BRAZIL MACRO **September 27, 2022**

MONETARY POLICY – COPOM MINUTES

INCREASED CAUTION PUTS BCB IN WAIT-&-SEE MODE

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

- The Brazilian Central Bank (BCB) published the minutes of its September 20-21 Copom policy meeting, when the authority held the Selic policy rate at 13.75%, interrupting a hiking cycle that had lasted for 12 meetings (since March 2021). All in all, the Copom minutes reaffirm our impressions after last week's statement.

- The BCB repeats the message that it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected", in the wake of the chosen strategy of "maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation."

- Given the split vote (7-2) against a hike of 25 bps in that meeting, the minutes explained the trade-off: on "the one hand, the additional interest rate increase would reinforce the vigilance stance and reflect the observation of a stronger than expected activity"; on the other hand, "caution and the need to evaluate, over time, the cumulative effects to be observed of the intense and timely monetary policy cycle already undertaken" were in favor of keeping rate. The two dissenters highlighted that "that the upside risks listed in the balance of risks may have longer-lasting impacts if they materialize, suggesting additional caution in assessing the reference scenario projections for the year 2024." We subscribe to that view. In general, the committee expects the impact of the tightening to be seen more clearly in economic activity (and in inflation) in 2H22.

- The BCB simulates an alternative scenario with the economy running at its potential (that is, a "zero" output gap), leading to IPCA estimates ~0.2-0.3 p.p. above the ones presented last week for the relevant horizons in the reference scenario. The "full-employment" IPCA numbers would be 4.9% (instead of 4.6%) for 2023 and 3.0% (instead of 2.8%) for 2024 – not much of a difference from a policy implementation standpoint.

- The minutes also shows an extensive discussion on the global economic scenario, seen as "adverse and volatile". Yet the authority believes that "a more tightening global monetary policy stance would have a disinflationary impact in Brazil in the medium term, as it leads to a widening of the global gap and less pressure on the prices of commodity and goods in general."

- Looking ahead, despite the message that the BCB could eventually turn back to "tightening mode", we believe a change in the flight plan (of rate stability for long) would require a massive deviation from the BCB's scenario. We continue to see the BCB dealing with inflation risks from now on by "autonomously" making its monetary stance more contractionary over time, with its policy steps lagging the gradual pace of decline in inflation expectations. Based on this view, our scenario anticipates that 2Q23 will see the tightest monetary policy stance in nearly 20 years.

- We pencil in a YE2022 Selic rate of 13.75%, as we see the room for imminent rate cuts narrowed by cyclical elements that could prompt a resilient inflation in the medium term (i.e., the absence of slack in both economy and employment). We do not expect rate cuts until 2H23, projecting a YE2023 Selic of 12.00%.

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OVERVIEW

The BCB published the minutes[1] of its September 20-21 Copom[2] policy meeting[3], with the authority keeping the Selic policy rate at 13.75%, interrupting a hiking cycle that had lasted for 12 meetings (since March 2021). In general, the minutes keep the tone of the statement, particularly reinforcing the BCB's message that the committee "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected", in the wake of the BCB's chosen strategy of "maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation."

DETAILS OF THE POLICY DISCUSSION

The Copom minutes provided more details on the policy options considered at last week's meeting, reminding the market that a 25-bp hike was under discussion. The talks among committee members followed the rationale that, on "the one hand, the additional interest rate increase would reinforce the vigilance stance and reflect the observation of a stronger than expected activity" but, on the other hand, "caution and the need to evaluate, over time, the cumulative effects to be observed of the intense and timely monetary policy cycle already undertaken would be in favor of the maintenance." The latter argument prevailed with seven committee votes. Interestingly, the two dissenters also highlighted that "that the upside risks listed in the balance of risks may have longer-lasting impacts if they materialize, suggesting additional caution in assessing the reference scenario projections for the year 2024." (Paragraphs #19 and #20)

