BRAZIL MACRO

October 21, 2022

MONETARY POLICY PREVIEW

UNCHANGED STRATEGY EXPECTED

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- The Copom — the Monetary Policy Committee of the Brazilian Central Bank (BCB) — is scheduled to announce its interest rate decision next week (Wednesday, October 26).
- In line with consensus, we expect the BCB to hold the Selic (policy) interest rate at 13.75%. In the accompanying statement, we believe the BCB will reiterate its intention to assess "if the strategy of maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation." That will take some time, and more observation on the economy, the inflation (and expectations) trends and outlook.
- Since the last Copom meeting, we have seen few significant changes in the macroeconomic environment. On the international side, the data continue to point to strong inflationary persistence and a forceful reaction by the monetary authorities in several major advanced economies.
- In Brazil, despite weak activity in August, the numbers indicate still robust GDP growth (and job market conditions) in 3Q22. Regarding inflation, we have seen mixed developments in recent weeks, with improvement in current inflation, a virtual stabilization in expectations, and worrisome CPI composition. Financial conditions in Brazil have continued to tighten in October, mostly as a result of higher global interest rates and a higher country-risk spread.
- We continue to believe that a change in the flight plan (of rate stability for an extended period) would require a significant deviation from the BCB's scenario. We continue to pencil in a YE2022 Selic rate at 13.75%, with rate cuts seen only for 2H23.

SOME BACKGROUND ON THE LATEST POLICY MOVES AND SIGNALS

At its September meeting[1], the BCB sought to deliver a hawkish message to halt a tightening cycle that had extended for 12 meetings and brought a total interest rate adjustment of +1,175 bps (to 13.75%) since March 2021. The authority pledged to "remain vigilant" and said it will assess "if the strategy of maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation". The BCB claimed that it "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected". In our view, the decision to hold interest rate stable at this juncture shows the BCB's confidence in its scenario and strategy: the Copom estimates that inflation is poised to land somewhere close to the mid-target (at 3.5%) for 1Q24 — the main policy horizon now. BCB officials highlight that its scenario foresees inflation convergence to the mid-target assuming Selic cuts starting in June 2023.

THE CONTEXT FOR THE OCTOBER MEETING

Since the last Copom meeting, we have seen few significant changes in the macroeconomic environment. This means the BCB has room to maintain its strategy of holding interest rates at contractionary levels for a sufficiently long period.

On the international side, the data continue to point to strong inflationary persistence in the U.S. economy, causing the Federal Reserve to adopt a rapid pace of monetary tightening, advancing even further into contractionary territory. Other major central banks — for example, the European Central Bank (ECB) — are also signaling rapid monetary tightening toward a contractionary policy stance. The outlook continues to indicate that a slowdown in the main economies is already in the pipeline, which will amplify the headwinds for emerging economies.

In Brazil, despite the weakness in broad activity in August, the numbers indicate still robust GDP growth in 3Q22. The IBC-Br is running at a sequential quarterly pace of 1.2% QoQ-sa, and we project the IBGE's official GDP growth at 0.7% (meaning ~3% in annualized terms). The labor market continues to show good employment growth (including formal jobs), with preliminary signs of gains in average income, given the lowest unemployment since 2015 (~9%). In our calculations, not only does the economy continue to operate at around its potential (we estimate a positive output gap of about half a point), but also the unemployment rate is likely running below its structural level, which we estimate at an interval of 10-11%. We continue to anticipate a slowdown in economic activity, especially from 4Q22 onward, but we note that a resilient labor market may mitigate the (lagged) impact of a contractionary monetary policy.

