BRAZIL MACRO

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MACRO COMPASS

KEEPING THE PACE

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- The USD/BRL pair closed the rolling week ended December 2 at 5.64 (implying a 1.5% loss), standing among the bottom performers in a basket of 31 of the most liquid currencies in the world. The weakening of the BRL took place even with the marginal weakening of the USD on a global scale, amid worries about the economic impact of the omicron variant of COVID-19. In addition to weak local activity data (especially 3Q21 GDP), the omicron-led rally in global yields helped produce a downward shift in local yield curve.
- On Thursday (December 2), the Senate approved the *Precatórios* amendment (PEC 23/2021) by 61 votes in the second round (threshold for approval is 49 votes). This constitutional amendment limits the annual settlement of judicial claims by the central government within the spending cap and changes the indexation of the federal expenditure ceiling, opening a space of BRL 120 billion to accommodate expenses for budget 2022 (especially the new social program – *Auxílio Brasil*).
- The Brazilian Central Bank (BCB) released bank lending data for October, which showed still strong growth in balances: 4.8% YoY. For households, non-earmarked loans posted a decrease of 1.3% MoM-sa. For non-financial firms, the drop was led by new earmarked loans, -30.5% MoM-sa. Looking ahead, we anticipate a slowdown in lending activity on the heels of elevated consumer indebtedness and higher interest rates.
- The latest batch of labor market data indicates continuity in the recovery trend. However, the economic reopening effect seems to be fading. Based on the IBGE's PNAD Survey, we calculate that the seasonally adjusted jobless rate was at 12.8% in September (August: 13.1%), as revisions in the data series placed labor market indicators much closer to pre-crisis levels. Based on the October CAGED survey, we estimate that the seasonally adjusted payroll growth eased to +197k in October (September: +220k).
- The 3Q21 GDP data pointed to a back-to-back contraction. The headline index retreated 0.1% QoQ-sa, stemming mainly from a (temporarily) plummeting farm output. Services continued to strengthen, with mobility-related segments on the driver's seat. Despite the supply constraints, the industry showed resilience and posted a flattish reading, with a little help from construction activity. This headline places GDP 0.1% below the pre-pandemic mark and implies a 4.8% carryover for 2021 (and -0.1% for 2022). The 4Q21 dataset for the economy did not start so well, as industrial production disappointed by retreating 0.6%, stemming mainly form a sharp tumble seen in mining (-8.6%). On Wednesday (December 8), the IBGE will release retail sales data for October, and we expect a gain of 0.8% MoM-sa for the broad index, the first positive figure since August 2021.
- We forecast the November IPCA (due on Friday, December 10) at +1.12% MoM. As opposed to what we projected a month ago, we no longer see a peak but a plateau around for inflation, around 10.5% until the end of 1Q22. Our November number implies 10.9% YoY (October: 10.6%). All in all, we remain very cautious about the inflation conditions and outlook, especially for next year, amid rising idiosyncratic risks that could further lift expectations for key policy horizons.
- On Wednesday (December 8), the Copom announces its monetary policy decision. We project another Selic rate hike of 150bps to 9.25%. Amid (fading) market discussions about the need to accelerate and intensify the tightening of monetary conditions, we believe the Copom will keep the pace, signaling a probably similar adjustment for February. We see the BCB signaling that monetary policy will advance further in contractionary territory, amid an upwardly skewed balance of risks (but roughly unchanged since October).

Most of the information in this report is up to the end of Thursday, December 02, 2021.

