BRAZIL MACRO February 1, 2023

MONETARY POLICY DECISION

PUSHING BACK EXPECTED RATE CUTS

Mauricio Oreng
mauricio.oreng@santander.com.br
+5511 3553 5404

- In its 252nd Copom meeting, the Brazilian Central Bank (BCB) again maintained the Selic policy rate at 13.75%, as widely expected.
- While we already expected a little tightening in the tone of the BCB, the Copom statement turned out to be more hawkish than we had been looking for. In terms of policy signals, the BCB clearly upped the tone further on the inflation risks, as fiscal uncertainties remain high and inflation expectations keep rising and drifting further away from the path of the mid-point targets. The BCB believes that "this scenario raises the cost of the disinflation that is needed to reach the targets established by the National Monetary Council."
- Overall, the latest developments have made the BCB much less confident that the path for the Selic rate as projected by analysts (interest rate on hold at 13.75% until September, then falling to 12.50% for YE2023 and 9.50% for YE2024) will suffice to assure inflation convergence to the target. The official inflation forecasts now send this very signal, showing a clear deterioration from the previous publication (December), driven mainly by the increase in inflation expectations.
- The BCB also adjusted its policy wording by claiming now that it will continue to assess "if the strategy of maintaining the Selic rate for a **longer period than in the reference scenario** will be enough to ensure the convergence of inflation."
- The Copom minutes, out next Tuesday (February 7), may shed further light on the BCB's scenario assessment and policy strategy. Judging from the tone of the statement, the BCB now seems to envisage a strategy of holding interest rates steady for even longer, in a response to the fiscal risks and spillovers (of the whole economic policy debate) on inflation expectations.
- For many months, we have been forecasting the YE2023 Selic rate at 12.00%, which happened to be an above-consensus call for quite some time until December (but not anymore, of course). There is little doubt that the odds are for the start of rate cuts to take even longer and for the whole eventual easing process to unfold much more slowly than previously thought.

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.
U.S. investors' inquiries should be directed to Santander Investment Securities Inc. at (212) 583-4629 / (212) 350-3918.
* Employed by a non-US affiliate of Santander Investment Securities, Inc. and is not registered/qualified as a research analyst under FINRA rules.

POLICY DECISION AND FLIGHT PLAN

In the 252nd monetary policy meeting of the Brazilian Central Bank (BCB), the Copom[1] kept the Selic rate at 13.75%[2]. The decision was in line with analysts' forecasts[3] and the yield curve.

The Copom statement turned out to be even more hawkish than we expected. In terms of policy signals, the BCB clearly upped the tone on the inflation risks, as fiscal uncertainties remain high and inflation expectations keep rising and moving further away from the path of the mid-point targets, both for the medium and long run. Judging from the BCB's tone, these elements are likely making the authority much less confident that the path for the Selic rate as projected by analysts[4] (with interest rate on-hold at 13.75% until September, then falling to 12.50% for YE2023 and 9.50% for YE2024) will suffice to assure the inflation convergence to the mid-targets trajectory. The authority took the opportunity to reaffirm its commitment with the inflation targets (3.25% for 2023 and 3.00% for 2024: the latter is now the most important year-end horizon for the BCB).

The official inflation forecasts[5] showed a clear deterioration from the previous publication (December), driven mainly by the increase in inflation expectations. The BCB now estimates IPCA inflation at 5.6% for 2023 (previously 5.0%; consensus: 5.7%), and at 3.6% for 3Q24 (the key policy horizon as of now, using the BCB's rule of thumb for six-quarters ahead; in December the BCB estimated 3.3% for 3Q24). Inflation is seen by the BCB at 3.4% for 2024 (previously 3.0%; consensus: 3.9%) assuming the aforementioned consensus path for the Selic rate.

The BCB introduced another type of simulation (widely used in the past), assuming a stable path for the Selic rate at 13.75% for the entire forecasting horizon: this simulation yields an IPCA estimate of 5.5% for 2023, 3.1% for the 3Q24, and 2.8% for 2024. By presenting this alternative simulation, the BCB possibly intends to show us that, in their models, a path with no Selic cuts until 2024YE takes IPCA much closer to their objectives, as compared to the current consensus path for the Selic rate.

Given the numbers, it is no wonder that the BCB concludes that the conditions (especially when it comes to fiscal policy and inflation expectations) "requires further attention when evaluating risks." The BCB goes on saying that "this scenario raises the cost of the disinflation that is needed to reach the targets established by the National Monetary Council." The BCB also "reaffirms its commitment to set monetary policy to meet the targets." The BCB also adjusted its previous language by claiming it will continue to assess if "if the strategy of maintaining the Selic rate **for a longer period than in the reference scenario** will be enough to ensure the convergence of inflation." The emphasized words replaced the previous plan of a stable Selic rate "**for a sufficiently long period**".

