Brazil Macro | September 2022

INFLATION

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Forecasting accountability

01

Forecast accountability: tax cuts impacting more than expected

- Also a quicker deceleration of industrial goods

	2022		
	old	new	Δ bps
IPCA	7.9	6.3	-164
Free prices	10.6	10.0	-46
Food-at-home	15.1	13.2	-30
Industrial goods	10.7	9.3	-34
Tradables	10.7	9.7	-21
Non-Tradables	10.5	6.3	-12
Services	8.5	9.1	18
Food-service	8.4	8.6	1
Airline tickets	43.0	54.3	7
Economic activity	8.0	8.2	2
Education	6.8	7.0	1
Inertial	8.4	8.9	3
Salaries	8.0	8.4	3
Administered prices	0.5	-2.3	-77
Gasoline	-7.7	-18.7	-74
Energy	-20.4	-18.8	7
Health insurance	7.9	6.9	-3
Bus fares	4.3	3.4	-2
Cores	11.0	8.8	-217

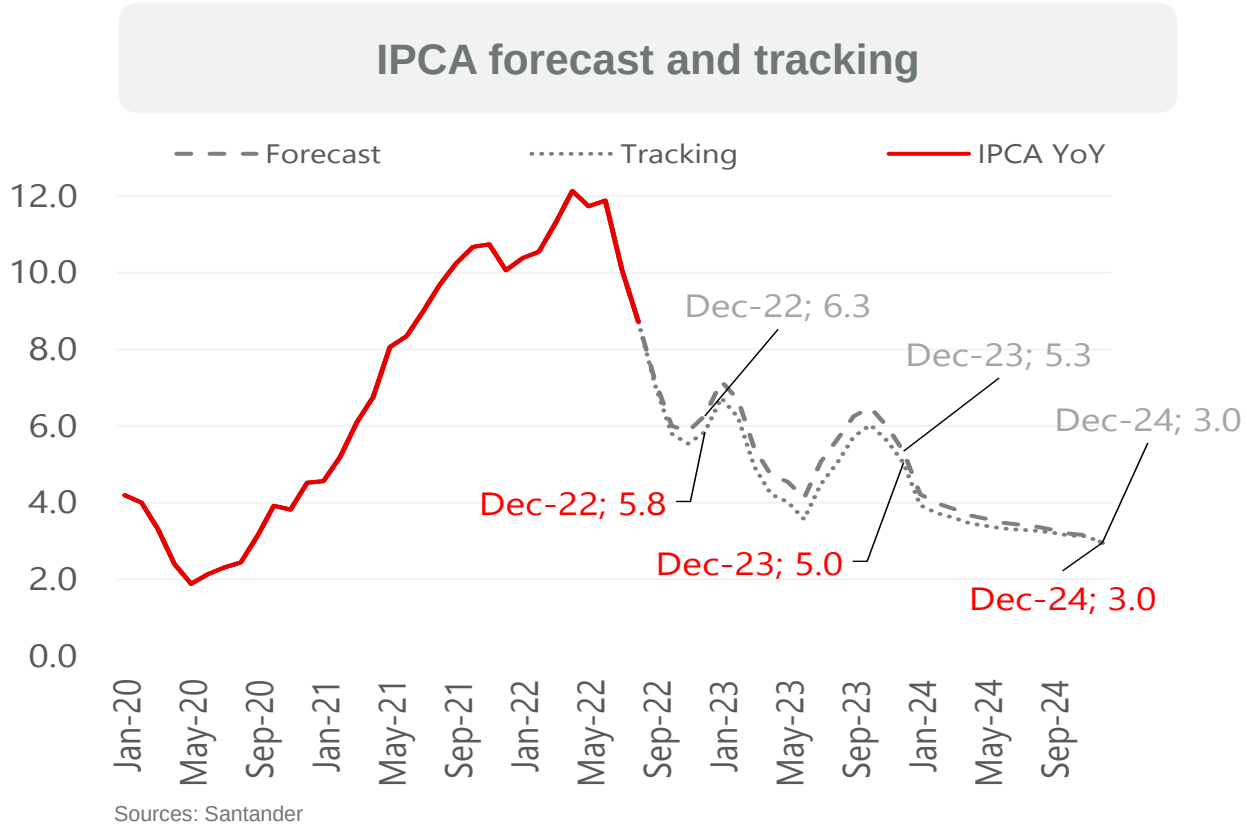
Sources: Santander

	2023		
	old	new	Δ bps
IPCA	5.7	5.3	-35
Free prices	5.0	4.6	-35
Food-at-home	3.5	3.2	-5
Industrial goods	4.1	3.0	-27
Tradables	4.5	3.0	-30
Non-Tradables	1.0	3.0	6
Services	6.3	6.3	0
Food-service	6.5	6.5	0
Airline tickets	5.0	5.0	0
Economic activity	6.0	6.0	0
Education	8.0	8.0	0
Inertial	6.0	6.0	0
Salaries	5.5	5.5	0
Administered prices	7.5	7.5	0
Gasoline	4.0	4.0	0
Energy	12.0	12.0	0
Health insurance	12.0	12.0	0
Bus fares	12.0	12.0	0
Cores	6.5	6.2	-30

Sources: Santander

High-frequency tracking: short-term surprises pushing estimates lower

- Since our scenario revision in the beggining of September, our high-frequency tracking was pushed lower
- Recent IPCA prints alongside high-frequency price surveys indicate that the balance of risks is tilted downwards



Sources: Santander

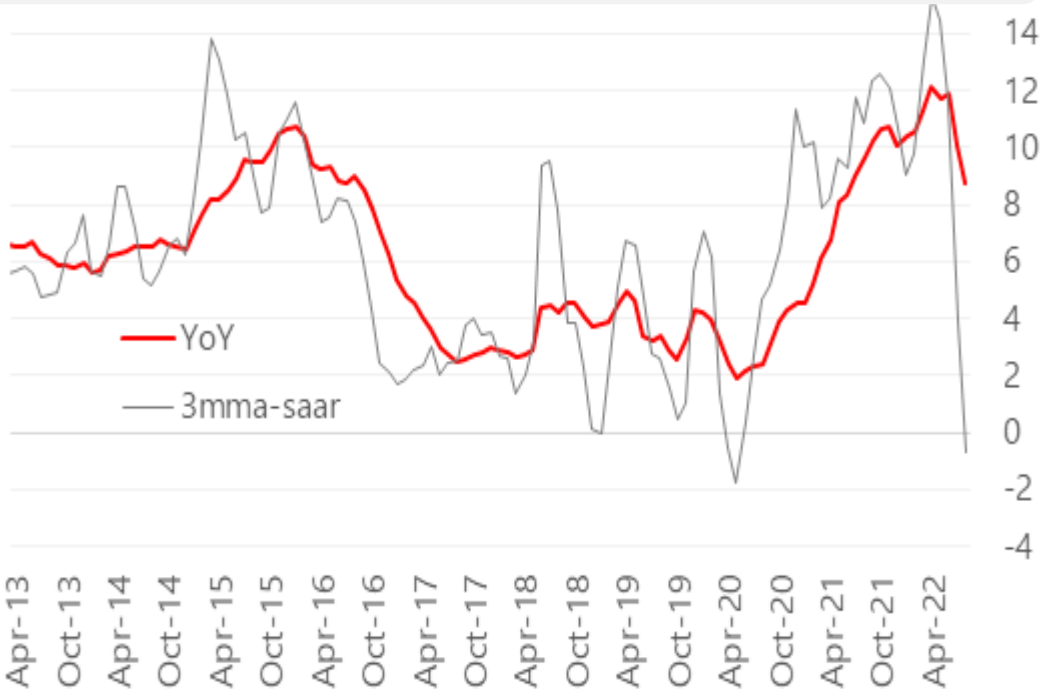
Picture: headline peak is behind

02

Inflation: headline peak

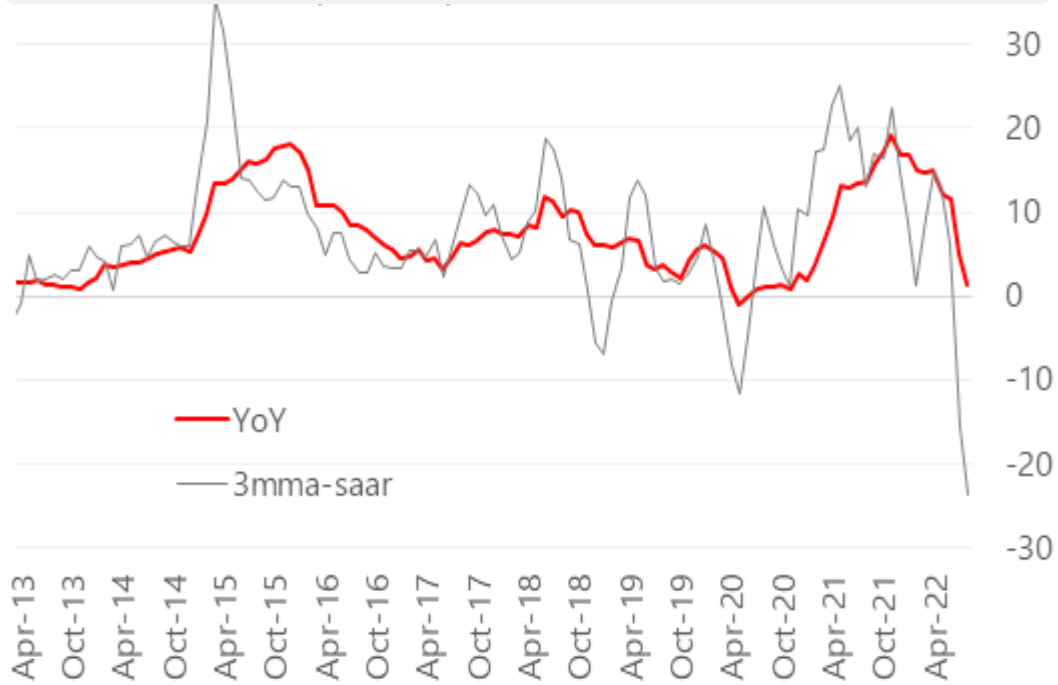
- We already expected inflation to peak, but it is worth highlighting that the major tax cuts in gasoline and electricity helped the movement to be more pronounced
- Regulated prices which comprise fuels and electrical energy (the main items impacted by the tax cut) are falling -20% 3MMA-saar