Figure 1. Brazil Macro Agenda for the Week of December 06 - 10, 2021

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
IGP-DI Inflation (% MoM)	FGV	Nov/21	Tue, 07-Dec	--	1.6
IGP-DI Inflation (% YoY)	FGV	Nov/21	Tue, 07-Dec	--	20.95
Core Retail Sales (% MoM)	IBGE	Oct/21	Wed, 08-Dec	0.7	-1.3
Core Retail Sales (% YoY)	IBGE	Oct/21	Wed, 08-Dec	-5.9	**-5.5**
Broad Retail Sales (% MoM)	**IBGE**	**Oct/21**	**Wed, 08-Dec**	**0.8**	**-1.1**
Broad Retail Sales (% YoY)	**IBGE**	**Oct/21**	**Wed, 08-Dec**	**-4.6**	**-4.2**
Copom Meeting - Selic Rate (%)	**BCB**	**--**	**Wed, 08-Dec**	**9.25**	**7.75**
IPCA Inflation (% MoM)	**IBGE**	**Nov/21**	**Fri, 10-Dec**	**1.12**	**1.25**
IPCA Inflation (% YoY)	**IBGE**	**Nov/21**	**Fri, 10-Dec**	**10.92**	**10.67**
Vehicle Production (thousands)	Anfavea	Nov/21	06 to 07-Dec	--	177.9

Source: Santander.

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

[1] **Santander Brazil - Macroeconomic Scenario:** ***"Higher Fiscal (and Inflation) Risks Weigh on the Growth Outlook" –*** December 02, 2021- Available on: https://bit.ly/Std-scenreview-dec21

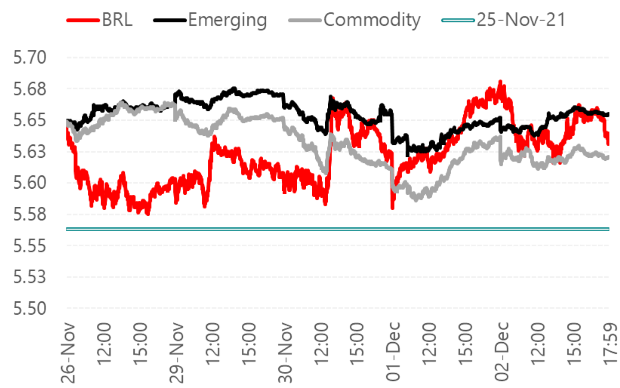
LOCAL MARKETS—FX

In spite of the USD weakening on a global scale in the last 5 business days, the USD/BRL pair closed the rolling week ended December 2 at 5.64 (or a 1.5% loss). The BRL was among the bottom performers in a basket of 31 of the most liquid currencies in the world during the period. The USD weakened 0.7% in the rolling week ended December 2, as gauged by the performance of the DXY index in the period driven by the initial perception that the omicron variant of the COVID-19 may dampen economic activity. But that contrasts with the hawkish statements delivered by FOMC members in the last **couple of weeks**, indicating that the tapering of asset purchases and the normalization of the US monetary policy may happen at a faster pace than the market previously thought. The USD/BRL pair did not benefit from that move of the USD and ranged between 5.58 and 5.68, thus failing to strengthen in the period as a setback in the global reopening would be negative for EMs in general.

LOCAL MARKETS—Rates

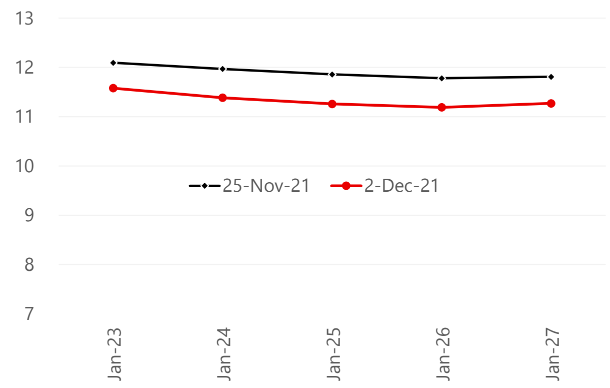
The risks of setbacks in the global pandemic situation stemming from the emergence of the omicron variant of COVID-19 and the back-to-back GDP contraction registered by the Brazilian GDP in 3Q21 led to a rally (nearly a parallel downward shift of ~40-60bps) in the local yield curve in the rolling week ended December 2. In our view, the relapse of COVID-19 due to the omicron variant has been taken by the markets as a potentially deflationary event that could bring some respite to the current pressures on prices and interest rates. In addition to that, the release of the Brazilian GDP in 3Q21 that indicated the country registered a "technical recession" in the period (more details in the Economic Activity section) has also added to the roster of reasons that the markets believe could be used by the monetary authority to keep the current pace of hikes, despite the continued increase in inflation expectations.