On the inflation front, we have seen mixed developments in recent weeks. On the one hand, we see a continuing drop in headline inflation, mostly (but not only) reflecting the recent tax cuts on "essential goods", particularly energy. This drop in current inflation seems to have influenced the recent trend in expectations, even for longer horizons: since the last Copom, we note a slight reduction in inflation expectations for 2023 and 2024 (the relevant policy horizons). We calculate that the 18-months-ahead expectations fell to 4.20% (from 4.63% on the eve of the last policy meeting), narrowing the gap from the 18-months-ahead target (according to our estimate) to about 1.1 p.p. from 1.7 p.p. at the time of the last Copom meeting. Importantly, a good deal of that downward move has to do with the calendar adjustment as 3Q ends and 4Q begins[2]. However, not only do expectations (in the case of 2024) remain above the inflation target, but inflationary composition is also worrying, given the rapid increase for cyclical components — as shown by the IPCA EX3. That core measure includes services and underlying industrial goods, and its trend remains in double-digit territory in sequential quarterly terms (11-12% annualized), well above the medium-term inflation target. Additionally, the non-food diffusion index has been running just below 70%, nearly two standard deviations above the average for the low inflation period (2017-1H20). In other words, the items outside the realm of food are seeing widespread increases. Overall, the numbers mean that inflation pressures remain scattered across

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[1] **Santander Brazil Monetary Policy: "*Strong Words to Halt An Intense Cycle*"** – September 21, 2022 – Available on: https://bit.ly/Std-COPOM-sep22

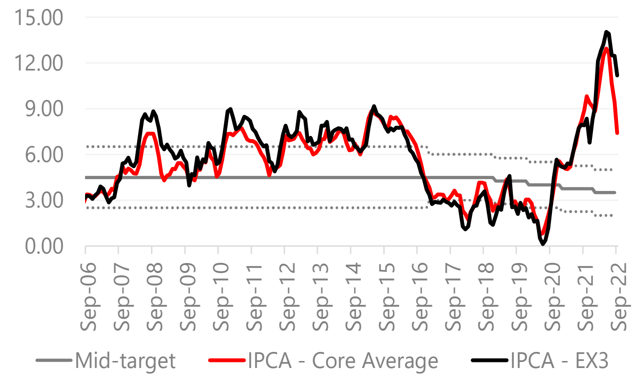
[2] The rule of thumb for the key (18-month ahead) policy horizon proposes that, for the 4Q22, the weight of calendar-2024 increases to 50% (from 25% in 3Q22). Given the lower levels of expectations for that year, as compared to calendar-2023, the increased weight of 2024 drives the average down. While that is not necessarily a spurious movement, it is important to note the "discontinuity" generated by the calendar effect.

the CPI basket, with cyclical and sluggish components (such as services) playing a key role in the high readings of late. This means a slow disinflation process ahead, especially as economic slack seems to have worn out.

In general, we expect little movement (if any) in the BCB's inflation projections, which should continue pointing to inflation "near" the target for 1Q24 — the focal horizon.

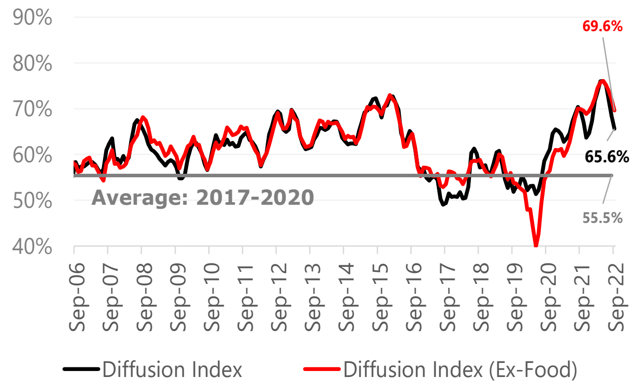
Financial conditions in Brazil have once again become tighter in October[3], mostly as the result of higher global interest rates and wider country-risk spread. Overall, we have continued to see contractionary financial conditions since 2Q22. When we look at the evolution of Brazilian (and other key) asset prices since the last Copom meeting, we observe gains in Brazilian stocks and some retracement in domestic yields at the front end of the curve. But these factors were not enough to offset the other contractionary elements, such as higher global yields and an increase in Brazil's sovereign CDS spread. In the realm of FX, the BRL has continued to perform surprisingly well of late, settling around USD/BRL 5.20-5.30 in recent days, amid a shaky global environment and an ongoing electoral campaign as the run-off vote approaches. Such a level of (departing point for) the exchange rate is not notably different from the one used by the Copom at its last policy meeting (USD/BRL 5.20), implying limited influence on the official IPCA estimates.

