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MACRO COMPASS

A RETURN OF FISCAL, PANDEMIC CONCERNS

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- Notwithstanding the constructive market conditions abroad on the heels of increased expectations of fiscal stimulus in the U.S. and further progress with immunization programs around the world, uncertainties regarding the evolution of the pandemic in Brazil and fears of a resulting "contagion" to fiscal policy conduct (i.e., extension of stimulus) weighed on some Brazilian asset classes this week, particularly on the BRL (which stood among the bottom-performers for the week) and the back end of the yield curve. The latter might also have been influenced by the rise of longer-dated U.S. treasury yields.
- Health authorities announced that Brazil's COVID-19 vaccination campaign will begin in January (though no start date has been set). Given the high level of new cases and deaths seen recently, the fear is that these numbers eventually get even higher in the wake of the holiday season.
- On the fiscal side, despite the challenging outlook ahead, the latest developments have been marginally "positive" with the sanction of the Budget Guidelines of 2021 (allowing continuity of government services and payments before the actual budget approval) and lower-than-expected expenditures related to COVID-19 in 2020, implying "better" fiscal numbers for the year and less pressure on the funding needs for the short run.
- We think the small trade deficit seen in December 2020, resulting mostly from non-recurring and merely accounting transactions of oil platforms, did not mean any change in the favorable dynamics for Brazil's foreign trade of late. We continue to see the current situation of the Brazilian balance of payments as a limiting factor for the (still high) FX rate "premium".
- The results for FGV's confidence data in December reinforced the mixed signals sent by the sectors in the recent months, in our view, reflecting a heterogeneous pace of recovery. Industrial confidence kept rising, reaching the highest level since 2010, but aggregate business confidence posted another decline, reversing the upward trend in place since July. We expect data releases from the tertiary sector for November will influence 4Q20 GDP estimates in the days ahead.
- For the coming week, December's IPCA reading (due on Tuesday, January 12) is set to mark the peak of inflation in monthly terms, in our view. We expect a +1.18% MoM change, with 2020 ending at +4.34%, just above BCB's mid-target for the year (4.00%), as a large (but already fading) food shock accounted for more than 60% of that variation.

This report uses information up to the end of Thursday, January 7, 2021.

Figure 1. Brazil Macro Agenda for the Week January 11-15, 2021

Indicators	Source	Reference	Date	Santander Estimate	Prior
Household Indebtedness (%)	BCB	Oct-20	Mon, 11-Jan	49.5	49.0
IPCA Inflation (% MoM)	**IBGE**	**Dec-20**	**Tue, 12-Jan**	**1.18**	**0.89**
IPCA Inflation (% YoY)	**IBGE**	**Dec-20**	**Tue, 12-Jan**	**4.34**	**4.31**
Services Volume (% MoM)	IBGE	Nov-20	Wed, 13-Jan	1.0	1.7
Services Volume (% YoY)	IBGE	Nov-20	Wed, 13-Jan	-6.5	-7.4
Core Retail Sales (% MoM)	IBGE	Nov-20	Fri, 15- Jan	-0.7	0.9
Core Retail Sales (% YoY)	IBGE	Nov-20	Fri,15- Jan	3.0	8.3
Broad Retail Sales (% MoM)	**IBGE**	**Nov-20**	**Fri, 15- Jan**	**0.7**	**2.1**
Broad Retail Sales (% YoY)	**IBGE**	**Nov-20**	**Fri, 15- Jan**	**3.5**	**6.0**
Payroll change (thousands)	CAGED	Dec-20	15 to 25-Jan	-	414.6

Source: Santander Brazil.

For details on Santander's economic forecasts for Brazil, please refer to our latest scenario review[1].

[1] **Santander Brazil - Macroeconomic Scenario: *"(Another) Challenging Year Ahead"* –** December 17, 2020- Available on: https://bit.ly/Sant-Scenario-Rev-Dec-20

LOCAL MARKETS—FX

Uncertainties regarding the evolution of the pandemic on the domestic front and its (eventual) influence on fiscal policy conduct weighed heavily on the performance of the BRL this week, in our view. This happened despite the fading of the "overhedge" tensions that influenced the Brazilian FX market in the last couple of weeks, and a relatively supportive environment for some classes of risky assets.