Figure 2. USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note 1: As of the close on Thursday, December 2, 2021.
Note 2: For other currencies, we use USDBRL values as a base-index

Figure 3. Brazilian Domestic Yield Curve (% p.a.)



Sources: Bloomberg, Santander.
Note: As of the close Thursday, December 2, 2021.

COMMODITIES

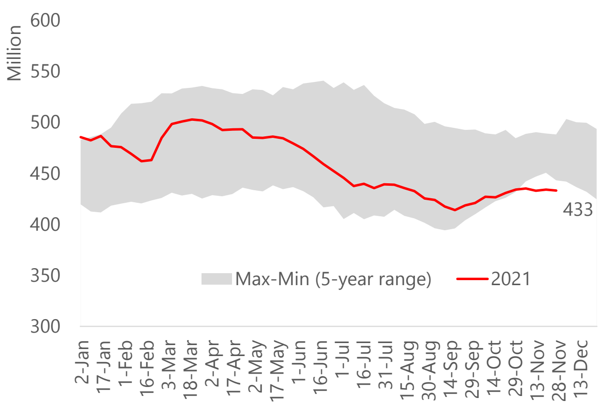
Crude oil plummeted amid fears over the emergence of the omicron variant. While much remains unknown about the new coronavirus variant, its spread sent oil prices downward (15% down from last week). It is still unclear whether it is more transmissible or if it causes more severe illness than previous variants. More information from ongoing research is expected in the coming weeks.

Adding to the sell-off in oil markets, OPEC+ agreed to proceed with its January output hike. The market was surprised with the decision to add 400k barrels a day against the expectation of a pause. Yet the organization kept its meeting formally open, and vowed to "make immediate adjustments if required" amid growing concern that the Omicron variant may hurt demand. The next OPEC+ meeting is scheduled for January 4.

EIA[2] reports a decrease in U.S. crude stockpiles. On Wednesday (December 1). The EIA reported that U.S. crude inventories decreased by 909k barrels for the week ending November 26, close to the expectation of a 1,054k barrels decrease. As a result, considering the last five years, inventories are already below the minimum level observed for this time of the year (total inventory was 433 million barrels (as of November 26)).

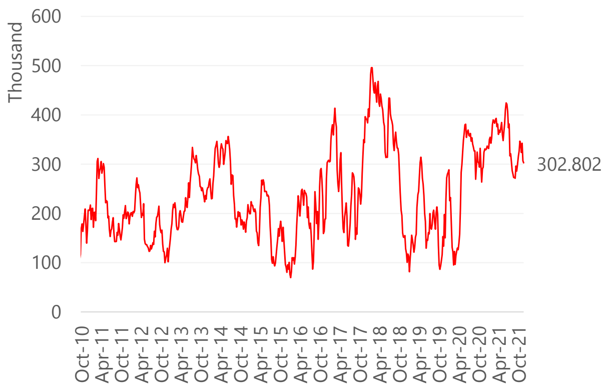
CFTC[3] reports a second decrease in speculative long positions in WTI crude oil. Money managers reduced their net long WTI crude futures and options positions in the week ended November 23, the CFTC reported on Friday (November 26). The positions in futures and options decreased by 4,257 contracts to 302,802.

Figure 4. EIA U.S. Crude Oil Inventories (Barrels)



Sources: EIA, Santander.

Figure 5. CFTC NYMEX Crude Oil Managed Money Net Total (Number of contracts)



Sources: COT, Santander.

