023E	-0.2	→	-0.2
Primary Fiscal Balance (% of GDP)	2021E	-3.1	↓	-3.2
	2022E	-2.2	→	-2.2
	2023E	-1.5	↓	-1.7
Gross Public Debt (% of GDP)	2021E	89.1	↓	86.2
	2022E	91.2	↓	88.8
	2023E	92.4	↓	91.2

Sources: Santander estimates.

EXECUTIVE SUMMARY: Elevated Risks and a Heterogeneous Recovery

Our scenarios have been challenged by the dynamism of current developments, as Brazil is currently one of the global epicenters of the COVID-19 pandemic. In our view, something that was a tail risk has become a reality, with an exponential increase in terms of deaths and infections. The spread of more contagious strains of COVID-19 has significantly increased the seven-day moving average of new infections from 45k daily cases reported during the first-wave plateau to more than 75k during the recent upsurge.

Moreover, the COVID-19 vaccination campaign is facing challenges. The key issue is the global shortage of vaccines. Although Brazil had secured more than 550 million doses by year-end 2020, delays continue in the arrival of imported raw materials for national production and in ready-made vaccines. The delay in closing vaccine import contracts has caused Brazil to lose its position in the global vaccine line. Currently, there is a relatively low stock of vaccines in the country, which may be insufficient to accelerate the population's immunization (about 500k doses applied per day), in a context of rapid viral contamination spread and low level of herd immunity. A faster pace of vaccine roll-out will be crucial for the 2H21.

As a result, the worsening of the pandemic led to new restrictions on social mobility in several Brazilian states, in an attempt to avoid a breakdown of the health care system. At the end of March, 17 of the 27 states reported extremely high levels of ICU occupancy in hospitals (above 90%), with three states at more than 100% of capacity.

Lower mobility, uncertainty about vaccination, and fewer government welfare transfers have affected the consumption of goods and services in recent months. After a positive surprise from economic performance during 4Q20, this year started with favorable activity results and a sequential increase. This led us to revise our GDP forecast for 1Q21 from -0.4% to + 0.2% QoQ-sa. However, we have been surprised by the large number of industry stoppages due to the lack of parts and components, mainly in the automotive sector, which brings a downward bias to the 0.6% drop we expect for 2Q21. Or course, the downside risks for 2H21 are magnified by the tighter mobility restrictions due to the pandemic.

In this context, we revised our 2021 GDP forecast from 2.9% to 3.0%, still below last year's carry-over effect (3.6%). This increase includes the resumption of some degree of fiscal stimulus (reintroduction of emergency aid and the possible return of other fiscal programs), the expectation of a more accelerated vaccination process, and the reopening of the economy in 2H21.

If the health crisis and its impact on activity were not enough, Brazil currently faces the most difficult test for economic policy since approval of the constitutional spending cap. The increase in mandatory expenditures in the federal budget (with a high indexation level), without fiscal adjustment measures, brought the discretionary expenditures in 2021 close to an unrealistic amount. Four months later, the recently approved 2021 budget shows that fiscal risks are still present. Approximately BRL26 billion in mandatory expenses was reduced without technical support or prior legal approval. Parliament made cuts in expenses it should not have done, in our view. Besides that, the first bimonthly budget report (a requirement of the fiscal responsibility law) had already pointed out the need to raise the forecast for mandatory expenses, with an increase of BRL17.6 billion. Any adjustment in the spending composition will have to occur by presidential veto, supplementary credits, or a freezing of discretionary outlays, which always brings friction in the relationship among ministries, Congress, and other government branches, with ensuing political consequences.

With possible consequences for governance, we believe there may once again be difficulty in voting on substantial reforms for the country, which are already hampered by the health emergency. In addition, it is widely expected that there will be an early start to the electoral debate (for 2022 general elections). Furthermore, the fiscal constitutional amendment (*PEC Emergencial*) approved in March, although it has brought some important regulatory advances, has not removed the fiscal risks, as subsequent implementation will depend on a favorable political environment—for example, on the reduction of tax benefits, or on the adherence of states and municipalities to actually implement the fiscal triggers as a tool to curb mandatory outlays.

Nothing is more emblematic of the increase in the perception of idiosyncratic risks than the volatility of the FX rate (USD/BRL). The rate has been floating between 5.12 and 5.87 since the beginning of the year (it was 4.30 before the pandemic). We have also observed an increase in risk premiums on the 10-year yield, from 2% at the beginning of the year to about 4% recently, close to the peak observed when the country lost its investment-grade rating in 2015.

The increase in uncertainties could not have occurred at a worse time. The rapid recovery from the pandemic in China and now in the U.S. will make these economies the two main engines of the global recovery, registering growth rates this year above 8% and 6%, respectively. In our view, the pressure on commodity prices will persist due to the continued scrambling of the global supply chain. As a consequence, we believe that reflation in the U.S. will be faster than initially expected. With the possibility of an increase in inflation and a gradual reduction in liquidity, 10-year Treasury rates in the U.S. have been rising (from 0.9% to 1.7%, reaching 2% in a few months), interrupting the recent depreciation of the USD and penalizing emerging economies' currencies.

In addition to contributing to internalize inflationary pressures, the impact of the increase in commodity prices should have implied an appreciation of the Brazilian currency, with one effect cushioning the other. However, with the increase in idiosyncratic risk in the domestic context, instead of appreciating, the currency depreciated. If it had moved in tandem with its peers, we estimate the Brazilian currency would have been close to 4.50/USD as of today. Instead, it persists at levels above 5.70, even after interventions by the BCB of about USD7 billion this year. Taking this into account, we updated our forecast for the FX rate to 5.25 at year-end 2021 and to 5.55 for 2022.

As a consequence, the persistent depreciation of the BRL has helped to amplify the spreading of the price shock that began at the end of last year. Thus, inflation expectations for the short term have been soaring, already exceeding the center-target for 2021 (we revised our forecast from 3.6% to 5.0%, with a center-target of 3.75%), and also threatening gains for 2022 (we updated our forecast from 3.2% to 3.7%; the target is 3.5%). In a risky convergence, following a recovery of profit margins in the industry, inflation (IPCA) is expected to reach 8.1% in July 2021, only after that starting a process of gradual decline, returning to the center of the inflation target only in 2H23.

In this process, the readjustment of the spending cap limit—by the 12-month IPCA calculated between July 2020 and June 2021, which we estimate at 8.1%—will be around BRL120 billion in 2022. This will allow an increase in discretionary outlays. Additionally, with the 2021 INPC estimated at 5.3% (almost 3 pp difference *vis-à-vis inflation in mid-2021*), we expect the rise of mandatory expenses to be relatively lower than the readjusted margin of the spending cap. In our view, this means that next year there will be room in the budget for granting some real wage increases for federal public servants, or even for the creation of a new welfare program, for example.

Pari passu, in order to ensure the inflation convergence to the targets, the BCB needed to kick-start the hiking season at higher speed. The Copom raised the Selic rate by 75 bps in its first move this year, and signaled that the next increase will be of the same magnitude. We estimate that the Selic will end the year at 5.5%, remaining at that level until the end of 2022, when we expect the Copom to restart the upward cycle until it reaches a neutral level, around 7% per year.

