Brazil Macro | April 2023

INFLATION

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Forecasting accountability

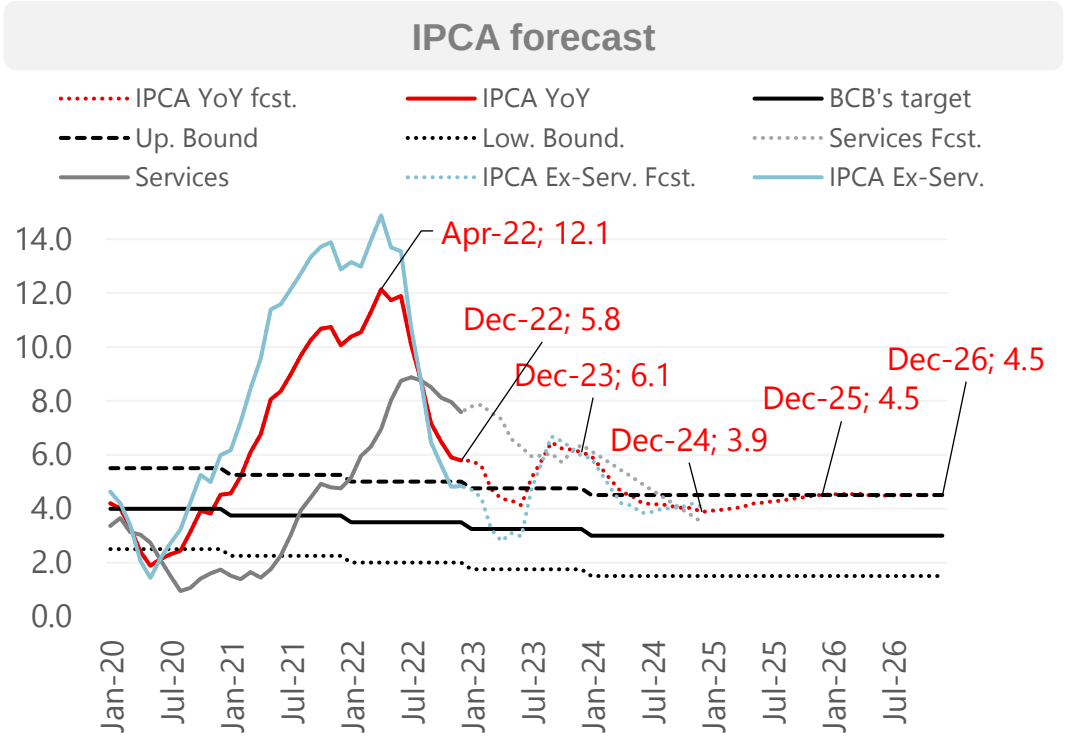
01

We revised our IPCA 2023, 2024 and 2025 forecasts upwards

- For IPCA 2023 there were minor adjustments based on recent inflation dynamics (from 5.9% to 6.1%)
- For IPCA 2024 we updated services inflation on the back of more inertia coming from 2023 and a hot job market (from 3.7% to 3.9%)
- For IPCA 2025 we rose the forecast from 4.0% to 4.5% and we kept IPCA 2026 at 4.5%

	2023			2024		
	old	new	Δ bps	old	new	Δ bps
IPCA	5.9	6.1	28	3.7	3.9	14
Free prices	4.4	4.5	11	3.3	3.5	14
Food-at-home	2.4	3.0	10	1.5	1.5	0
Industrial goods	2.7	2.9	4	2.0	2.0	0
Tradables	2.7	2.9	4	2.0	2.0	0
Non-Tradables	2.5	2.7	1	2.0	2.0	0
Services	6.6	6.4	-8	5.0	5.4	15
Food-service	5.9	6.2	2	5.0	5.5	3
Airline tickets	10.1	-0.5	-6	5.0	5.0	0
Economic activity	7.0	7.0	0	5.0	5.5	5
Education	8.2	7.7	-2	5.0	5.0	0
Inertial	5.3	5.5	2	5.0	5.5	4
Salaries	6.4	6.2	-1	5.0	5.5	3
Administered prices	10.3	10.9	15	5.0	5.0	0
Gasoline	14.9	17.7	14	5.0	5.0	0
Energy	7.6	8.6	4	5.0	5.0	0
Health insurance	10.3	10.3	0	5.0	5.0	0
Bus fares	2.4	2.4	0	5.0	5.0	0
Cores	5.6	5.5	-5	3.7	3.8	10

Sources: IBGE, Santander.



Sources: IBGE, Santander.

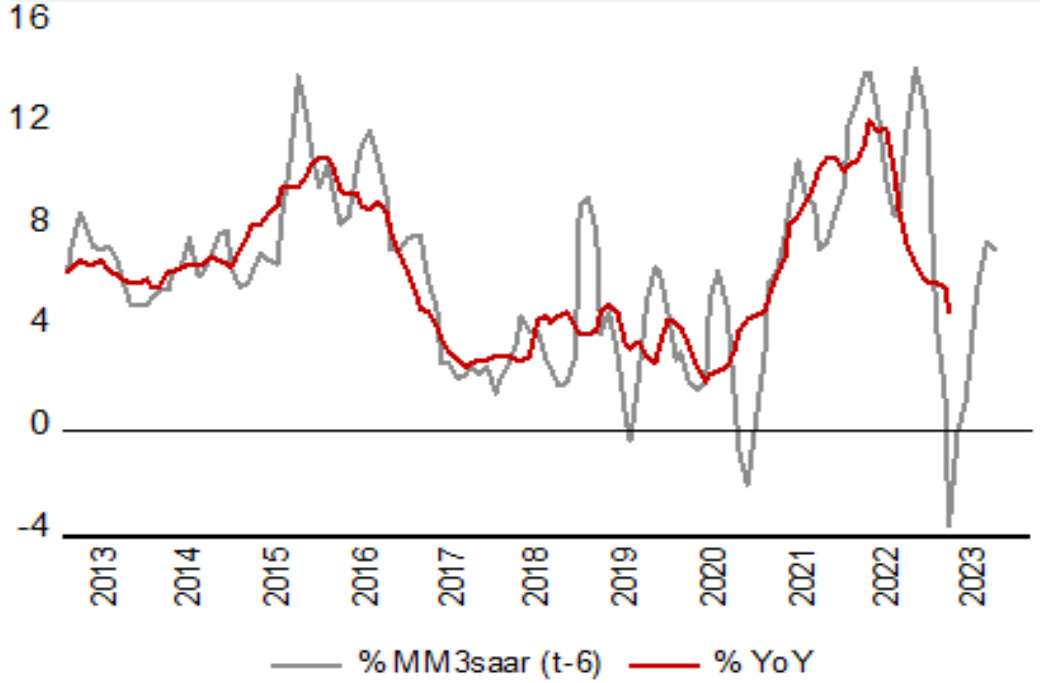
Picture: a major part of the disinflation process has already happened

02

Headline inflation: from 12.1% in April 2022 to 4.7% in March 2023

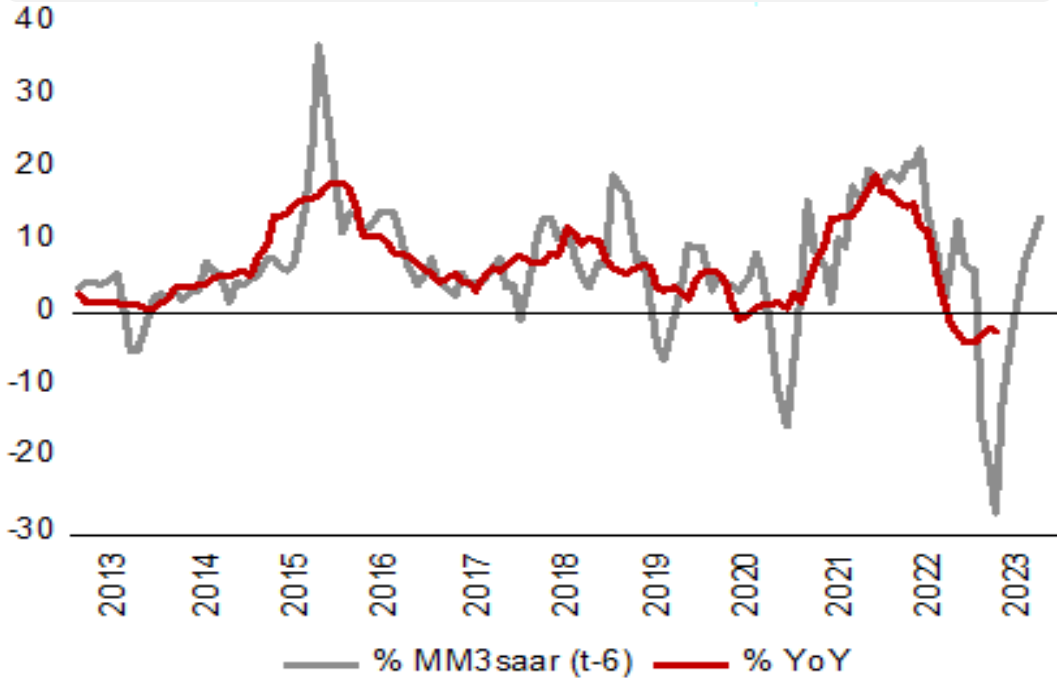
- Inflation is still far from the 3.0% mid-target, but a considerable disinflation has happened
- The major part of the disinflation was driven by volatile prices, more specifically, the relief in regulated prices after tax cuts in fuels, electricity and telecom

Headline IPCA inflation



Sources: IBGE, BCB, Santander.

Regulated prices inflation

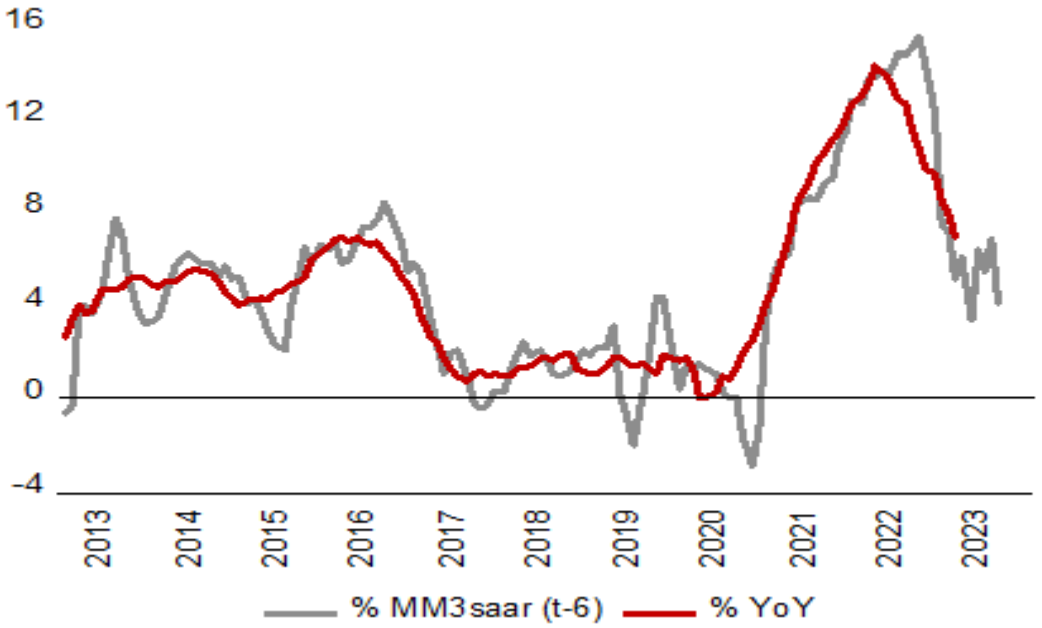


Sources: IBGE, BCB, Santander.

