BRAZIL MACRO

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MACRO COMPASS

WAITING FOR THE VACCINES

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- Brazilian assets painted a mixed picture in recent days. On one hand, the BRL rallied and outperformed peers (with FX rate back to the 5.20s) on the heels of some relief regarding advances in the local COVID-19 immunization program, easing perceptions of tail risks for economic activity and fiscal policy outlook. On the other hand, nominal yields sold off with a flattening pattern, as front-end rates took a cue from inflation risks (e.g., higher core IPCA, commodities) and expectations of a less accommodative BCB (Brazilian Central Bank). The back end was led by higher U.S. Treasury yields.
- Brazil's COVID-19 vaccination campaign is due to begin on January 20, 2021. New cases and deaths are unfortunately at levels comparable to (or higher than) the first wave, with the numbers probably reflecting the social gatherings during the holiday season.
- On the inflation side, IPCA ended 2020 at 4.52%, above the mid-target (4.00%), but with a benign composition, as 60% of the headline stemmed from food. December's monthly print showed a deterioration in some underlying measures at the margin. But we do not expect this riskier trend to continue, and still foresee a benign inflation scenario for 2021.
- We recalculated the margin to execute the budget within the constitutional spending cap for 2021, considering the final inflation numbers for 2020. We estimate an insufficiency of BRL14.5 billion. While we believe compliance remains feasible, it will require a great deal of fiscal discipline, especially amid difficult conditions from the economic and health standpoints.
- Anbima's data for December show that domestic new issuance of debt and equity was the largest monthly figure since October 2010. In our view, the capital markets outlook for 2021 is positive. However, BCB data shows that consumer indebtedness is on the rise, which could mean another headwind for spending in 2021.
- Incoming real activity numbers reinforce the likelihood of solid growth in 4Q20, in our view. Our tracking for the 4Q20 GDP was updated to 2.5% QoQ-sa (up by 0.2 p.p.), after releases of data on the industry and services segments for November. For the coming week, we expect the BCB's monthly activity index (IBC-Br) release to cap the activity dataset for November.
- Next Wednesday, the BCB is due to announce its monetary policy decision. We expect the Selic rate to remain at the historical low of 2.00%, in line with consensus. In its statement, we believe the committee will keep its forward guidance (of stable interest rates under certain conditions), but probably hint at its potential scrapping in March. We do not rule out a change of that policy signal for this meeting, however, given the higher-than-expected core inflation readings for December.

*** ***This report uses information up to the end of Thursday, January 14, 2021.***

Figure 1. Brazil Macro Agenda for the Week January 18-22, 2021

Indicators	Source	Reference	Date	Santander Estimate	Prior
IBC-Br Activity Index (% MoM)	**BCB**	**Nov-20**	**Mon, 18-Jan**	**0.6**	**0.9**
IBC-Br Activity Index (% YoY)	**BCB**	**Nov-20**	**Mon, 18-Jan**	**-1.0**	**-2.6**
Selic Rate (%)	**BCB**	**--**	**Wed, 20-Jan**	**2.00**	**2.00**
Formal Job Creation (thousands)	Labor Min.	Dec-20	18 to 25-Jan	-130.0	414.6
Federal Tax Collection (BRL billion)	IBGE	Dec-20	20 to 25-Jan	159.1	140.1

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

After a troubled start this year, with the BRL having weakened to nearly USD/BRL5.51 last Monday, the BRL has strengthened considerably since last Tuesday and got back close to the USD/BRL5.20 level seen at the end of last year. Barring a surprising reversal in this trend during Friday's trading session, we think the BRL should be among the top performers of emerging currencies this week.

In order to put the sound performance of the BRL into perspective, we calculated the level at which the USD/BRL pair would be if it had followed the average change of two different categories of currencies, namely: emerging and commodity currencies. According to their performances, the USD/BRL should be hovering around the 5.40 level rather than the ~5.20 where it ended on January 14, 2021.

In our view, like other EM currencies and risky assets, the constructive global backdrop (on the heels of US stimulus and rollout of COVID-19 vaccines) continues to favor the BRL. Yet we think recent developments regarding the immunization program in Brazil (more details in the "COVID-19 Monitoring" section) have improved the prospects for the battle against the pandemic in the country, thus reducing fears about the increasing pressure that further delays in the vaccination schedule may have on the recovery of economic activity and on the upcoming fiscal decisions (budget 2021, renewal of stimulus). By the same token, statements delivered by candidates for the speakership in Congress showed support for complying with the constitutional spending cap rule. In our view, these idiosyncratic factors may have further contributed to the BRL's strengthening these days.