If, on the inflation side, monetary policy normalization had to be accelerated, on the fiscal side this means higher costs to finance the debt. It is important to note that Brazil's public debt is increasing significantly (with our estimates pointing to a leap from 74% of GDP in 2019 to around 100% of GDP in 2027, even if fiscal discipline is maintained), and half of it's the federal debt maturity is up to 2.5 years. In addition, more than two-thirds of debt is floating-rate bonds, and thus the savings in the payment of interest on the debt since 2016 may be more than reversed.

As a consequence, the country is gradually and silently moving toward a scenario of persistent public debt at extremely high levels and financing more public spending with more inflation. Our estimates lead us to believe

that a Selic rate above 7% would already be a sufficient condition to generate an unsustainable path of the public debt, leading to with a scenario of fiscal dominance.

Despite the effect of the fiscal imbalance, the external sector remains resilient. The increase in commodities prices (and terms of trade) is happening alongside FX rate depreciation—a rare case in the empirical evidence—and continues to promote a positive adjustment of the Brazilian external accounts. We expect a current account balance of +USD17.6 billion this year, as a result of more exports (up 20%) and a moderate growth in imports (+4.4%) due to the fragile recovery in activity. Although at first this seems like good news, Brazil is an emerging country, hard hit by the pandemic, but one that should oddly become a savings exporter due to an unattractive business environment for investments.

As the scenario worsens, and as the outlook for structural adjustment remains cloudy, in our view, asset prices will incorporate the increased risk, leading to a continued lack of confidence, a slow activity recovery, higher inflation, and continued income inequality. It becomes redundant to say that Brazil is exchanging more current public spending for fewer jobs and lower income in the medium term.

KEY HYPOTHESES IN OUR BASELINE SCENARIO

Figure 2. Summary of Key Hypotheses Behind Our Macroeconomic Forecasts for Brazil

THEME	KEY HYPOTHESIS
International	• Vaccination process advances abroad, especially in the U.S., and is expected to accelerate in Europe as vaccine supply increases in the second quarter. This leads to fading macroeconomic effects of the pandemic throughout 2021, allowing a cyclical recovery in global GDP. • Despite robust additional fiscal stimulus in the U.S., we still look for an accommodative Fed stance, with tapering starting in 2022 and rate hikes only in mid-2023.
Commodities	• An economic recovery led by China should boost demand for commodities in 2021, favoring the terms of trade for producing countries (like Brazil). • Vaccination programs around the globe allow greater mobility, a tailwind for demand, especially in 2H21.
COVID-19	• Materialization of 80% of the National Immunization Plan (PNI), with 442 million doses available by end of 2021. • In our baseline scenario, we assume a vaccination rate of 700k/day throughout 2Q21, rising to 1.5 million/day in the 2H21, meaning 350 million doses administered by end of 2021.
Fiscal Policy	• Maintenance of the current fiscal framework, with compliance with the spending cap rule, after the adjustments for 2021 authorized by the budget watchdog (TCU) of leftovers (‘*restos a pagar*’) expenditures from 2020 War Budget and the *PEC Emergencial* Amendments. • Economic policy still seeks debt sustainability, with the approval of partial reforms to increase potential GDP toward 2% and keep the neutral interest rate at no more than 4% per year. • Possible adoption of new fiscal stimulus measures does not compromise the primary fiscal result target for 2021 and its gradual reduction in the coming years. • But execution risks for reforms and the fiscal consolidation process increase amid a shakier political environment.
Balance of Payments	• Favorable commodity prices in tandem with the increase in international trade flows expected to favor trade surpluses. • Idiosyncratic (read fiscal, political) risks should limit the room for a significant strengthening of the BRL. These factors should weigh on portfolio flows in the medium term.
Economic Activity	• The lingering impacts of the pandemic imply a weak start in 1H21, but expect progress in the vaccination campaign and a rise in mobility to reignite economic activity from mid-2Q21 onward. • The expected increase in household indebtedness not expected to lead to credit supply constraints in 2021. • Labor force normalization should lead the unemployment rate to a substantial rise in 1H21. As the economy reopens, employment should recover in 2H21, with job market slack still notable. • Limited episodes of corporate bankruptcy, meaning no major and persistent impact on the country’s productive capacity.
Inflation	• Higher oil prices for 2021: Brent from US$65/bbl year-end to US$70/bbl. • Cost/supply-related shocks are stronger and lasting longer than expected, and pass-through is higher than anticipated, impacting IPCA 2021. • For 2022, although we still expect the shocks to fade and see a relatively benign scenario for inflation, now we are incorporating a slight spill-over of shocks to IPCA 2022. • Slow recovery demand preventing higher pass-through of shocks to general prices (secondary effects).
Monetary Policy	• The BCB maintains the more hawkish reaction pattern recently adopted, reducing a large part of the stimulus soon and observing the economy’s reaction from 4Q21 onward. Hikes restart at the end of 2022, with full normalization (towards a neutral rate of 4% in real terms) in 2023.

Sources: Santander.

COMMODITIES: Bumps on the Road to Reopening

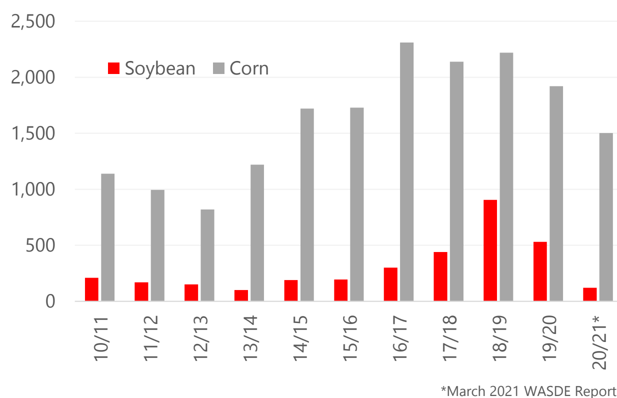
Bumps in the global vaccine supply chain as well as the continued upsurge in COVID-19 infections—leading to renewed lockdown measures—have recently clouded prospects for a global economic recovery. Yet we see the likelihood of stronger demand ahead, given the ongoing vaccination programs, especially in 2H21.

In agriculture, Chinese demand for grains is still robust despite the risks posed by the African swine fever, as large flash sales of corn were registered in March. With grain prices high, feed costs have been squeezing livestock producers. In energy, near-term demand has been below market expectations, prompting postponements in OPEC+ supply increases. In metals, China steel production has been hit by mandatory curbs as the central government seeks to reduce air pollution.

In our view, the food commodities market is likely to remain tight in the near term. The "Prospective Plantings" and "Quarterly Grain Stocks" reports to be released on March 31, 2021, will provide information on types of crops and amount of acres for the next marketing year. Risks are tilted to the upside, in our view, depending on a good 2021-22 crop yield. As for energy, we think production cuts by OPEC+ could be prolonged to sustain oil prices until COVID-19 related restrictions are behind us and mobility finally picks up, so we see the risks tilted to the upside for energy as well. Lastly, we think the pent-up demand from China's credit stimulus will lose momentum in 2H21, weighing on metals demand. With supply also likely to ramp up throughout the year, we believe the risks are tilted to the downside.