[2] Energy Information Administration.
[3] U.S. Commodity Futures Trading Commission.

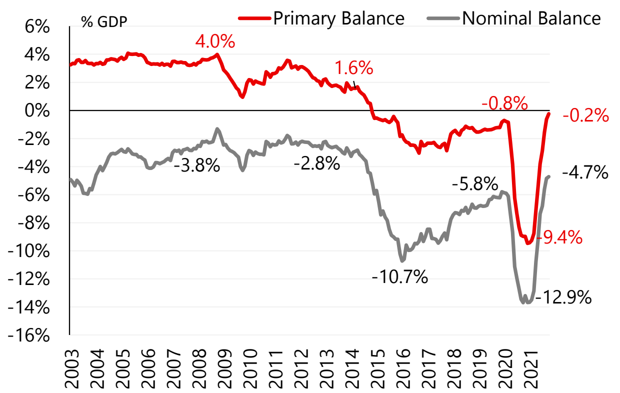
FISCAL POLICY AND LEGISLATION

According to data published on November 30 by the BCB, the consolidated public sector posted a primary surplus of BRL35.4 billion in October, a tad lower than our forecast (BRL37.5 billion) and close to the market's median estimate (+BRL35.0 billion). This was the best result for October since 2016. In YTD terms, considering the positive results for regional governments, the public sector reached a primary surplus of BRL49.6 billion (0.7% of GDP) in October, compared to a deficit of BRL633 billion (10.4% of GDP) in October 2020, affected by a massive fiscal stimulus, and compared to -BRL33.0 billion (0.5% of GDP) in 2019. In the 12-month reading, the primary deficit reached BRL20.4 billion (0.4% of GDP) in October, compared to BRL52.9 billion (0.6% of GDP) in September, maintaining a downward trajectory after a sharp reduction in the fiscal stimulus in 2020 vs. 2021 (close to 9.4% of GDP summing up both years). We estimate that the consolidated public sector deficit could reach BRL10 billion in 2021 (0.1% of GDP). In our view, we cannot rule out a primary surplus this year, given potential further surprises from the effects of inflation, along with higher dividends and tax payments from companies related to the commodity sector.

Regarding the debt statistics, gross debt remained at 82.9% of GDP in October, with the effects of the rise in interest payments (+0.6pp impact) being offset by a higher nominal GDP (-0.9pp of impact). Meanwhile, net debt was 57.6% of GDP, 1.0 pp lower on the same basis of comparison, affected by a more depreciated FX rate (-0.6 pp of impact). We expect gross debt to fall this year, however, to 81.8% of GDP, assuming higher nominal GDP with an 18% rise in 2021 (driven by the price shock impact on the GDP deflator). Finally, we expect the BNDES to repay the Treasury a total of BRL100 billion, already ~BRL60 billion was repaid until October, and the remaining values are expected to be paid in November. See details in the link[4].

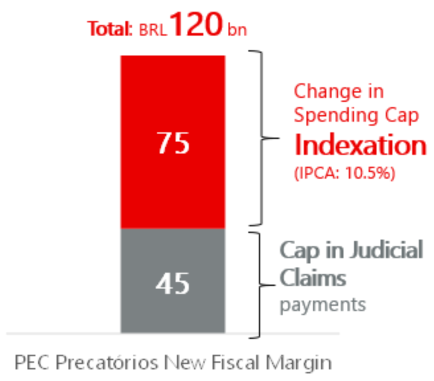
On Thursday (November 2), the Senate approved in two rounds the so-called *Precatórios* Amendment (PEC 23/2021) by more than 60 votes, out of 89 Senators compared to the 49 needed for passing. The constitutional amendment limits the annual settlement of judicial claims by the central government within the spending cap and changes the indexation of the federal expenditure ceiling. According to our calculations, the new legislation opens a space of about BRL120 billion for new spending within the constitutional ceiling in 2022 and is key for the government's intention to implement the new welfare program, called *Auxílio Brasil*. As the Senate changed the legislation, parts of the proposal will return to the Lower House for final approval, and parts could be directly enacted, which we believe will be on time to increase *Auxílio Brasil* monthly benefit and include more beneficiaries. The main changes in the Senate's version were: (i) reduction in the time period from judicial claim payments cap to 2026 instead of 2036; (ii) removal of the court-debt ordered owed to the Fundef (educational fund) from the constitutional spending cap; (iii) earmark the fiscal margin to welfare, pensions, and healthcare; (iv) guarantee that every Brazilian in a situation of social vulnerability will have the right to a basic income with a permanent program. All in all, the transiting in the Senate did not change the core of the proposal.