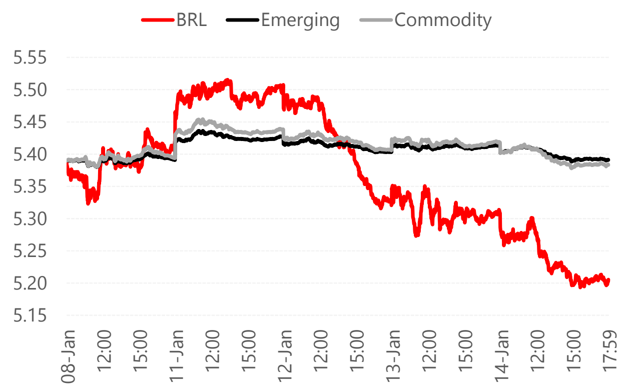
LOCAL MARKETS—Rates

A little bit of a bear flattening on the nominal yield curve took place in recent days. The front-end of the curve (Jan-22 DI future) rose to 3.27% (+24 bps since our last report), while the back-end (Jan-27 DI future) rose to 7.10% (+14 bps since our last report). Hence, the steepness in this segment fell to 384 bps from 393 bps since last Thursday.

At the front end, despite a better performance of the BRL, commodity prices continued their sharp upward trend and, more important, December's IPCA inflation surprised to the upside, so market participants started to price in a higher probability of an earlier Selic rate hike. At the long end, there were apparently no clear drivers for the sell-off, but a relevant candidate is the rise of the 10-year US treasury yield.

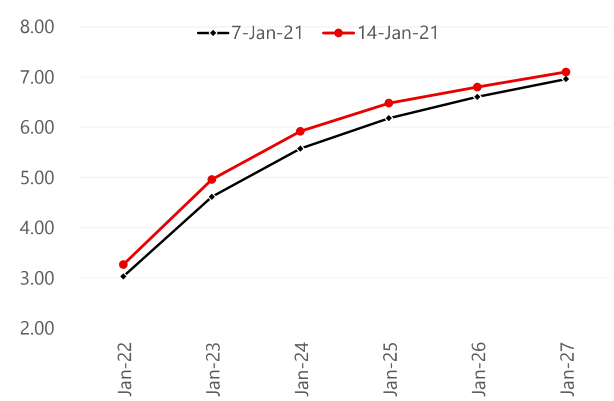
We continue to see potential for volatility ahead, amid lingering uncertainties about the next fiscal policy steps, especially as the pandemic continues to pose threats to the speed of the reopening process in many regions. Even though a fiscal solution is not expected until late 1Q21, we still see some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

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



Source: Bloomberg, Santander.
Note: As per the closing of Thursday, January 14, 2021.

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



Source: Bloomberg, Santander.
Note: As per the closing of Thursday, January 14, 2021.

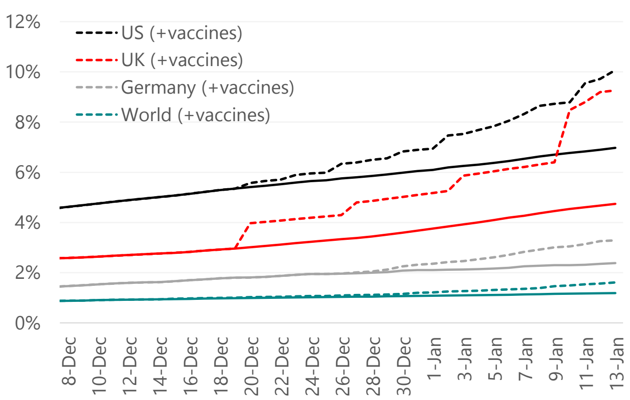
COVID-19 MONITORING

U.S. new cases peaked, while hospitalizations are flattening. The Holiday season prompted a surge in new cases to a record level, but the rate of increase in hospitalizations has been decreasing. Vaccination pace in the country is currently at 710k/day (7-day moving average), closing the gap to the government's target of 1 million. In Europe, lockdown measures in the U.K. show signs of having effects, as the curve of new cases appears to be starting to drop. Yet, hospitals are at risk of being overwhelmed. In spite of some progress in vaccination, longer restrictions could take place in Europe as cases soar in Spain and Italy, with Germany potentially remaining in lockdown until April. In our view, that may place further obstacles on the pace of global economic recovery in the short run.