Industrials: the relief is happening

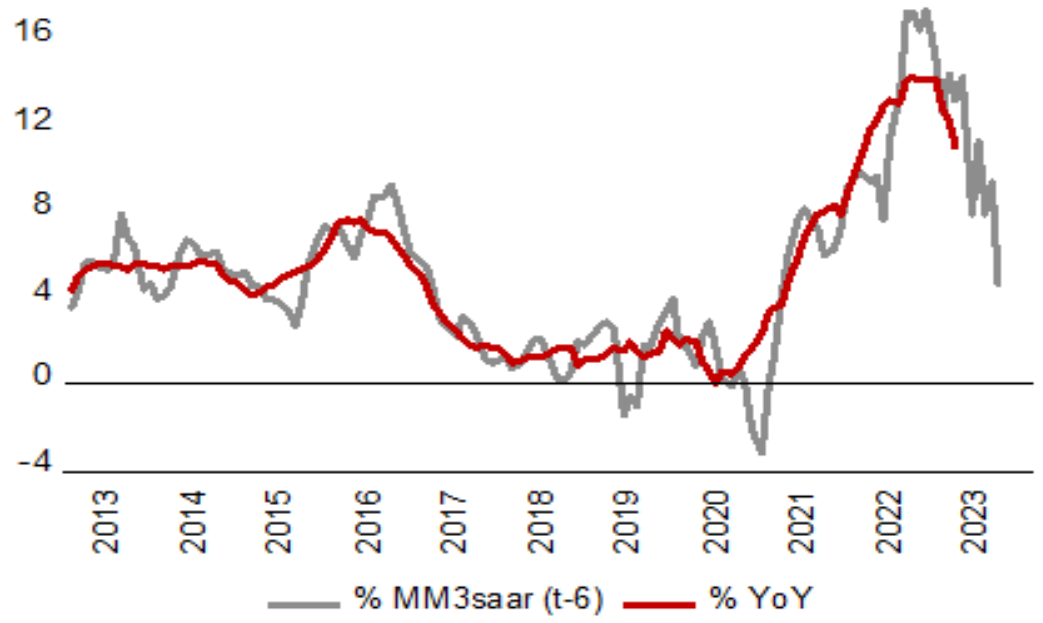
- Headline industrial goods were decelerating sharply, but the process is seeing a pause at around 5.0% 3MMA-saar
- However, core industrial goods—that was lagging the headline—started to see a steep fall at the margin, reaching 4.6% 3MMA-saar

Headline industrial goods inflation



Sources: IBGE, BCB, Santander.

Core industrials inflation

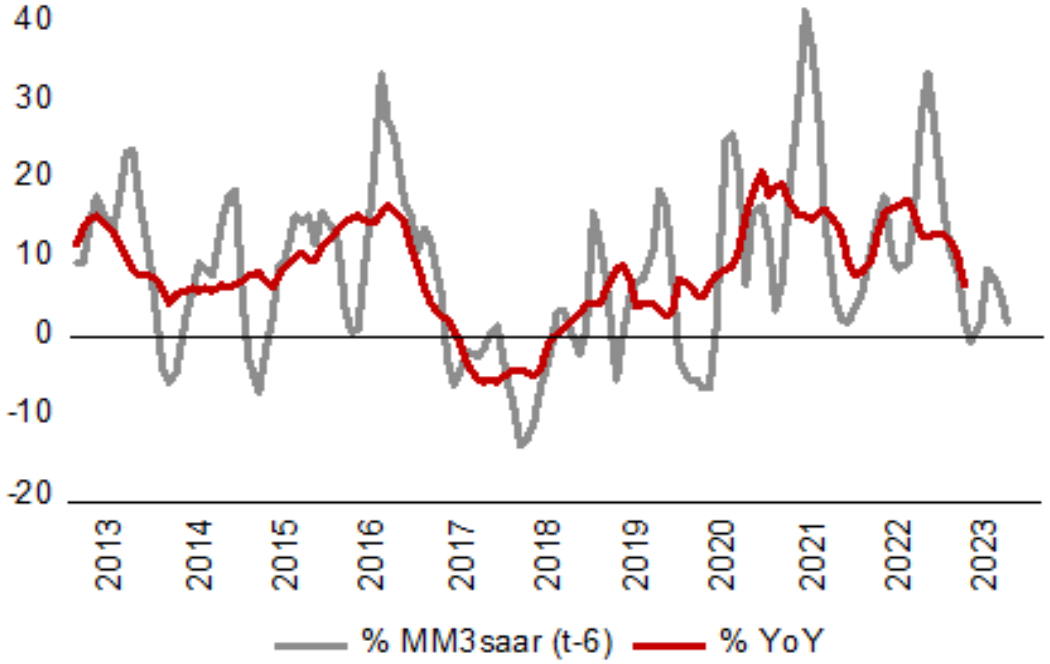


Sources: IBGE, BCB, Santander.

Food inflation: the relief is happening

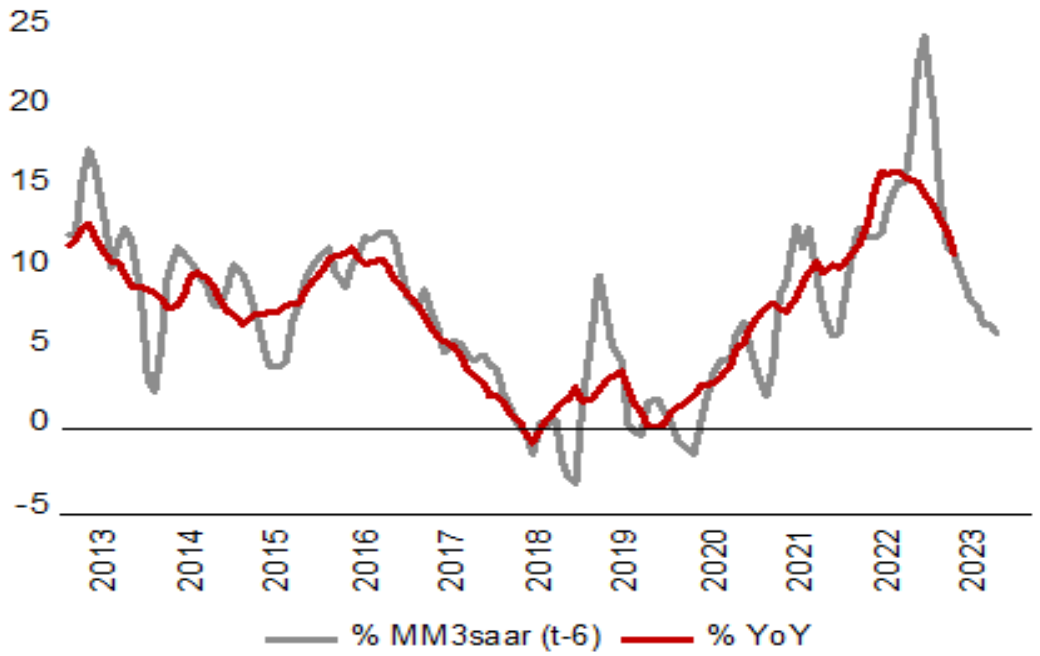
- In food, inflation has been persistent, but at the margin it started to decelerate more clearly
- Core food inflation (mostly industrialized items) is helping in this disinflation process

Headline food inflation



Sources: IBGE, BCB, Santander.

Core food inflation

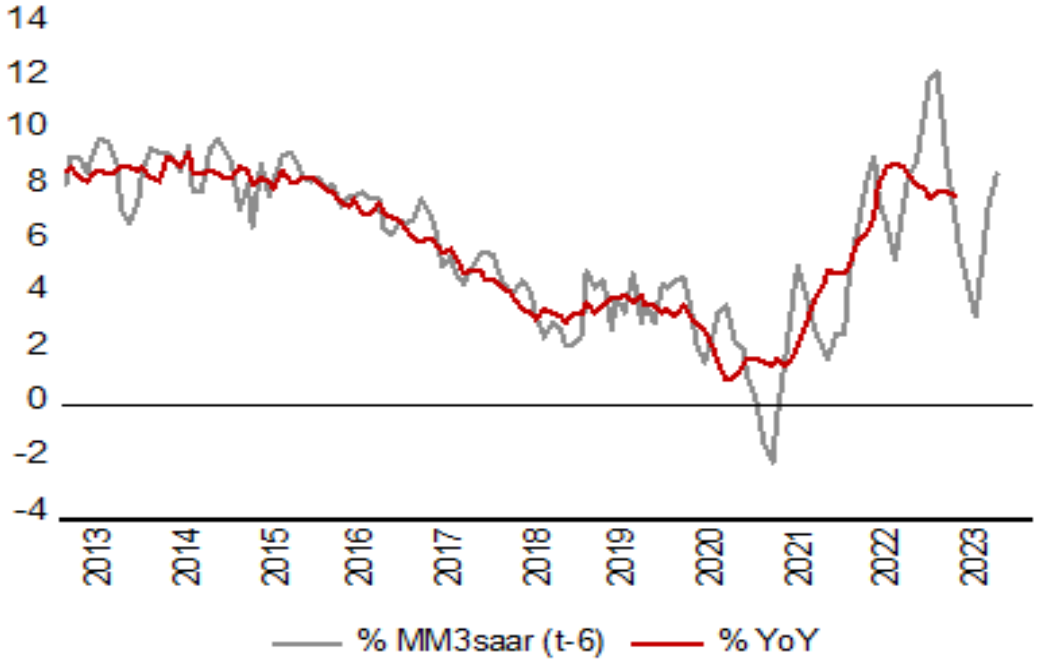


Sources: IBGE, BCB, Santander.

Services inflation still running high

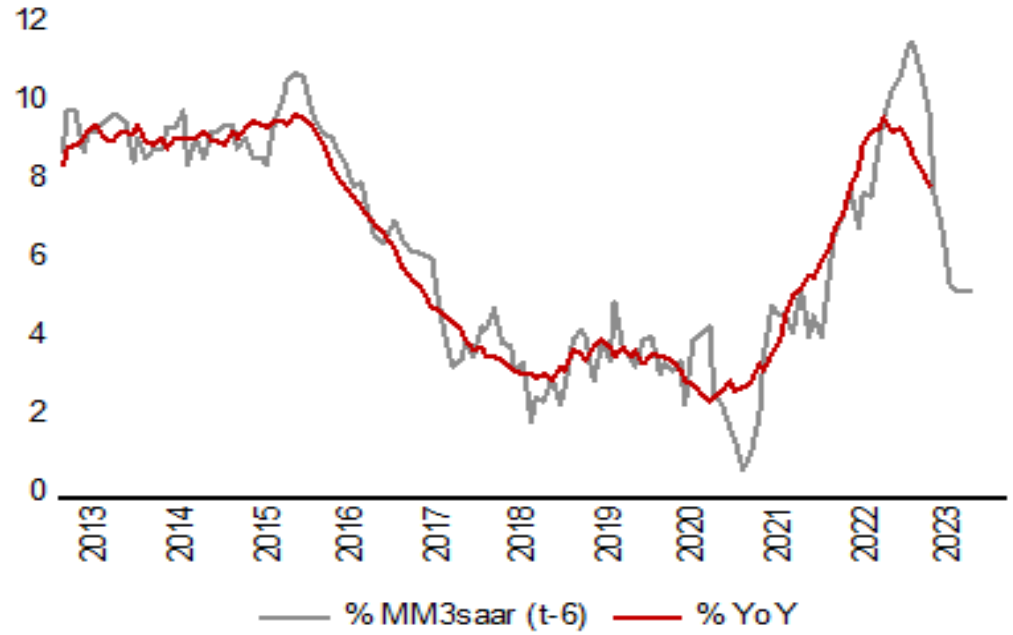
- Headline services went to 7.6% in March 2023 (from 8.9% YoY in July 2022) and the 3MMA-saar measure shows a choppy trend
- Core services inflation decelerated from 9.5% YoY in September 2022 to 7.8% in March 2023, so despite the bit sharper disinflation, core services level is still around the same as the headline. But in trend terms, the core presents a clearer downward trend (hovering at 4.9% 3MMA-saar at the margin)

Headline services inflation



Sources: IBGE, BCB, Santander.

Core services inflation

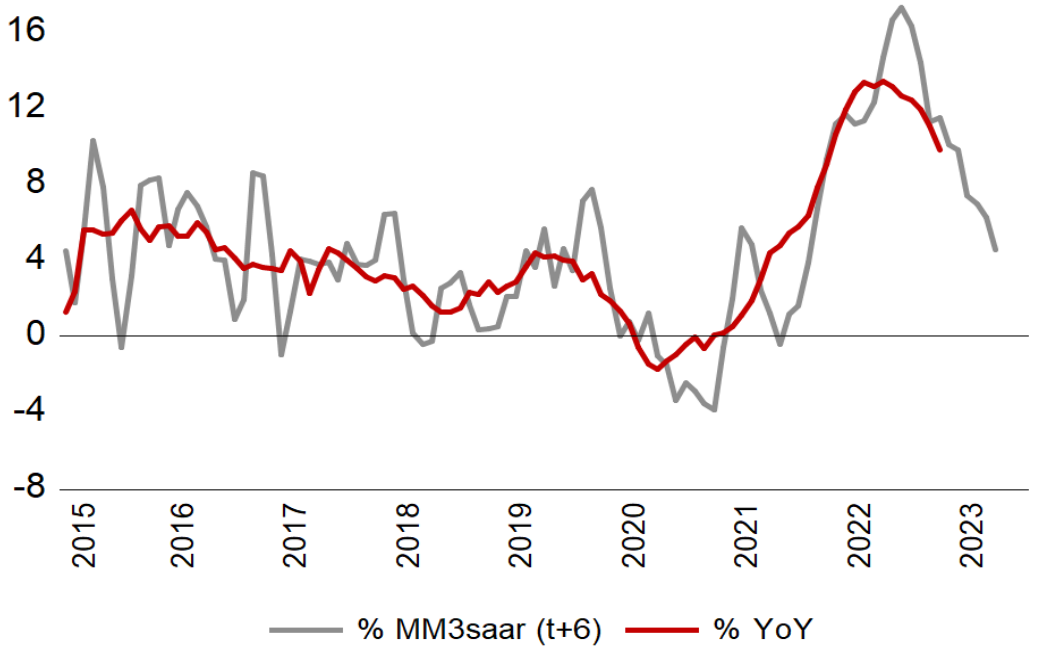


Sources: IBGE, BCB, Santander.