Headline IPCA inflation



Sources: IBGE, BCB, Santander

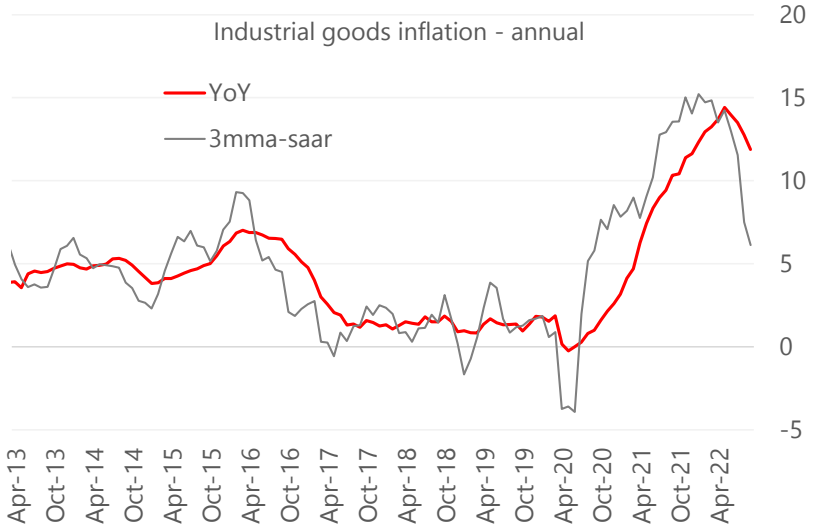
Regulated prices inflation

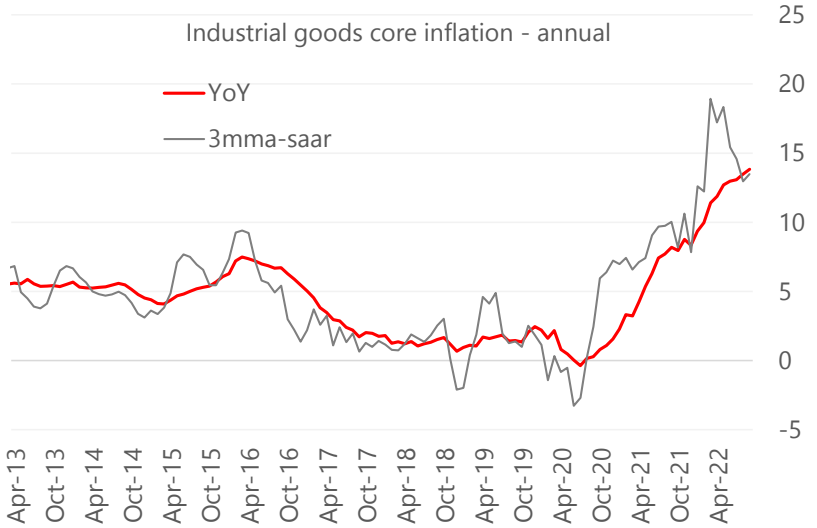


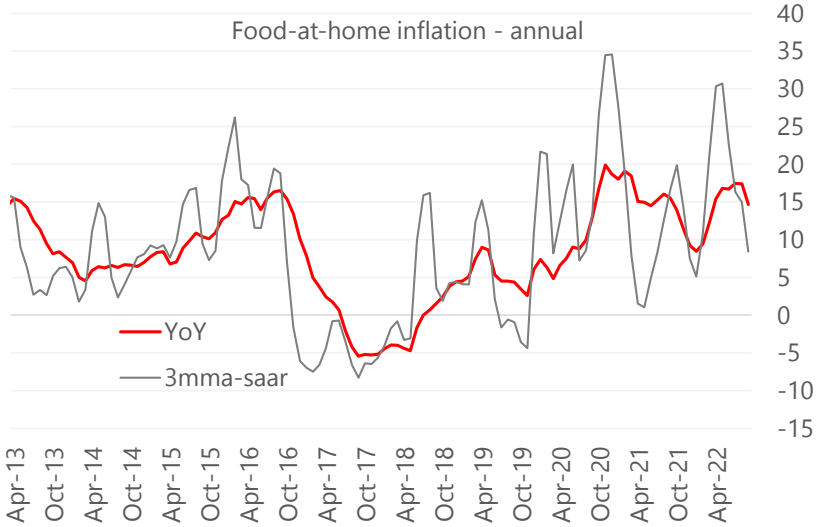
Sources: IBGE, BCB, Santander

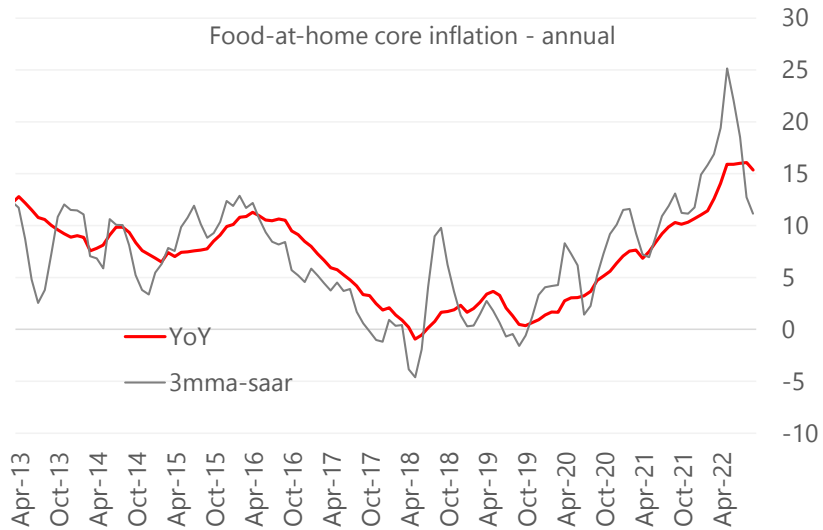
Industrials and food inflation: the relief is happening

- Industrial goods are decelerating sharply: a great part is due to tax cuts in ethanol fuel, but we are seeing relief in durable goods too
- In food, the relief is starting, but the movement is less pronounced







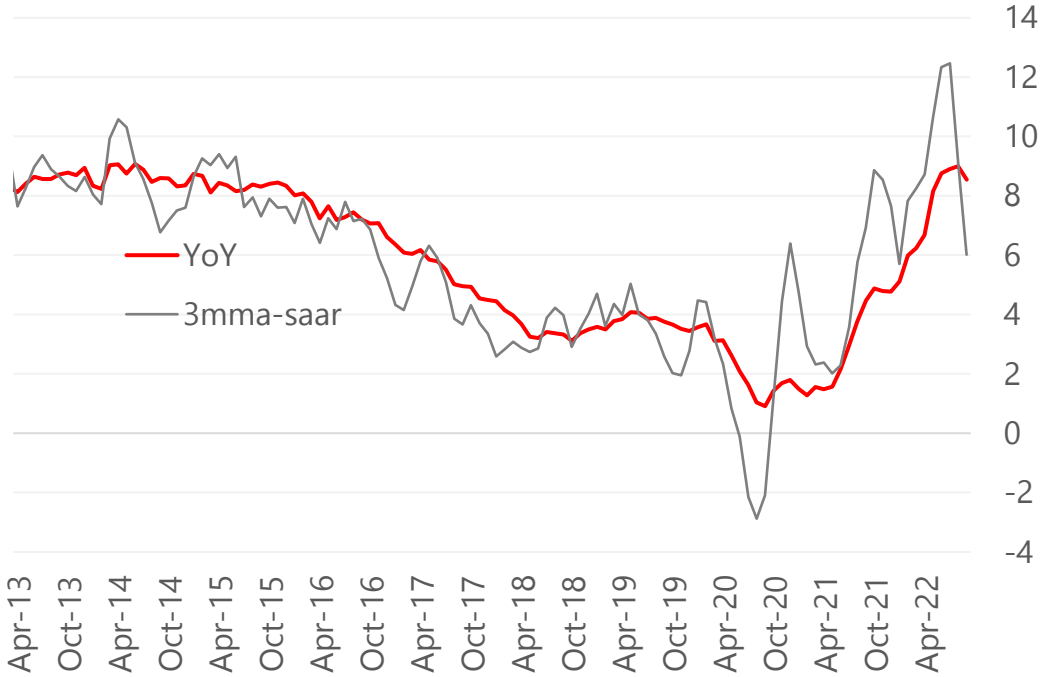


Sources: IBGE, BCB, Santander

Services inflation still running high, particularly the core

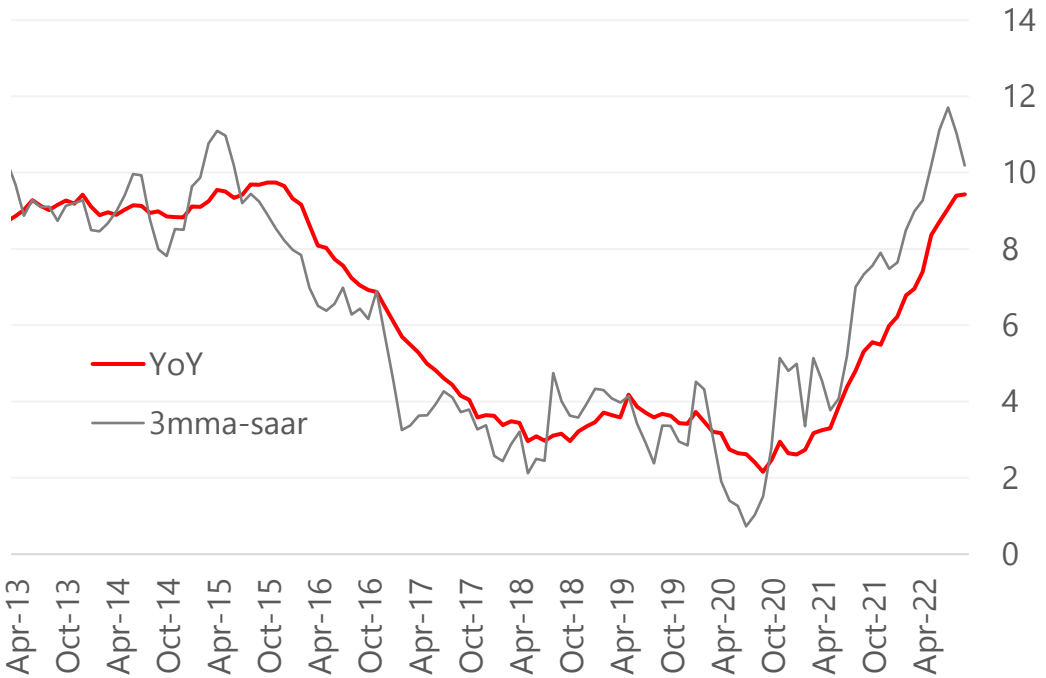
- Headline services is still running high, although it decelerated a bit at margin (but mostly driven by volatile prices)
- In particular, core services are still hovering 10% 3MMA-saar, with no clear sign of deceleration