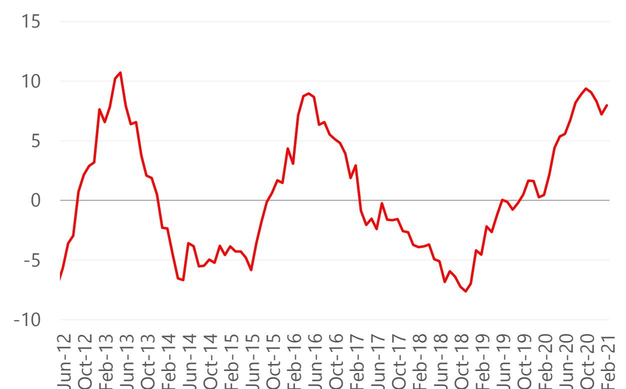
All in all, we maintain a bullish view on commodities. For the coming months, we look for a small accommodation in prices, but with aggregate indexes still running at historically high levels.

Figure 3.A. – U.S. Grain Stocks (Million Bushels)



Sources: USDA, Santander.

Figure 3.B. – China Credit Impulse (%, YoY)



Sources: Bloomberg, Santander.

COVID-19 in Brazil: Amid the Worst of the Pandemic, Vaccination Advances

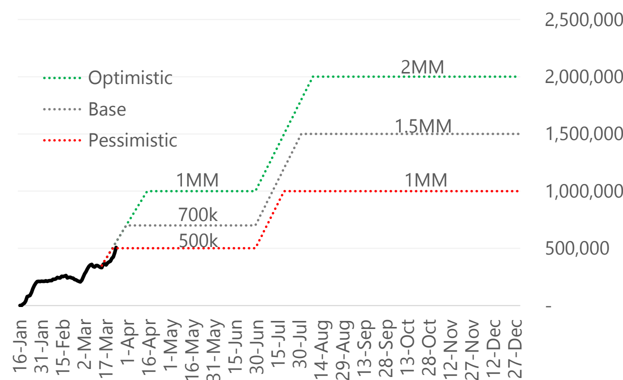
A persistent second wave of infections, likely driven by a more contagious strain of the coronavirus, has pushed Brazil into its worst phase in the pandemic. In the last days of March, both daily new cases and deaths from COVID were seeing record-high numbers. The ICU occupancy rate was above 90% in at least 17 states, and key regions in the country imposed tighter (mobility and activity) restrictions in an attempt to curb the transmission. The risk here is that these new restrictions could spill over to 2Q21, weighing further on tertiary activity. As of March 28, 20 million doses (out of 35 million available) had been administered in the country, with the rate of vaccination picking up to 582k/day.

Nonetheless, since our last scenario review, Brazil's vaccine outlook has improved, with more contracts being secured, supplies making their way into the country, and the vaccine rollout accelerating. According to the National Immunization Plan (PNI), Brazil has already secured more than 552 million doses for 2021, with local governments pursuing parallel vaccine deals. In our base scenario, we assume a vaccination pace of 700k/day throughout 2Q21, rising to 1.5 million/day in 2H21. The 552 million doses breakdown is: 224 million of Fiocruz/AstraZeneca; 100 million of Butantan/CoronaVac; 42 million from COVAX; 10 million of Sputnik; 20 million of Covaxin; 100 million of Pfizer; 38 million of Janssen; and 13 million of Moderna. By the end of the year, we expect the nearly 80% of the population to have been vaccinated.

In our view, the numbers suggest a gradual immunization of a large percentage of the population, allowing a continuing gradual relaxation of social distancing restrictions throughout the year, especially in 2H21. We believe this supports our assumption of a broader reopening of (socially integrated) services in the latter part of the year, and "normalization" by the end of it.

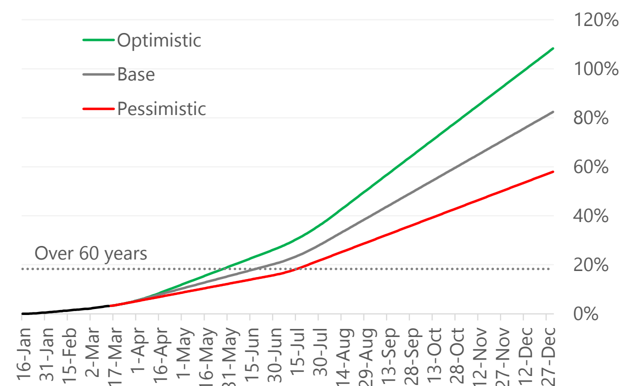
Given the country's tradition of successful nationwide immunization campaigns, we see the likelihood tilted to the upside when it comes to our assumptions about the vaccine rollout in Brazil.

Figure 4.A. - Vaccination Pace (Daily Shots)



Sources: Brazilian Ministry of Health, Santander.

Figure 4.B. - Population Fully Vaccinated (%)



Sources: Brazilian Ministry of Health, Santander.

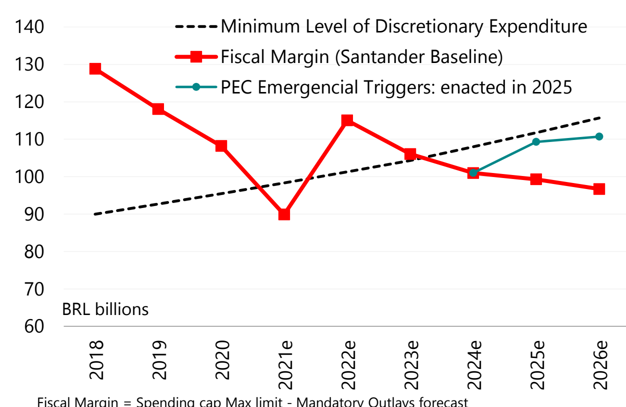
FISCAL POLICY: On a Tightrope 2.0—Flirting with Fiscal Dominance

We see fiscal risk continuing to increase in Brazil. In our view, as a result of the inflationary shock, the spending cap rule has lost part of its anchoring power. The focus now is on the sustainability of government debt.

Since our last scenario review (February 11, 2021), a constitutional amendment (*PEC Emergencial)* was approved, setting up the conditions and rules for an emergency fiscal regime. The law allowed the implementation of a new round of emergency aid for four months, with a total budget limit of BRL44 billion, and also created "fiscal triggers"[1] that may favor compliance with the spending cap for the medium term. However, the final text saw a watering down of the economic team's proposal, meaning less potential for fiscal savings, which we believe was a way to avoid an even greater watering down of the reform. Although substantial, this reform will not guarantee fiscal consolidation, and the debate in Congress concerning its approval showed the difficulty of approving tougher fiscal measures. Another key aspect of this issue is that, as a result of the inflationary shocks[2] in 2020-2021, the constitutional spending cap has lost part of its anchoring power. This is due to the inflation mismatch between the price index used to readjust the spending cap limit and the index used to correct the minimum wage (important index for pensions), and other mandatory outlays[3]. In our scenario, the constitutional spending cap margin will rise by as much as BRL120 billion in 2022. Consequently, even with a real increase in mandatory expenses next year, we believe compliance with the spending cap by 2026 is more feasible than it was before the current inflationary shock. Still, for 2021, the outlook remains challenging. The approved budget for this year showed the difficulty of allocating the expenditures within the spending cap limit, thus compressing the level of discretionary outlays. In our view, the government continues to walk a tightrope to avoid a further deterioration in the fiscal outlook.