Services breakdown shows mixed signals

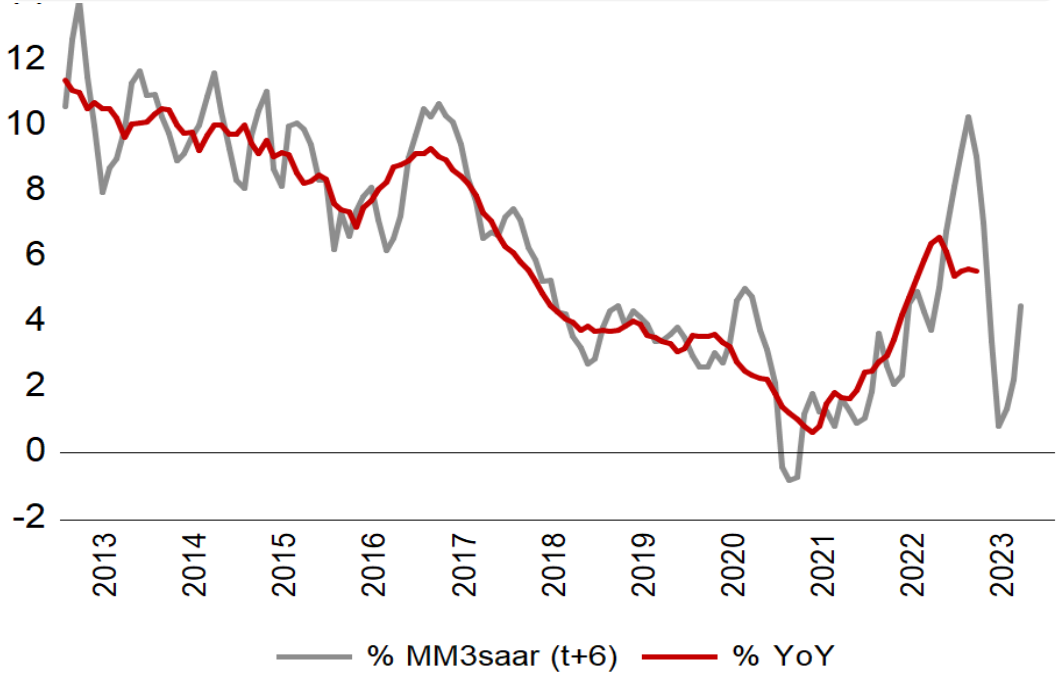
- Services related to economic activity are decelerating quickly, running at 4.5% 3MMA-saar at the margin
- Services related to wages started accelerating back againg, but are still running below the YoY measure (4.5% 3MMA-saar vs. 5.6% YoY), still suggesting further deceleration ahead

Services linked to economic activity



Sources: IBGE, BCB, Santander.

Services related to wages

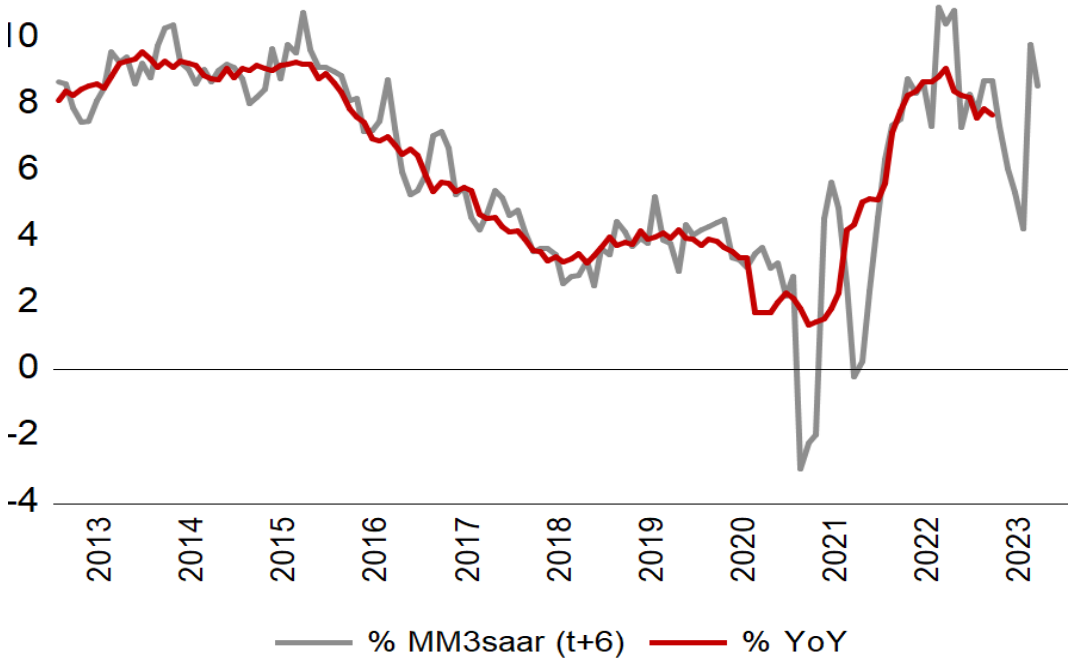


Sources: IBGE, BCB, Santander.

Services breakdown shows mixed signals

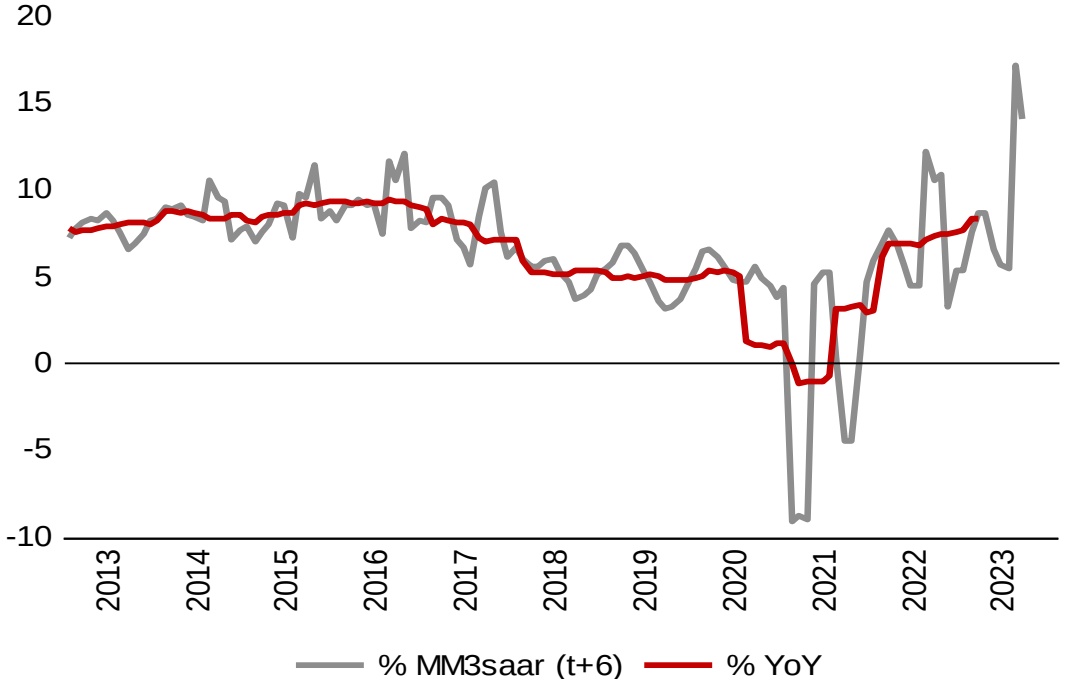
- Inertial services were cooling down sharply (and even unexpectedly), but saw a rebound
- However, we downplay this rebound, because it was pushed by the one-off adjustment in education fees, which are concentrated in February

Inertial services (includes education)



Sources: IBGE, BCB, Santander.

Education services

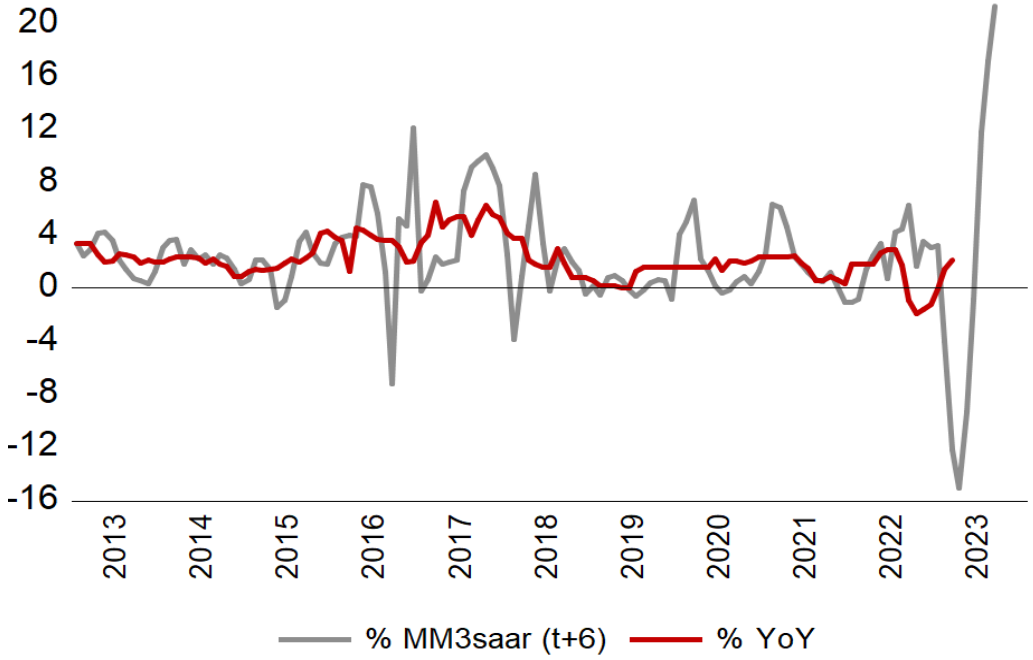


Sources: IBGE, BCB, Santander.

Services breakdown shows mixed signals

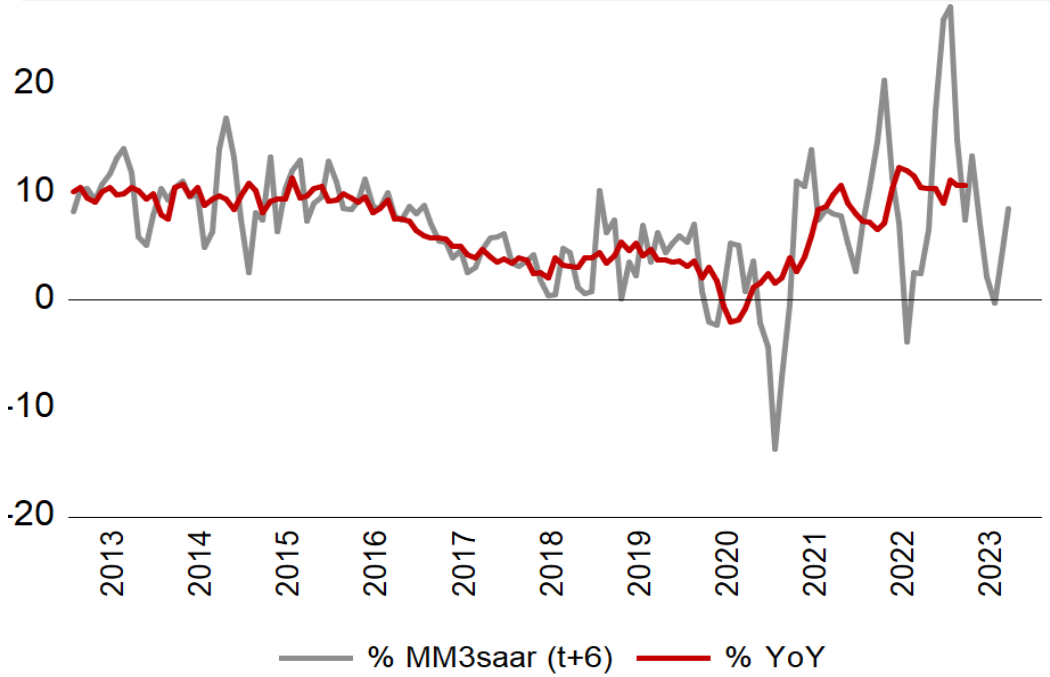
- Telecom services are being impacted by the reinstatement of taxes that were cut last year
- Volatile services is seeing a rebound after a major disinflation at the margin

Telecom services



Sources: IBGE, BCB, Santander.

