Fixed Income & Economics Daily

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FX & RATES STRATEGY RESEARCH

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ECONOMICS

- **BRAZIL: Macro Compass – Five Reasons for an Extended Monetary Easing Cycle**
- **POLAND: Labor Market Data Slightly Below Expectations**
- **POLAND: Core CPI Fell in February, HICP Plunged**
- **POLAND: Exports Below Expectations, But Did Not Disappoint**

LATAM ECONOMICS

BRAZIL MACRO COMPASS

ECONOMICS

Five Reasons for an Extended Monetary Easing Cycle

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Upcoming Data: We Expect a 25-bp Cut at Next Week's Copom Meeting

Brazil's Monetary Policy Committee (Copom) meets next week (on Wednesday) for its last rate decision this quarter. We expect the monetary easing cycle that began in October 2016 to continue, with the overnight policy rate (Selic) falling to 6.5% per year. Copom will probably, in our view, leave the door open for an additional cut in May should inflation expectations continue to fall. Our call is sustained by the following factors:

1. **Current inflation continues to surprise to the downside**. CPI inflation between December 2017 and last February (the period for which the Central Bank provided short-term estimates in its *December Quarterly Inflation Report*) came in 25 bps below Copom's official forecasts. Year-to-date median market expectations for YE2018 annual inflation were revised from 3.96% to 3.67% (our forecast is 3.5%), while Copom's main forecast for that variable was still at 4.2% in the February meeting. An update is likely to bring this estimate closer to market consensus and justify new rate cuts, in our view.
2. **It's not only about food prices…** Foodstuff prices, which fell 4.9% in 2018, continue to push headline inflation down, but this effect is getting weaker, as prices normalize. Conversely, core inflation and components more sensitive to the economic cycle continue to decelerate: 12-month core inflation fell 62 bps year to date (to 3.22% in February), with 12-month service inflation moving from 4.52% to 4.2% in the same period. We expect core inflation to remain around the current level for the remainder of the year.
3. **The external scenario remains benign**. A reversal of the benign international scenario is a risk factor often mentioned by Copom that still has not materialized. Since the February meeting, both 10-year U.S. Treasuries and Brazil country risk have traded sideways.
4. **The economic recovery has been gradual**. The latest data has been weakening forecasts of a stronger-than-consensus GDP growth in 2018 (see "What's New" below), implying a slowly narrowing output gap and few inflationary pressures from demand.

5. **Copom has been in data-dependent mode**. In the February minutes, the Committee stated that low and falling core inflation could open room for additional monetary easing, and we believe this is exactly what most recent indicators have been showing. This stance is likely to be kept next week, in our view.

On Monday, the Central Bank releases its monthly GDP proxy for January. We expect 3.2% y/y growth, with the indicator contracting 0.5% in the month. Finally, on Friday, IBGE releases its preliminary CPI inflation reading (IPCA-15) for March. We expect monthly inflation at 0.08%, with 12-month inflation decelerating to 2.78% (from 2.86% on February IPCA).

What's New: Weak January Data

January retail and services volume data, released this week, surprised to the downside, offsetting part of the strong December economic activity performance. Core retail sales were up 3.2% y/y (consensus: 3.4%), while the volume of services fell 1.3% m/m (consensus: +0.8%). We attribute a slightly downward bias to our 3.2% 2018E GDP growth forecast.