Figure 1. Underlying Inflation Trends (%QoQ-saar)



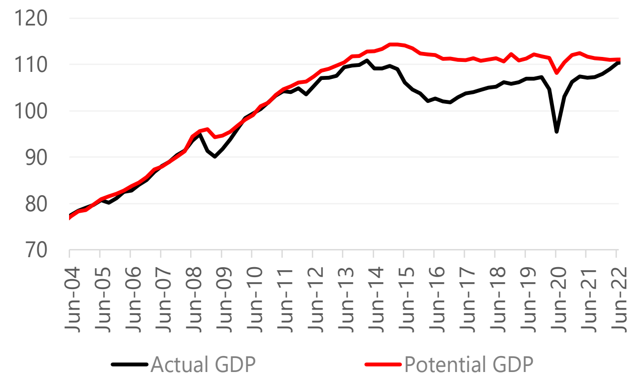
Sources: IBGE, Santander.

Figure 2. IPCA Diffusion Indexes (% sa)



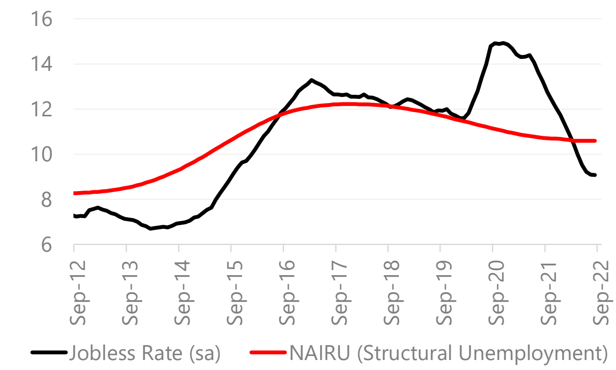
Sources: IBGE, Santander.

Figure 3. Broad Economy Slack (2010=100, sa)



Sources: IBGE, Santander.
Note: Quarterly GDP series.

Figure 4. Job Market Slack (3m, sa)



Sources: IBGE, Santander.
Note: Monthly frequency (3-month averages).

WHAT CAN WE EXPECT FOR THE MEETING AND FOR FUTURE STEPS?

In line with consensus, we expect the BCB to hold the Selic (policy) interest rate at 13.75% at the Copom meeting taking place on October 25-26. In the accompanying statement, we believe the BCB will reiterate its intention to assess "if the strategy of maintaining the Selic rate for a sufficiently long period will be enough to ensure the convergence of inflation." In our view, the BCB will continue to affirm that "will not hesitate to resume the tightening cycle if the disinflationary process does not proceed as expected".

[3] **Santander Brazil Economic Activity: "*Economic Activity: Financial Conditions Continue to Worse in October*"** – October 19, 2022 – https://bit.ly/Std-FCI-oct22

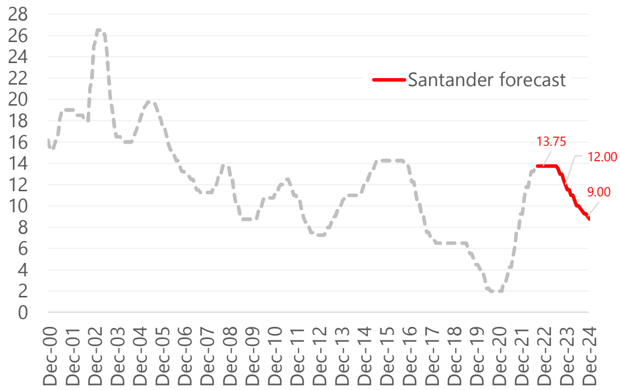
Thus, we maintain our view that the Copom will remain "vigilant" regarding the next steps and will continue signaling a flight plan in which it keeps interest rates stable for a sufficiently long period.

As for the balance of risks, it is likely that the BCB will continue to (implicitly) hint at a lack of bias, although our assessment is that upward asymmetry still prevails with regard to the inflation outlook, especially given the greater persistence of the upside factors relative to the downside risk elements.