The USD/BRL pair closed Thursday (cutoff date for this report) at 5.40. For the week, the Brazilian currency posted a loss of nearly 4%, putting the BRL amongst the bottom-performers within its peer class. Not even the USD500 million of USD swaps tendered by the Brazilian Central Bank (BCB) on Wednesday seemed enough to ease market participants' minds regarding the possibility of new rounds of fiscal incentives if the pandemic outlook gets worse in Brazil.

In this sense, as the political milieu is fully dominated by the race for the speaker positions in both the Senate and the Lower House, and as the holiday season might affect the upward tendency of COVID-19 contagion, we expect uncertainties to prevail for BRL dynamics in coming weeks, thus limiting the effect of a global risk-on scenario and balance-of-payments fundamentals. See links below.[2][3]

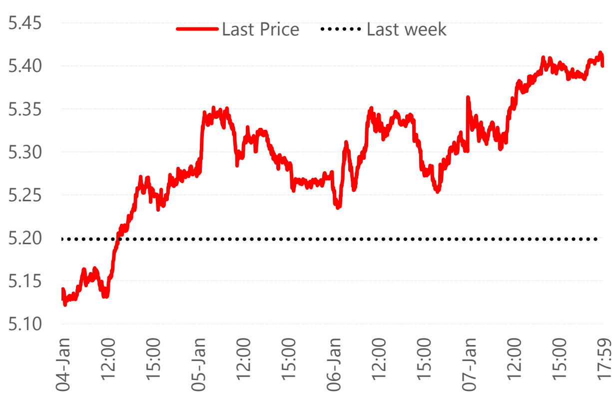
LOCAL MARKETS—Rates

The nominal yield curve bear steepened in recent days. As per Thursday's closing (cutoff date for this report), the front-end (Jan-22 DI future) stood at 3.03% (+17 bps from last Wednesday), while the back-end (Jan-27 DI future) traded at 6.96% (+55 bps from last Wednesday). Hence, the steepness in this segment rose to 393 bps from 355 bps at the end of the previous week.

At the front-end, the poor performance of the BRL, alongside the rise in commodity prices, might have contributed to push yields higher. At the long end, the rise of the 10-year US treasury yield to above 1.00% contributed to pushing up the long end. Fears about an eventual extension of last year's extraordinary fiscal stimulus also influenced that movement, in our view.

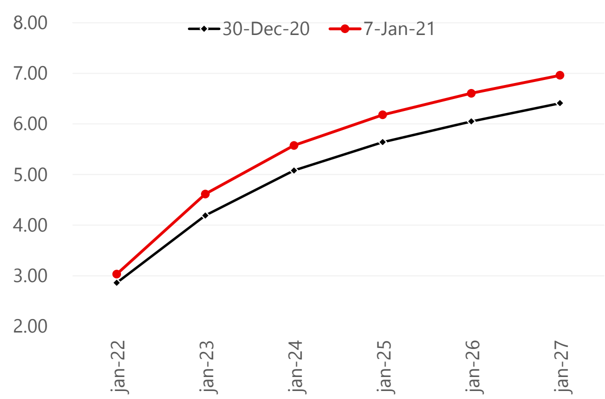
We continue to see potential for volatility ahead, amid lingering uncertainties about the next fiscal policy steps, especially as the pandemic continues to pose threats to the speed of the reopening process in many regions. Even though a fiscal solution is not expected until late 1Q21, we still see some value receiving in the very front end of the nominal yield curve, for we see the likelihood for a rate hike by BCB in 1Q21 at "virtually zero", and limited probability for a move in the 1H21.

Figure 2.A. – USD/BRL - Intraday Prices



Source: Bloomberg.

Figure 2.B. – Brazilian Domestic Yield Curve (% pa)



Source: Bloomberg.

[2] **Santander Brazil – External Sector – *"Trade Balance December 2020"* –** January 4, 2020- Available on: http://bit.ly/Sant-tradebal-dec-20
[3] **Santander Brazil – External Sector – *"Light at the End of the Tunnel"* –** January 6, 2020- Available on: http://bit.ly/Sant-ext-sec-light-at