Volatile services (food service + airline tickets)

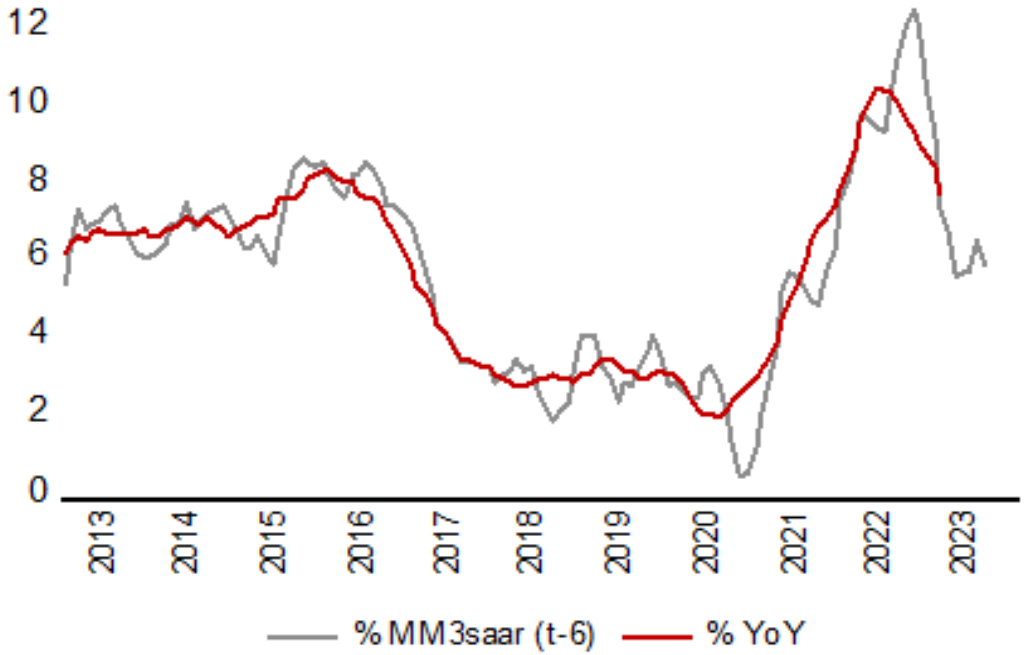


Sources: IBGE, BCB, Santander.

Core gauges and the diffusion index: some relief, but levels still high

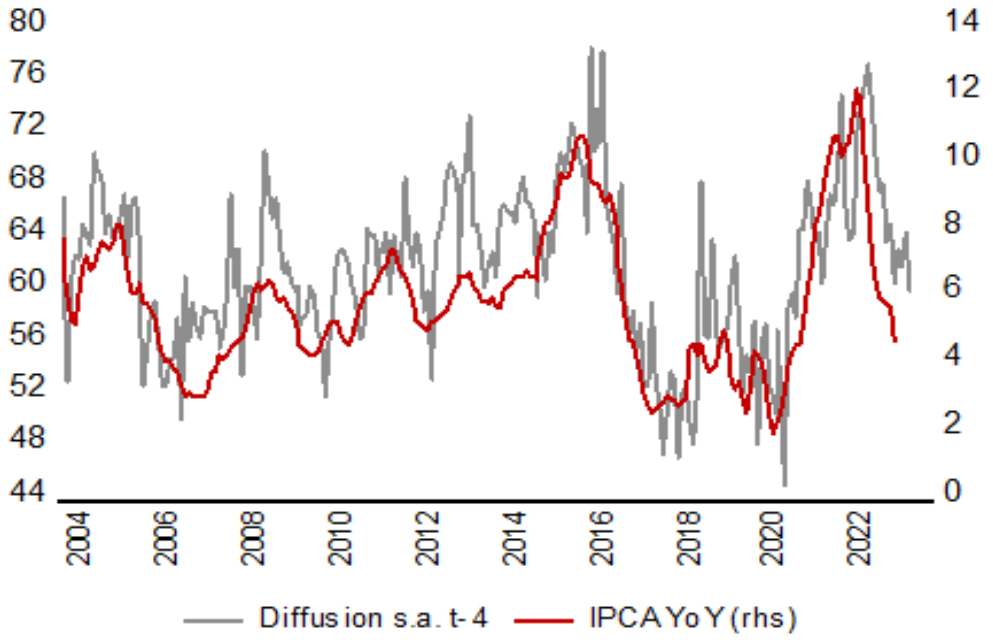
- Core gauges peaked and reached 6.1% 3MMA-saar in March 2023, still a high level, with no clear trend at the margin
- The diffusion index cooled down but is still high, compatible with headline inflation running at around 6.0% YoY

Average core inflation



Sources: IBGE, BCB, Santander.

Diffusion index



Sources: IBGE, BCB, Santander.

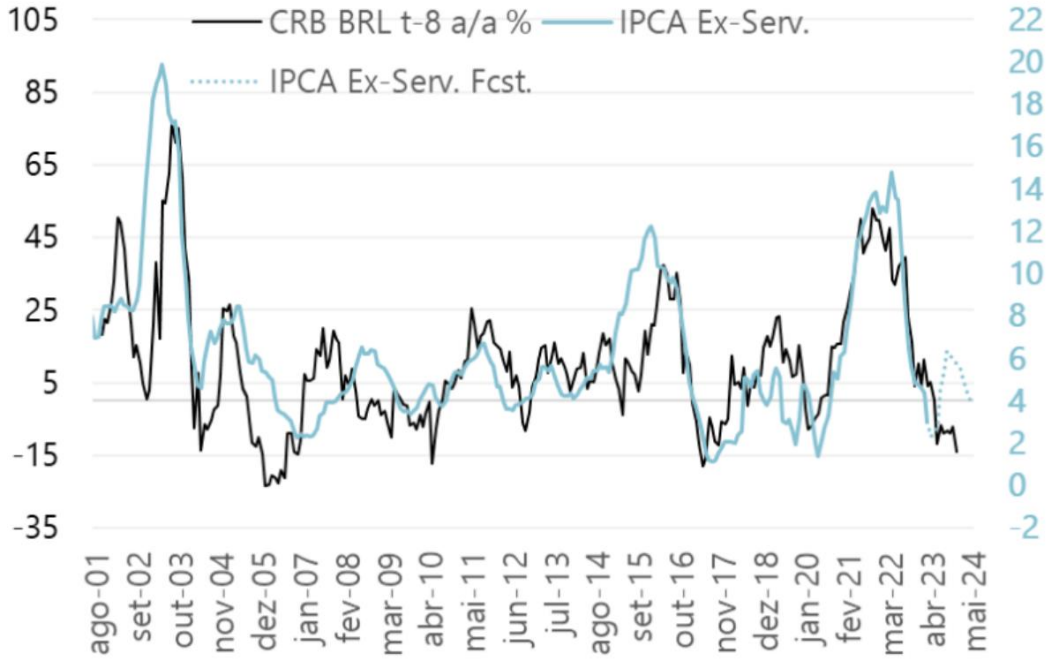
Looking ahead: the difficult part of the disinflation process is now

03

What to expect from now on? The relief in volatile prices should see a pause

- Although usual drivers (commodities+brl) of volatile prices still point to disinflation ahead, the reinstatement of taxes that were cut last year--most of them accounted for in the regulated prices group--should pressure the IPCA EX-Services

Commodity prices in BRL and IPCA Ex-Services forecast



Sources: IBGE, Bloomberg and Santander

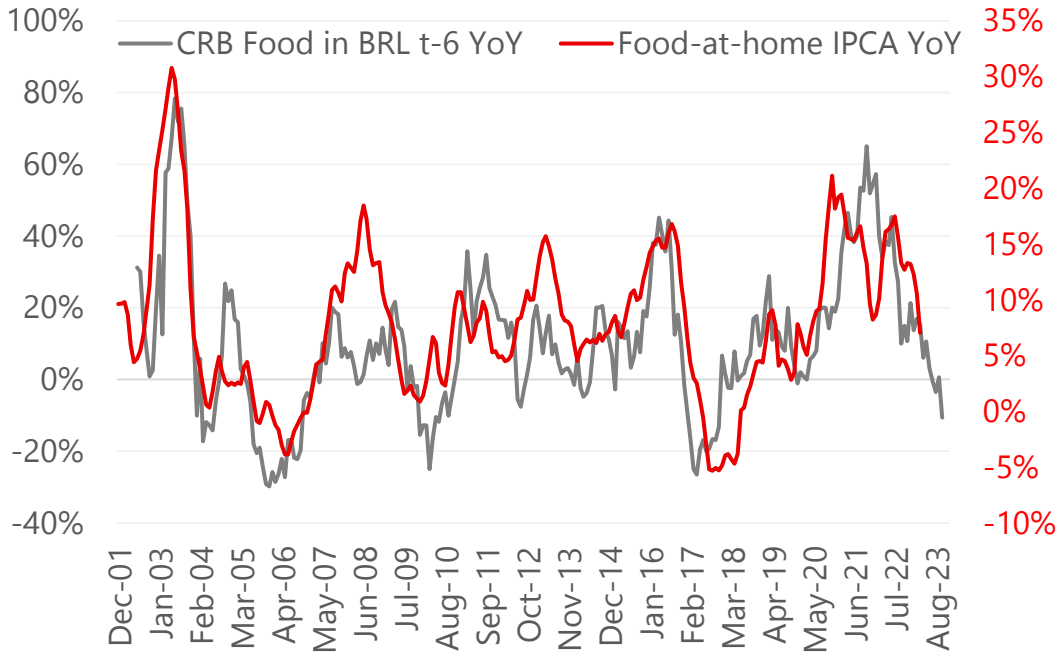
Regulated prices forecast

Sources: IBGE, FGV, Santander

Food-at-home: in this part of volatile prices, the relief should continue

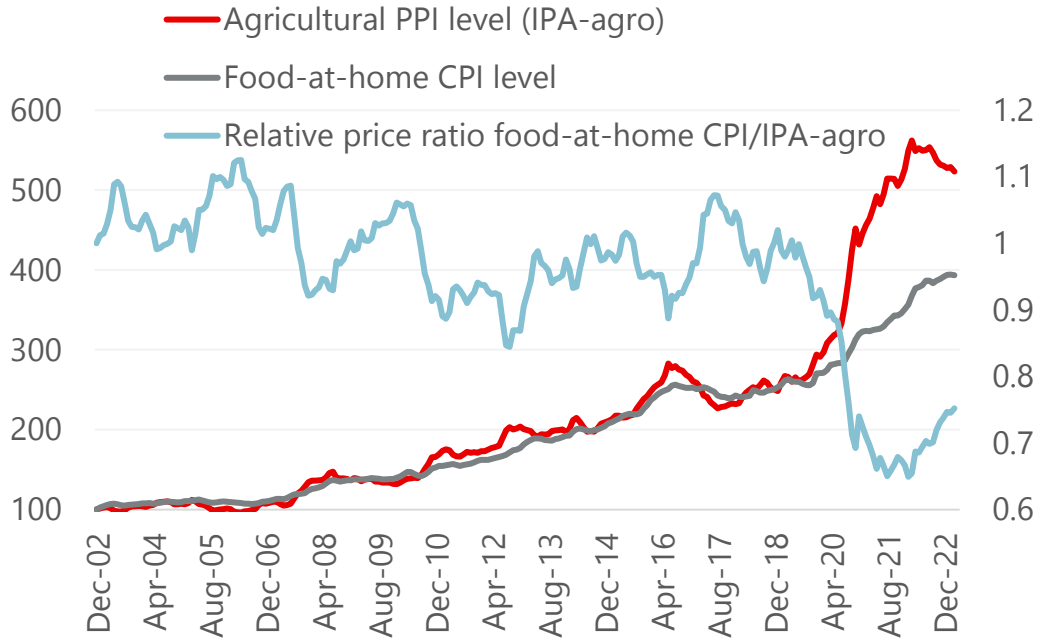
- Food-related commodity prices continue to indicate space for a disinflation ahead
- The risk: there seems to still be a backlog of price raises at the wholesale level that didn't reach the consumer; therefore, even with a fall in wholesale prices, there is a chance that the pass-through to consumers end up being low, as retailers re-gain margin

Food inflation on IPCA and CRB Food in BRL terms



Sources: IBGE, Bloomberg,Santander.