We continue to believe that a change in the flight plan (of rate stability for an extended period) would require a substantial deviation from the BCB's scenario. Thus, we 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. Our scenario anticipates that 2Q23 will see the tightest monetary policy stance in 20 years.

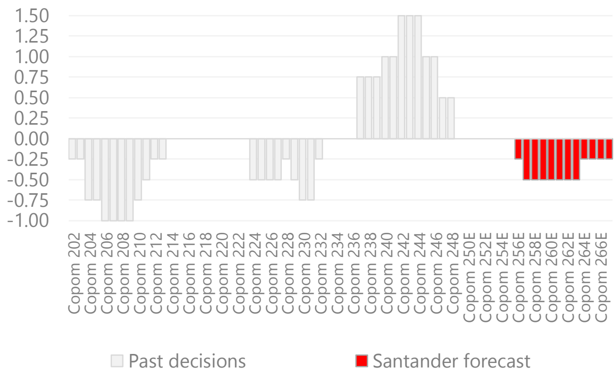
We continue to pencil in a YE2022 Selic rate at 13.75%, as we see the room for immediate cuts narrowed by cyclical elements that could generate risks of resilient inflation for the medium term (namely, the absence of slack in both the economy and employment, as well as fiscal stimuli). We forecast rate cuts only in 2H23 and look for a Selic rate at 12.00% for YE2023 and 9.00% for YE2024. This likely means a tight monetary stance until 2024.

Figure 5. Santander Selic Forecast (% pa)



Sources: Brazilian Central Bank, Santander.

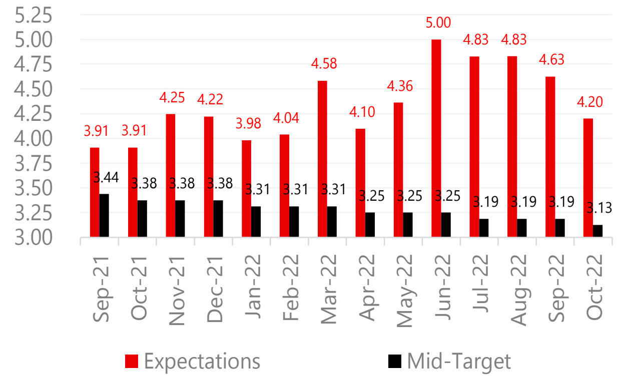
Figure 6. Historical, Expected BCB Moves (% pp)



Sources: Brazilian Central Bank, Santander.

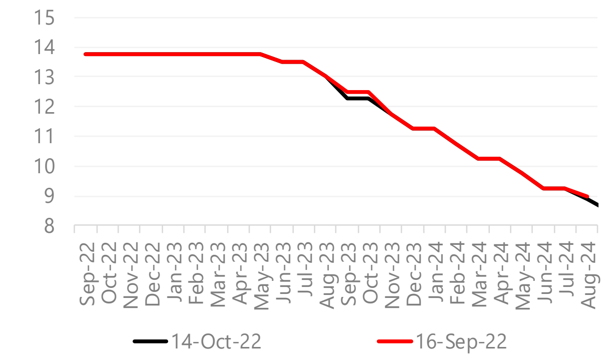
Refer to a summary of the Copom dataset and the following graphs.

Figure 7. Calendar-Adjusted IPCA Estimates, Target
(18 months ahead)



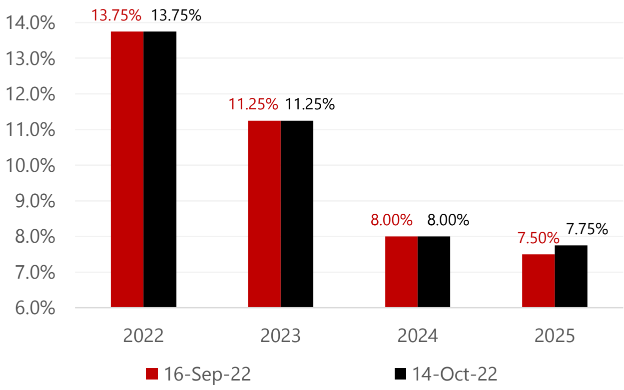
Sources: Brazilian Central Bank, Santander.
Note 1: IPCA expectations and target adjusted for the weight of each calendar-year as a policy horizon. For 4Q22, this means 50% for 2023 and 50% for 2024.
Note 2: Figures for the end of month.