Headline services inflation



Sources: IBGE, BCB, Santander

Core services inflation

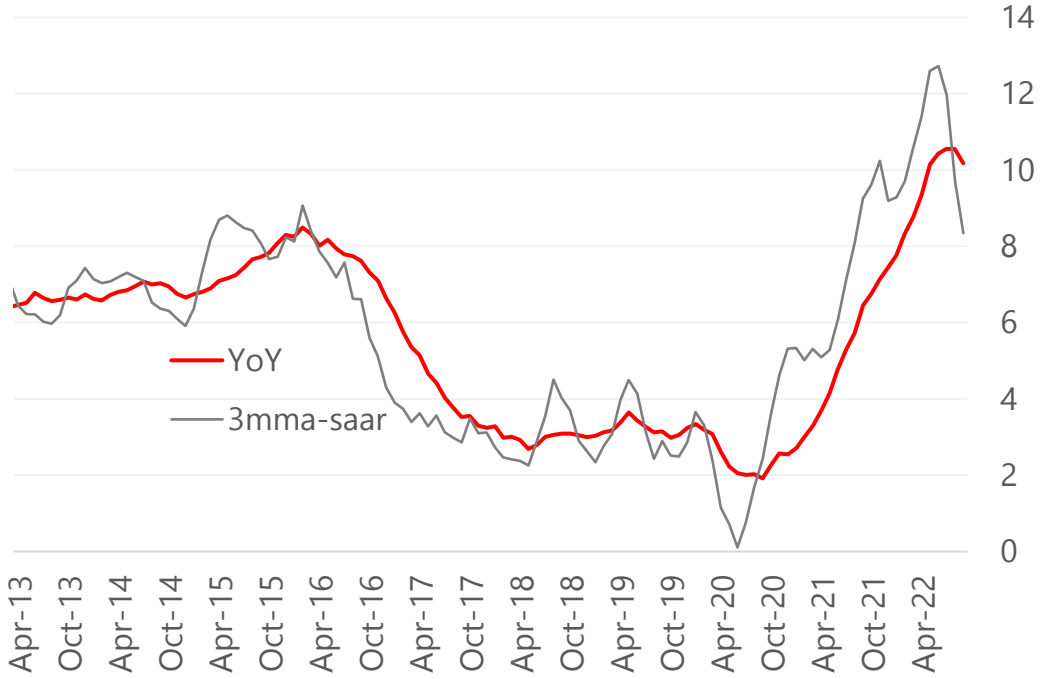


Sources: IBGE, BCB, Santander

Core gauges: preliminary relief

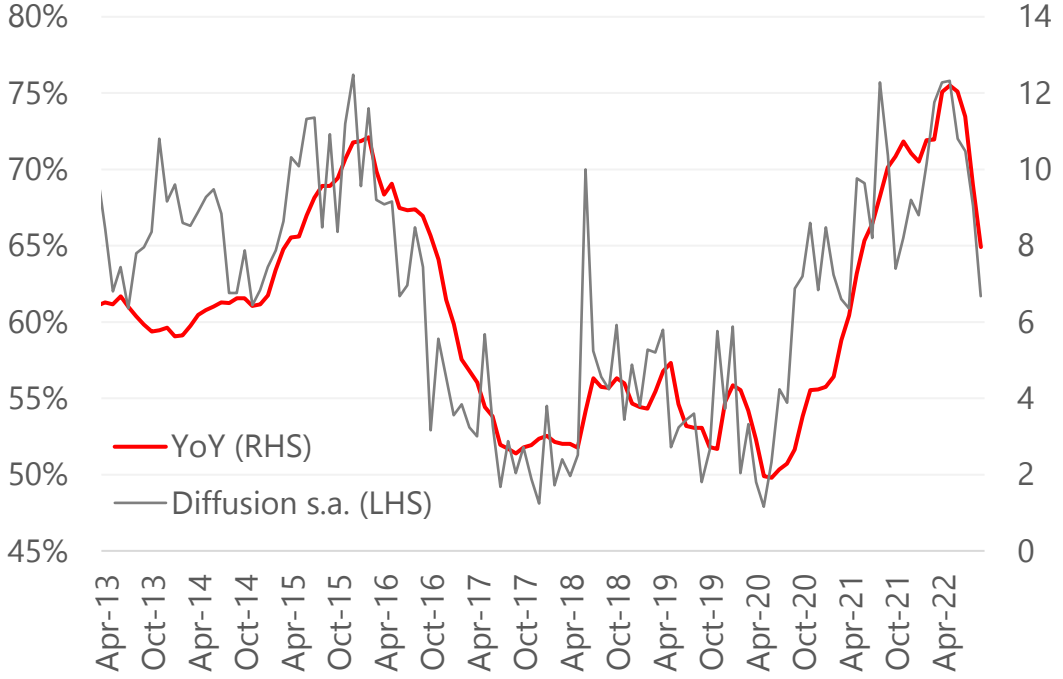
- Core gauges started to decelerate at the margin
- Part of the movement could be influenced by the tax cuts, but we are starting to see some relief in underlying inflation indeed
- The diffusion index also started to fall

Core inflation reaching new highs



Sources: IBGE, BCB, Santander

Diffusion index close to the highs



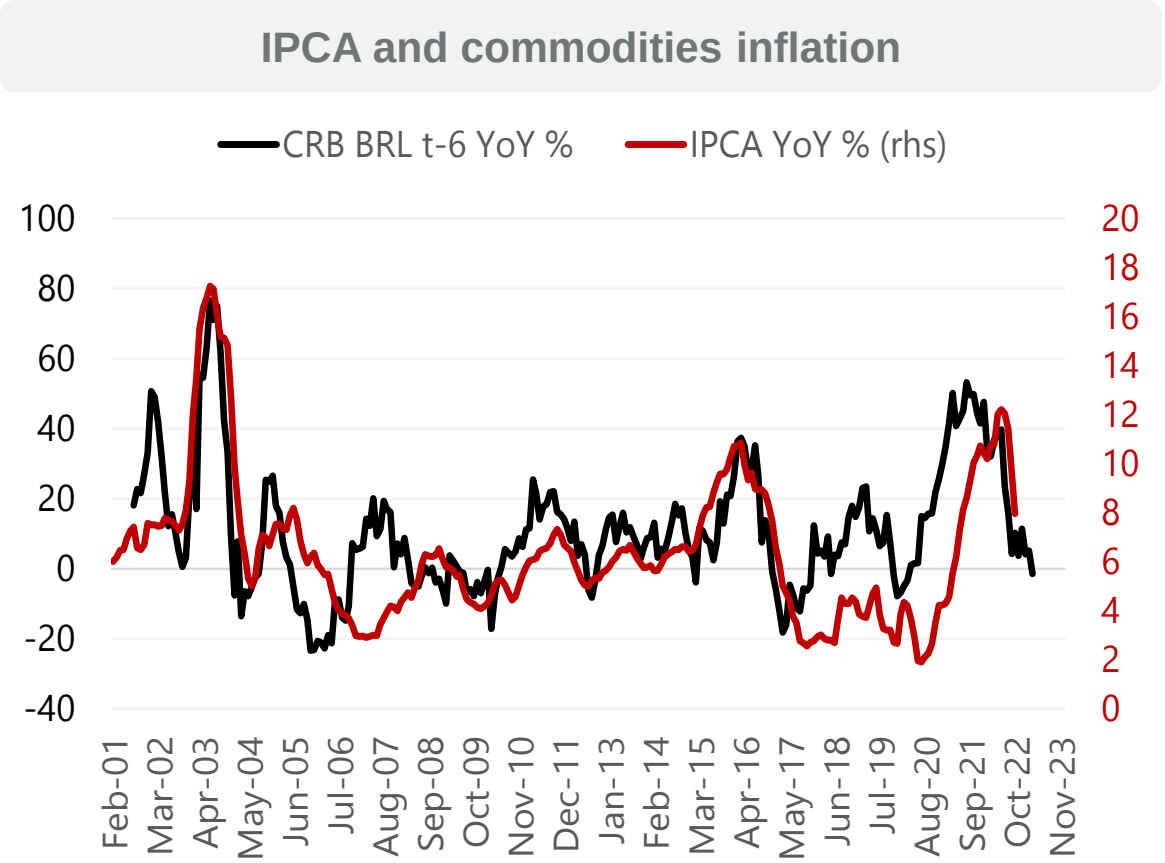
Sources: IBGE, BCB, Santander

Looking ahead: the focus now is on the dynamic of core gauges and expectations

03

What to expect from now on? A relief from “imported inflation”

- Even with USDBRL coming back to above 5, commodities’ prices in BRL terms still point to a disinflation ahead