Distortion of relative price (consumer x wholesale)

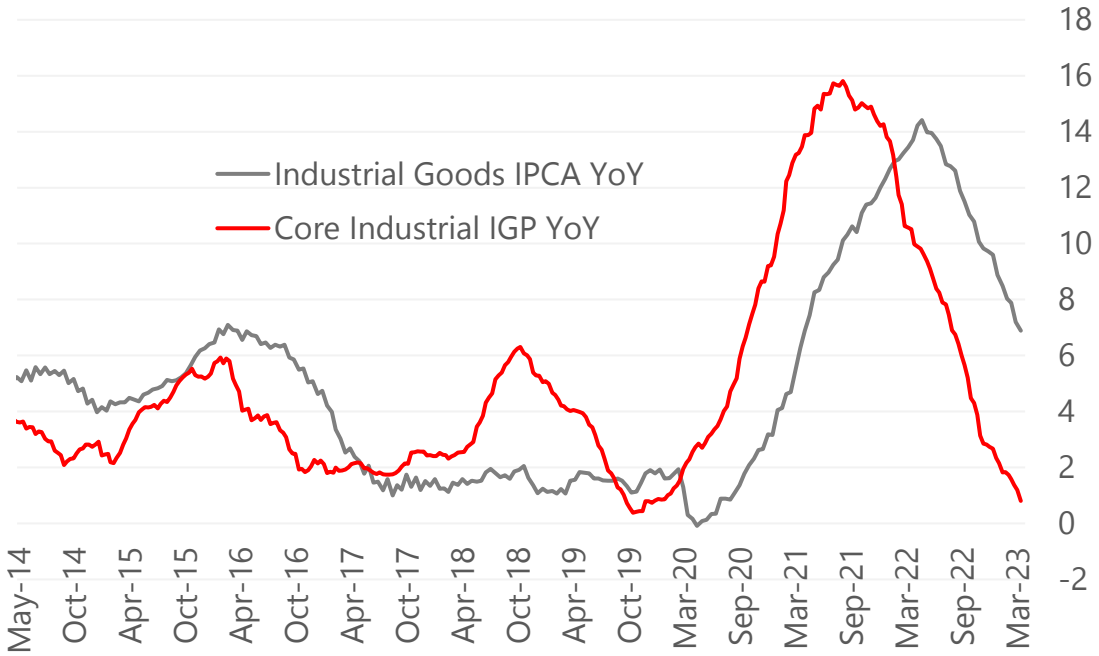


Sources: IBGE, FGV, Santander.

Industrial goods: some more space for disinflation

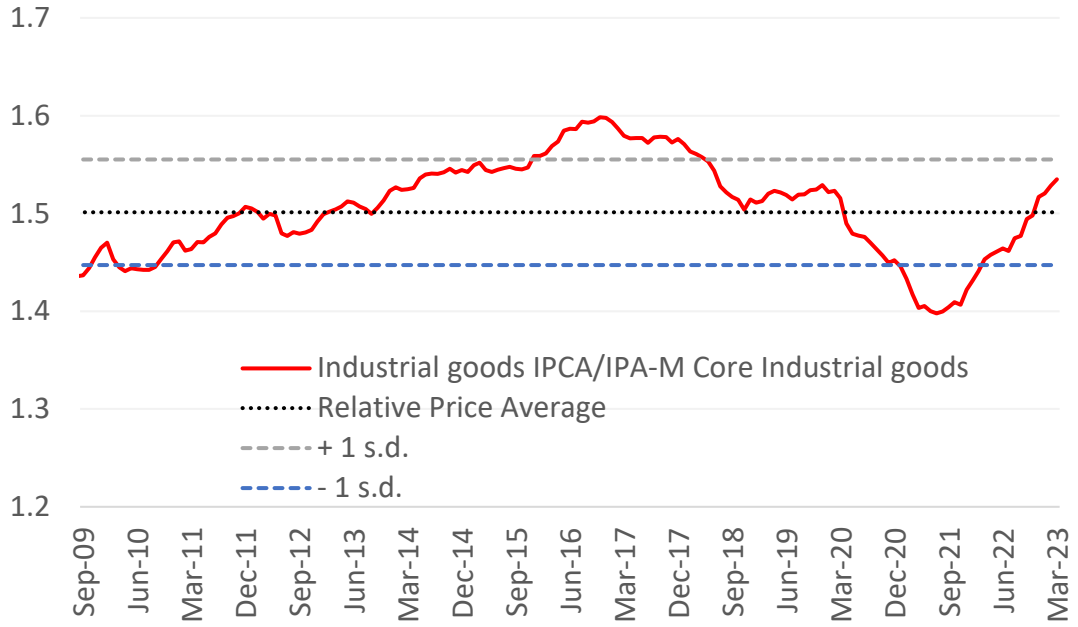
- Industrial goods inflation at the wholesale/producer level is decelerating sharply and the consumer level will continue to follow
- The relative price relation shows that prices at the consumer level already recovered to the proportion of the shock at the wholesale level; and actually it shows that there is space for industrial goods at the consumer level to fall more

Core-PPI-Industrial vs. Industrial goods in IPCA



Sources: IBGE, FGV, Santander.

Relative price (consumer x wholesale)

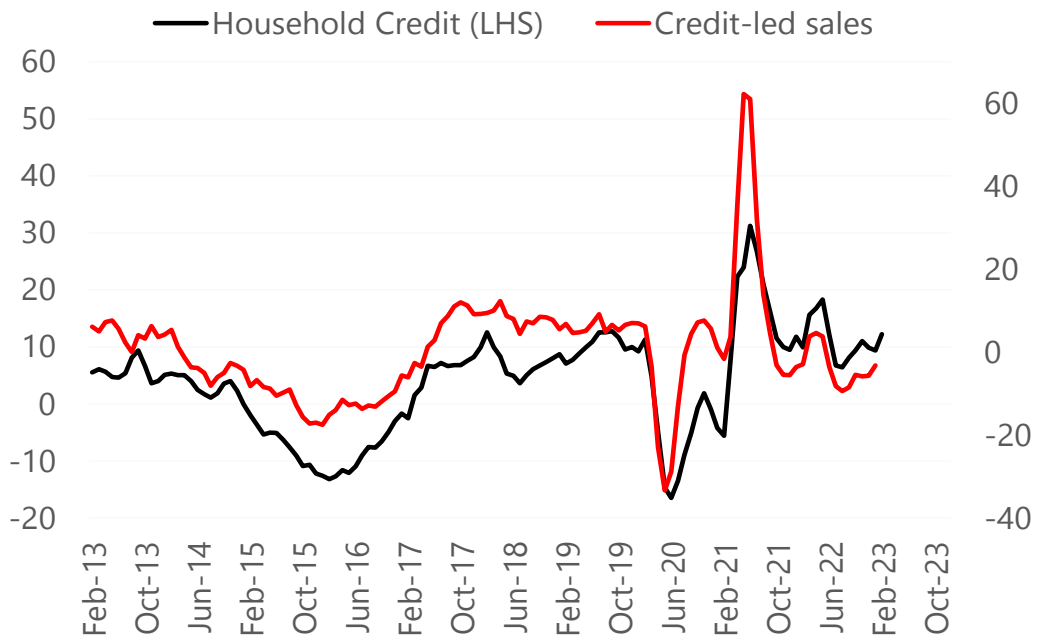


Sources: IBGE, FGV, Santander.

Lower demand for durable goods

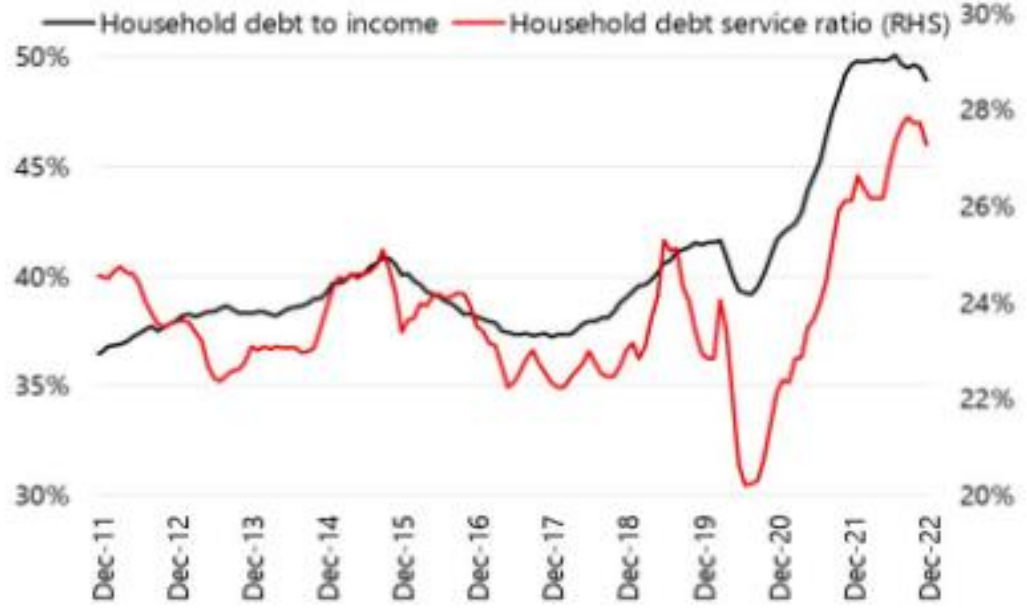
- For households, new loans have decelerated (although they are still growing considerably). However, debt-income and debt-service ratio levels are really high, suggesting a small space for demand through credit
- Credit-led retail sales are decreasing

Credit-led retail sales and New loans to households - % YoY mm3



Sources: IBGE, BCB, Santander

Households are highly indebted

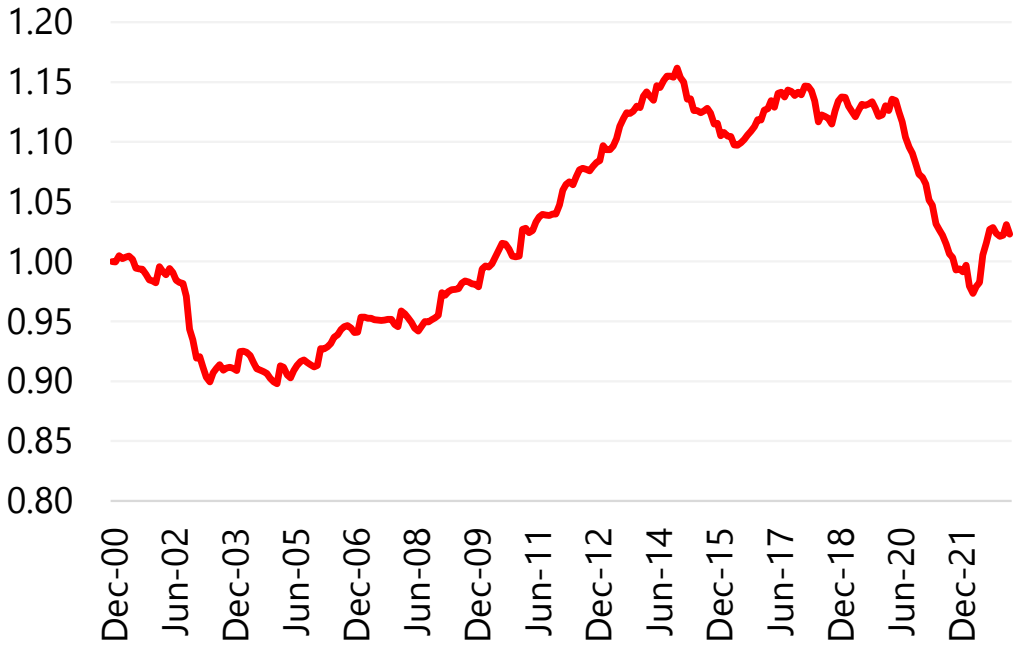


Sources: BCB, Santander

Services: a slower disinflation, as prices at this sector are more inertial

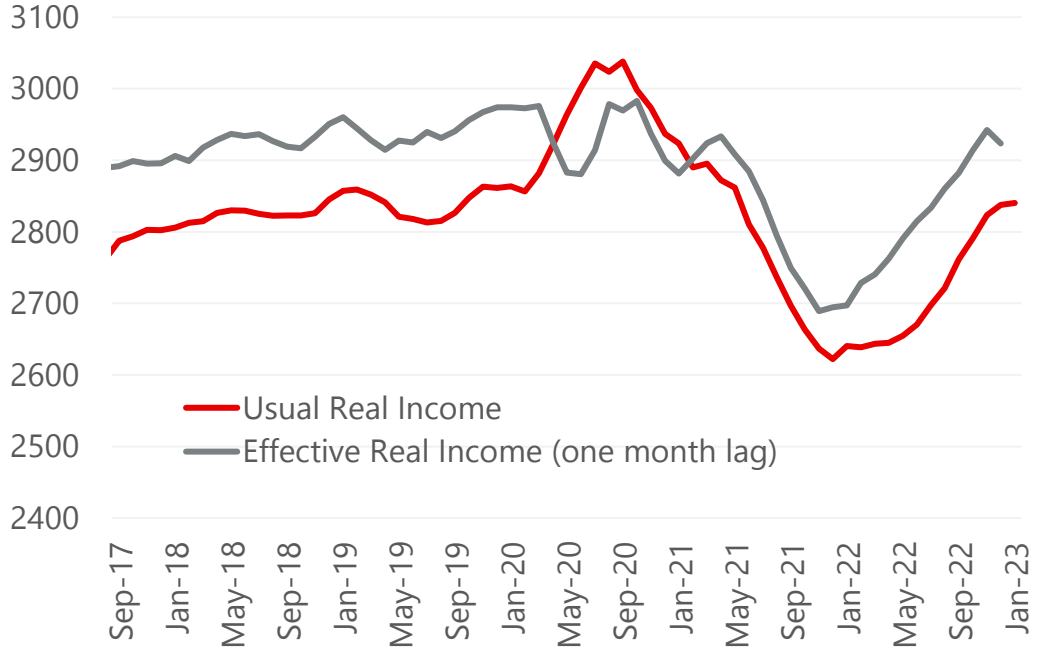
- Services is still lagging the volatile prices inflation, as the relative price between IPCA services/IPCA ex-services is still distorted
- As a result, services should continue to run above the rest of IPCA for a while and, in the short-term, is being helped by the recovery of the real wages/income, which influences more this sector than credit