In Brazil, COVID-19 vaccination campaign to begin next week. Anvisa (Brazil's national sanitary watchdog) has scheduled a meeting on Sunday (January 17, 2021) to discuss the emergency use authorization request from *Instituto Butantan*/Sinovac and *Fiocruz*/Astrazeneca. Upon approval, vaccine distribution should start after a few days, even though the Ministry of Health claimed the rollout will come first for state capitals. Out of the 8 million initial doses expected for January, *Instituto Butantan* holds 6 million in inventories, while 2 million will come from AstraZeneca's production in India. The latter are expected to arrive in Brazil during the weekend. At a regional level, São Paulo state moved up the date of the *Plano SP* reclassification of the reopening process to Friday (January 15, 2021), from an initial scheduled date of February 5, 2021. Some regions in the state are expected to step back in phases owing to the recent increase in cases and hospitalizations.

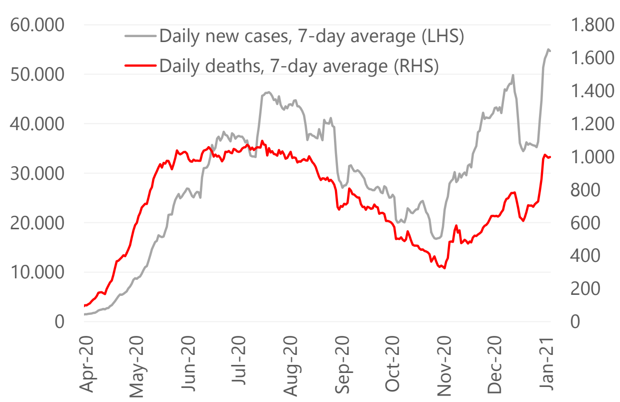
Johns Hopkins data for Brazil reports an average of 54k daily new cases (7-day moving average) on Wednesday (January 13, 2021), up 50.2% from last week, while daily deaths (7-day moving average) stood at 998, up 37.1% in the same comparison. As expected, these numbers might reflect social gatherings during the holiday season.

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



Source: John Hopkins University, Our World in Data, Santander.

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



Source: Brazil Ministry of Health, Santander.

FISCAL POLICY

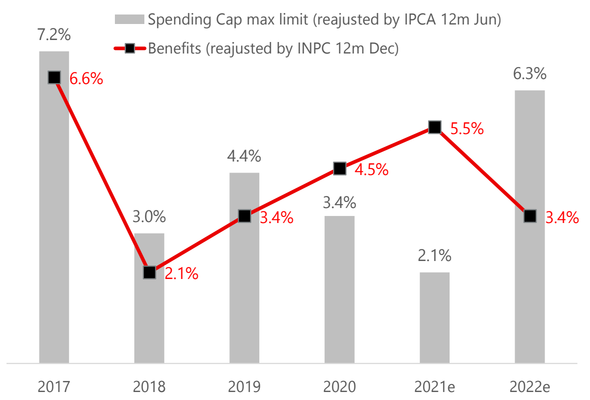
We recalculated the spending cap margin for 2021, considering the final inflation numbers for 2020; forecasts for federal tax collection in December 2020.

The inflation index used to adjust the government transfers (INPC[2]) ended 2020 at 5.45%. The value is higher than we anticipated (5.1%), and the assumption (5.26%) used in the provisional measure that increased the minimum wage to BRL1,100 in 2021. This adds a bit more pressure on the mismatch between the inflation index used to readjust the constitutional spending cap and the index used to adjust government programs. That creates additional difficulties to complying with the rule in 2021. See link below[3]

As an upshot, our estimate of insufficiency to comply with the spending cap rule has risen from BRL11.3 billion to BRL14.5 billion, making its fulfillment in 2021 even more challenging. While feasible, that would take a severe fiscal discipline this year, and potentially lead to reduced discretionary expenses and a partial shutdown of some public services. The necessity of accommodating the higher minimum wage in 2021 budget estimates and the vetoes regarding the budget's rigidity are factors that should generate an intense debate in Congress in 1Q21, in our view.