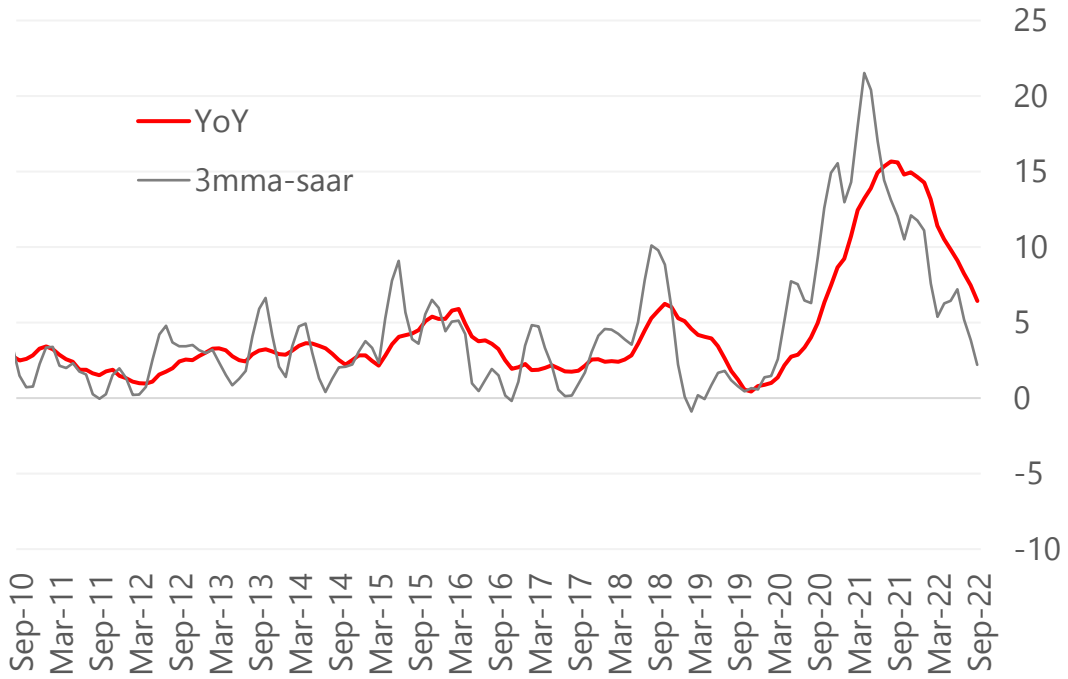


Sources: IBGE, Bloomberg, Santander

Some preliminary signs of lower pressure on the industrial side

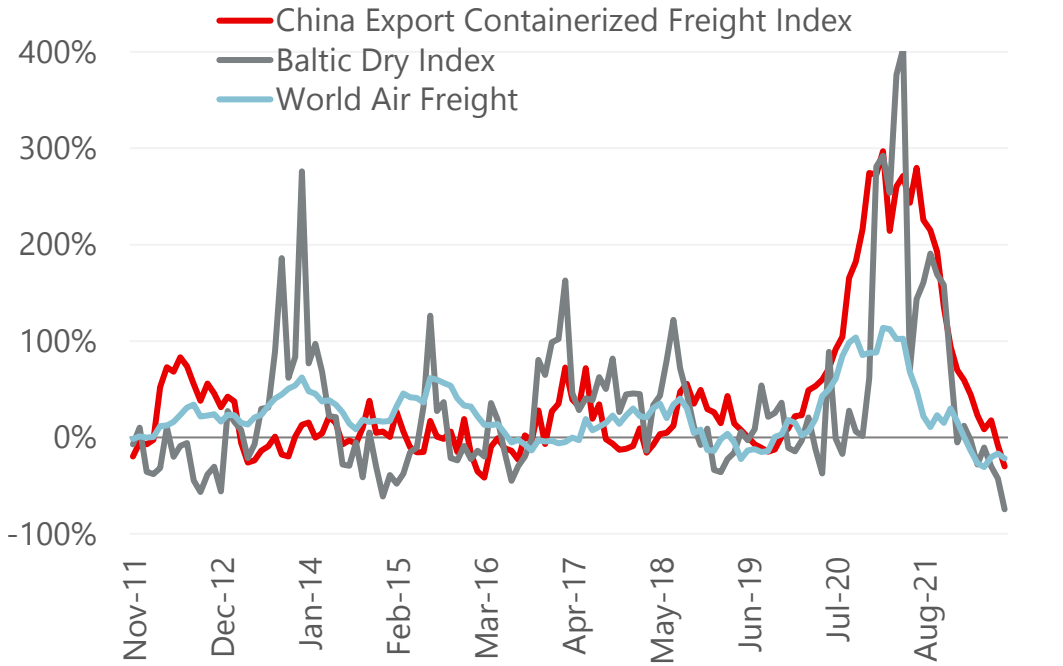
- Industrial goods at the wholesale/producer level are already decelerating, which should reach the consumer level soon
- Anecdotal evidences that at least part of the supply shocks are fading: freight costs, for example

Core-PPI-Industrial



Sources: FGV, Santander

Freight Costs % YoY

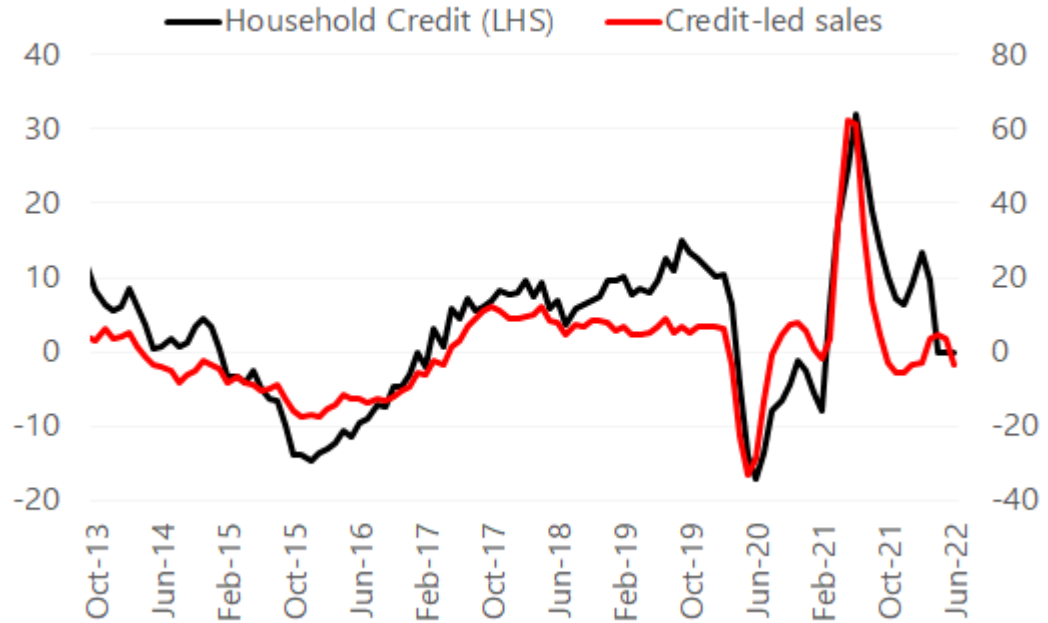


Sources: Bloomberg

Lower demand for durable goods

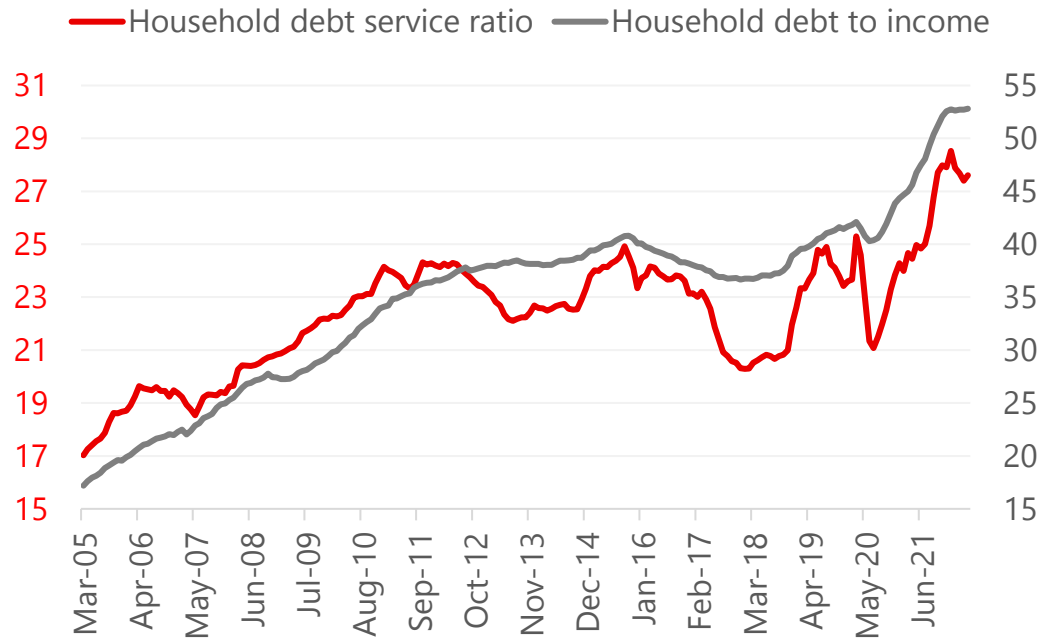
- For households, new loans are slowing down and debt is at the highest levels (and still rising)
- Credit-led retail sales are slowing