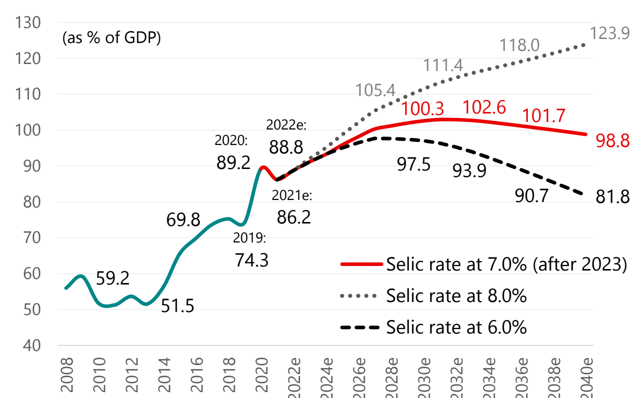
In light of all this, we believe the main fiscal thermometer will be the sustainability of public debt. As a result of higher idiosyncratic risk, we now believe the Selic rate will reach 7% in the medium term (previously 6%). This interest rate level makes the convergence of gross debt even slower, remaining practically stable at 100% of GDP until 2030 (Figure 5.B.). Thus, it is a borderline situation, since any additional shock that raises the neutral interest rate or reduces potential GDP (at 1.8% per year) could be enough to affect the debt convergence, in our view. For this reason, we see this as a latent fiscal dominance scenario, which reinforces the importance of passing further fiscal reforms and maintaining fiscal discipline. Regarding the new forecasts, we project the central government's primary deficit for 2021 at BRL275 billion (3.2% of GDP), vs. BRL255 billion in our last scenario. For 2022 onward, we continue to expect primary deficits to gradually decline. In addition, we forecast gross debt to reach 86.2% of GDP in 2021, falling from 2020, due to a revision in nominal GDP.

Figure 5.A. – PEC Emergencial and Spending Cap



Sources: National Treasury, Santander.

Figure 5.B. – Gross General Government Debt



Sources: Brazilian Central Bank, Santander.

1 According to the new legislation, the triggers will start working when the ratio of 'mandatory expenses to total expenses' reaches 95%. This value was 92.6% in 2020. In case the triggers turn binding, the level of discretionary expenditure will be close to its lower bound (or even lower) for a proper functioning of the government. In our scenario, the triggers will be binding only in 2025 (or later), and should allow fiscal savings of ~BRL20 billion for 2025-26.

2 See the Inflation section of this report for more details.

3 According to our estimates, the spending cap margin will be updated by the 12-month IPCA until June 2021 (close to +8.0%). The minimum wage should be adjusted by the INPC of December 2021, which, according to our tracking, should reach +5.2%.

BALANCE OF PAYMENTS: Don't Blame It On Me

Notwithstanding expected current account surpluses and higher direct investments in the country, we expect the lack of progress on structural reforms and greater political polarization to keep the BRL relatively weak.

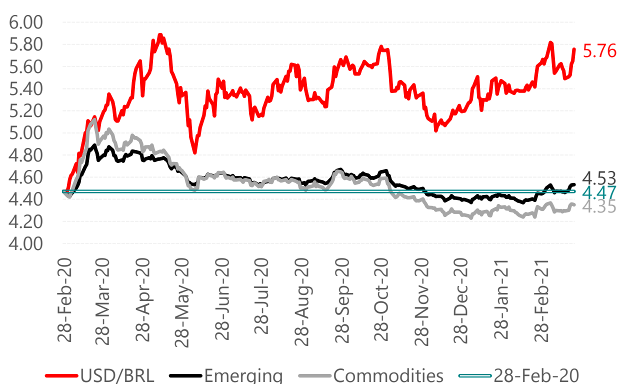
As we stated in our report *The Persistence of (Fiscal) Risks*[4], the reversal of the DXY declining trend was one of the factors that we mentioned could lead to some weakening of the BRL. The approval of a sizeable fiscal package in the U.S. has increased the likelihood of that reversal in the DXY happening sooner rather than later. In addition, we expected an increasingly polarized political environment due to the anticipation of (positioning for) the presidential race, thus hindering the progress of structural reforms. Since we believe that the bulk of the discrepancy between the performance of the BRL and that of peer currencies hinges on skepticism regarding the prospects for structural changes in Brazilian government debt and economic growth dynamics, this delay could keep pressuring the BRL throughout 2022.

With market participants seeing increased execution risks for key macro reforms, we expect the assessments about the Brazilian economy to worsen in the coming months, especially as the recent aggravation of the pandemic outlook in the country is likely to create further pressure for more fiscal stimuli, while the public sector's balance shows no room for that move, in our view.

This latent tension could prevent the BRL from strengthening notably in the coming months, in our view, as it is expected to keep the risk premium we see embedded in the BRL's current pricing. However, we believe the beginning of a (partial) normalization of monetary policy could pave the way for some appreciation of the currency compared with current levels (at the time of writing, the USD/BRL pair was hovering around 5.80). As the initial move was earlier (and bolder) than we previously expected, we believe further Selic hikes to be implemented will allow the BRL to recede to around USD/BRL5.25 by December 2021.

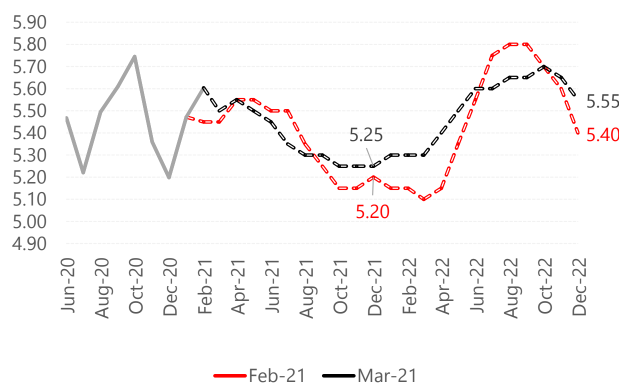
Nonetheless, we think this monetary policy influence over the BRL should cease this year (more details in the Monetary Policy section). At the same time, from April 2022 onward, the proximity of the elections is likely to heighten political tensions and create additional pressure on the FX rate, in our view. Consequently, we could witness a new wave of depreciation of the BRL, which we forecast to end 2022 at USD/BRL5.55—previously, we expected it to reach USD/BRL5.40. More than ever, we expect developments on the political and fiscal fronts to set the path for the BRL. Although with weaker ending points, the average level of the FX rate should not differ much from the one we projected in February, which led us to keep the forecasts for the current account surpluses in 2021 and 2022 unchanged at USD17.6 billion and USD7.3 billion, respectively.

Figure 6.A. – USD/BRL versus Peer-Currencies



Sources: Bloomberg, Santander.

Figure 6.B. – Brazilian FX Rate (USD/BRL)



Sources: Bloomberg, Santander.