The BCB continued to signal that the "monetary tightening cycle has been quite intense and timely" and that "due to the long and variable monetary policy lags, much of the expected contractionary effect and its impact on current inflation are still to be seen." The Copom expects the impact of the tightening to show more clearly on economic activity in the 2H22. Yet the BCB recognizes that "measures to sustain aggregate demand hinder a more precise evaluation about the stage of the economic cycle and the impacts of monetary policy." (Paragraph #18)

The minutes also show that, according to the BCB estimates, "the scenario using the interest rate trajectory extracted from the Focus survey (i.e., with Selic rate at 13.75% for YE2022 and 11.00% for YE2023), remains consistent with the strategy of inflation convergence to around the target over the relevant horizon". This focal horizon is the 1Q24, as thoroughly explained both in the communiqué and minutes. The authority also mentions that "if the alternative scenario of maintaining tax exemption on fuels in 2023 materialize, it will again emphasize horizons that include 1Q23". Yet the Copom stresses that this would have no significant impact on the interest-rate outlook, as the primary effects of the tax breaks are not influencing the Copom moves, according to the document. (Paragraphs #16 and #17)

Policy transmission was also discussed in the Copom minutes. The authority sees no problem in the functioning of the domestic credit mechanism, indicating that "the pass-through of the Selic rate to the final rates of different types of credit has occurred as expected", even with a greater than expected resiliency in corporate lending. The BCB keeps the view that "a large part of the impact of monetary policy is still to be observed, both in economic activity and inflation, and that there was no substantial change in the transmission channels of monetary policy." Naturally, the authority believes that, in time, the higher interest rate will also produce effects on the inflation side, as the BCB notes "there are several factors that may affect the path of services inflation, among them the drop in current inflation itself, which reduces the inertial effect on these items". Yet the BCB recognizes the upside risks for services inflation due to a stronger economy and pledges to keep monitoring this topic to check the adequacy of its strategy. (Paragraphs #10 and #11)

[1] Refer to the minutes of the 249th COPOM meeting in English (https://www.bcb.gov.br/en/publications/copomminutes).
[2] The COPOM is the monetary policy committee of the Brazilian Central Bank (BCB).
[3] **Santander Brazil – Monetary Policy: *"Copom Decision: Strong Words to Halt an Intense Cycle"* –** September 21, 2022- Available on: https://bit.ly/Std-Copom-sep22

COMPLEMENTARY VIEWS ON THE SCENARIO ASSESSMENT

Elsewhere in the minutes, the BCB provided details on its scenario assessment. On economic activity, the BCB cites a stronger than expected growth in the 2Q22 and reaffirms that "the set of indicators released since the previous Copom meeting still suggests that the economy kept growing at the margin [for the 3Q22], albeit more moderately." The job market is also seen in expansion, "although not completely reverting the real income decline observed in recent quarters." **On inflation, the authority recognizes that CPI remains high**, despite "the recent reduction in prices of more volatile items and the impacts of tax measures". While referring to the softening in industrial costs on the heels of "the decrease in producer prices and the reduction of pressures in global value chains", the BCB still sees "the components more sensitive to the economic cycle and the monetary policy, which present greater inflationary inertia" running above the target. (Paragraphs #4 and #5)

The authority also touched on discussions about the output gap. The Copom notes the high uncertainty of estimates on the degree of economic slack and notes a "discussion if the output gap is narrower than that currently used by Copom in its reference scenario." The BCB simulates an alternative scenario with the economy running at its potential (that is, a "zero" output gap), leading to IPCA estimates ~0.2-0.3 p.p. above the ones presented last week for the relevant horizons in the reference scenario. The numbers would be 4.9% (instead of 4.6%) for 2023 and 3.0% (instead of 2.8%) for 2024. Not much to make a difference from a policy implementation standpoint. (Paragraph #9)