Figure 6. Public Sector Fiscal Balance (12m)



Sources: Brazilian Central Bank, Santander.

Figure 7. Fiscal Margin for New Expenditures 2022



Sources: National Congress, Santander.

[4] **Santander Brazil Fiscal - *"Positive Seasonal Primary Surplus in October"* –** November 30, 2021 – Available on: https://bit.ly/Std-Fiscal-113021

BALANCE OF PAYMENTS

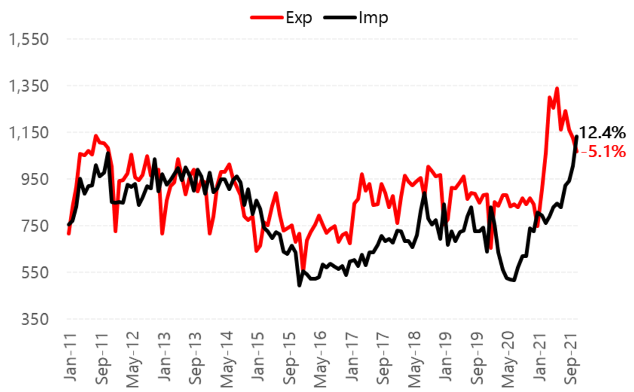
The November trade balance registered a US$1.3 billion deficit driven by rising imports of intermediate goods aimed at alleviating problems in the domestic supply chain and declining exports related to momentary sanitation bans. In our opinion, these are temporary setbacks that we expect to be overcome shortly, thus keeping unchanged the constructive prospects for the Brazilian foreign trade.

Brazilian export revenue tallied US$20.3 billion last month and fell short of our US$21.0 billion estimate due to a stronger decline in foreign sales of animal proteins stemming from sanitation bans imposed by China and other countries. Although the outcome translated into a drop of 5.1% in daily average proceeds in seasonally adjusted terms—the third in a row—the level of export revenue continues to run at fairly high levels, which is a good omen for future results as we expect current bans to be lifted soon.

Similar to what happened with export revenues, the amount of import outlays in November 2021 stood below our expectation (US$21.6 billion vs. US$22.4 billion, respectively), thus leading the final balance to come in line with our estimate (-US$1.3 billion vs. -US$1.4 billion, respectively). The daily average of imports increased 12.4% in seasonally adjusted terms, with the bulk of the expansion referring to intermediate goods aimed to partially relieve troubles in the domestic supply chain. Hence, once the domestic production lines normalize, we expect import outlays to lose part of the current steam they have shown of late.

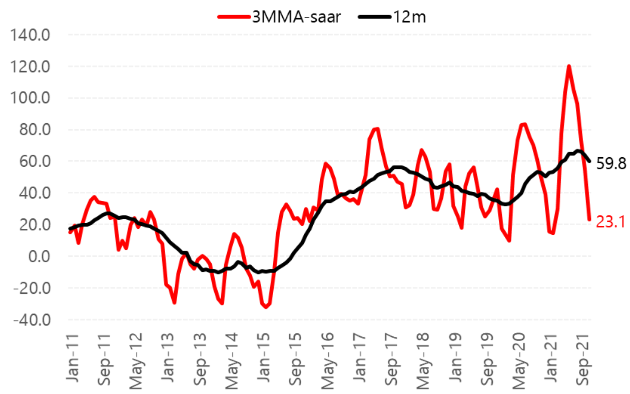
All in all, although the 3MMA-saar of the trade balance in November 2021 points towards an important decline to a surplus of US$23.1 billion as compared with the surplus of US$59.8 billion on a 12-month basis in the same period, we expect the constructive underlying trade dynamics to prevail ahead as these temporary setbacks fade.