Relative price: IPCA Services/IPCA Ex-Services



Sources: IBGE, Santander

Increase in income to levels pre-pandemic is helping the recovery



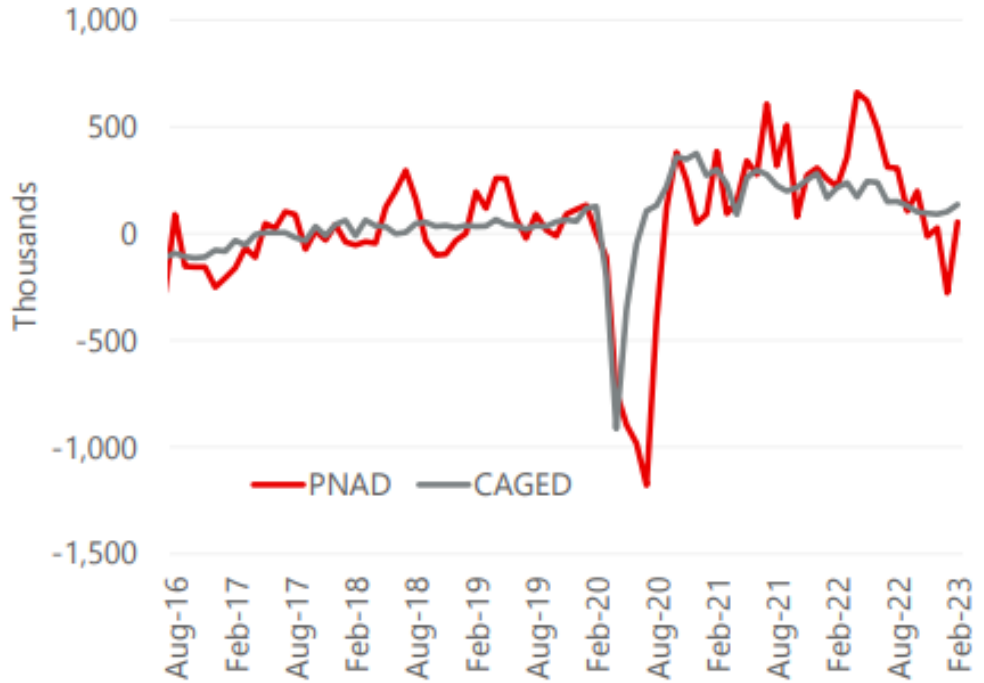
Sources: IBGE, Santander

Santander

But looking ahead the job market should weaken and drive the deceleration of services

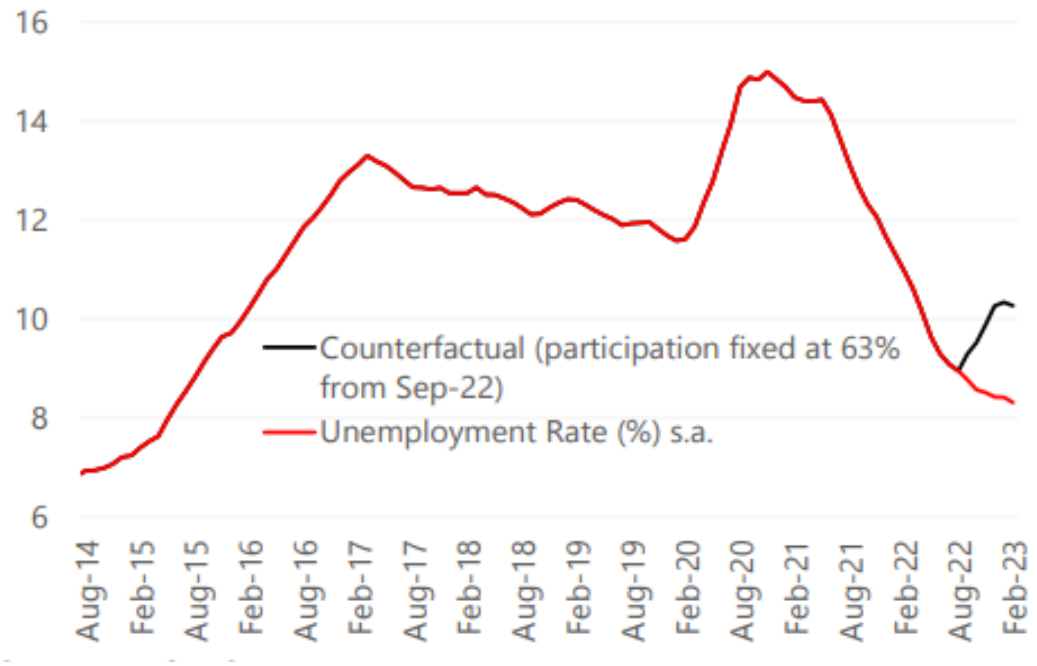
- Net job creation is weakening
- And the participation rate seems too low; a counterfactual exercise with participation at pre-pandemic levels show that unemployment would be considerably higher

Formal net job creation is weakening



Sources: IBGE, Santander.

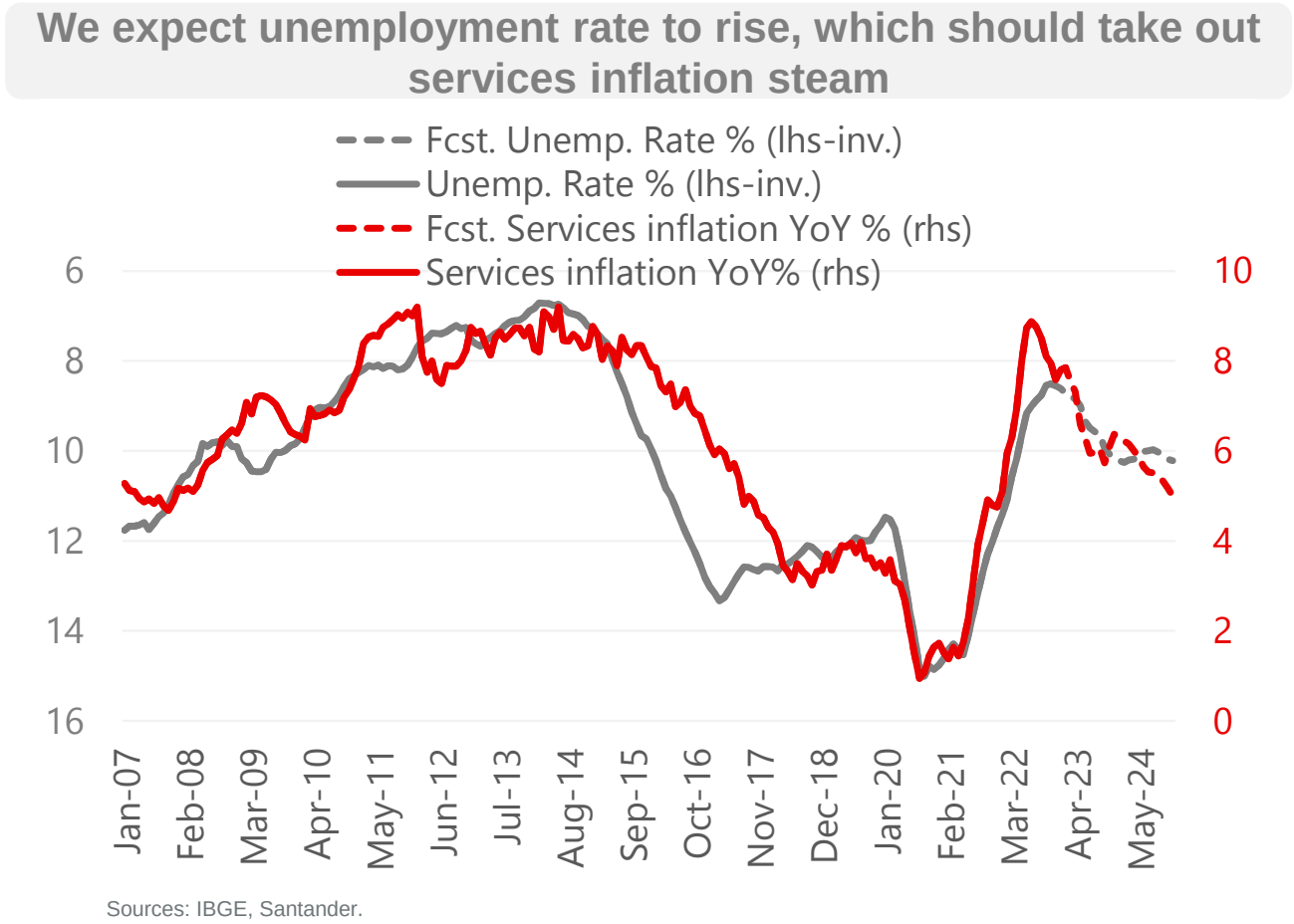
Counterfactual unemployment rate with participation rate at the average of pre-pandemic



Sources: IBGE, Santander.

Unemployment should rise and push services inflation down, at a slow pace

- With unemployment rising and wages controlled, demand for services should reduce
- The end of the “normalization” of the consumption basket should also make demand for services lower for the next quarters

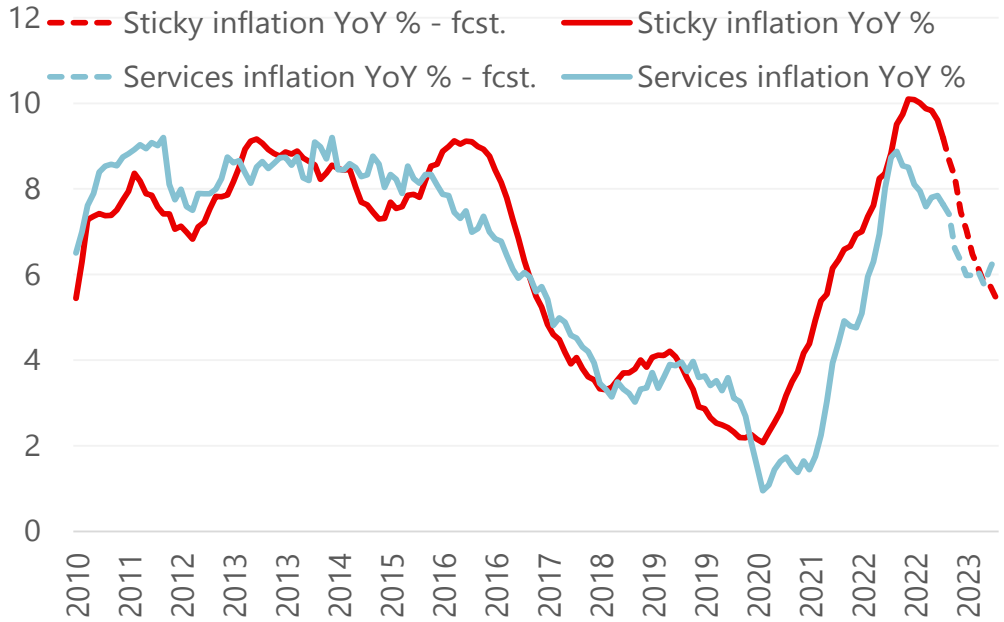


Sources: IBGE, Santander.