Figure 8. Median Selic Rate Expectations
(% annual, monthly path)



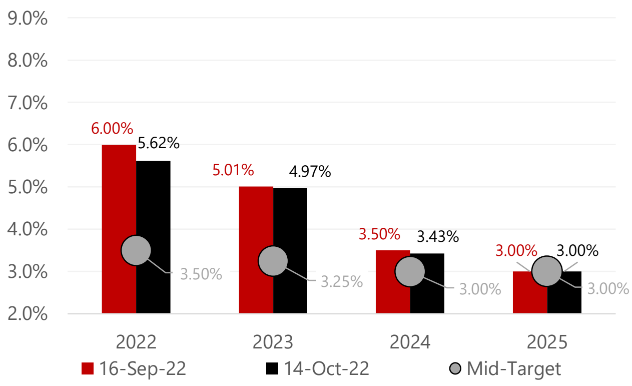
Sources: Brazilian Central Bank, Bloomberg, Santander.
Note: As of the most recent BCB Focus report: October 14, 2022.

Figure 9. Median Selic Rate Expectations
(% annual)



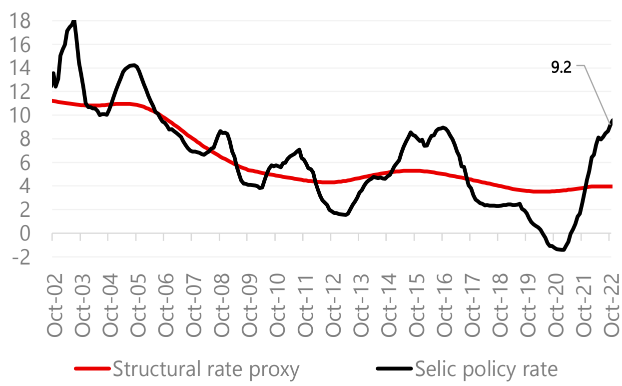
Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus report: October 14, 2022.

Figure 10. Median IPCA Inflation Expectations
(% annual)



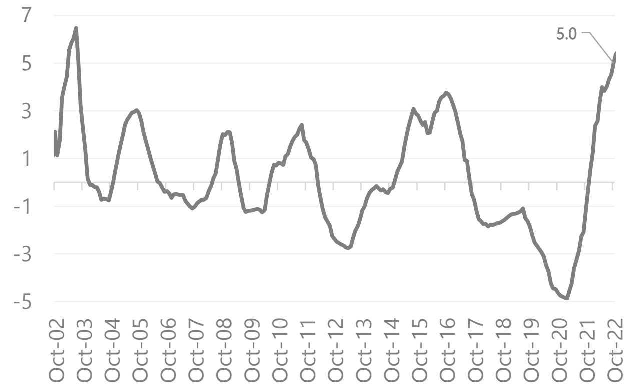
Sources: Brazilian Central Bank, Santander.
Note 1: As of the most recent BCB Focus report: October 14, 2022.

Figure 11. Real Rates: Short Term vs. Long Term
(monthly average, % annual)



Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: The neutral rate proxy is based on long-term real yields (5y5y forwards) adjusted by a constant historical term premium of 100bps.
Note 2: Average data for October 2022 up to the 14th.

Figure 12. Estimated Monetary Policy Stance
(gap between long- and short-term real rates)



Sources: Brazilian Central Bank, Bloomberg, Santander.
Note 1: To calculate the policy stimulus, we subtract from the real policy rate the real level of neutral rate proxy (see graph on the left side).
Note 2: Average data for October 2022 up to the 14th.