Figure 8. Trade Balance Components (USD million/working day, sa)



Sources: SECINT, Santander.

Figure 9. Trade Balance (USD billion)



Sources: Brazilian Central Bank, Santander.

CREDIT

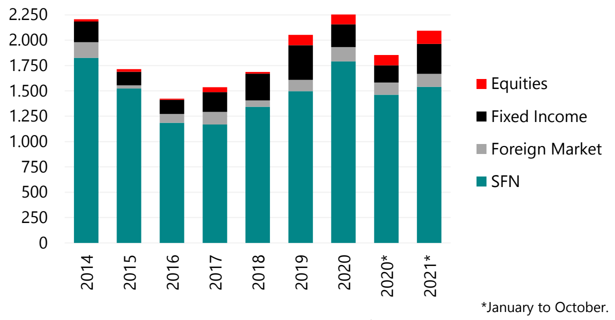
In October, total outstanding loans in the National Financial System (SFN, in Portuguese acronym) posted inflation-adjusted growth of 4.8% YoY to BRL4.5 trillion (0.3% MoM-sa), up 8.1% YoY for households (0.7% MoM-sa) and up 0.6% YoY for non-financial corporations (-0.3% MoM-sa). The nominal growth rate of total outstanding loans has remained the same at 16.0%. In addition, credit to corporations fell to 11.4% from 11.6%, while the volume of credit for households continued to accelerate, rising to 19.7% from 19.4%. **See details in the link**[5]

New loans adjusted for inflation and seasonality (BCB methodology) recorded an increase, 2.3% in October. For households, the non-earmarked segment posted a decrease of 1.3% MoM-sa. This result is mainly composed of personal credit total (-9.8% MoM-nsa) and vehicle purchases (-0.5% MoM-nsa). In the earmarked segment, rural credit and real estate financing decreased (-11.6% MoM-nsa and -5.9% MoM-nsa, respectively). For companies, there was an increase of 0.5% MoM-sa in October in the non-earmarked segment. The earmarked segment registered a significant decrease of 30.5% MoM-sa after the last month rise (7.2%). This result was mainly driven by BNDES funds (-47.9% MoM-nsa) and Others (-63.9% MoM-nsa).

Considering total corporate financing YTD through October 2021 (new loans in the SFN, debt and equity issues in the capital markets) vs. the year-ago period, issuances in the capital markets were 56.6% higher, while SFN concessions were up 5.3%. As a result, total corporate financing was up 13% compared to the year-ago period.

Still regarding non-earmarked loans, the seasonally adjusted default rate (% of 90-day past-due loans) was at 4.3% and 1.6% for households and corporations, respectively. Importantly, the household debt-service ratio continued to rise, reaching the highest point in the series, 59.9% in August, and without real estate financing, the household debt-service was 37%. In addition, the debt-to-income ratio rose to 30.1% in August, and without real estate financing, the debt-to-income ratio was 27.5%. We see these figures as a risk for NPLs and credit growth going forward. **For details on Santander's credit outlook, please refer to our last chartbooks**[6]