Reaffirming its commitment not only to the disinflation process but also to the process of re-anchoring expectations, the Copom notes that inflation expectations "have shown deterioration at longer horizons since the previous meeting." The BCB also continued to claim that "future monetary policy steps can be adjusted" and that it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected".

BALANCE OF RISKS, SCENARIO ASSESSMENT

Despite the lack of major changes in the balance of risk analysis, the aforementioned policy signal sent by the BCB -- with the Copom considering now a flight plan for the Selic rate implying a tighter path compared to the consensus – is probably an implicit signal that the upside inflationary risks are prevailing (on the downside risks), probably generating an asymmetry in the perceived outlook. Still

[1] The Copom is the monetary policy committee of the Brazilian Central Bank.
[2] Refer to the statement of Copom #252 in English (https://www.bcb.gov.br/en/monetarypolicy/Copomstatements) and Portuguese (https://www.bcb.gov.br/controleinflacao/comunicadoscopom).
[3] **Santander Brazil Monetary Policy: "*Copom Preview: Eyeing the Balance of Risks*"** – January 30, 2023 – Available on: https://bit.ly/Std-COPOM-p-feb23
[4] Refer to the last BCB's Focus survey among professional forecasters, as of January 27, 2023 (https://www.bcb.gov.br/en/publications/focusmarketreadout)
[5] The simulations assume USD/BRL at 5.15 and then evolving with the purchasing power parity (PPP) as well as oil price following the futures curve for the next six months and then stable in real terms in USD. The scenarios assume energy tariff flag "yellow" for both December 2023 and 2024.

the BCB apparently chose not to explicitly refer to the netting out of upside and downside inflation risks, at least for now. As per the composition of the future CPI risks, the BCB continues to view as upside risks i) “greater persistence of global inflationary pressures”, ii) “heightened uncertainty about the country's future fiscal framework and fiscal stimuli that support aggregate demand” and iii) “an output gap tighter than the one currently adopted by the Committee”. On the opposite side, i) further declines in commodity prices, ii) an even slower global activity and iii) “the continuity of tax cuts assumed to be reversed in 2023” are seen as downside risks.

Elsewhere in the statement, the scenario assessment portraits the BCB a bit more sanguine (or, better said, less bearish) on the global developments, as “recent global activity data has shown some resilience”, and the BCB believes that the “relaxation of sanitary restrictions in the Chinese economy attenuates the possibility of new global supply chain disruptions”. Still, the “global environment continues to be adverse and volatile”, amid persistent global inflation (“despite more positive signs at the margin”), tight monetary policy in DMs, and expectations of below-potential global growth.

The authority still sees the local activity data confirming the Copom’s scenario of slower demand growth going forward. On inflation, while highlighting some moderation in CPI of late, the BCB affirms that “consumer inflation as well as the various measures of underlying inflation are above the range compatible with meeting the inflation target.”

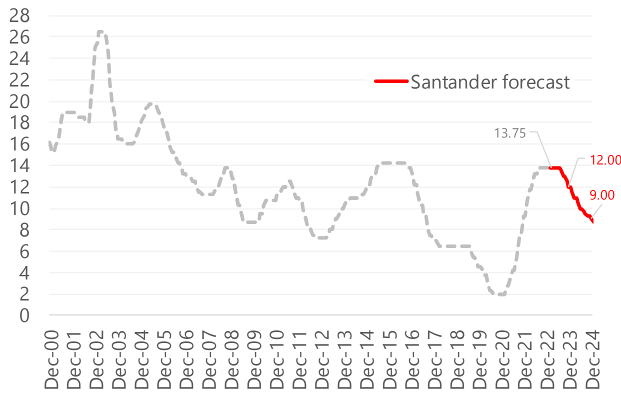
WHAT TO EXPECT AHEAD?

Next Tuesday’s Copom minutes will likely shed further light on the BCB’s scenario assessment, perceived risks, and policy strategy. Judging from the tone of the statement, the BCB is now envisaging a strategy of holding interest rates steady for even longer (than previously thought), given the fiscal risks and the spillovers (of the whole economic policy debate) in inflation expectations.