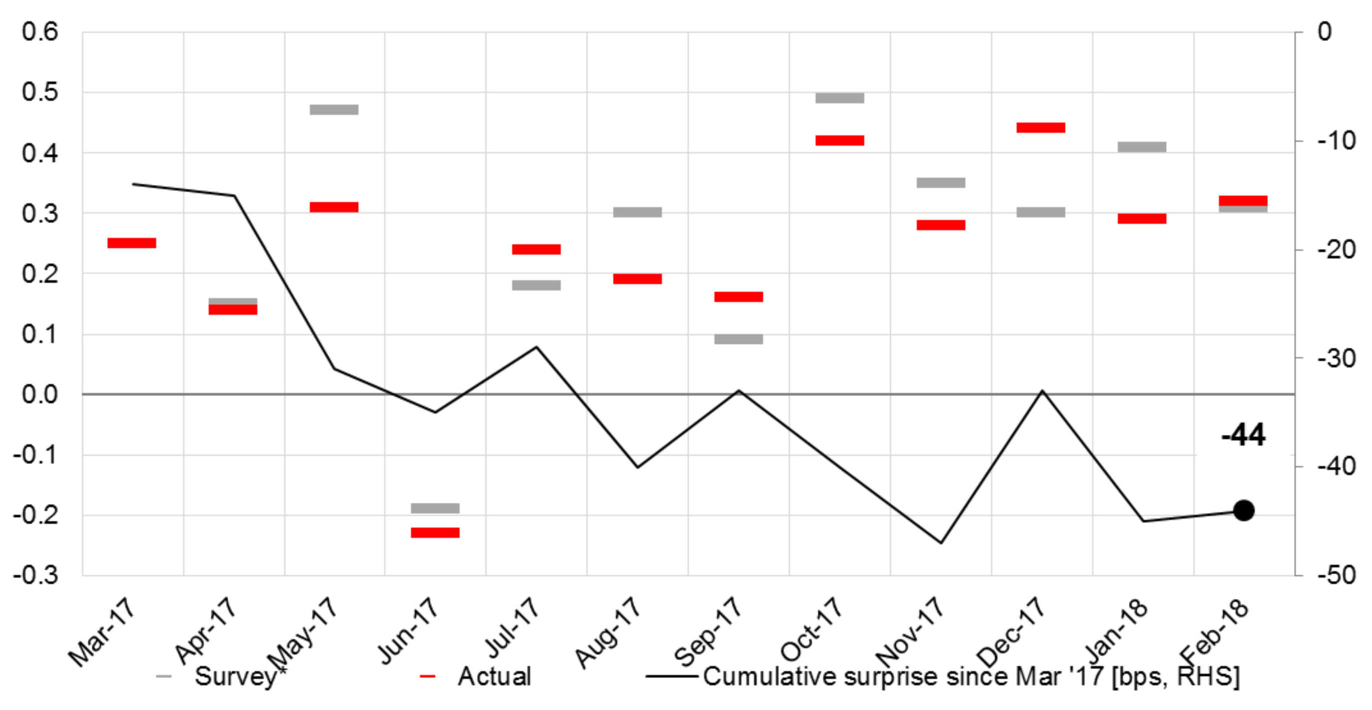
In-depth Research: Normalizing Food Prices

In *Food (Inflation) for Thought (2): Forecasts* (March 9, 2018), we continue analyzing the expected dynamic of food prices in the next months. We use own forecasts for the commodity prices more relevant to Brazil's food consumption basket to back our estimates for the foodstuff sub-item, which weighs 16% in the headline index and was responsible for most of the strong disinflation of 2017. We expect food inflation at around 4% in 2018.

Chart of the Week: A Year of Positive Inflation Surprises

Over the past year, Brazil's CPI inflation has been consistently surprising to the downside. The cumulative surprise in the last 12 months is 44 bps, one of the main reasons behind our most recent revisions on the monetary policy call (see more in the "Upcoming Data" session above).

Brazil—Monthly CPI Inflation (%), Survey vs. Actual



*Median of Bloomberg's survey. Sources: IBGE, Bloomberg, Santander.

Political Agenda: What Do Brazilians Expect From the October Elections

Congress remains in a deadlock while the “party window” is open, with negotiations between parties and representatives willing to change sides dominating the legislative agenda. Parties are reluctant to appoint members to important house committees while loyalties remain unclear, and this situation should prevail, in our view, until April 6, when the “party window” closes.

The National Industry Confederation’s “Portrait of the Brazilian Society” survey was released this week, focusing on issues pertinent to presidential elections. According to the survey, 44% of the Brazilians are pessimistic regarding elections, mostly because of corruption and lack of confidence in the candidates. Also 44% of those polled believe that the focus of the future president should be on broadly defined “social change”, including education, healthcare, public security and inequality reduction. Surprisingly, only 21% of the sample said that economic stabilization should be a top priority, which might frustrate those expecting the ongoing recovery to benefit candidates somehow linked to the government.

Number of the Week

48%

Almost half of Brazilian electors do not support or sympathize with any political party, according to a recent CNI/Ibope survey. The Workers’ Party (PT) is still the most popular in the country, preferred by 19% of those polled.

Quote of the Week

A country with 206 million mouths to feed can’t think about deindustrializing.

— Ciro Gomes, PDT’s pre-candidate for the presidency, quoted by *Valor* (March 15, 2018).

