BRAZIL MACRO

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MONETARY POLICY – INFLATION REPORT

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

SUMMARIZING THE NUMBERS

- The Brazilian Central Bank (BCB) published its 2Q22 inflation report today, offering its latest simulations and forecasts. This time around, a more concise-than-usual publication was largely anticipated by last week's press conference with Copom officials. No new policy messages were found in today's release.

- On economic activity, the authority forecast 2022 GDP growth of 1.7%, compared to a previous estimate of 1.0%. The upward revision follows the upside surprise in the 1Q22 GDP headline and the solid numbers seen so far for 2Q22, both implying higher carryover for the year. Yet the BCB continues to expect a softening in activity in 2H22, reflecting the effects of monetary tightening, the impact of supply shocks, and the payback from the anticipation of year-end bonuses in 1H22.

- The BCB sees the output gap as narrower than it did in its previous inflation report, mainly based on stronger-than-expected GDP and employment. That is another factor behind the recent upward revisions in the official inflation forecasts. Yet the BCB believes that the narrowing trajectory of the output gap, under way since the trough of 2Q20, is decelerating, with a widening trend poised to restart in 2Q22. The authority estimates the economy was running 1.1% below its potential in 1Q22 and projects the output gap will widen to -1.3% for the 2Q22 and -1.7% for 4Q23.

- Once again, the BCB raised its own estimate for the neutral level of real interest rates, which is now seen at 4.0%. That variable was previously at 3.6%, as of the 4Q21 inflation report. Not too long ago, the real structural level of interest rates was estimated (by both analysts and the BCB) at 3.0%. In practical terms, this implies a less tight policy stance for the short-term, which illustrates the need for a little more tightening than the Selic path assumed in the simulations.

- On inflation, the BCB projects IPCA at 4.0% for 2023 — the relevant policy horizon now — assuming: the Selic rate at 13.25% for YE2022 and 10.00% for YE2023; real FX at USD/BR 4.90; and year-end oil prices around USD110/bbl (and stable in real terms). The BCB tests two alternative scenarios, one assuming oil prices rising 2% annually for the entire horizon and a second one assuming a stable Selic rate at 13.25% all the way to YE2023. The former implies IPCA inflation of 4.3% for 2023, and the latter yields IPCA of 3.7% for 2023. This number suggests the BCB may believe that a terminal Selic at 13.75% (and stable at that level for a considerable time) can bring inflation to "around the target in the relevant horizon." Additionally, the BCB now estimates a probability of 29% that IPCA could come in above the upper target (4.75%), which is higher than the 12% estimated in the last inflation report.

- All in all, we continue to see the BCB more inclined to follow the "smoothing policy rate strategy" ahead, meaning avoiding a steeper peak for interest rates in this cycle but keeping rates at a much higher level for much longer. We identify upside risks for our own call for interest rates at 13.50% for YE2022 and 10.50% for YE2023, especially in the medium term.

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The BCB has published its 2Q22 inflation report[1], offering analyses, simulations and forecasts by the monetary authority. This time around, a more concise-than-usual[2] publication was largely anticipated by last week's press conference with Copom officials.

Owing to the strike of BCB workers, the publication of the 2Q22 inflation report came out a week later than initially scheduled (June 23), thus following the press conference with Governor Roberto Campos Neto and Economic Policy Director Diogo Guillen as of last Thursday. On that occasion, part of the core content of the inflation report (from a policy standpoint) was released, reducing considerably the amount of new information (from a markets standpoint) in today's event.

BROADER MACROECONOMIC SCENARIO

While most of the interesting information was disclosed in last week's press conference, we summarize below some of the main elements related to the BCB's scenario.

On economic activity, the authority forecast 2022 GDP growth of 1.7%, compared to a previous estimate of 1.0%. The upward revision follows the upside surprise in the 1Q22 GDP headline and the solid numbers seen so far for 2Q22, both implying a higher carryover for the year. Yet the BCB continues to expect a softening in activity in the 2H22, reflecting the effects of monetary tightening, the impact of supply shocks, and payback from government transfers anticipated to families in 1H22. On the supply side, there were substantial upward revisions in industry (to +1.2% from -0.3%) and services (to +2.1% from +1.4%), driven by upside surprises in 1H22. On the demand side, consumer spending is seen as stronger (+1.7% from +1.1% previously), as is the contribution from net exports (now 1.2 p.p., from 0.8 p.p. previously), which more than offset downward revisions for investment (now -2.7%, previously -1.5%) and government spending (now +1.8%, previously +2.3%). These adjustments on the demand side also follow revised estimates given the available data for 1H22. The BCB highlights greater than usual uncertainty for the economy, in a context of growing downside risks for global activity with a backdrop of continued war in Ukraine and persistent inflationary pressures.