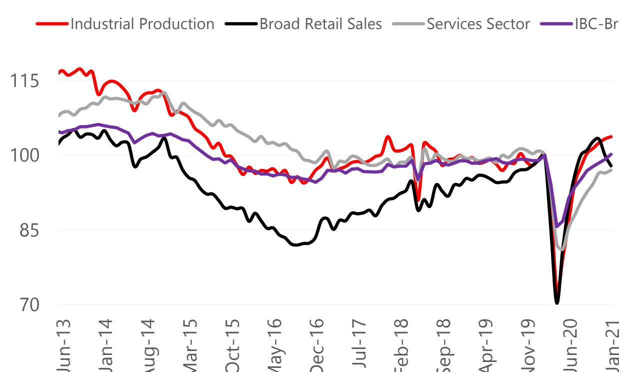
[4] **Santander Brazil - Macroeconomic Scenario: *"The Persistence of (Fiscal) Risks"* –** February 11, 2021- Available on: http://bit.ly/Sant-ScenRev-fev21

ECONOMIC ACTIVITY—CORE: Impact of Pandemic Expected to Slow the Recovery

GDP ended 2020 recording a contraction of 4.1%, much better than what was anticipated at the outset of the pandemic (at one point, our expectations reached -6.4%). In 4Q20, GDP showed a natural (post-rebound) deceleration in the pace of recovery, but still posted solid sequential growth (3.2%). Despite being insufficient to fully offset the losses from the crisis, the fourth quarter's result left a strong carryover (3.6%) for 2021[5]. In January, some of the main activity indexes surprised positively. Industrial production grew at the margin (+0.4%), while the services sector also grew sequentially (+0.6%). On the other hand, broad retail sales were weak once again (-2.1%), accumulating almost 6% of contraction since December 2020. The IBC-Br, the Central Bank's monthly proxy for GDP, ended January with solid growth[6] (1.0%), leaving a strong carryover for 1Q21 (1.8%). For February, other timely indicators still point to a continuing recovery in economic activity, but for March, the signals point to a sharp contraction, given the resurgence of the pandemic. The tighter social distancing measures will hit the tertiary sector hard, but the public health crisis will also affect the industrial sector, as the latter already suffers from input shortages.

Regarding our most recent scenario review, the resurgence of COVID-19 implied a steeper deterioration of mobility at the end of 1Q21, likely to continue until mid-April, contaminating 2Q21. In average terms, we expect worse mobility conditions for 1H21. On the other hand, there is an improving outlook for the vaccination campaign, meaning a faster recovery of mobility in 2H21, in our view. Regarding the GDP path, the strong carryover left by January's positive figures reduces the likelihood of a stronger fall in economic activity in 1Q21, in our view, even with a likely sharp contraction in March. Nevertheless, the expected economic activity adverse result at the end of 1Q21, concomitant with a likely weak figure in April, implies a quite negative carryover into the coming quarter, requiring strong (and unlikely) sequential growth in the subsequent months to mitigate it, even if helped by the new round of emergency aid (i.e., government transfers) for households. Thus, we expect an contraction of GDP for the 1H21. From mid-2Q21 onward, with progress on vaccinations and the sequential recovery of mobility, we expect a gradual resumption of economic activity, driven mainly by the services sector. The incorporation of a new monetary policy path, with a higher interest rate in 2021, had a negative impact on our forecasts for 2022. **In annual terms, we are upwardly revising our 2021 GDP slightly to 3.0% from 2.9%, partly due to the higher carryover left by the fourth quarter result (3.6%, compared to 3.2% in the previous scenario). The incorporation of a new monetary policy path, with a higher terminal interest rate, motivated our downward revision of 2022 GDP, to 2.0% from 2.3%.**

Figure 7.A. – Economic Activity (Feb-20=100, sa)



Sources: IBGE, Brazilian Central Bank, Santander.

Figure 7.B. – GDP Breakdown (%)

GDP Projections					
	2018	2019	2020	2021e	2022e
Total GDP	1.8	1.4	-4.1	3.0	2.0
Agriculture & Livestock	1.3	0.6	2.0	2.0	1.8
Industry	0.7	0.4	-3.5	5.0	2.0
Services	2.1	1.7	-4.5	2.7	2.1
Household Consumption	2.4	2.2	-5.5	1.9	1.9
Government Consumption	0.8	-0.4	-4.7	3.8	1.1
Investments	5.2	3.4	-0.8	6.4	3.6
Exports	4.1	-2.4	-1.8	12.9	1.7
Imports	7.7	1.1	-10.0	7.9	9.1

Sources: IBGE, Santander.

[5] **Santander Brazil Economic Activity - *"Solid Growth But Only Partial Recovery"* –** March 03, 2021 - Available on: http://bit.ly/Sant-econact-030321
[6] **Santander Brazil Economic Activity - *"A Positive Surprise at the Start of 1Q21"* –** March 15, 2021 - Available on: http://bit.ly/Sant-econact-150321

ECONOMIC ACTIVITY—EMPLOYMENT: Weak Conditions, Despite Conflicting Signs

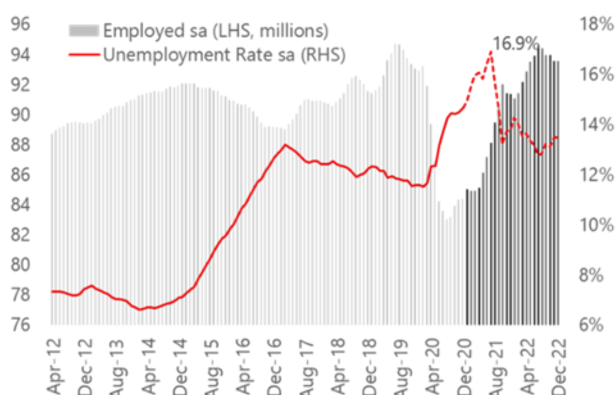
The latest batch of employment data[7] continues to show contradictory signs, as the two main indicators point to different conclusions about the labor market. On the one hand, CAGED net formal job creation data has been showing consecutive all-time records for monthly figures in the past few releases and has fully offset the losses suffered in the pandemic. On the other hand, IBGE's PNAD survey still points to the unemployment rate at historical highs and to a precarious labor market.

The IBGE National Household Survey (PNAD) showed that the unemployment rate reached 14.2% in the three months to January. We estimate that the seasonally adjusted unemployment rate has been consistently rising since March 2020, while the effective real wage bill has indicated considerable YoY drops. The CAGED survey, on the other hand, posted a net formal job creation of +401.6k in February 2021. The figure stood above the all-time record for the month (+281k in 2011), which represented the sixth consecutive monthly record for the indicator. In seasonally adjusted terms, net formal job creation keeps showing results above 250k per month, a very high level in a historical perspective.

In our view, the PNAD survey continues to paint a more precise picture of the current labor market situation. We believe CAGED results may be underreporting layoffs in the recent period, as the number of responding establishments is below its pre-pandemic average. Furthermore, the gap between new unemployment insurance claims and layoffs in CAGED is close to its all-time high (on a 12-month basis), indicating that the level of monthly layoffs should be higher than the figures suggest. Finally, the comparison between CAGED and PNAD data indicates that the difference between the job creation series cannot be explained by the informal sector only. The selection within PNAD data of private sector formal workers (most of the population covered by CAGED) shows a good long-term correlation with the CAGED series until the beginning of the pandemic, when the data provided by IBGE indicated a larger impact on employment (Figure 8.B).