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



Sources: IBGE, BCB, Santander

Households are highly indebted

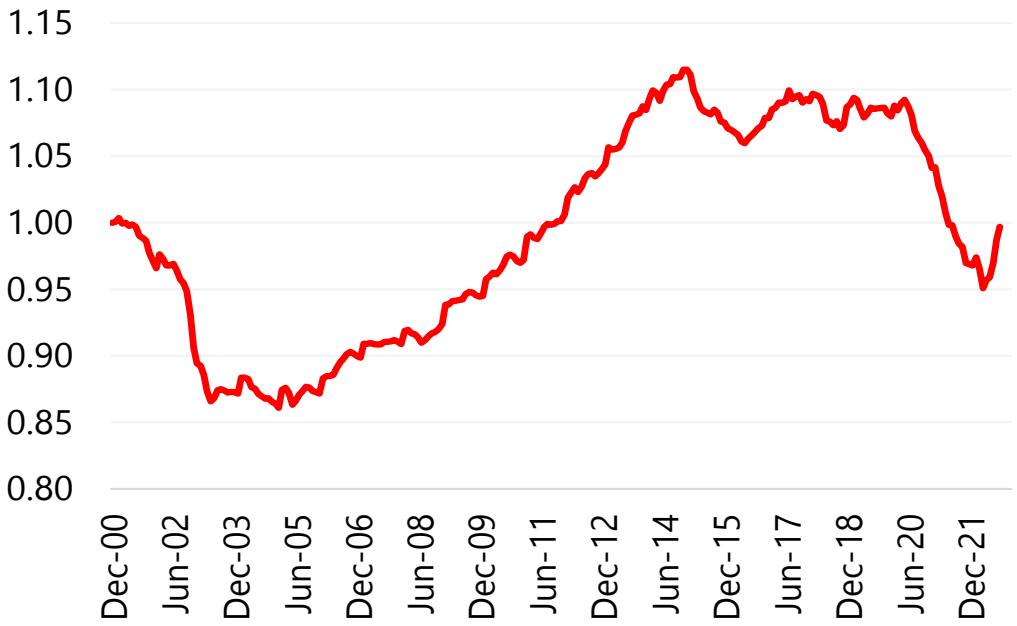


Sources: BCB, Santander

Services: still the main risk

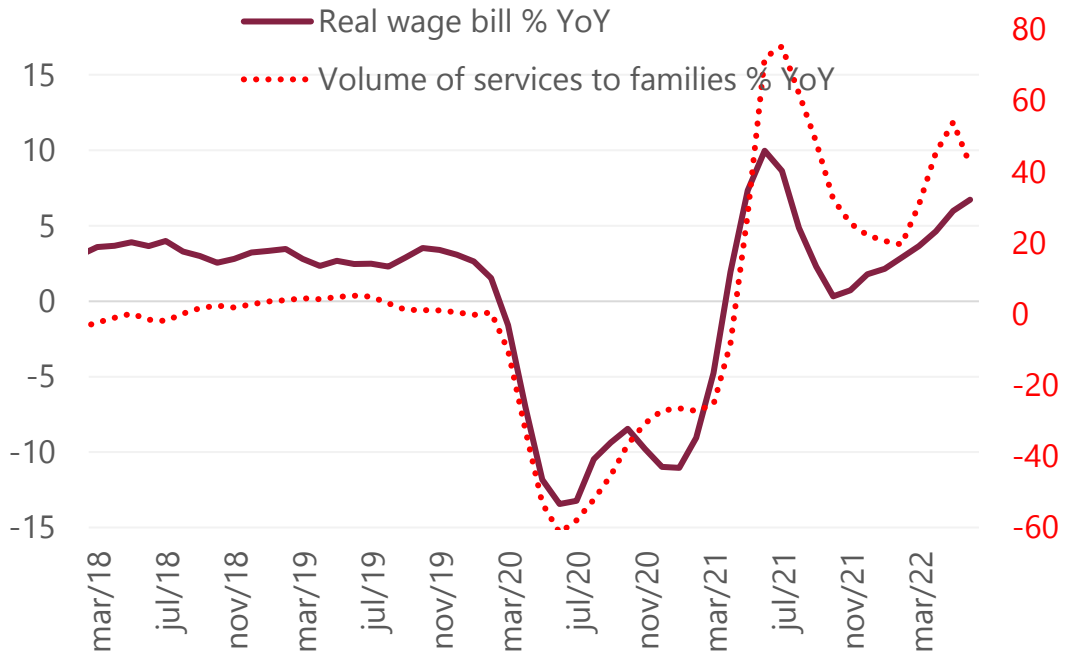
- Services are now benefiting from the end of social distancing measures and enjoying a relative-price adjustment (after lagging all the shocks in other sectors)
- Looking ahead, we expect the economy to cool down (monetary policy acting), rising unemployment and helping services inflation to cool down

Relative price: IPCA Services/IPCA Ex-Services



Sources: IBGE, Santander

Increase in real wage bill sustaining demand for services

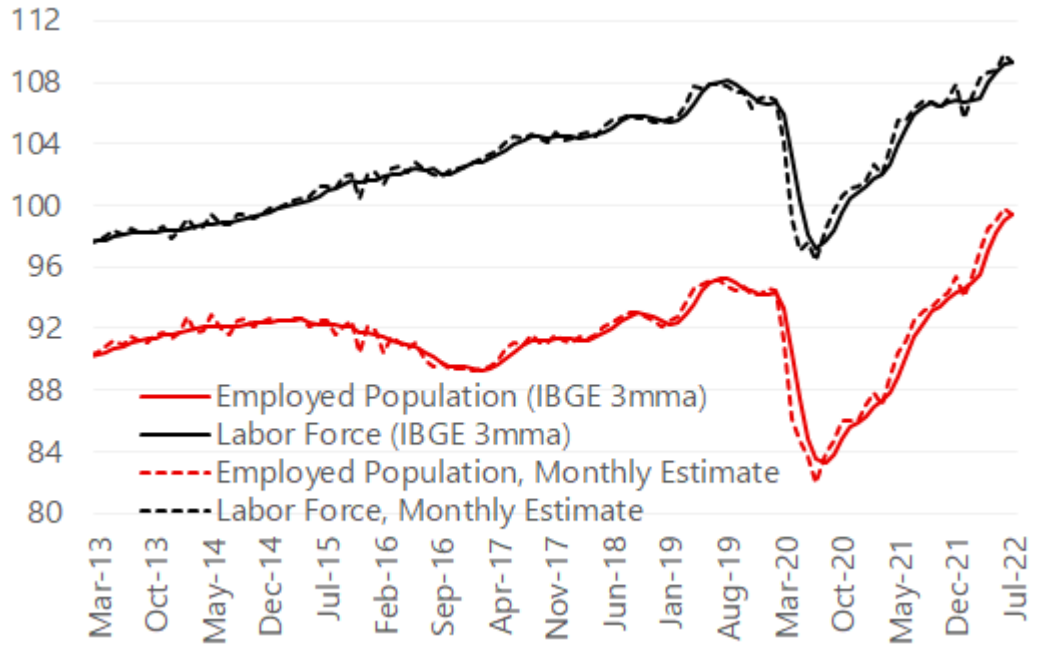


Sources: IBGE, Santander

But the job market hotness is not impacting wages, at least not yet

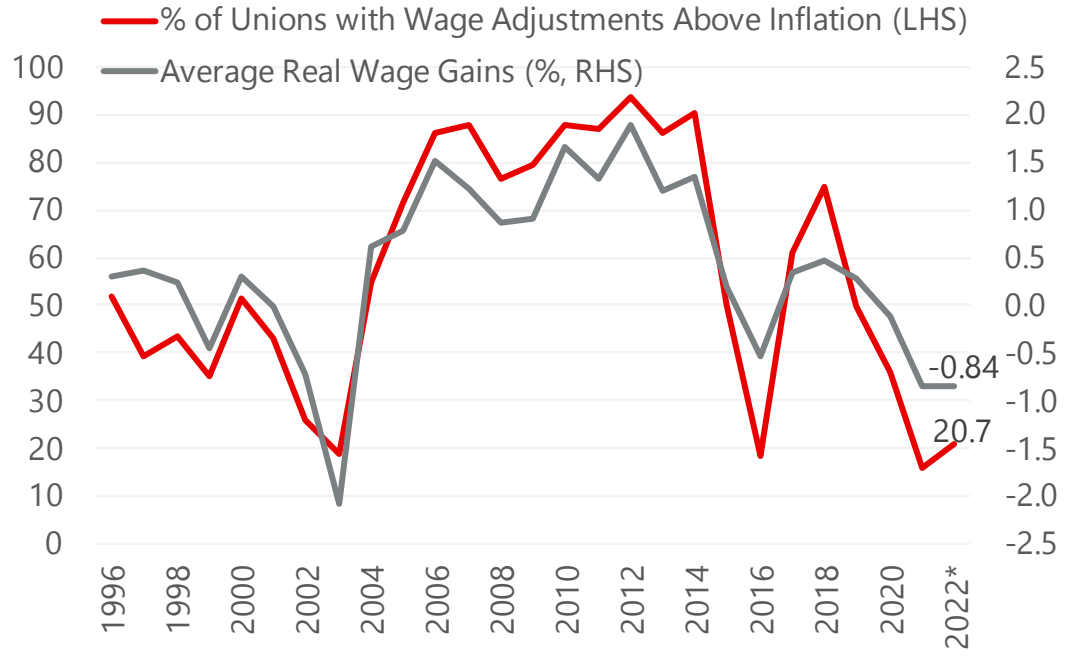
- The real wage bill is increasing on the back of rising employment, not on higher wages
- In fact, wages adjustments above inflation are at the lowest levels in history

Employment is way above pre-pandemic



Sources: IBGE, Santander.