Figure 13. Proxy for the Copom Dataset, Part 1

ECONOMIC TOPIC	LATEST DATA		THIS MEETING	MOST RECENT	PREVIOUS
Key Variables	*When?*		*Oct-22*	*Sep-22*	*Aug-22*
INFLATION					
Forecasts (% p.a.) - BCB's Focus report					
Calendar-Weighted Forecast (~18 months)	14-Oct-22	↓	4.20	4.63	4.83
Calendar-Weighted Target (~18 months)	14-Oct-22	↓	*3.13*	*3.19*	*3.19*
Calendar-Weighted Expectations Gap	14-Oct-22	↓	*1.07*	*1.45*	*1.64*
Forecast for a year ahead (12 months)	14-Oct-22	↑	5.24	5.18	5.52
Forecast for 2022 - target: 3.50%	14-Oct-22	↓	5.62	5.99	7.15
Forecast for 2023 - target: 3.25%	14-Oct-22	↓	4.97	5.01	5.33
Forecast for 2024 - target: 3.00%	14-Oct-22	↓	3.43	3.50	3.30
Forecast for 2025 - target: 3.00%	14-Oct-22	→	3.00	3.00	3.00
Breakeven inflation rates (% p.a.)					
1-year	14-Oct-22	↑	5.77	5.72	6.08
2-year	14-Oct-22	↑	5.79	5.75	6.11
5-year	14-Oct-22	↑	6.24	5.09	4.59
10-year	14-Oct-22	↑	5.84	5.65	6.38
Actual CPI data					
Headline (% YoY)	Sep-22	↓	7.2	8.7	10.1
Headline (% QoQ, saar)	Sep-22	↓	-5.7	-0.6	4.0
Core IPCA EX3 (% YoY)	Sep-22	↑	11.5	11.3	10.8
Core IPCA EX3 (% QoQ, saar)	Sep-22	↓	11.7	12.6	12.4
New cores average (% YoY)	Sep-22	↓	10.1	10.4	10.4
New cores average (% QoQ, saar)	Sep-22	↓	7.5	9.3	10.4
Diffusion index (sa, 3m)	Sep-22	↓	66.6%	68.6%	70.5%
Diffusion index ex-food (sa, 3m)	Sep-22	↓	69.6%	72.1%	73.9%
MONETARY POLICY					
Selic rate (% p.a.)					
Current level	14-Oct-22	→	13.75	13.75	13.25
Forecast for 2022	14-Oct-22	→	13.75	13.75	13.75
Forecast for 2023	14-Oct-22	→	11.25	11.25	11.00
Forecast for 2024	14-Oct-22	→	8.00	8.00	8.00
Forecast for 2025	14-Oct-22	↑	7.75	7.50	7.50
Yield curve (% p.a.)					
1-year OIS swaps (pré-DI)	14-Oct-22	↓	13.2	13.5	13.6
2-year OIS swaps (pré-DI)	14-Oct-22	↓	11.9	12.1	12.7
Ex-ante real interest rate (% p.a.)					
1-year (OIS swaps vs. inflation forecast)	14-Oct-22	↓	7.5	7.9	7.7
FISCAL POLICY					
Primary Fiscal Balance (% GDP)					
Forecast for 2022	14-Oct-22	↑	1.0	0.9	0.3
Forecast for 2023	14-Oct-22	→	-0.5	-0.5	-0.3
Forecast for 2027	14-Oct-22	↑	0.6	0.5	0.5
Forecast for 2030	14-Oct-22	↑	1.0	0.8	0.9
Gross General Government Debt (% GDP)					
Forecast for 2022	14-Oct-22	↓	77.7	78.0	79.0
Forecast for 2023	14-Oct-22	↑	81.9	81.8	82.0
Forecast for 2027	14-Oct-22	↑	87.0	86.7	86.0
Forecast for 2030	14-Oct-22	↑	90.0	88.9	87.0

Sources: IBGE, FGV, Brazilian Central Bank, Anbima, Bloomberg, Santander.

Last update: October 17, 2022.