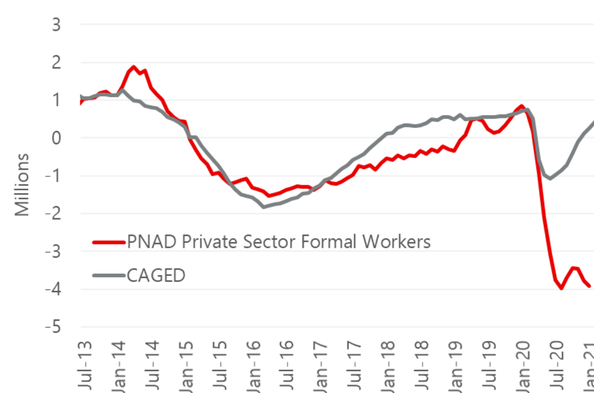
We continue to estimate a significant rise in the unemployment rate throughout 1H21. Since the pandemic began, there has been a significant drop in the labor force and the participation rate, which has remained at low levels despite some slight recovery in 2H20. We expect that most of the workers who became discouraged due to the pandemic will return to the labor force in 1H21, as the new round of government emergency cash transfers is smaller than in 2020, and, more importantly, some mobility restrictions are still expected to be lifted as the vaccination campaign progresses (despite some tightening on mobility expected between March and April). Employment, on the other hand, should experience a more consistent recovery only in 2H21, when the economic reopening process is more consolidated. Therefore, we project the unemployment rate to fall toward the end of the year, after peaking at high levels in 2Q21, with joblessness running above its natural level for some time.

Figure 8.A. – Unemployment Rate Scenario



Sources: IBGE, Santander.

Figure 8.B. – Net Job Creation (12-month)



Sources: IBGE, CAGED, Santander.

[7] **Santander Brazil Labor Market - *"PNAD Slows Down, CAGED Speeds Up"* –** March 31, 2021 - Available on: http://bit.ly/Sant-labor-Mar21

ECONOMIC ACTIVITY—CREDIT: A (Partial) Rebound in February

Recent data (BCB) for February show that total outstanding loans in the National Financial System (SFN, in the Portuguese acronym) posted inflation-adjusted growth of 10.3% YoY in January, reaching BRL4.0 trillion. New loans adjusted for inflation and seasonality (using the BCB methodology) rose 5.1% in the month, a significant increase from January (+1.5% MoM-sa).

For households, the non-earmarked segment saw an increase of 5.8% MoM-sa in February, driven by overdraft, payroll-deducted personal loans for retirees and vehicle financing. Nonetheless, recent restrictions owing to a worsening of the pandemic are likely to weigh on March figures, in our view. In the earmarked segment, real estate financing remains high (55.1% YoY), as financial conditions are favorable. Importantly, both the debt-to-income and debt service ratios for households have been rising fast, a risk for delinquencies and credit supply as the economy recovers.

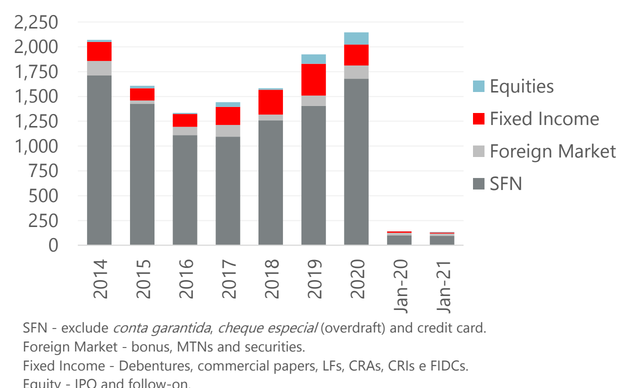
For companies, there was an increase of 1.7% MoM-sa in the non-earmarked segment, with working capital rebounding at the margin. In the earmarked segment, February saw an increase of 47.7% MoM-sa. Despite the slowdown in these pandemic-related types of credit, a new Pronampe's round of BRL16 billion is expected for the coming months.

In capital markets, issuances of corporate bonds (debentures) saw an increase in February. Looking at the allocation of proceeds, 37% have been allocated for infrastructure investments in 2021 (as opposed to only 12% in 2020). This is likely a result from issuances under law 12.431, a government's attempt to foster long term funding in capital markets for infrastructure projects. Considering total corporate financing (new loans in the SFN, debt and equity issues in the capital markets) in 2021 (until February), compared to same period of 2020, total corporate financing is down -9% compared to the year-ago period. Issuances in the capital markets are -32% lower, while SFN concessions are -3% below.

We revised our projections for total outstanding growth (inflation adjusted) to 3.0% in 2021 and 5.3% in 2022 (see Figure 6-B), from 5.5% and 5.6%, respectively. The 2021 revision was driven by revision significant increase in our inflation projections (see Inflation section below).

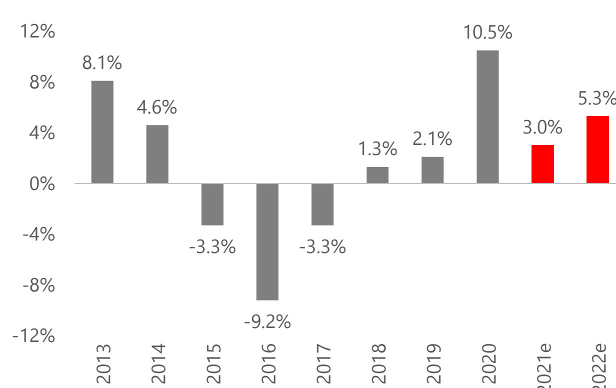
Risk factors for our baseline scenario: recent restrictions across the country due to a pandemic worsening likely to delay a recovery in personal income, while an increase in defaults and household indebtedness could induce a curbing of credit supply. For non-financial corporations, the same setbacks could lead to liquidity problems and higher indebtedness.

Figure 9-A. Total Corporate Financing (BRL billion, Inflation Adjusted)



Sources: Brazilian Central Bank, Anbima, Santander.

Figure 9-B. Forecast – Growth in Outstanding Loans (%, Inflation Adjusted)



Sources: Brazilian Central Bank, Santander.

INFLATION: Stronger and More Persistent Cost Shocks Pushing Up Inflation

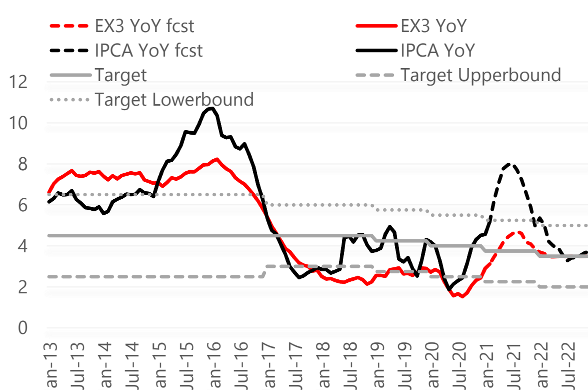
Since our last scenario revision, we made a major upward adjustment in our short-term forecast, and now we forecast IPCA 2021 ending the year above the target. For the medium/long term the adjustment was smaller, but enough to bring our IPCA 2022 forecast slightly above the target.