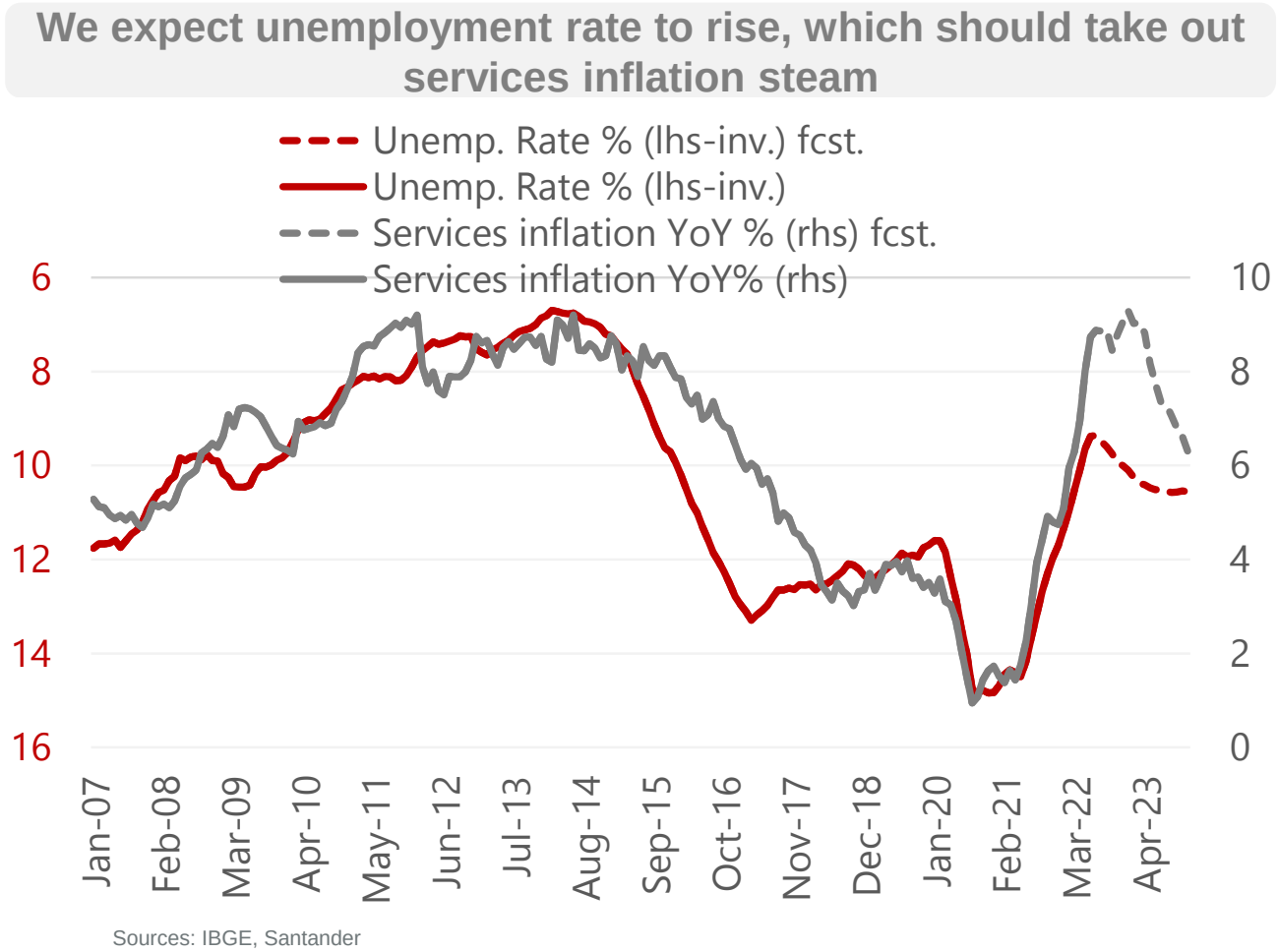
But the % of wages adjustments above inflation is at the lowest levels in history



Sources: Dieese, IBGE, Santander.

With monetary policy kicking in, unemployment should rise and curb services inflation

- 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
- With that, broad core gauges should start to converge

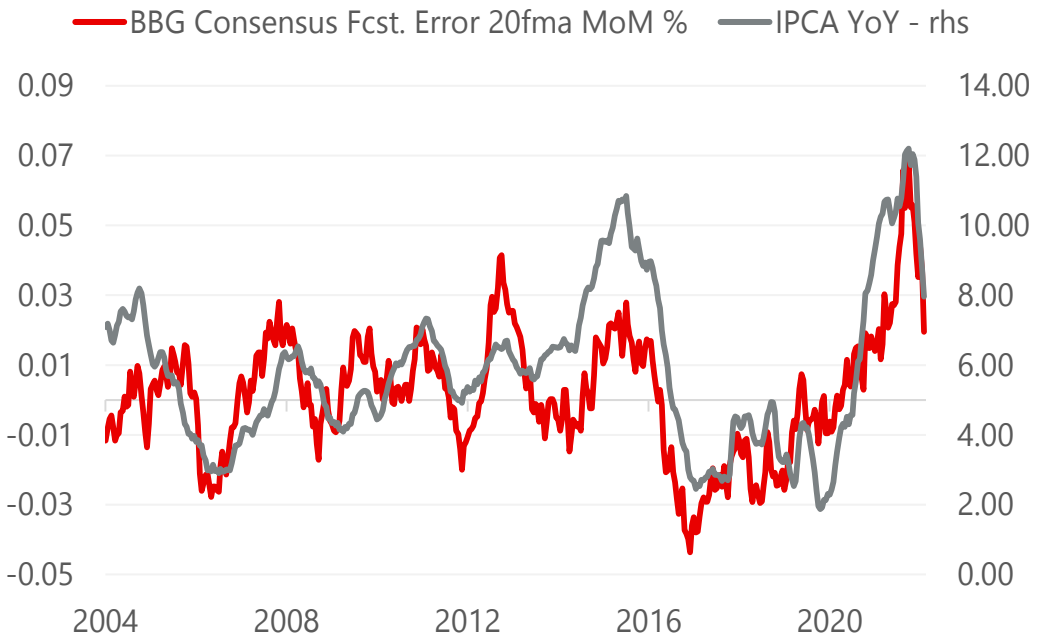


Sources: IBGE, Santander

Inflation expectations: the end of short-term surprises?

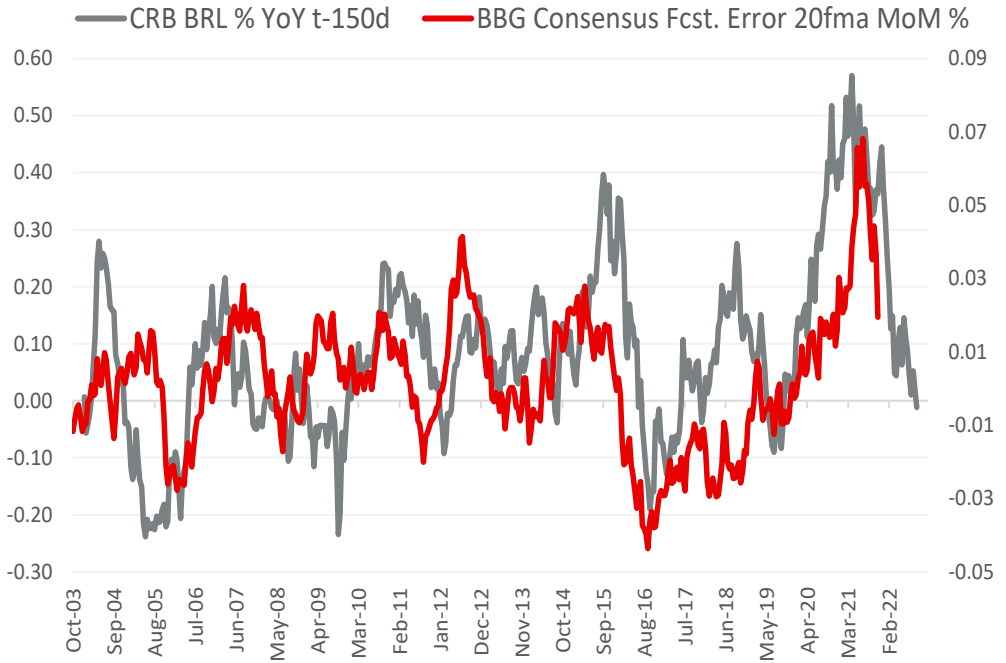
- Montlhy inflation surprises are highly correlated to the state of inflation: if inflation is accelerating, upward surprises follow and vice-versa. Consequently, as IPCA has peaked, inflation surprises are starting to come downwards
- Moreover, usually inflation surprises are driven by volatile prices, particularly commodities and the exchange rate, and those two prices are pointing to a reduction of inflation surprises

Inflation surprises are highly correlated to the state of inflation



Sources: IBGE, Santander

CRB in BRL is pointing to further deceleration of inflation surprises

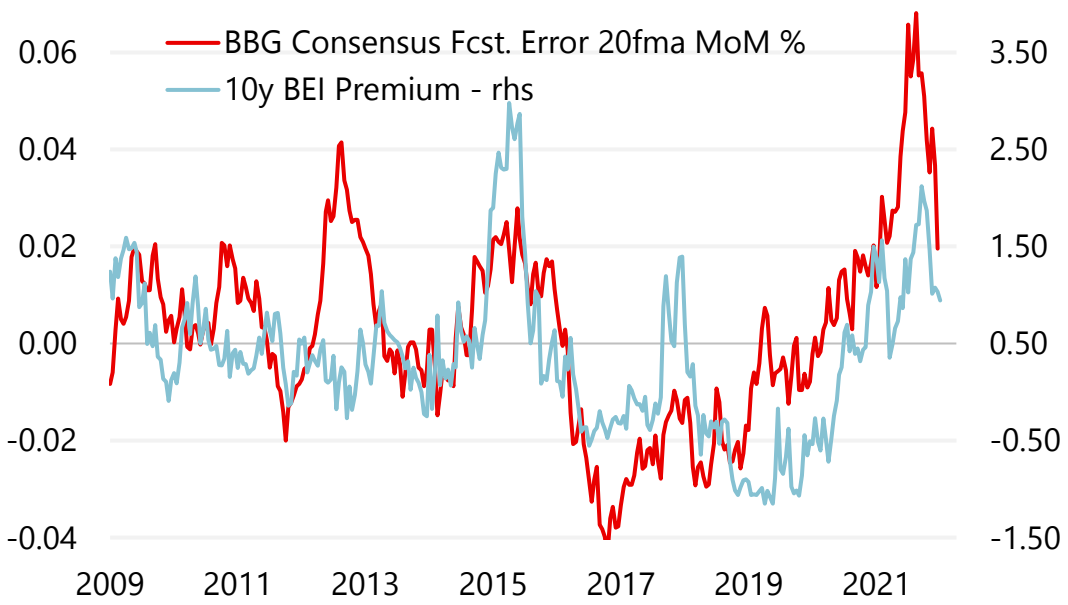


Sources: IBGE, Santander

Surprises tend to drive break-even inflation premium

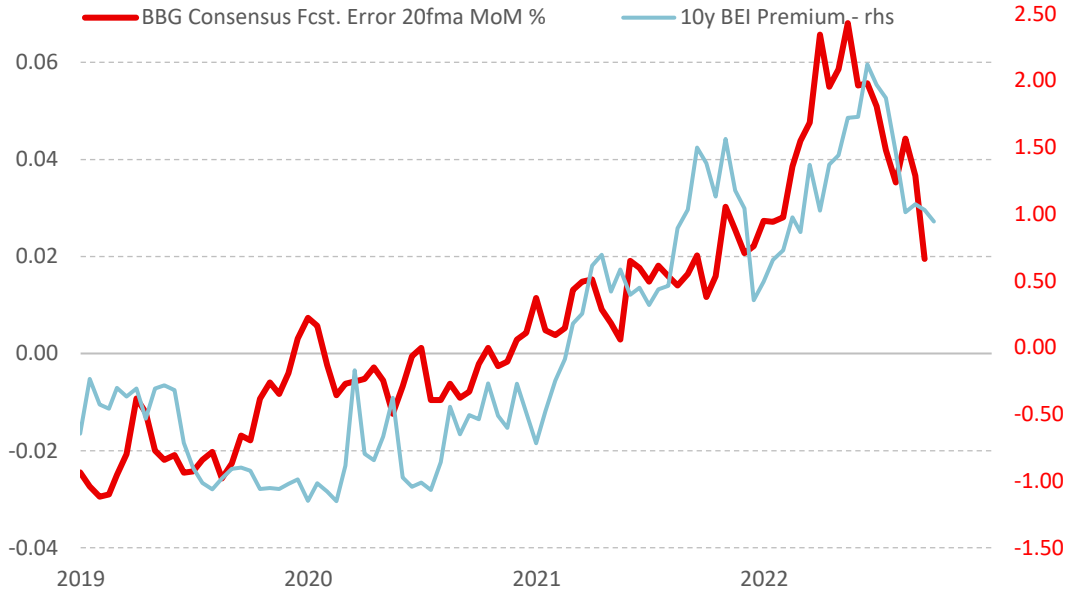
- Short-term surprises usually are incorporated in long term expectations, via a higher risk-premium
- With surprises coming down, expectations could continue to see a relief