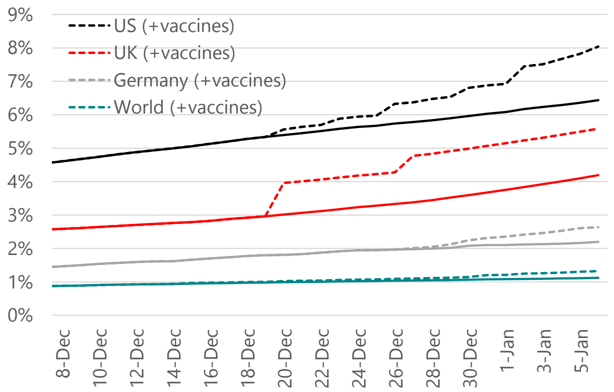
COVID-19 MONITORING

Despite the vaccine rollout in some countries, January is looking grim as the holiday season seems to be contributing to an increasing pace of community transmission of COVID-19 in many regions. Given the usual lag between the infection, the testing and the data recording, a post-holiday spike in cases is possible for the coming days. Vaccination in the U.S. is currently at 358k a day, below the hovernment's target of 1 million. The pace has been even slower in Europe, where new national lockdowns in UK and Germany are expected to last until mid-February and end-January, respectively. That may place further obstacles on the pace of global economic recovery in the short run.

In Brazil, health authorities announced that the COVID-19 vaccination campaign will begin in January (although no specific date has been set). According to recent statements, the federal government has secured 354 million doses for 2021 (100 million from Sinovac Biotech and 254 million from AstraZeneca-Oxford). Instituto Butantan, the local partner of Sinovac, submitted on Thursday (January 7, 2021) the emergency use authorization request to Anvisa (Brazil's national sanitary watchdog), which will have 10 days to decide. Negotiations are underway with other companies (Sputnik, Janssen, Pfizer, Moderna and Bharat). The Ministry of Health also claimed that 60 million syringes and needles in the inventories of states and municipalities are ready for use. In the short run, the first 2 million AstraZeneca jabs are expected to come from India. Meanwhile, the risk of new lockdowns across the country rises as a second wave continues to show signs of strength.

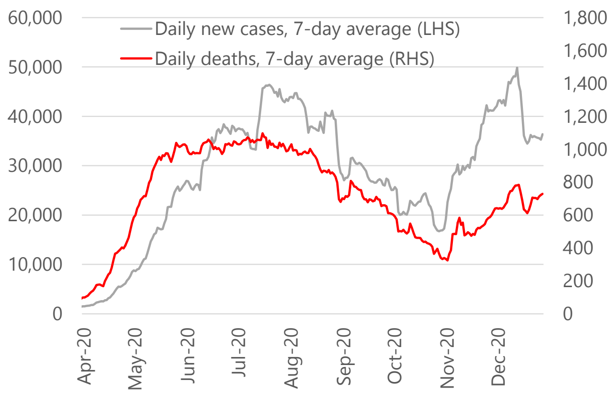
Johns Hopkins data for Brazil reports 36k new cases (seven-day average) on Wednesday (January 6), up 0.4% from last week, while daily deaths (seven-day average) were 728, up 9.5% in the same comparison. The fear is that these numbers eventually get even higher in the wake of the holiday season.

Figure 3.A. – (Total Cases + Vaccines) - % Population



Sources: John Hopkins University and Our World in Data.

Figure 3.B. – Daily COVID-19 Cases, Deaths in Brazil



Sources: Brazil Ministry of Health.

FISCAL POLICY

On December 31, 2020, the federal government sanctioned the Budget Guidelines Law (LDO, in the Portuguese acronym) of 2021, which allows the execution of at least one-twelfth of the draft budget until Congress approves the final version. In practical terms, this allows continuity of government services and payments before the actual budget approval (expected only for March). The sanctioning came with vetoes to reduce the budget rigidity, considering that the level of discretionary expenses (BRL100 billion in LDO) is already close to the threshold for the well-functioning of government services, according to our estimates.

In addition, the government signed a provisional measure raising the national minimum wage by 5.3% to BRL1,100 for 2021, in line with our scenario and higher than LDO estimate (BRL1,088). This increase squeezes a tad more the margin to comply to the spending cap this year, as we estimate an insufficiency of around BRL11 billion. See links below[4].

In our view, the necessity to accommodate the higher minimum wage in 2021 budget estimates and the vetoes regarding the budget rigidity are factors that should generate an intense debate in Congress in 1Q21.