The minutes also brings an extensive discussion on the global scenario, seen as "adverse and volatile". The BCB continues to expect a slowing global economic growth ahead, on the heels of "the reversal of countercyclical policies in major economies, the persistence of the war in Ukraine with its consequences on natural gas supplies to Europe, and the continuation of the Covid-19 policy in China." Despite the challenging global inflation environment, especially given the persistent effects of the employment cycle on services costs, the BCB believes that "an incipient normalization in supply chains and an accommodation in the prices of major commodities in the recent period, which should lead to a moderation in global goods-related inflationary pressures." (Paragraphs #1 and #2)

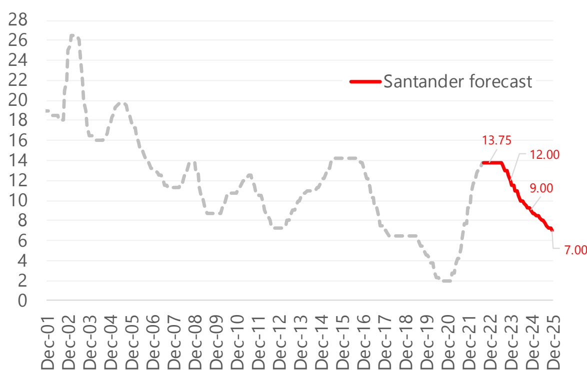
The BCB hopes the international environment may provide some help on the domestic inflation front. The Brazilian authority highlights the recent signals from the major (advanced economies') central banks, showing "monetary policy responses required to ensure the re-anchoring of inflation, as well as the determination present in the communication (…) to reduce inflationary pressures." The Copom believes that "a more tightening global monetary policy stance would have a disinflationary impact in Brazil in the medium term, as it leads to a widening of the global gap and less pressure on the prices of commodity and goods in general." (Paragraphs #7 and #8)

WHAT TO EXPECT AHEAD?

All in all, the Copom minutes reaffirms the impressions we got from the statement. By pausing (likely ending) the tightening cycle, the BCB shows confidence in its scenario of inflation convergence to around the mid-point target for the adjusted policy horizon, with annual IPCA expected to reach 3.5% in 1Q24, assuming the policy strategy of high rates for long. In our view, despite the remarks in the communiqué that the Copom could eventually continue the hiking cycle in the foreseeable future, we still believe that a change in the flight plan (rate stability for a sufficiently long period) would require a large deviation from the BCB's scenario. In fact, we see the BCB dealing with the inflation risks in the future by autonomously making its monetary stance more contractionary over time, with its policy steps lagging a bit the gradual speed of decline in inflation expectations. In fact, our scenario anticipates that 2Q23 will see the tightest monetary policy stance in more than 20 years. **We pencil in the YE2022 Selic rate at 13.75%, as we see the room for rate cuts in the short term, narrowed by cyclical elements that could generate risks of resilient inflation in the medium term**, especially with an apparently complete erosion of economic and job-market slack. We forecast a stable Selic until the end of 1H23 and look for gradual rate cuts to start in the 2H23, taking rate down to 12.00% by YE2023.

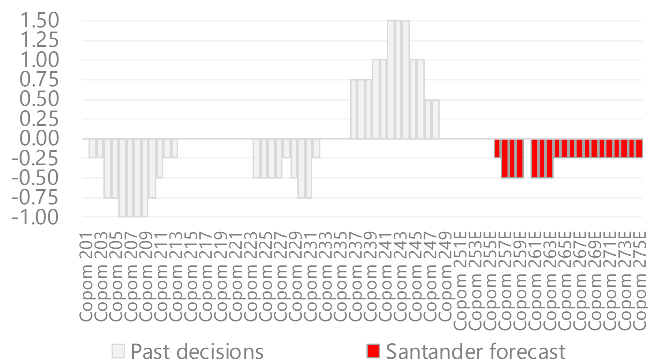
Refer to a few graphs in the next page.