Inflation surprises tend to lead the break-even inflation premium



Sources: IBGE, Santander

ZOOM Inflation surprises and 10y break-even inflation premium

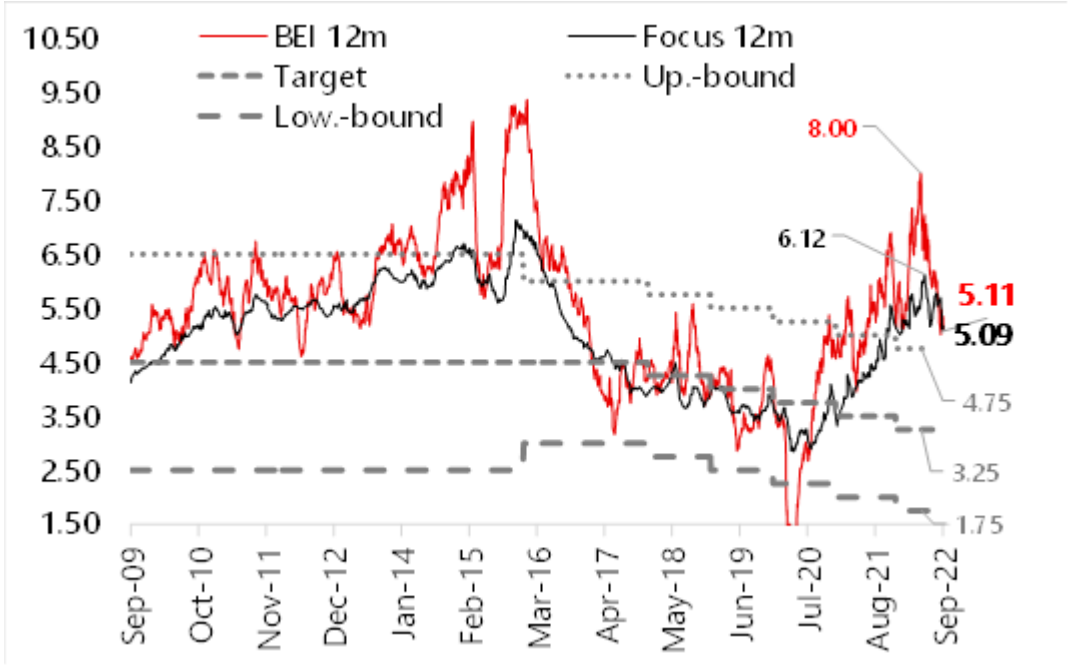


Sources: IBGE, Santander

Inflation expectations: a relief in medium-term expectations?

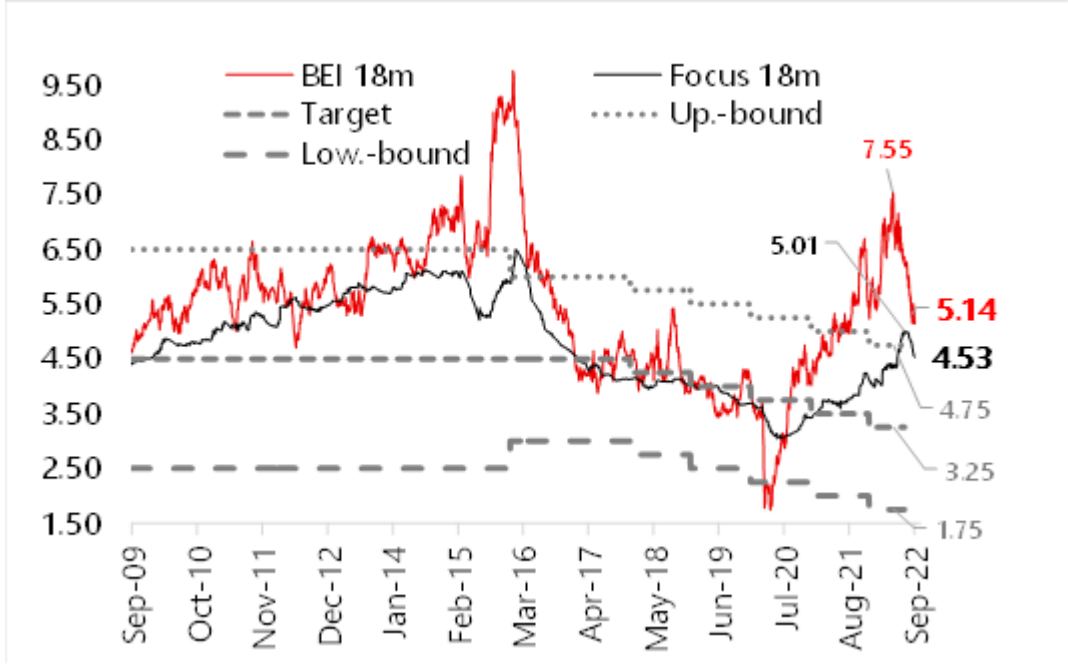
- Although they are still far from the mid-target, both survey- and market-based expectations are seeing a relief recently
- The end of upward surprises in inflation should help the convergence to continue, but there is a risk that services/core gauges remain high and prevent/delay the convergence to the exact mid-target

12-month ahead survey- and market base inflation expectations



Sources: IBGE, Santander

18-month ahead survey- and market base inflation expectations

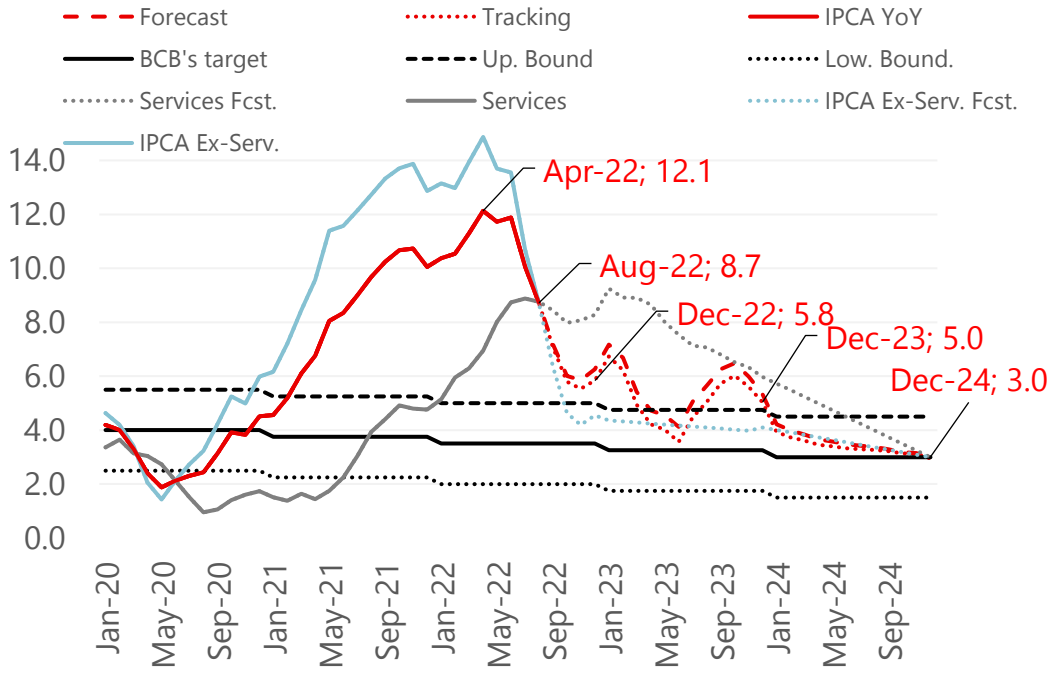


Sources: IBGE, Santander

Inflation outlook: the worst is behind, attentions turn to re-anchoring of expectations