Otherwise, COVID-related expenses (i.e., the so-called war budget[5]) ended 2020 below expectations. The total spending totaled BRL524 billion, below the BRL605 billion that had been budgeted. Yet part of that budget will still be executed in 2021, such as BRL20 billion for the purchase of vaccines, already accounted for in the 2021 LDO.

With this more conservative stance on the spending side at the end of 2020, the primary deficit and the gross debt should end 2020 slightly lower than the (symbolic) levels of 10% and 90% of GDP—our last forecasts were close 10.4% and 91.7% of GDP, respectively. Yet the outlook remains challenging and demands severe fiscal discipline ahead. A crucial hypothesis of our scenario is that the extraordinary fiscal stimuli will be (almost entirely) restricted to 2020, so that government spending will once again be constrained by the constitutional spending cap rule in 2021.

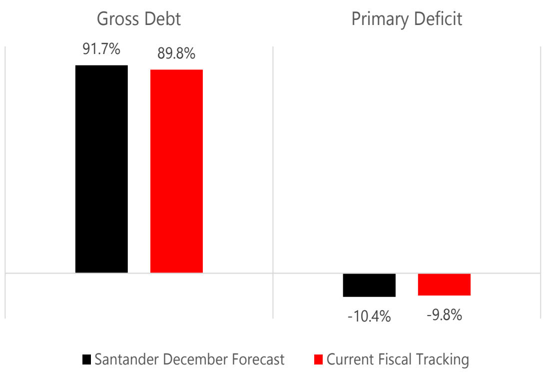
Figure 4.A. – "War" Budget (BRL billions)

Accumulated	Dec-20	Budget	Executed
Formal Employment program (MP 935)	33.5	51.5	65.0%
Bolsa Família expansion (MP 929)	0.37	0.37	100.0%
Emeregency Aid (MP 937)	**293.1**	**322.0**	**91.0%**
Transfers to regional governments (MP 939)	78.3	79.2	98.8%
Credit for payroll (MP 943)	6.8	6.8	100.0%
Energy Sector (MP 950)	0.9	0.9	100.0%
Ministry of Health and others	**44.9**	**50.8**	**82.4%**
Guarantees for credit measures (MP 977)	58.1	58.1	100.0%
Financing of Tourism Infrastructure (MP 963)	3.1	5.0	61.6%
Emergency Credit Program - "Maquininhas"	5.0	10.0	50.0%
Vaccine Acquisition	0.0	20.0	0.1%
Total	**524.1**	**604.7**	**86.2%**

Updated until 01/05/2021

Sources: National Treasury and Santander.

Figure 4.B. – Fiscal Forecasts for 2020 (% GDP)



Source: Santander estimates.

[4] **Santander Brazil Fiscal Policy–"*Spending Cap Rule: Squeezing the 2021 Margin, Relieving 2022*"–** December 03, 2020- Available on: http://bit.ly/Sant_Spdcap_Dec20

[5] "War Budget" means a separated federal budget to account for expenses related to fighting the heath and economic impact from COVID-19.

BALANCE OF PAYMENTS

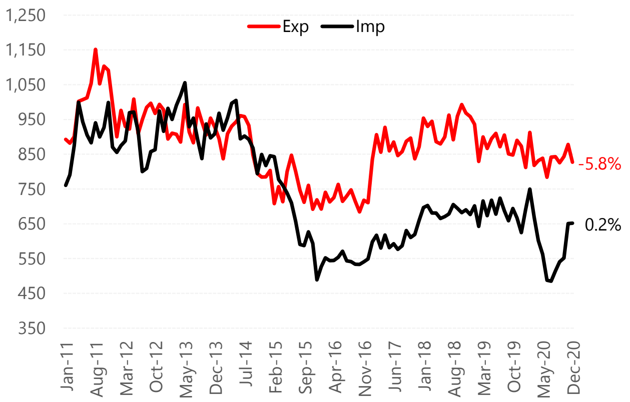
The Brazilian trade balance registered a USD42 million deficit in December 2020, which was below our estimate (USD200 million surplus), on the heels of USD18.4 billion in exports and USD18.4 billion in imports (our estimates were USD18.4 billion and USD18.2 billion, respectively). Based on that, the trade surplus reached USD51.0 billion in 2020, thus falling short of our estimate for the last year (USD57.2 billion), but overcoming the USD48.0 billion positive outcome registered in 2019.