The BCB was surprised by the more advanced stage of the cyclical recovery, pointing to a less wide output gap than previously thought. Yet the authority sees a deceleration in the output gap's narrowing trajectory, under way since the trough reached in 2Q20. The Copom also believes the output gap will resume a widening trend in 2Q22. The authority estimates the economy was running 1.1% below its potential in 1Q22 and projects the gap will widen to -1.3% for 2Q22. Yet the BCB notes that this means a less wide output gap than estimated in previous inflation reports, which is a by-product of a stronger-than-expected GDP and employment conditions. In the March inflation report, the authority saw the economy running 2.3% below its potential in 4Q22 and forecasted an output gap of -1.8% for 1Q22. The June inflation report shows the BCB estimates the economy will be running 1.7 p.p. below its potential in 4Q23, with the widening gap reflecting the impact of a restrictive monetary policy stance. Given these considerations and estimates by the BCB about the output gap, one can conclude that part of the upward revision in the BCB's inflation estimates of late is also a reflection of a stronger economy, and not only of the supply shocks.

The deterioration of financial conditions is another element that will start to weigh on the economy, partly reflecting the restrictive monetary policy stance. The BCB estimates more restrictive financial conditions in Brazil, mainly owing to higher yields (in Brazil and globally), higher oil prices, lower stock prices (in Brazil and globally), wider credit spreads (Brazil sovereign CDS), and a stronger USD. But the BCB makes the disclaimer that while "more restrictive financial conditions point to lower future economic activity," it can generate ambiguous effects on inflation, "depending on the factors that will condition its movement."

Despite an upward revision, the BCB continues to expect slower growth in bank lending this year. The authority forecasts growth in total outstanding loans of 11.9% for 2022, up from a previous estimate of 8.9%. The BCB explained that the revision is based on the impact of higher estimates for inflation and activity, as well

[1] Refer to the Inflation Report boxes (https://www.bcb.gov.br/en/publications/inflationreportboxes) and presentation (https://www.bcb.gov.br/en/about/presentatspeechs)

[2] This time, the inflation report brings no new boxes with policy-related studies, focusing only on the BCB's new forecasts for GDP, credit and balance of payments.

as a stronger-than-expected performance of the segment of free-market loans to consumers. The BCB's revision also reflects recent changes in the credit framework, such as allowing a higher debt servicing limit for payroll-deducted loans (*consignado*) and expansion and stimulus in loan programs for smaller firms, such as Pronampe and Peac. The BCB notes that this still means a slowing pace of lending vs. the growth seen in 2020 and 2021 (~16% per year), which is in line with the monetary tightening being implemented.

Regarding the external accounts, the monetary authority continues to expect a slight current account surplus for this year. The BCB looks for a current account surplus of USD4 billion, nearly unchanged from the previous estimate of USD5 billion (as of the 1Q22 inflation report). This estimate relies on a record-high trade surplus in 2022 (revised higher by USD 3 billion to USD 86 billion), with higher prices affecting forecasts for both exports and imports (in the context of heightened global inflationary pressures). The services deficit estimate was kept at USD26 billion. The deficit in primary income was revised to USD59 billion (previously: USD56 billion), reflecting an expectation of higher remittances of profits and dividends, on the heels of a stronger domestic activity and higher commodity prices. The BCB also anticipates that challenging global conditions will affect portfolio inflows for emerging economies and Brazil: while the authority kept the estimate for direct investment in the country (IDP, in Portuguese) at USD55 billion, meaning comfortable external financing via that segment, it marked down its estimate for portfolio inflows to USD7 billion (previously: USD11 billion).

Once again, the BCB raised its own estimate for the neutral level of real interest rates, which is now seen at 4.0%. That variable was previously at 3.6%, as of the 4Q21 inflation report. Not too long ago, the real structural level of interest rates was estimated (by both analysts and the BCB) at 3.0%. As an upshot, the BCB notes that the deviation of real interest rates[3] from the neutral interest rate (i.e., a measure of how contractionary/expansionary the monetary policy stance is) is lower throughout most of the horizon considered (except for the last three quarters of 2023), compared to the previous inflation report. Given that YE2023 is the policy horizon and considering the lagged effects of interest rates on inflation, this fact illustrates the necessity of even more tightening than the path of interest rate simulated in the BCB's forecast.

THE INFLATION NUMBERS AND SIMULATIONS

The BCB notes that IPCA inflation stood a full 1.08 p.p. above the estimate for the three-month period ending May 2022, with IPCA posting a 3.18% change for the period. Back in March, the BCB had estimated aggregate inflation of 2.10% for these months. The authority notes that the upside surprise stemmed mostly from free-market prices (and across the board in that segment, including food, industrials, and services). The effects of (IPI) tax cuts on manufacturers fell short of the BCB's estimates.