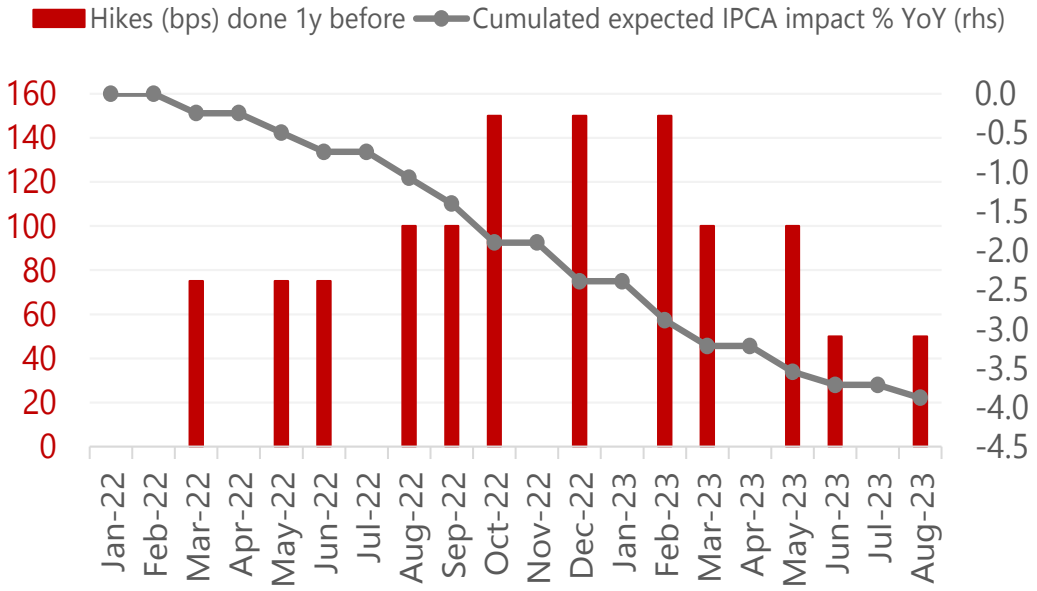
- The risks for inflation now are the “quality” (core gauges high) and the expectations
- We believe the bulk of the monetary policy tightening is about to kick-in more intensely: so far, just 425-bps of Selic hikes have reached the economy; 750-bps are yet to come. This should be enough to control the risks cited above in the medium-term and bring inflation back to the target by 2024

IPCA forecast



Sources: IBGE, BCB, Santander

Monetary policy lag: date of expected impact of each Selic hike done so far and likely effect on IPCA



*BCB’s models consider 4 to 6 quarters of monetary policy lag, here we use 4 quarters (12 months).
**Impact on IPCA estimated just by cumulating the BCB’s model rule-of-thumb of +100 bps Selic = -33 bps IPCA YoY.

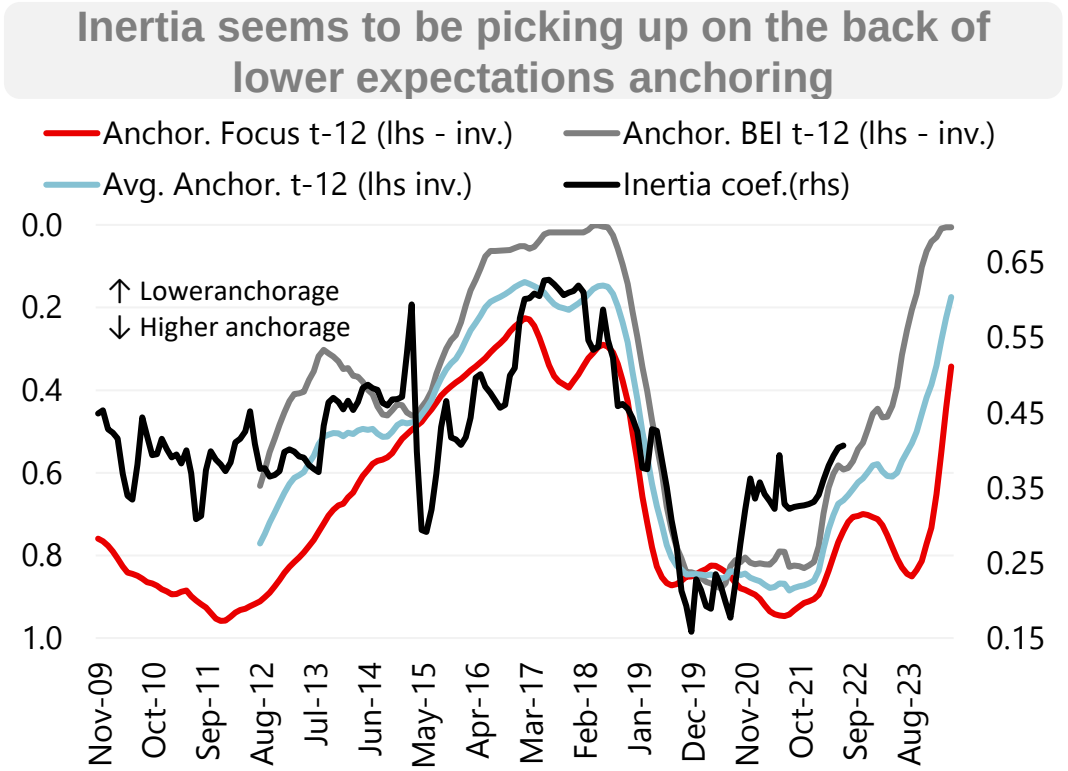
Sources: BCB, Santander

Main Risks: inertia and fiscal outlook

04

With expectations detached from the target, inertia gains steam

- The unanchoring of inflation expectations makes the price-setting process more based on past inflation, rising inertia
- We see inertia is picking up with the rise of domestic risk, making inflation stickier and turning it in a more self-fulfilling process

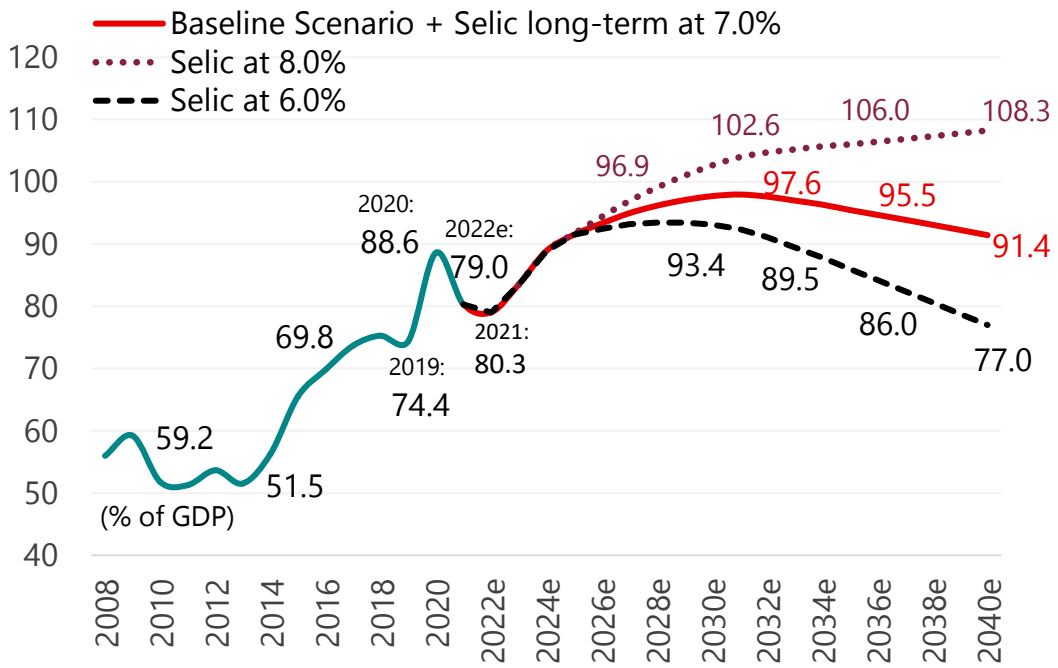


Sources: Santander

Uncertainty regarding fiscal outlook

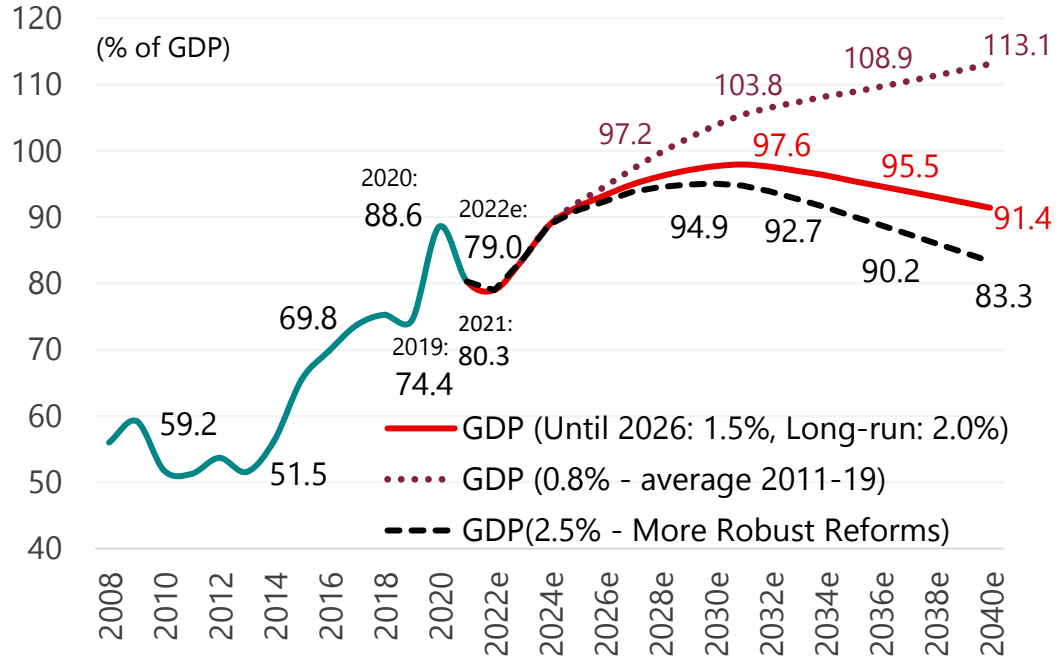
- Small changes in estimates for potential output and/or neutral interest rates leads to challenging outlooks for the debt-to-GDP ratio
- With uncertainties regarding the fiscal outlook, inflation expectations could remain detached from the target

Government Debt – Simulations for Selic Rate Hypotheses



Sources: BCB, Santander

Government Debt– Simulating for Trend GDP Hypotheses



Sources: BCB, Santander.

Notes: Debt issuances: we added a spread of + 1.0 pp in addition to the Selic rate in the models.

PEC Emergencial: Funds (+BRL150 billion for liquidity cushion in 2021 + BRL30 billion in 2022)

2022 GDP Deflator: 10% | GDP: 1.9% | Selic Rate: 14.25%

2023-40: GDP deflator: 3.9%, which is Inflation target + 0.9% (close to the average difference of the last decade between IPCA and GDP deflator)

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Simple Personal Fair

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