For the short term (until 2021 year-end), although we continue to see slowly recovering demand, we are incorporating an even higher cost-/supply-related shock. The major revision came in gasoline inflation, as oil prices surprised with a sharp increase, and this item has a strong and direct pass-through to IPCA. Besides oil, the industrial goods group's inflation has also risen, as it remains under upward pressure, with a more persistent negative effect of the pandemic on the global supply chain (alongside a depreciated BRL). Industry inventories remain low, and it will take more time until they recover (our estimate is 4Q21-1Q22, from 2Q21-3Q21 previously). In food-at-home, we did not change our forecast. On the negative side, agricultural commodities prices continue to be high. However, we still believe the group will decelerate from the strong rise in 2020, as pass-through becomes more difficult after an 18% YoY rise in 2020 and lower emergency income stimulus this year—although we do not see the space for further cooling off, as we estimate there is still substantial repressed inflation at the wholesale level. In services prices, there was no change in our forecast, which accounts for a slow recovery in line with a gradual reopening of the economy.

Looking ahead (2022), we continue to believe that the main shocks—although stronger and lasting much longer than expected—are temporary, so we expect the scenario to continue benign for the medium/long term, if there is no disruption in the fiscal regime leading to a de-anchoring of expectations. Regarding industry, we expect that pandemic-related distortions in the production chain should have ended by 2022, and inventories will be at a more normal level, while demand will still be recovering at a gradual pace, so the high idleness in the economy will play its usual role in curbing price increases more effectively. On food, our scenario is compatible with China's pork herd being already fully recovered, reducing somewhat the demand for proteins and soybeans, while the increase in agricultural income will result in bigger planted areas, which should prevent prices from rising significantly. Services prices will continue to rise at a gradual pace, in our view, in line with the weak job market. Finally, we expect administered prices to continue to suffer mild pressure from repressed adjustments from 2020. However, we have raised our forecast, basically accounting for the much higher inertia from 2021 causing some spillover to 2022.

With all these factors in place, we revised our IPCA 2021 forecast to 5.00% from 3.60% and our IPCA 2022 from 3.20% to 3.70%. Our 2021 forecast is way above the 3.75% BCB's mid-point IPCA inflation target (and close to the upper bound of 5.25%), while for 2022 it is slightly above the mid-target of 3.50%, at 3.70%. While above the target, we see the rise in IPCA 2022 as an accommodation of a substantial shock and not as hard evidence of the start of widespread inflation (at least not yet), although the risks are tilted to that side, particularly considering the fiscal risks.

Figure 10.A. – IPCA Headline, Cores, Forecasts (% YoY)



Sources: IBGE, Brazilian Central Bank, Santander.

Figure 10.B. – IPCA Details, Forecasts (% YoY)

	2018	2019	2020	2021e	2022e
IPCA	**3.8**	**4.3**	**4.5**	**5.0**	**3.7**
Free prices	**2.9**	**3.9**	**5.2**	**3.9**	**3.3**
Food-at-home	**4.5**	**7.8**	**18.2**	**5.1**	**2.0**
Industrial goods	**1.1**	**1.7**	**3.2**	**4.4**	**3.8**
Tradables	1.0	1.7	3.2	4.4	3.8
Non-Tradables	1.9	1.8	3.0	4.4	3.8
Services	**3.4**	**3.5**	**1.8**	**3.1**	**3.5**
Food-service	3.2	3.8	4.8	5.6	5.0
Airline tickets	16.9	2.3	-17.2	15.0	12.0
Economic activity	1.7	2.9	0.7	1.9	2.5
Education	5.5	5.0	1.1	3.0	5.0
Inertial	2.8	3.4	2.9	3.0	3.1
Salaries	3.7	3.2	1.8	2.4	2.5
Administered prices	**6.2**	**5.5**	**2.6**	**7.9**	**4.8**
Gasoline	7.3	4.0	-0.2	19.1	4.5
Energy	8.7	5.0	9.1	-1.3	4.0
Health insurance	11.2	8.2	2.5	13.1	8.0
Bus fares	6.3	6.6	1.3	1.6	6.0
Cores	3.3	3.5	2.8	3.8	3.5

Sources: IBGE, Brazilian Central Bank, Santander.

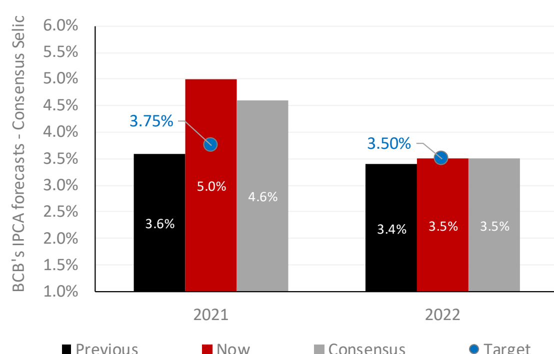
MONETARY POLICY: Sooner, Faster, Greater Hikes (Than Previously Thought)

At the last Copom meeting[8], the Brazilian Central Bank (BCB) raised the Selic rate by 75 bps, to 2.75%, in line with the more hawkish camp of market participants. This decision kicked off what the authority is calling (at least for now) "a process of partial normalization". In the statement, the BCB justified the faster pace with a belief that "a swifter adjustment has the benefit of reducing the probability of not meeting the inflation target in 2021, as well as of keeping longer horizon expectations well anchored." The BCB sees this strategy as consistent with achieving the mid-target next year. At the next meeting, the board expects to maintain the pace, with another 75-bp hike. The BCB models point to a Selic of 4.50% at YE2021 and 5.50% at YE2022 as sufficient to keep 2021 IPCA below the upper target (5.25%) and 2022 IPCA at mid-target (3.50%), with the FX rate at ~BRL5.70/USD.

In its minutes[9], however, the Copom confirmed that the asymmetry in the balance of risks justified faster hikes than implied by the inflation simulation in the baseline scenario. In recent communications, the committee has presented sanguine views of the economy, seeing a strong activity recovery in recent months, a faster than expected reduction in job-market slack, and expecting a solid economic rebound when the effects of the vaccination process start to materialize (2H21). On inflation, despite the assessment that mounting cost pressures are temporary, the BCB sees the influence of positive demand shocks (i.e. strong spending). Several members of the Copom saw risks of second-round effects from the higher inflation of late (through inflation expectations for 2022, the key policy horizon). The 1Q21 inflation report[10] shed a bit more light on the BCB's views: the authority forecasts 2021 GDP at +3.6% (previously +3.8%), with downward effects from the pandemic partly offset by a better carryover from 2020 and positive data early in 1Q21. According to the BCB, the economy is about 3.2% below its potential in 1Q21, and the output gap is expected to close in 2022, as the BCB anticipates a strong recovery in 2H21 on the back of widespread administration of COVID-19 vaccines.