Sticky and semi-sticky inflation on a downward, but slow trend

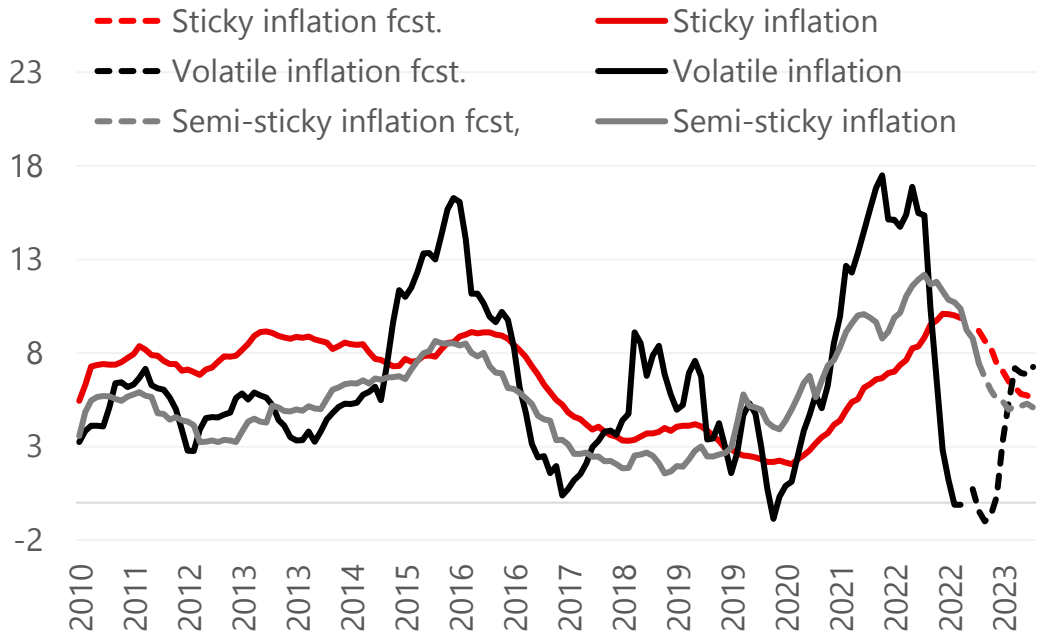
- As we said in previous slides, the volatile part of inflation should see a rebound, but sticky and semi-sticky items should continue on a slow downward trend, reaching ~5.0%-5.5% by 2023ye (from peaks around ~10%-12%)

Sticky inflation vs. Services inflation



Sources: IBGE, Santander.

Sticky, semi-sticky and volatile inflation decomposition

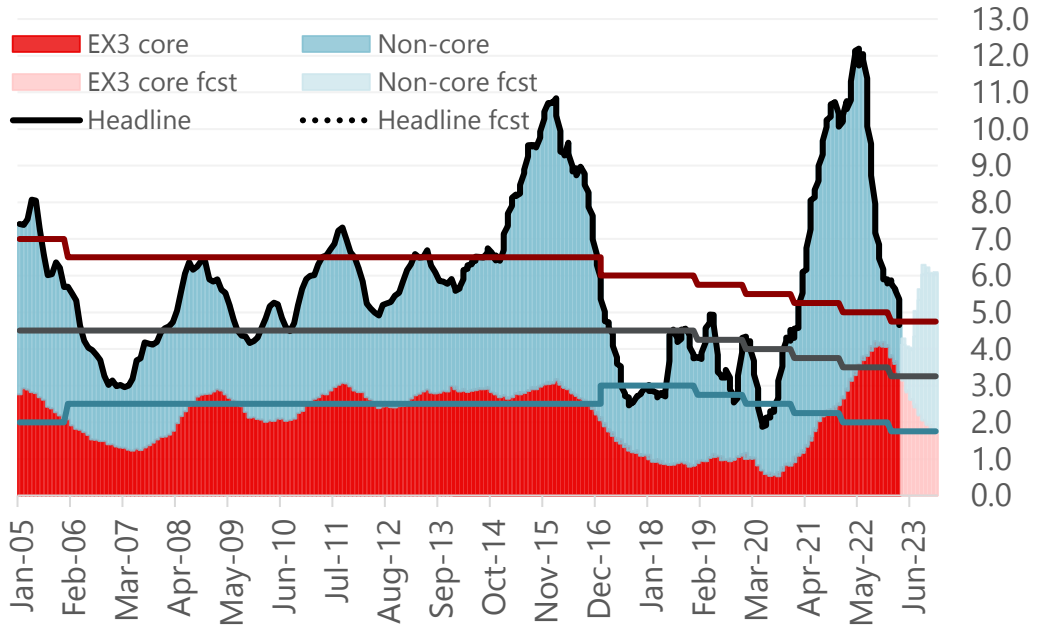


Sources: IBGE, Santander.

Bottom-line: volatile inflation will rebound and core gauges will decelerate slowly

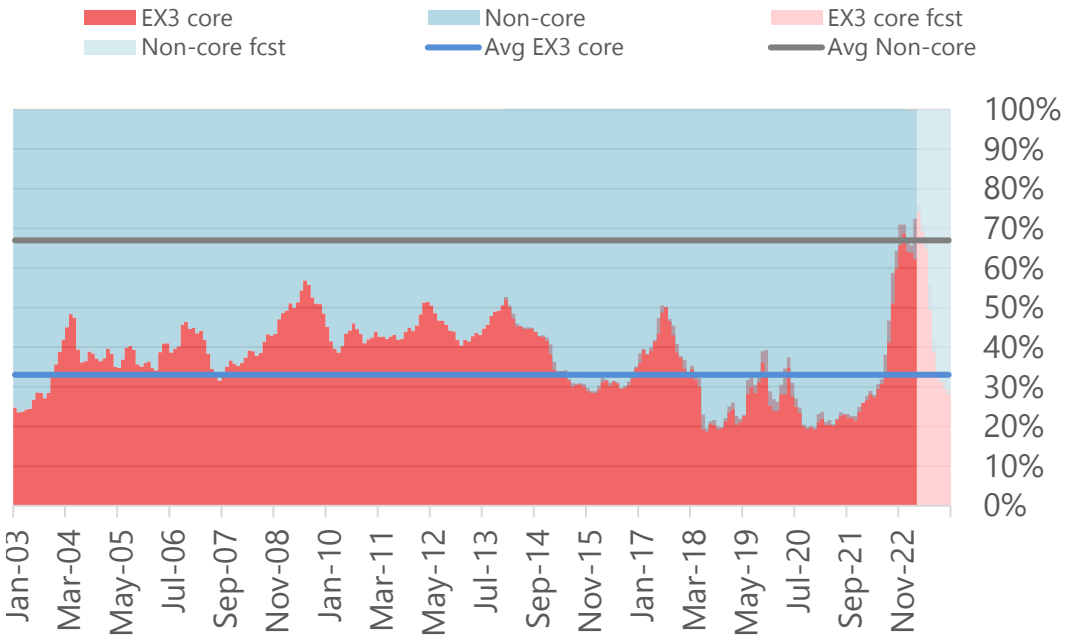
- The disinflation process is entering a more difficult period, where volatile inflation rebounds and core/sticky inflation decelerates at a slow pace
- The contribution of the core to headline inflation should continue the downward trend until the end of the year and recede back to account for around 30% of total inflation (which is the historical average)

IPCA decomposition: core and non-core



Sources: IBGE, Santander.

Contribution of core and non-core to headline IPCA



Sources: IBGE, Santander.

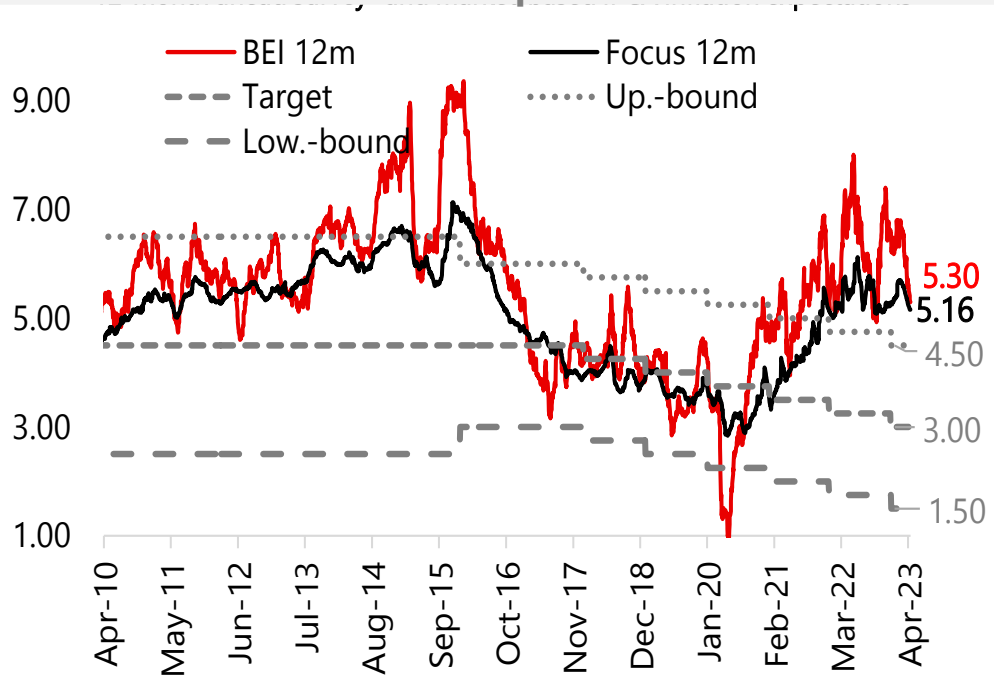
Main Risk: expectations de-anchoring

04

Inflation expectations: de-anchored from the target

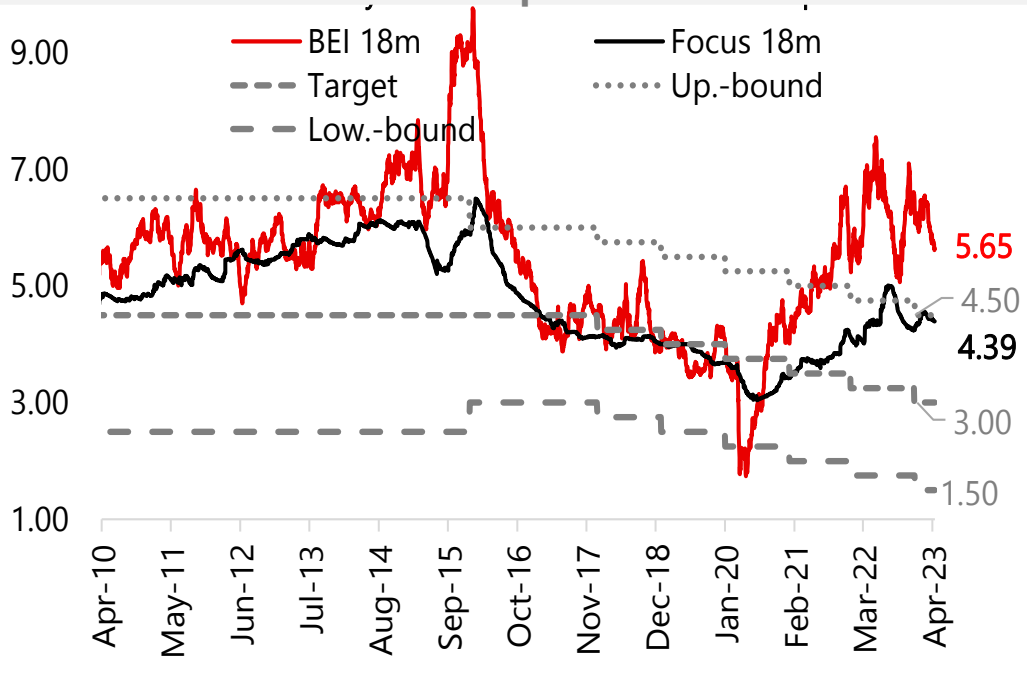
- Expectations for the relevant horizon of monetary policy are de-anchored from the target, which makes the disinflation process more difficult
- At the margin, we are seeing a convergence of the break-even inflation (although still well above the target). The survey-based expectations did not move much, but usually the BEI anticipate movements in the survey

12-month ahead survey- and market-based inflation expectations



Sources: BCB, Bloomberg, Santander.

18-month ahead survey- and market-based inflation expectations

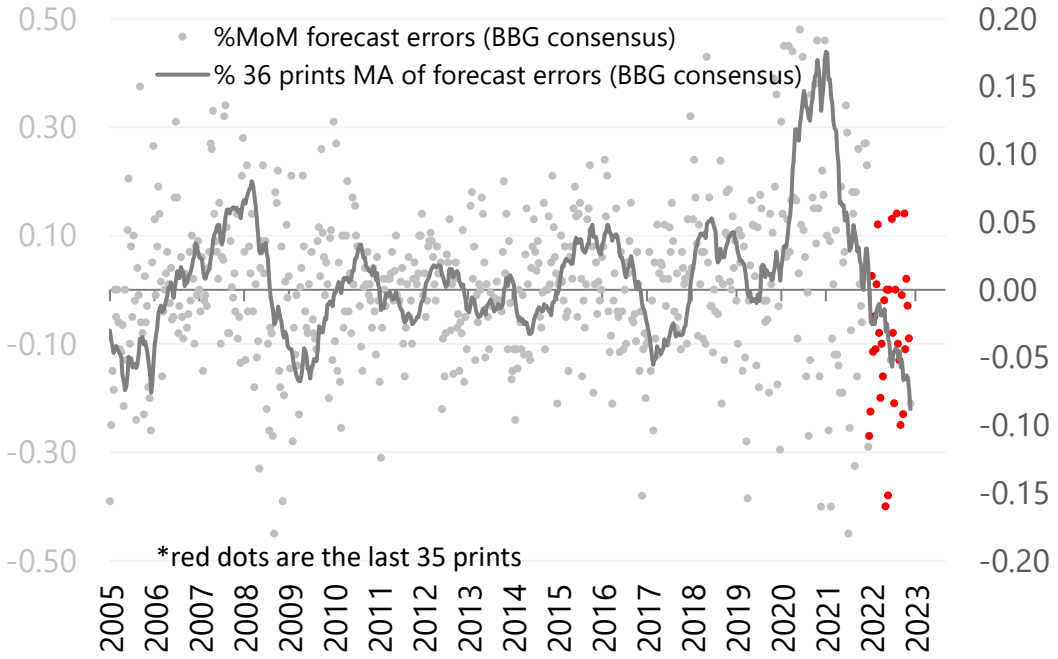


Sources: BCB, Bloomberg, Santander.