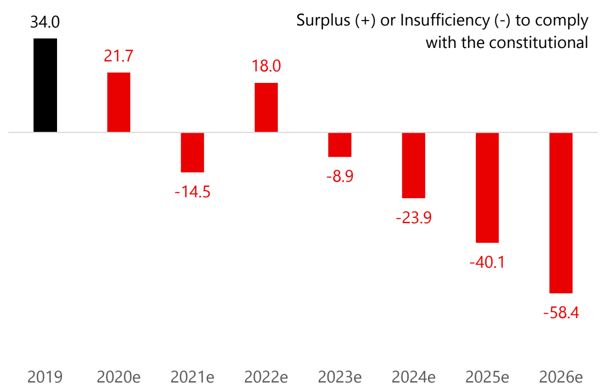
The Brazilian internal revenue service may publish next week the federal tax collection data for December 2020. Our estimate is BRL159.1 billion, which would mean an increase of ~4.6% compared to December 2019, in real terms. With this result, the total federal tax collection of 2020 would register a full-year plunge of 6.8% in real terms, equivalent to tax losses of ~BRL110 billion compared to 2019. Tax collection has been recovering gradually, driven by the better performance of economic activity and the payment of taxes that had been delayed early in the pandemic. We expect some deceleration in the pace of recovery ahead, considering the end of the fiscal stimulus and possible impacts of the increase of COVID-19 cases, which may translate into some softening in tax proceeds.

Figure 4.A. – Key Inflation Indexes for the Budget



Source: IBGE, Santander.

Figure 4.B. – Spending Cap Rule Margin (BRL billion)



Source: National Treasury, Santander.

[2] INPC inflation index aims to correct the purchasing power of wages, by measuring price variations of the consumption basket of the working population with the lowest income.

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

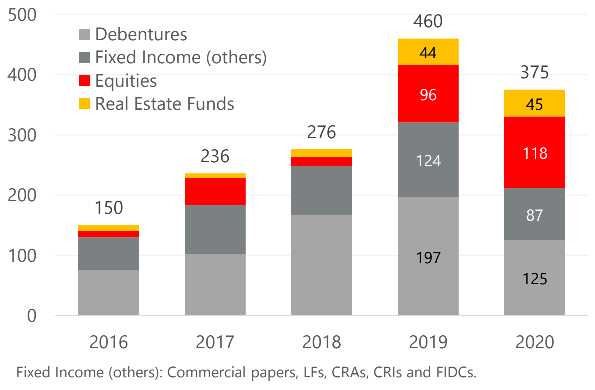
CREDIT

December new issuance in capital markets was the largest monthly figure since October 2010. Anbima's data show that new issuance totaled BRL63 billion, a massive surge from November's volume (BRL26 billion). Debentures stood out with BRL28.6 billion, but other instruments followed suit. Issuance in fixed income accounted for BRL9.2 billion; equities totaled BRL19.9 billion; and real estate funds came in at BRL5.9 billion. Despite the uncertain economic backdrop triggered by the COVID-19 pandemic, 2H20 saw a gradual recovery in issuance. In our view, the capital markets outlook for 2021 is positive, depending on macro developments, especially linked to the fiscal decisions and outlook.

Considering total financing in 2020 (BRL375 billion, inflation adjusted), there was a decrease of 18.4% in capital market transactions relative to 2019. Fixed income, notably debentures, contributed the most to the overall decrease, as issuance of this debt instrument in 2020 was 33.9% lower than in 2019. In our view, this follows the initial risk-off response of markets to the outbreak of the COVID-19 pandemic, leading an initial search for bank lending. In line with what happened in the banking segment, and as a result of companies' short-term liquidity needs, working capital led the allocation of proceeds (34.2% in 2020 against 30.2% in 2019). In our view, the recent cycle of interest-rate cuts—propped up by the monetary policy response to the pandemic—also played a part in it, possibly reflecting in a shift towards equity markets in such a low-rate environment. In that sense, equity issuance in 2020 was 32.5% higher than in 2019, reflecting this portfolio shift generated by historically-low interest rates. In December, IPOs accounted for BRL15.3 billion, the highest monthly reading of the year. Follow-on issuance volume recovered from November's dip, posting BRL4.6 billion. For real estate funds, the accumulated volume of issuance in 2020 was 6.4% above 2019, illustrating the recovery in housing market.