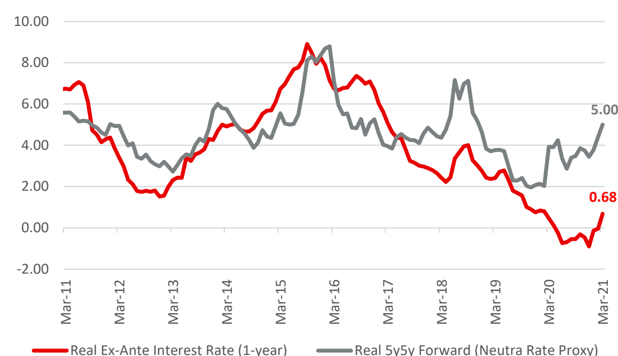
We revised our YE2021 Selic rate forecast to 5.50% (previous: 4.00%), incorporating an additional hike of 75 bps in May and four subsequent moves of 50 bps until October 2021. Our estimate is consistent with a an *ex post* real rate around ~0.5% and an *ex ante* real rate around 2.5%, assuming no major changes in inflation and policy expectations until year-end. We continue to anticipate a two-stage normalization process, with hikes restarting (at a pace of 50 bps per meeting) at the last meeting of 2022, reaching (what we today see as) a neutral level of 7% in nominal terms (or 4% in real terms) at the end of 1Q23. Indeed, our revised estimate for the terminal rate follows a likely increase in the structural level of interest rates in Brazil, given the rise in the fiscal risks. Importantly, as these estimates assume a scenario of no disruption in the fiscal regime, we see clear upside risks to our expected path for the Selic rate.

Figure 11.A. BCB's Inflation Simulations



Sources: Brazilian Central Bank, Santander.

Figure 11.B. Interest Rates and Monetary Stimulus



Sources: Brazilian Central Bank, Bloomberg, Santander.

FORECASTS: Santander & Consensus

[8] **Santander Brazil Monetary Policy - *"Harder (stance), Better (activity), Faster (pace), Stronger (shocks)"* –** March 18, 2021- Available on: http://bit.ly/Sant-copom-mar21
[9] **Santander Brazil Monetary Policy - *"Keeping the Hawkish Tone"* –** March 23, 2021 - Available on: https://bit.ly/Sant-Copom-230321
[10] **Santander Brazil Macro Compass - *"Mounting Concerns About The Pandemic And The Budget"* –** March 26, 2021 - Available on: http://bit.ly/Sant-Macrocomps-260321

Figure 12-A. Evolution of Santander and Consensus Forecasts for 2021 Since Our Last Scenario Revision

	2021E					
	Consensus			Santander		
	11-Feb-21		26-Mar-21	11-Feb-21		26-Mar-21
IPCA Inflation (%)	3.7	↑	4.8	3.6	↑	5.0
GDP Growth (%)	3.4	↓	3.2	2.9	↑	3.0
Selic policy rate (%, year end)	4.00	↑	5.00	4.00	↑	5.50
Exchange rate (USD/BRL, year end)	5.02	↑	5.33	5.20	↑	5.25
Current Account (USD billion)	-12.6	↑	-11.2	17.6	→	17.6
Primary Budget Balance (% GDP)	-2.8	↓	-3.1	-3.1	↓	-3.2
Net Govt. Debt (% GDP)	64.0	↑	64.8	65.4	↓	62.4

Note: Based on the BCB's Focus reports.
Sources: Brazilian Central Bank, Santander estimates.

Figure 12-B. Evolution of Santander and Consensus Forecasts for 2022 Since Our Last Scenario Revision

	2022E					
	Consensus			Santander		
	11-Feb-21		26-Mar-21	11-Feb-21		26-Mar-21
IPCA Inflation (%)	3.5	↑	3.5	3.2	↑	3.7
GDP Growth (%)	2.5	↓	2.3	2.3	↓	2.0
Selic policy rate (%, year end)	5.00	↑	6.00	4.50	↑	6.00
Exchange rate (USD/BRL, year end)	5.00	↑	5.26	5.40	↑	5.55
Current Account (USD billion)	-25.2	↓	-26.8	7.3	→	7.3
Primary Budget Balance (% GDP)	-2.1	→	-2.1	-2.2	→	-2.2
Net Govt. Debt (% GDP)	65.4	↑	66.2	67.8	↓	64.7

Note: Based on the BCB's Focus reports.
Sources: Brazilian Central Bank, Santander estimates.

MAIN RISKS

Figure 13. Summary of Main Risks to Our Macroeconomic Scenario for Brazil

THEME	MAIN RISKS
International	• Eventual outbreak of variants of coronavirus that prove more contagious and/or highly resistant to the available vaccines, causing new setbacks in the reopening process in key regions. • A hypothetical building of inflationary pressures following the massive fiscal stimulus in the U.S., eventually prompting the Fed to start rolling back the monetary stimulus sooner than expected.
Commodities	• Upside risk: additional economic and fiscal stimulus (especially in China and the U.S.) could boost prices even further in the short run. Weather risk from La Niña could marginally risk LatAm 2020-2021 crops. • Downside risk: delays in vaccination or new virus variants could trigger tightening in mobility conditions, weighing on consumption.
COVID-19	• Upside risk: more vaccines could soon be approved, increasing the number of available doses and pulling forward our vaccine forecasts. Given Brazil's tradition of nationwide vaccination, risks are strongly tilted to the optimistic scenario, where the entire population is vaccinated by end-2021. • Downside risk: global shortage of vaccine supplies could delay the vaccination process. Current vaccines could be ineffective against new coronavirus variants.
Fiscal Policy	• Upside risk: approval of reforms with a significant fiscal impact, reducing the idiosyncratic risk. • Downside risk: loss of credibility in the fiscal consolidation process, causing financial conditions to deteriorate. Changes in the current fiscal framework without addressing the country's structural problems. Policy changes damaging the credibility of the constitutional spending cap.
Balance of Payments	• Upside risk: commodity prices not declining in 2022, thus opening room for a larger trade balance surplus and, consequently, for a larger current account surplus. • Downside risk: frustration with the institutional environment leading to the departure of portfolio flows and to the reduction of direct investments in the country.
Economic Activity	• Upside risk: Massive vaccination campaign unrolls faster than expected, increasing mobility and positioning the services sector to recover earlier than expected. • Downside risk: Tighter social distancing measures lasting longer than expected, continued shortage of inputs in manufacturing, and delays in the vaccination campaign would likely set back the process of economic resumption from mid-2Q21 onward.
Inflation	• Upside: risks: (i) a slower recovery of industry (and inventories) increasing supply-related costs; (ii) in the same fashion, a more intense and persistent exchange rate pass-through on industrial goods; (iii) another round of depreciation in the exchange rate (related to fiscal risks); (iv) a higher transmission of the cost-related shocks to general prices (services, for example); and (v) de-anchoring of inflation expectations (related to fiscal risks) • Downside risks: (i) cost/supply-related shocks could normalize faster than we expect; (ii) the fiscal cliff (i.e., reduction of emergency stimulus) may hit demand harder than we anticipate and result in lower inflation; and (iii) BRL could appreciate more than we estimate, as BCB hikes the interest rate, raising the carry of the currency.
Monetary Policy	• Upside risk: new shocks in volatile prices may raise further fears of secondary-round effects (expectations). Fiscal policy decisions could lead to de-anchoring in inflation expectations. • Downside risk: vaccination delays, mobility restrictions, and the fiscal cliff could all affect the activity recovery. A slower than expected improvement in the labor market could keep slack greater for longer (e.g., in services).

Sources: Santander.

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