A full re-anchor seems unlikely, but what could make expectations at least stop worsening?

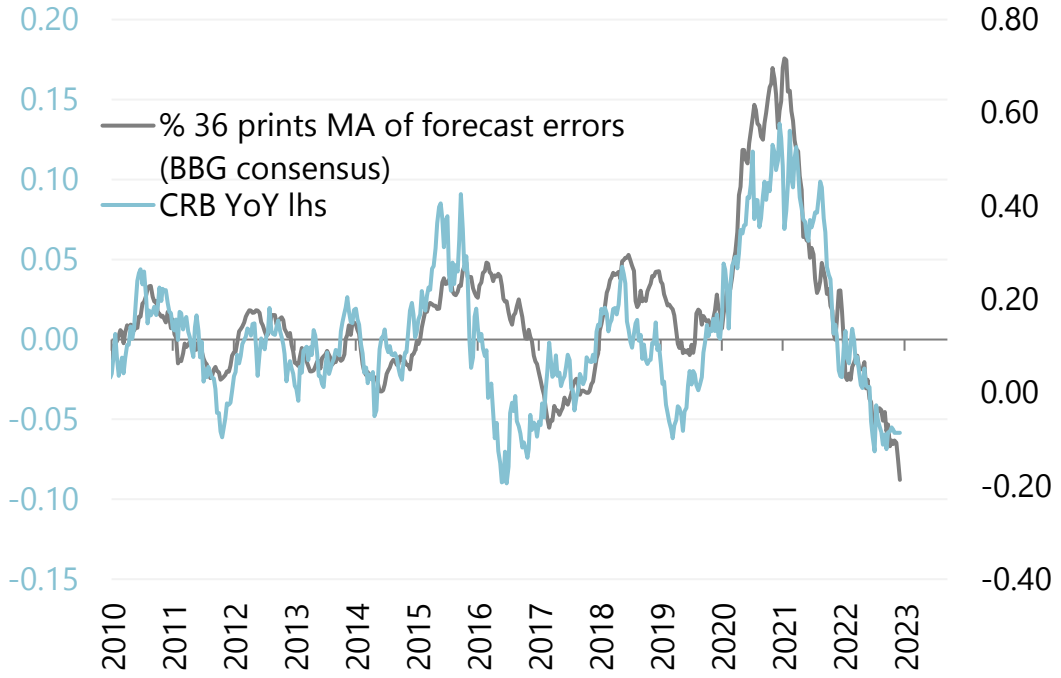
- For the past 35 prints, 70% came in below expectations (9% came in line and just 20% came in above forecasts)
- The surprises seem to be mostly driven by the commodity prices in BRL terms: once it peaked YoY, IGP surprises started to reduce

Inflation surprises at the wholesale/producer level (IGP-10, IGP-M, IGP-DI)



Sources: FGV, Santander.

IGP (PPI) surprises tend to be led by commodity prices in BRL terms

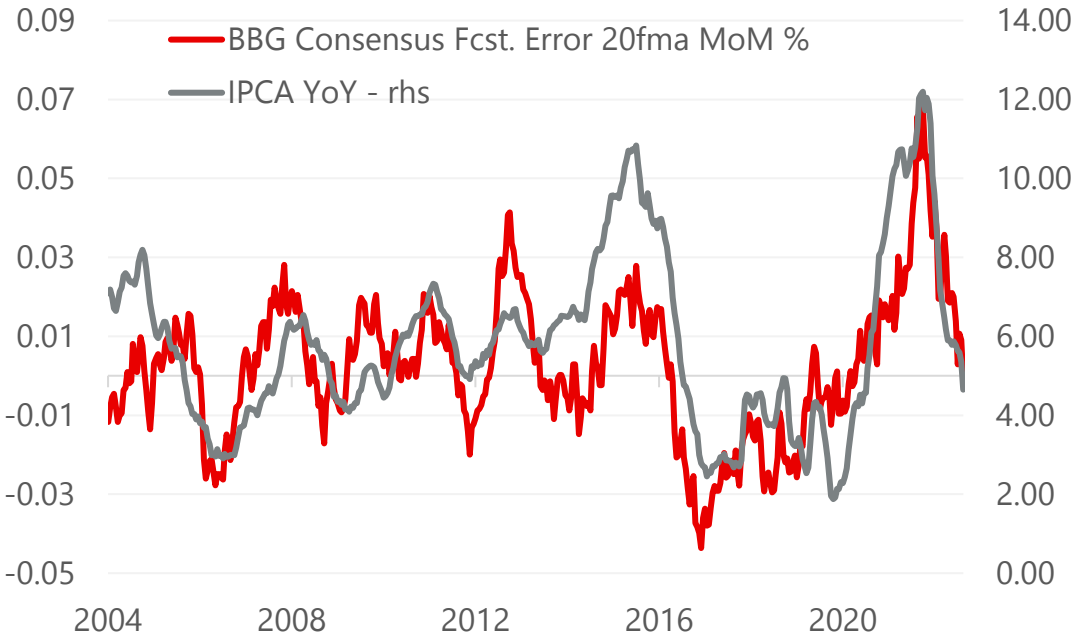


Sources: FGV, Santander.

Inflation expectations at the consumer level: no more upward surprises, on average

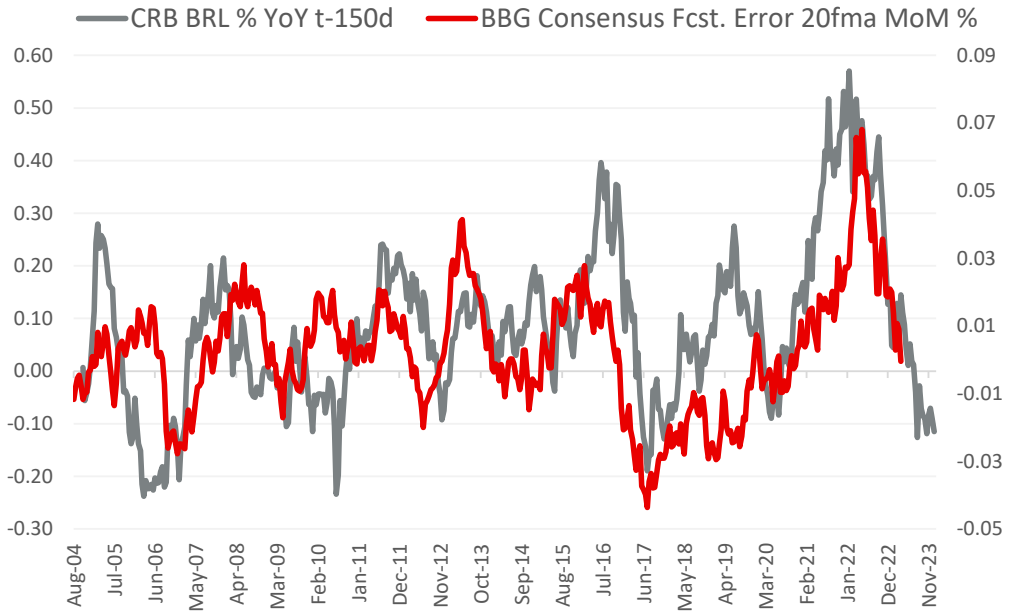
- Monthly inflation surprises are highly correlated to the state of inflation: if inflation is accelerating, upward surprises follow and vice-versa. Consequently, as IPCA has peaked, inflation upward surprises reduced and are running at zero on average
- Having stated that inflation at the producer level is led by commodity prices and the exchange rate, by transitivity, inflation at the consumer level is also led by commodity prices in BRL terms and it is pointing towards further deceleration of surprises in IPCA

IPCA inflation surprises are highly correlated to the state of inflation



Sources: IBGE, Bloomberg, Santander.

CRB in BRL is pointing to further deceleration of IPCA inflation surprises

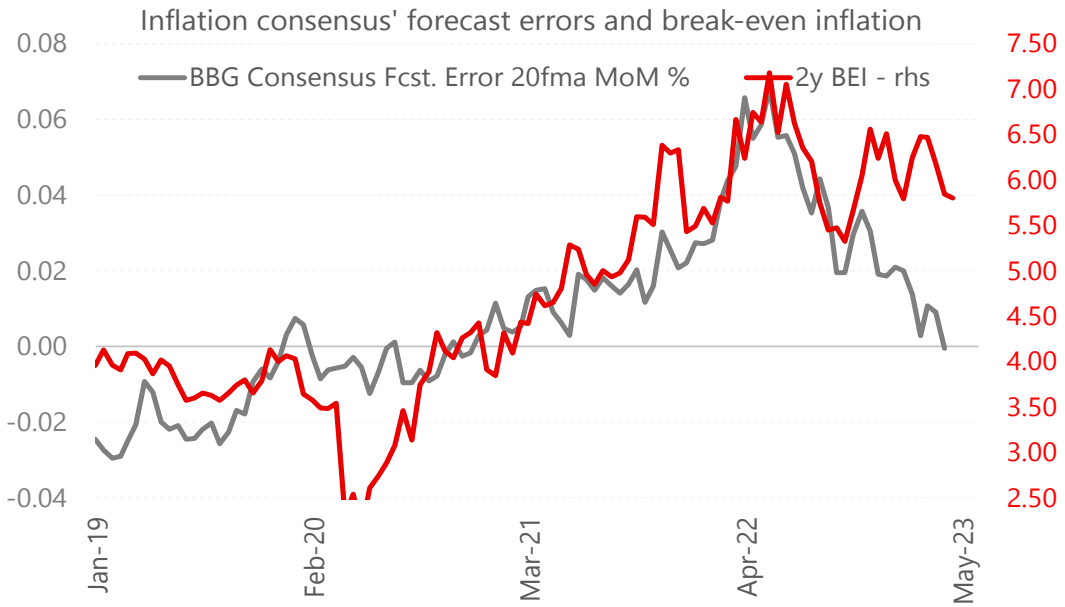


Sources: Bloomberg, Santander.

Short-term inflation surprises tend to influence medium/long-term expectations

- Short-term surprises usually are incorporated in market-based (BEI) long-term expectations
- Then the BEI tends to drive the survey-based expectations

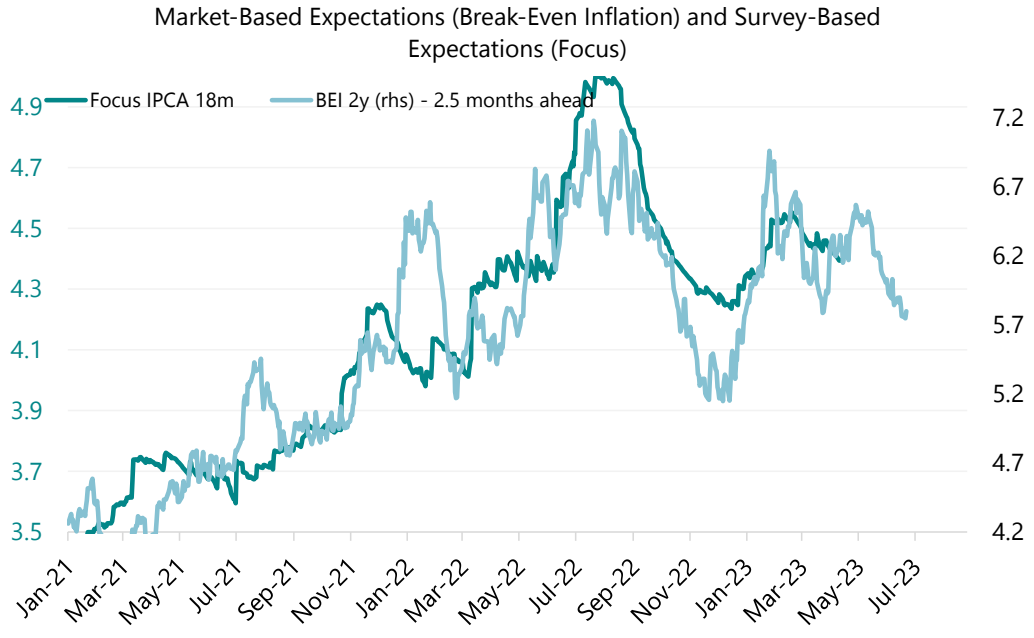
2y BEI is starting to fall at the margin, because of recent IPCA downward surprises



Source: Santander
*12 month moving average of the monthly IPCA (and IPCA-15) prints' consensus error at Bloomberg

Sources: Bloomberg, Santander.

Usually the BEI anticipates movements on Focus



Sources: BCB, Bloomberg, Santander.

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