The deficit observed in December 2020 ended a 10-month streak of surpluses on the heels of the same reason that caused the last monthly imbalance a year ago: deals related to oil platforms. Stripping out these platform deals from both exports and imports, the resultant USD4.7 billion surplus seen last month was the seventieth consecutive positive result in these terms, and the annual surplus in 2020 would have reached USD61.2 billion, instead of the official number of USD51.0 billion.

The favorable dynamics of the foreign trade is reinforced by the performance of the 3-month moving average of seasonally adjusted figures in annualized terms, which indicated a hefty surplus of USD58.4 billion on the margin last month. Although below the USD65.2 billion we project for 2021, we believe that the maintenance of favorable commodity prices, further expansion in the international trade flow and a stronger economic pace of the global economy on the heels of progress in the immunization against the Covid-19—let alone the lagged effects of the BRL weakening in real terms—should allow the performance of exports to outpace imports' one once again this year.

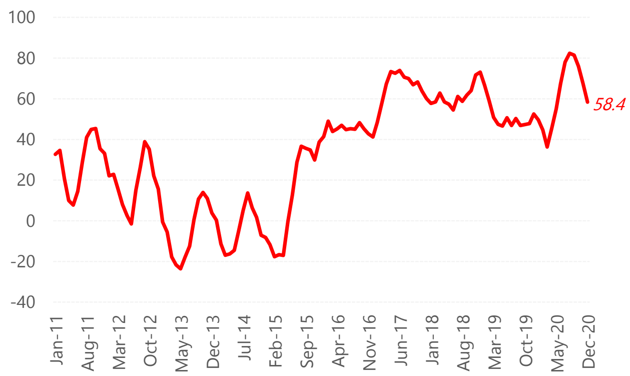
All in all, Brazilian external sector data continue to contrast with the performance of its currency, and, if our assessment proves right, they should contribute to the BRL strengthening in the coming months. See links below[6].

Figure 5.A. – Exports, Imports Ex-Oil Platforms (USD million/working day, s.a.)



Sources: SECEX, Santander.

Figure 5.B. – Trade Balance Ex-Oil Platforms (USD billion, 3MMA saar)



Sources: SECEX, Santander.

[6] **Santander Brazil – External Sector – *"Trade Balance December 2020"* –** January 4, 2020- Available on: http://bit.ly/Sant-tradebal-dec-20

ECONOMIC ACTIVITY

Business surveys for December reinforced a mixed picture across sectors in recent months, reflecting a heterogeneous pace of recovery.

Industrial confidence points to continued improvement (1.6%), with the headline index running at the highest level since 2010. Industrial capacity utilization is running close to the historical average, which suggests that any supply constraint tends to be temporary. The survey indicates that desired inventories are running at historically low levels, which we see as sort of a tailwind for production ahead. In terms of outlook, we still are unconcerned about demand/supply mismatches in the medium term, as we also expect demand to shift back from the goods to the services sector on the heels of the economy's reopening (yet this will naturally hinge on a consistent sanitary solution to the pandemic) across this year.

The aggregate business confidence posted a sequential decline (-0.4%), rolling back the upward trend seen since July and with the headline index returning to a reading below the pre-crisis level (February). These figures reflect the uncertainty regarding the pace of recovery of the Brazilian economy in the coming months, amid a second wave of COVID-19 contagion. The remaining sector’s figures reflect the slowdown in economic activity and reduction in optimism, with retail sales (-1.9%) and consumer (-3.9%) confidence ending 4Q20 with a slowdown pace. Possibly, these tertiary sector's figures are slightly influenced by the increase in COVID-19 contagion, with temporary setbacks in the reopening process in some regions.

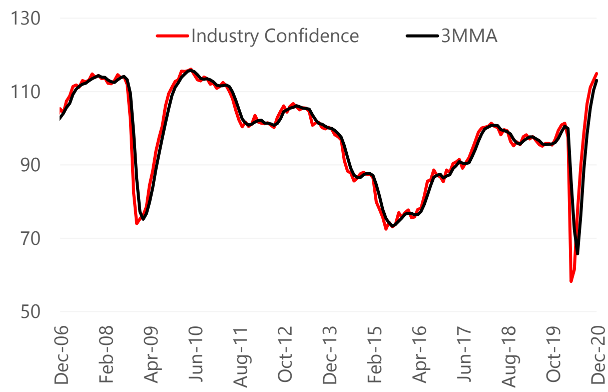
For the coming week, important activity releases (for November) are scheduled. These figures should help shape economic activity expectations, possibly reinforcing the possibility of solid sequential growth in 4Q20. On Wednesday (January 13), the services sector data will be available, and we expect a sequential growth of 1.0% MoM. On Friday (January 15), retail sales will be published, and we expect monthly changes of -0.7% and 0.7% for the core and broad indexes, respectively.