What We’ve Been Reading

- “Brazil Mutual Funds Seeing Strong Inflows” (*Emerging Market Views*). Multi-market funds led record inflows (USD 80 billion) to the Brazilian fund industry in 2017.
- *Preparing Brazil for the future of work: Jobs, technology, and skills*, by Nicola Calicchio, Michael Chui, and Nicolas Grosman (McKinsey Global Institute). The authors estimate that the equivalent of around 15.7 million full-time jobs could potentially be displaced in Brazil by 2030 due to automation technologies.
- “Russia’s credit rating rises; Brazil’s falls” (*The Economist*). A few days after Fitch downgraded Brazil to BB-, in February, S&P Global raised Russia back to investment grade.
- “In Brazil, nostalgia grows for the dictatorship — not the brutality, but the law and order”, by Marina Lopes (*The Washington Post*). Public security should be a top issue in the elections, and a large share of the population associate law and order with the military dictatorship that ended in 1985.
- “Violent crime in São Paulo has dropped dramatically. Is this why?”, by Roberto Muggah and Ilona Szabó de Carvalho (*World Economic Forum*). In contrast to other Brazil states, São Paulo’s homicide rates have been continuously falling for almost two decades – in São Paulo City, that rate is now five times lower than the national average. The authors attribute this to improvements in law enforcement practices and stricter control on firearms.

Recent Publications (Available on Our Website)

- *Food (Inflation) for Thought (2): Forecasts* (March 9, 2018)
- *Food (Inflation) for Thought: Relative Prices* (March 7, 2018)
- *One-Off Is Not Enough* (February 20, 2018)
- *Even Better Than the Real Thing* (February 15, 2018)
- *Social Security Reform: Same Proposal. Different Probability?* (February 8, 2018)

ECONOMICS

Labor Market Data Slightly Below Expectations

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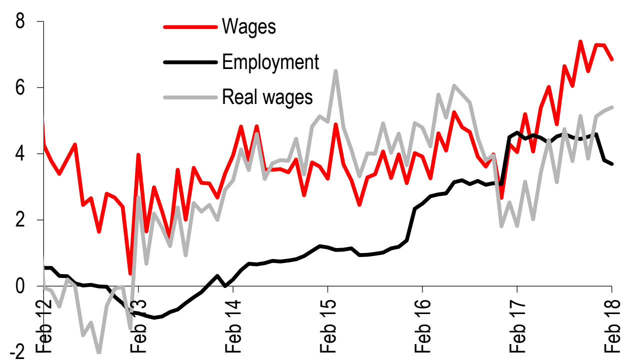
Employment in the corporate sector rose 3.7% y/y, or 10.4k m/m, in February, slightly lower than we expected (3.8% and 14k). Employment growth was weaker than in February 2017 (16.5k), but stronger than in 2012-2016, so we cannot call it a major disappointment. **In our view, demand for labor remains strong in the Polish economy, as demonstrated by rising numbers of job offers.**

Wages rose 6.8% y/y, less than expected by us (+7.5%) and consensus (+7.2%). We do not yet know which category was responsible for the deceleration vs. January's +7.3%, but this will be revealed in the Statistical Bulletin on March 23. The effect from a lower number of working days was partially responsible for this slowdown, particularly in case of manufacturing, but there might have also been some shifts in the timing of bonus payments in mining. Some big mining companies reintroduced the so-called 14th wage bonus. We assumed these bonuses would be disbursed in February, but today's reading suggests it could happen in a different month. **In our view, wage growth will return to above 7% y/y in the months to come.**

In February, the real wage bill in the enterprise sector rose 9.3% y/y, on the same scale as in January and above the average growth in 2017 (+8.3% y/y). **The strong growth of household incomes should be supportive of private consumption, which we expect to rise c5.0% in 1H2018**.

Labor market statistics, % y/y



Source: Stats Office, BZ WBK.