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



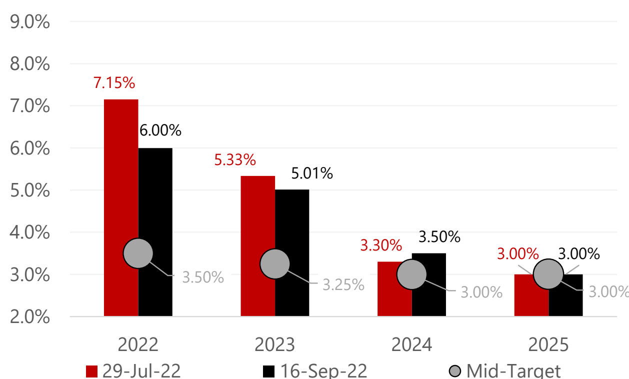
Sources: Brazilian Central Bank, Bloomberg, Santander.

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



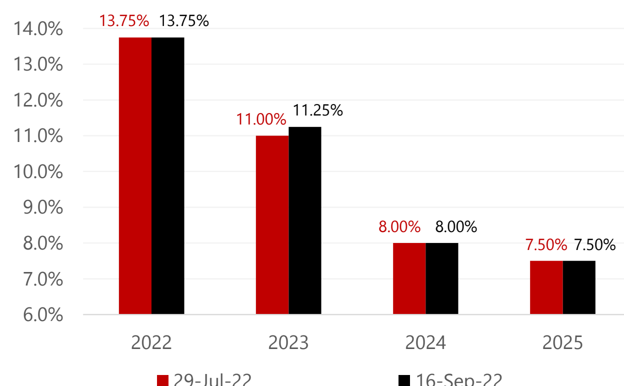
Sources: Brazilian Central Bank, Bloomberg, Santander.

Figure 3. Median Annual IPCA Forecasts (Consensus)



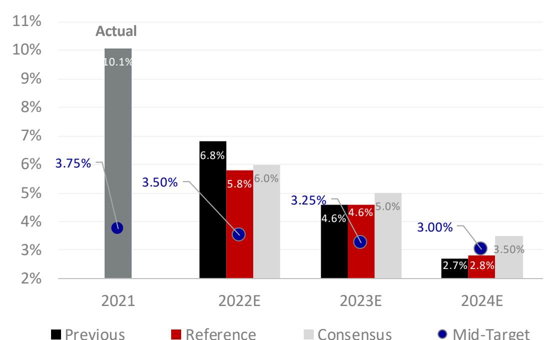
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 4. Median Annual Selic Forecasts (Consensus)



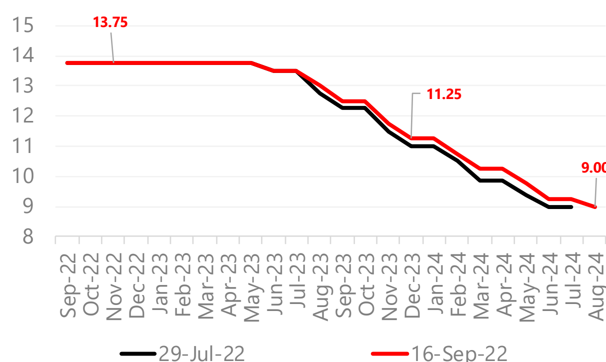
Sources: Brazilian Central Bank, Santander.
Note: Based on BCB's weekly Focus survey with professional forecasters (refer to https://www.bcb.gov.br/en/publications/focusmarketreadout).

Figure 5. BCB's Inflation Forecast (% annual)



Sources: Brazilian Central Bank, Santander.
Note: IPCA simulations assume Selic rate from the Focus survey and USD/BRL starting at 5.20 and evolving according to Purchasing Power Parity (PPP). Oil prices "follow approximately the futures market curve for the following six months and then start increasing 2% per year onwards."

Figure 6. Median Monthly 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).

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
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