Figure 14. Proxy for the Copom Dataset, Part 2

ECONOMIC TOPIC *Key Variables*	LATEST DATA *When?*		THIS MEETING *Sep-22*	MOST RECENT *Aug-22*	PREVIOUS *Jun-22*
REAL ACTIVITY					
GDP forecasts (% p.a.) - BCB's Focus report					
Forecast for 2022	14-Oct-22	↑	2.71	2.65	1.97
Forecast for 2023	14-Oct-22	↑	0.59	0.50	0.40
Forecast for 2024	14-Oct-22	→	1.70	1.70	1.70
Forecast for 2025	14-Oct-22	→	2.00	2.00	2.00
Actual activity data					
IBC-Br (% QoQ, saar)	Aug-22	↑	4.9	3.8	3.0
Industrial production (% QoQ, saar)	Aug-22	↑	0.4	2.5	3.7
Retail sales (% QoQ, saar)	Aug-22	↓	-10.0	-6.2	-0.5
Services volume (% QoQ, saar)	Aug-22	↑	8.9	8.1	8.0
Unemployment rate (% 3m, SA)	Aug-22	→	9.1	9.1	9.2
Real average wage (% YoY, 3m)	Aug-22	↑	-0.6	-2.9	-5.1
Real wage bill (% YoY, 3m)	Aug-22	↑	7.7	6.1	4.8
Caged payrolls (thousands, SA, 3m)	Aug-22	↑	218	228	218
Economic confidence (2011=100)	Sep-22	↑	90.6	87.7	85.6
EXTERNAL SECTOR					
FX rate (USD/BRL)					
Current level	14-Oct-22	↑	5.33	5.17	5.28
Actual: 5-day average (previous week)	14-Oct-22	↑	5.26	5.19	5.26
USD/BRL (to be) used in simulations	14-Oct-22	↑	5.25	5.20	5.30
Forecast for 2022	14-Oct-22	→	5.20	5.20	5.20
Forecast for 2023	14-Oct-22	→	5.20	5.20	5.20
Forecast for 2024	14-Oct-22	→	5.10	5.10	5.10
Forecast for 2025	14-Oct-22	→	5.15	5.15	5.15
Current account balance (USD Billions, 12m)					
Current level (12-month rolling)	Jul-22	↓	-36.6	-33.6	-32.9
Forecast for 2022	14-Oct-22	↓	-30.0	-26.5	-18.0
Forecast for 2023	14-Oct-22	↓	-34.0	-32.0	-29.0
Forecast for 2024	14-Oct-22	↓	-37.8	-36.4	-39.7
Forecast for 2025	14-Oct-22	→	-38.4	-38.4	-39.7
ASSET PRICES					
Santander Brasil's financial conditions index*	**Oct-22**	↑	**1.5**	**1.2**	**0.7**
IC-Br (% YoY)	Sep-22	↑	13.4	17.7	22.6
CRB Commodity Index (Futures, USD terms)	Oct-22	↓	277	278	282
CRB Commodity Index (Futures, BRL terms)	14-Oct-22	↑	1,469	1,442	1,482
CRB Commodities in BRL: 50-day average	14-Oct-22	↓	1,471	1,485	1,548
Brent Oil Price (USD bbl) / 1st Active Future	14-Oct-22	↑	92	89	94
Brazil 5-year CDS (basis-points)	14-Oct-22	↑	312	264	279
Ibovespa stock index (points)	14-Oct-22	↑	112,072	111,936	103,775
DI Jan-23 (% p.a.) / Futures	14-Oct-22	↓	13.69	13.74	13.79
DI Jan-24 (% p.a.) / Futures	14-Oct-22	↓	12.88	13.09	13.28
DI Jan-25 (% p.a.) / Futures	14-Oct-22	↑	11.79	11.74	12.51
NTN-F 2027 (% p.a.) / Pre-Fixed Rate	14-Oct-22	↑	11.80	11.65	12.63
NTN-F 2029 (% p.a.) / Pre-Fixed Rate	14-Oct-22	↑	11.98	11.72	12.85

Sources: IBGE, FGV, Brazilian Central Bank, Anbima, Bloomberg, Santander.

Last update: October 17, 2022.

* Note: Higher levels of the FCI (Financial Conditions Index) denote tighter conditions.

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