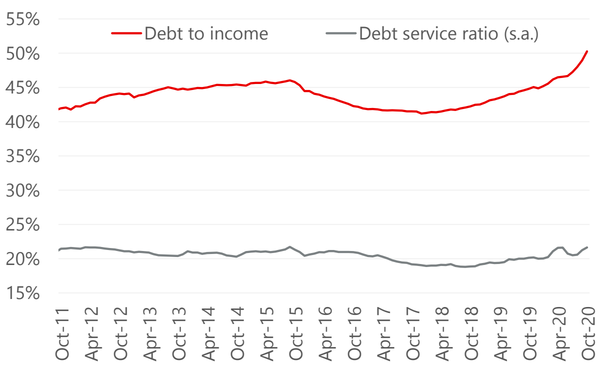
Consumer indebtedness on the rise. Brazilian Central Bank (BCB) data for October show household debt to income at 50.3%, up +1.3 p.p. from September (+5.5 p.p. from October 2019), with the historical average standing at 43.7%. It is the largest monthly increase in the data (starting in March 2011). The household debt service ratio was 21.7%, up +0.4 p.p. from September (+1.5 p.p. from October 2019), with the average standing at 20.5%. This increase in consumer indebtedness is another indication, in our view, that nonperforming loans (NPLs) should rise in the coming months, as the emergency aid is rolled back.

Figure 5.A. –Issuances in Domestic Markets (BRL billion, CPI adjusted)



Source: Anbima, Santander.

Figure 5.B. – Consumer Indebtedness (% of Expanded Aggregate Wages)



Source: Brazilian Central Bank, Santander.

INFLATION

IPCA 2020 was not as bad as the headline would suggest. The 2020 IPCA inflation closed at 4.52%, above the 4.00% target of the BCB. However, it is worth highlighting that the food shock (+18.2% YoY) was impressive, accounting for 60% of the total variation for the year. In other words, the IPCA ex-food finished the year just at 2.4%—and the official average of cores ended at 2.8%—that is, at very low levels. It is also worth noticing that services inflation was very low, ending 2020 at 1.7%, while industrial goods inflation ended a bit higher, but still below the target, at 3.2%. All in all, despite the high headline, 2020's IPCA inflation was qualitatively good.

But the monthly print was not great in qualitative terms. Analyzing at the margin, December's IPCA was higher than expected: 1.35% MoM vs. our forecast of 1.18% and the market's median expectation of 1.21%. For the month, the reading was qualitatively worse: the biggest surprise came in industrial goods (+10 bps of surprise), but services (+6 bps) and food-at-home (+2 bps) also surprised. As a result, the average of cores registered +0.65% MoM change, while we expected a milder variation of +0.44%.

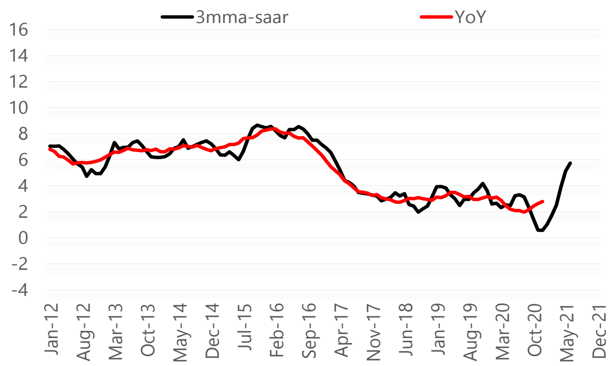
We revised our short-term IPCA forecasts upwards: January went to 0.36% MoM (from 0.19%) and February went to 0.31% MoM (from 0.28%). On top of the December reading's surprise, commodity prices continue to rise, while the BRL is not appreciating (contrary to our expectation). This short-term revision led us to revise our 2021 tracking from 3.0% (still the official forecast) to 3.2%, but we still believe in a benign scenario, with the food shock fading, services accelerating at a slow pace (weak job market), industrial goods decelerating (as the mismatch between supply and demand ends) and administered prices being an upward pressure. However, we see risks tilted to the upside. See link below[4].