For many months, we have been forecasting YE2023 Selic rate at 12.00%, which happened to be an above-consensus call for a long period until December (but not anymore, of course). We sense **there is little doubt that the odds are for the start of rate cuts to take even longer and for the whole eventual easing process to unfold much more slowly than previously thought.**

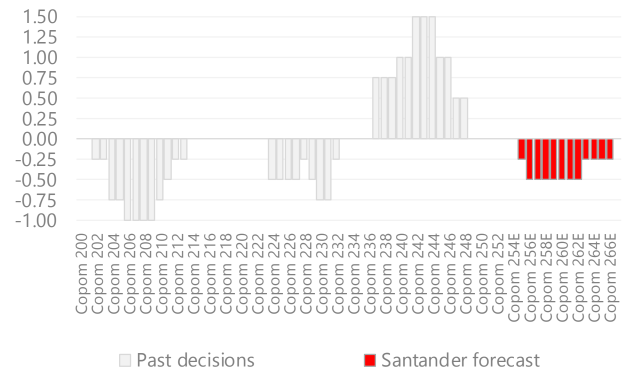
Refer to graphs on the next page.

Figure 1. The Path for the Selic Policy Rate (monthly average, % p.a.)



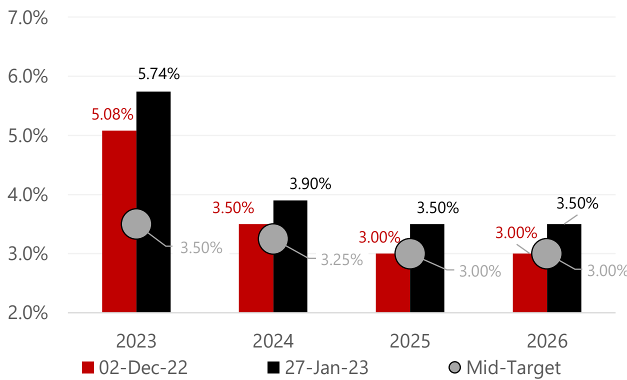
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 2. Selic Rate Moves in Copom Meetings: History and Forecast (in percentage points)



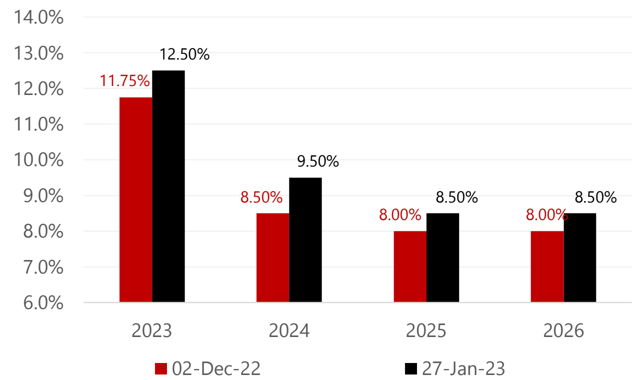
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



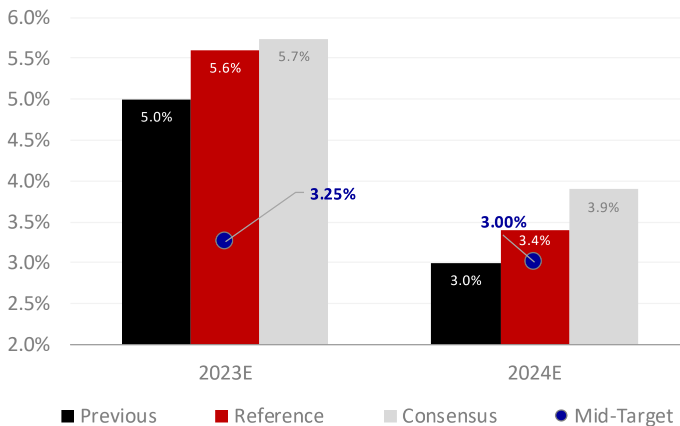
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 4. Median Annual Selic Forecasts (Consensus)



Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 5. BCB's Inflation Estimates (% Annual IPCA) – Reference Scenario



Sources: Brazilian Central Bank, Santander.
Note: Assuming FX rate departing from USD/BRL 5.15, and then moving along with the PPP (purchasing power parity). Oil price following the futures curve for six months and stable in real terms in USD. Uses consensus forecast for the future path of interest rate.

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 Vasquez*	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
Murilo Riccini*	Head, Chile	murilo.riccini@santander.cl	56 22336 3359

Electronic

Bloomberg	SIEQ <GO>
Reuters	Pages SISEMA through SISEMZ

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Mauricio Oreng*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

© 2022 by Santander Investment Securities Inc. All Rights Reserved.