ECONOMICS

Core CPI Fell in February, HICP Plunged

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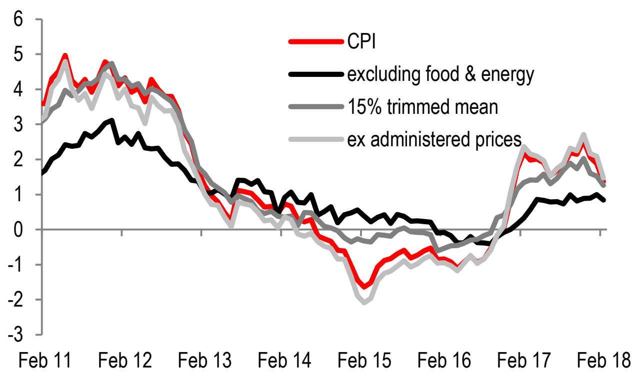
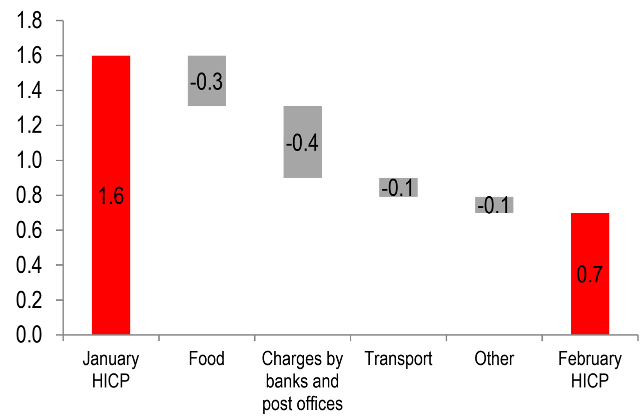
Core inflation ex food and energy fell to 0.8% y/y in February from 1.0% y/y in January, breaking the gradual upward trend observed over the last few months. Core inflation is one of the key elements for the Monetary Policy Council and its decline is supportive of the MPC's dovish message. **We still expect core CPI to rise towards 2.0% y/y at the end of 2018, and this would be one of the arguments encouraging the MPC to hike rates in late 2019.**

February HICP for Poland plunged to 0.7% from 1.6% in January. The eyebrow-raising decline in HICP was markedly greater than the reduction in CPI (to 1.4% from 1.9%), with **core HICP falling to 0.1% in February from 0.9% in January**. Analysis of detailed data finds that this plunge can be attributed mostly to a strong decline (-14% y/y) in a small category "charges by banks and post offices". This category subtracted as much as 0.4pp from HICP and 0.7pp from core HICP. Data corrected for this category (HICP at 1.1% and core HICP at 0.8%) are in line with CPI trends. We have no clue what drove the decline in "charges by banks and post offices", and would not rule out the possibility of erroneous data.

CPI and core CPI, % y/y



Breakdown of change in HICP, pp



Stats Office, Eurostat, BZ WBK.

ECONOMICS

Exports Below Expectations, But Did Not Disappoint

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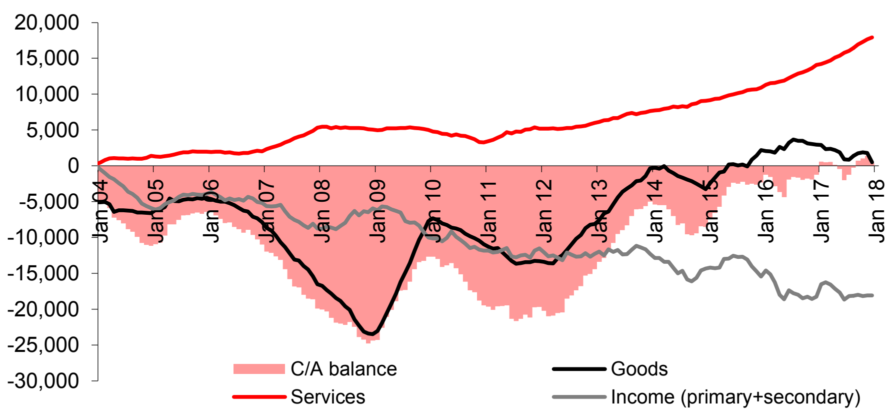
In January, the current account surplus hit €2bn, in line with our expectations (€1.9bn). Exports amounted to €16.9bn (+10.5% y/y), imports were €17.1bn (+15.4% y/y). Thus, the NBP data did not confirm the worrying signals from the Statistics Office, implying January exports at about €16.0bn.

The trade deficit amounted to €0.2bn. In 2017, Poland's foreign trade balance was positive; **for 2018, we expect a trade deficit, as strong consumption and a rebound in investment should accelerate imports.** January data showed a continuation of positive trends in services exports (+17.1% y/y with a positive balance of +€1.6bn) as well as positive income balance (€0.6bn), supported by Common Agriculture Policy funds flow from the EU. **The 12-month current account balance was neutral at 0.0% of GDP**. We expect this measure to improve in the quarters to come, driven by strong services exports and higher income inflows from the EU.

Current account balance, 12-month rolling (EUR mn)



Stats Office, Eurostat, BZ WBK.

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