Figure 6.A. – IPCA by Groups %

	MoM			YoY	
	dec/20	Santander	Dev.	nov/20	dec/20
IPCA	1.35	1.18	0.17	4.3	4.5
Administered prices	2.04	2.09	-0.01	0.9	2.6
Free prices	1.11	0.86	0.19	5.5	5.2
Food-at-home	2.12	1.96	0.02	21.1	18.2
Industrial goods	0.91	0.46	0.10	2.6	3.2
Services	0.83	0.67	0.06	1.6	1.7
EX3 core	0.60	0.36	0.24	2.4	2.4
Average of cores	0.65	0.44	0.21	2.6	2.8

Source: IBGE, Santander.

Figure 6.B. – Core Inflation Average – Annual %



Source: IBGE, BCB, Santander.

[4] **Santander Brazil Inflation – *"IPCA December: Some Negative Surprises"*–** January 13, 2021 - Available on: http://bit.ly/sant-ipca-dec20

ECONOMIC ACTIVITY

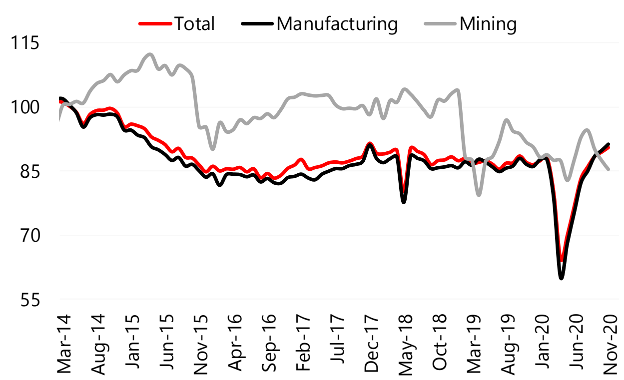
Sequential improvement of Industrial Production. The data for November (out last Friday) has confirmed expectations of a monthly gain (1.2% MoM-sa), with the headline index now up 2.6% since February (pre-crisis mark). The carryover for 4Q20 stands at 5.0%. The environment of high confidence and capacity utilization, as well as inventory at levels historically below the desirable suggests a good outlook for future production in the coming months, in our view, mainly due to inventory replenishment. See link below[5]

Services surprise positively. The data for November was above market expectations (2.6% MoM-sa vs consensus of 1.0%), but still not enough for a full recovery from the losses wrought by the crisis: the headline index is still down by 3.2% since February. This positive result was driven by the rebound of the segments most hurt by the reduction in social interactions, which are gradually moving toward full recovery. November's result leaves a carryover of 6.1% for 4Q20, and we expect a sequential gain in December as mobility seems to have slightly improved, although the increase in contagion seen in the first weeks of 2021 may decelerate this movement. See link below[6]

Regarding retail sales, our proprietary coincident indicator (IGET) registered an increase in December (+6.6%), but from a very depressed basis following the sharp fall seen in the previous month (-9.5%). Our tracking for broad retail sales based on IGET is at 0.4% (6.8% YoY) in December, possibly driven by the sharp increase in e-commerce, amid continued social distancing. See link below[7]

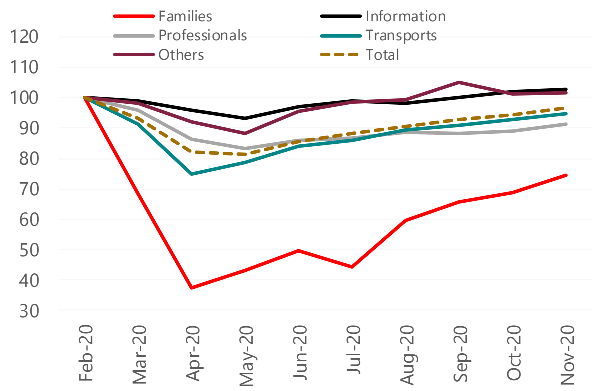
Next Monday (January 18), the BCB will publish its monthly activity index, capping the batch of economic activity indicator releases for November. Given the key-sectorial information available up to now, we are projecting a monthly gain of 0.6% (-1.0% YoY). These figures reinforce our expectation of solid sequential growth in economic activity in 4Q20. We are projecting a 4Q20 GDP growth of 2.8% QoQ-sa, and our tracking is at 2.5%.

Figure 7.A. – Industrial Production (2012=100, sa)



Source: IBGE, Santander.

Figure 7.B. – Services Breakdown (Feb-20=100, sa)



Source: IBGE, Santander.