Figure 6.A. – Business Confidence by Sectors

Dec-20	Level (sa)	MoM %	Feb-20 Chg %
Business	**95.2**	**-0.4**	**-0.8**
Industry	114.9	1.6	13.3
Consumer	78.5	-3.9	-10.6
Retail Sales	91.7	-1.9	-8.1
Building	93.9	0.1	1.2
Services	86.2	0.9	-8.7

Sources: FGV and Santander.

Figure 6.B. – Industrial Confidence



Sources: FGV and Santander.

INFLATION

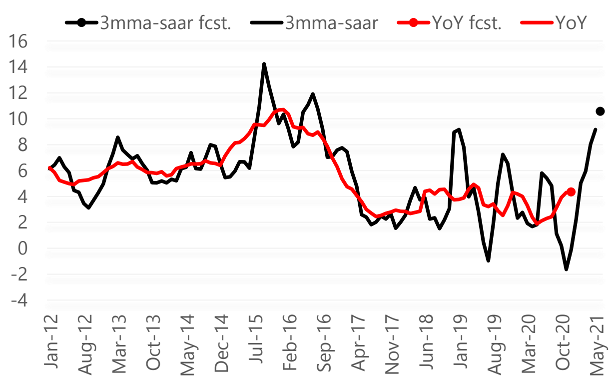
December's IPCA reading should mark the peak of inflation in month-over-month terms. On Tuesday (January 12, 2021), IBGE is scheduled to release IPCA inflation for December, and we expect another hefty reading of +1.18% MoM (+4.34% YoY). Once again, one of the main sources of upward pressure should be food-at-home inflation, though we see a deceleration in MoM terms to +1.96% MoM (from +3.33% in November). The main pressure, however, will probably come from electricity, following the assignment of the Red 2 flag by Aneel (the top flag in terms of extra costs for consumers), which should account for 39 bps of the +1.18% MoM IPCA inflation. This time services should also contribute to the upward pressure (+0.67% MoM) because of airline tickets, which is forecast to rise 28.3% (note: this number repeats the result published in the IPCA-15 preview). Yet this high number is in line with the seasonality and the item is highly volatile, so it does not indicate a signal of services prices gaining traction, in our view. Finally, industrial goods should decelerate to +0.46% MoM.

In terms of underlying measures, the average of cores should rise around +0.43% MoM, meaning the trend (3mma-saar) can stabilize or even show a slight deceleration.

Looking ahead, for the short term, high-frequency food-price surveys at the consumer level showed an unexpected acceleration, alongside international gasoline prices. We raised our January trackings to +0.18% MoM (from -0.02%), but for the other next months the trackings remain at +0.28% for February, +0.30% for March and +0.30% for April; our 2021 year-end forecast remains unchanged, standing at +3.0%.

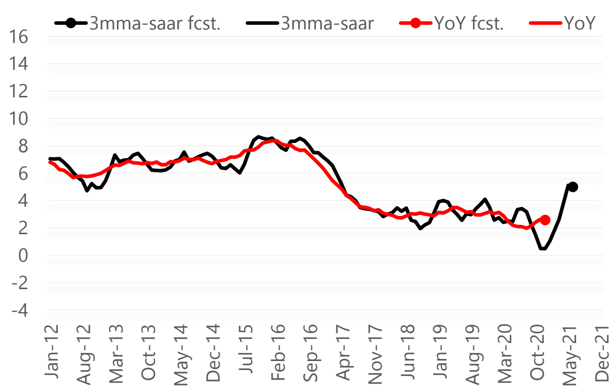
For the medium term, we continue to see a benign scenario for inflation, with fading shocks, a negative output gap and anchored inflation expectations, so we believe inflation should continue below the target and with a benign composition (low core measures) in the medium term.

Figure 7.A. – IPCA Inflation - Annual



Sources: IBGE, Santander.

Figure 7.B. – Core Inflation Average - Annual



Sources: IBGE, BCB and Santander.

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