For the short term, the BCB expects accumulated inflation of 1.99% for the next three months (June to August), meaning a year-over-year reading of 11.3% in August. The BCB estimated IPCA at 0.81% for June, 0.84% for July, and 0.33% for August, with the slowdown in mid-3Q reflecting favorable food price seasonality. While these numbers already incorporate the latest hike in fuel prices, the official estimates still do not account for the recent changes in tax legislation affecting energy and other "essential" prices. (Note: Santander's scenario has 0.71% for June, -0.19% for July, and -0.10% for August, totaling 0.41% for the period, as we incorporate part of the effects of recent initiatives to curb energy prices.)

The BCB's scenario assumes the following set of hypotheses:

- Selic policy rate trajectory as per the Focus survey (among professional forecasters): 13.25% for YE2022, 10.0% for YE2023, and 7.50% for YE2024.
- FX rate departing from USD/BRL 4.90 (the rounded value of the five-day average in the week before the Copom meeting) and evolving according to purchasing power parity (PPP).
- Oil price to follow the futures curve for six months, ending the year at USD110/bbl, and increasing 2% per year from January 2023 onward (i.e., stable in real terms, assuming the inflation target in USD).
- Electricity tariff flat "Yellow" for December 2022, 2023. and 2024.

[3] This calculation is based on the 4-quarter ahead Selic forecasts deflated by IPCA inflation forecasts for the same period, both using data from the (weekly) Focus survey.

- Neutral real interest rate of 4.0%.
- According to the BCB, the "baseline scenario projections do not incorporate the impact of the tax measures on fuel, electricity and telecommunications prices that are in progress."

In the baseline scenario, the BCB models point to IPCA inflation of 8.8% for 2022 (+2.5 p.p.[4]; upper-target: 5.00%), 4.0% for 2023, the policy horizon (+0.9 p.p.; mid-target: 3.25%), and 2.7% for 2024 (+0.4 p.p.; mid-target: 3.00%). These numbers were already known from the communiqué[5] and minutes[6], with the novelty (already anticipated in last week's press conference) being the BCB simulations for different assumptions. The BCB tests two alternative scenarios, one assuming oil prices rising at an annual rate of 2% for the entire forecasting horizon and a second one testing a stable Selic rate at 13.25% for the entire forecasting horizon. The scenario with oil prices at current levels in real terms implies IPCA inflation of 9.2% for 2022 (+0.4 p.p. vs. the baseline scenario), 4.3% for 2023 (+0.3 p.p. vs. the baseline scenario), and 2.7% for 2024 (unchanged from the baseline scenario). The exercise assuming the Selic is stable at its current level yields an IPCA estimate of 3.7% for 2023 (-0.3 p.p. vs. the baseline scenario). This number suggests the BCB may believe that a terminal Selic at 13.75% (and stable at that level for a considerable time) can bring inflation to "around the target in the relevant horizon." The committee also reinforced the message that the uncertainty surrounding the assumptions and projections is currently greater than usual and has grown since the last meeting.

Regarding the fan charts of inflation forecasts, which illustrate the probability distribution of expected inflation outcomes, **the BCB now sees 100% probability that IPCA will breach the upper end of the inflation target band (5.00%) this year.** This probability was previously estimated at 88% in the 1Q22 inflation report. **For 2023, the central bank estimates a probability of 29% that IPCA could come in above the upper target (4.75%), which is higher than the 12% estimated in the last inflation report**. For 2024, the BCB currently estimates the probability of breaching the lower end of the targeted band (1.5%) as being greater than the probability of breaching the upper end (4.5%): the former is seen at 19% whereas the latter is estimated at 10%.

LOOKING AHEAD

We continue to see the BCB more inclined to follow the "smoothing policy rate strategy" ahead, meaning avoiding a steeper peak for interest rates in this cycle but keeping rates at a much higher level for much longer. Naturally, this planned strategy may be under scrutiny in the coming weeks and could eventually be reconsidered (or recalibrated) depending on the size of future additional deviations in key variables, mainly inflation expectations for 2023. All in all, we believe the BCB signaling reinforces the likelihood of a terminal Selic rate of 13.75% (i.e., a 50-bp move in August) and bolsters our expectation of likely disappointment for market participants with the easing cycle expected to start next year. Thus, we see upside risks for our own call for interest rates at 13.50% for YE2022 and 10.50% for YE2023, and the bias is even larger for our medium-term outlook.

[4] As compared to the 1Q22 inflation report.
[5] **Santander Brazil: "*Copom Decision: Keeping Options Open, For Now*"** – June 16, 2022 – Available on: https://bit.ly/Std-COPOM-jun22
[6] **Santander Brazil: "*Copom Minutes: Going for the Smoothing Strategy?*"** – June 22, 2022 – Available on: https://bit.ly/Std-COPOM-min-jun22

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

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