[5] **Santander Brazil Economic Activity – "*Upward Trend Continues*"–** January 08, 2021 - Available on: http://bit.ly/Sant-Ind-Prod-Nov20
[6] **Santander Brazil Economic Activity – "*Solid Quarterly Growth Expected Ahead*"–** January 13, 2021 - Available on: http://bit.ly/sant-pms-nov20
[7] **Santander Brazil Economic Activity – "*Acomodação no 4T20*"–** January 12, 2021 - Available (in Portuguese) on: http://bit.ly/Sant-igetdez-20

MONETARY POLICY

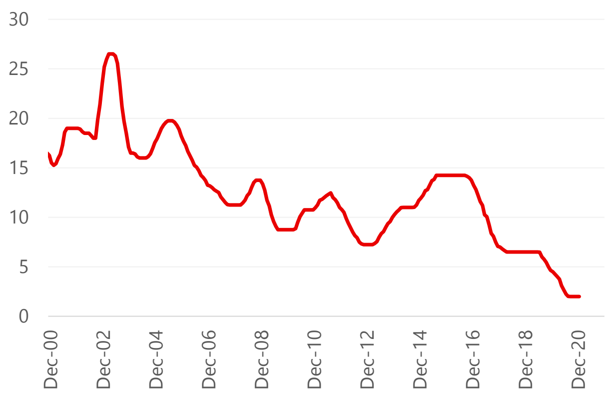
On Wednesday (December 09, 2020), the BCB will announce its policy decision. We expect the Selic rate to remain at the historical low of 2.00%, in line with a broad market consensus (including both analysts and investors).

The market should focus in the statement, amid expectations regarding the elimination of the BCB's forward guidance (of stable interest rates if certain conditions are met). The possibility of changing the policy signal was open in the last COPOM meeting, as the committee listed the conditions for ending this "commitment." According to the BCB, the end of the forward guidance could follow: (i) an eventual increase of 2021 inflation expectations and projections toward the mid-target; or (ii) the switching of the policy horizon from YE2021 (when inflation is seen below the target next year) to YE2022 (when inflation is seen at the target, assuming some Selic hikes starting in August).

Taking the BCB at their word, we still see March's COPOM as the main candidate for the end of the forward guidance (FG), since it will mark the transition from YE2021 to YE2022 as the key monetary policy horizon. While the first meeting of the year is historically too soon to change the policy horizon, we see rising odds for an eventual elimination of the FG at this meeting, especially following the hefty gains in underlying inflation measures in this week's December IPCA report. That could stoke BCB fears of possible spillovers of such (predominantly exogenous) inflationary shocks to inflation expectations for key policy horizons. Additionally, rising input costs in BRL terms could also prompt the BCB and the markets to revise higher their IPCA estimates for 2021, heading for the Copom meeting. Abandoning the FG now would allow the BCB to take back a small amount of monetary stimulus—equivalent to 25bps in Selic rate terms, according to BCB estimates presented in the last inflation report. At the same time, such a move could help buy the BCB a little time to watch key developments on upcoming fiscal decisions and the economic reaction without the emergency fiscal stimulus. A subsequent reaction from the yield curve and the possibility of unwanted effects (in terms of tightening) on financial conditions would be a risk to consider before this relatively soon decision.

Amid persistently high economic slacks (especially in the service sector, biggest in the economy and most directly affected by the social distancing measures) and well-anchored inflation expectations, we continue to view the current pace of economic recovery and inflation pickup as mostly driven by temporary factors, notably the large (but temporary) volume of government transfers to households during the pandemic. The CPI acceleration in place also reflects a temporary shift in the consumer spending profile, with a migration of spending away from services and into goods. An exogenous shock in food and energy prices, as well as a pass-through of the FX depreciation, completes the list of culprits for the excess inflation seen last year (full-2020 reading of 4.5%, compared to a mid-target of 4.0%). Assuming a still credible fiscal consolidation process ahead, our baseline scenario is predominantly disinflationary for 2021 and 2022. Under these conditions, we believe the BCB will start a gradual normalization process in October.

Figure 8.A. – Nominal Selic Rate



Source: Brazilian Central Bank, Santander.

Figure 8.B. – Ex-Ante 1-Year Real Interest Rate

Source: Bloomberg, Brazilian Central Bank, Santander.

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