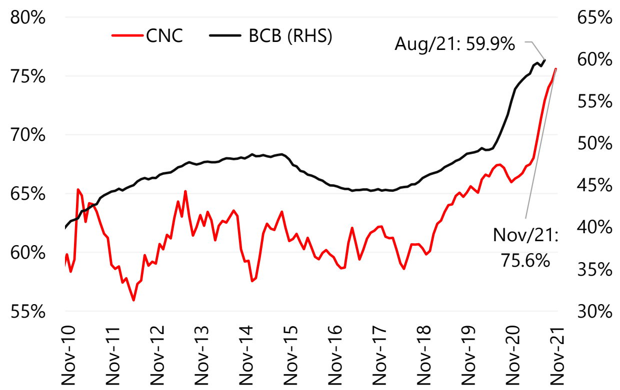
Figure 10. Total Corporate Financing (BRL billion, Inflation adjusted)



SFN - exclude *conta garantida, cheque especial* (overdraft) and credit card.
Foreign Market - bonus, MTNs and securities.
Fixed Income - Debentures, commercial papers, LFs, CRAs, CRIs e FIDCs.
Equity - IPO and follow-on.

Sources: Brazilian Central Bank, Santander.

Figure 11. Household Debt-to-Income and Debt Service Ratio (%)



Sources: Brazilian Central Bank, Santander.

[5] **Santander Brazil Credit - *"Early Warning Signs for Household Defaulting Rates"* –** November 26, 2021 – Available on: https://bit.ly/Std-credit-112621

[6] **Santander Brazil Credit - *"Chartbook – Household Debt is a Risk for Loan Growth and Delinquencies"* –** December 02, 2021 – Available on: https://bit.ly/Std-chart-credit-dec21

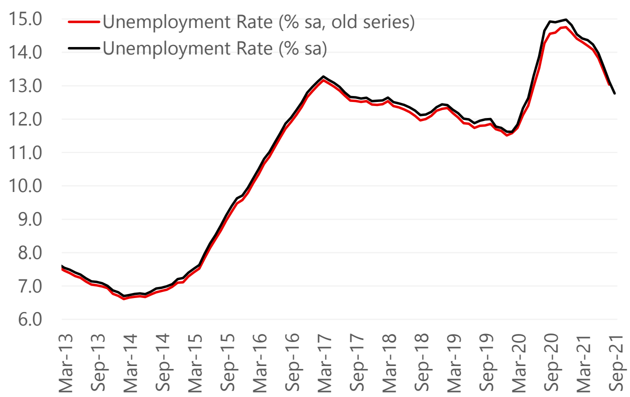
LABOR MARKET

According to the IBGE's National Household Survey (PNAD), the unemployment rate stood at 12.6% in the three months to September, slightly below our estimate and market consensus (both at 12.7%), implying a 2.3 p.p. drop from the year-ago level (14.9%). We calculate that the seasonally adjusted jobless rate stood at 12.8%, a decrease compared to the August level (13.1%). The September PNAD release brought a methodological revision to all employment series. There was a slight upward impact over the unemployment rate series, especially during the beginning of the pandemic. This stemmed from positive revisions in both the employed population and the labor force estimates. We think that these changes tend to have little impact on our medium- and long-term labor-market views. The decrease in the seasonally adjusted unemployment rate stemmed from increases of 0.6% MoM (sa) and 0.2% MoM (sa) in the employed population and the labor force, respectively. The labor market participation rate stood at 62.2% (sa), stable compared to the August result. The participation rate has also been revised, and is much closer to the pre-crisis mark (down 0.7 p.p. from the February 2020 level). Formal employment posted a 1.1% MoM SA increase, while informal employment remained stable. This result led the formalization rate to 57.4% (sa), an increase from the August result (57.2%). In our view, the growth in formal employment still seems to be related to the normalization in the PNAD survey, which has recently resumed in-person interviews, after over one year being done by phone. Informal employment, on the other hand, seems to have lost momentum. The effective average real income posted a 1.8% MoM (sa) decrease in August (data lagged one month relative to other PNAD series), while the usual real income had a 1.2% MoM (sa) decrease in September. The series are 5.1% and 6.0% below their pre-crisis mark, respectively.

According to the October CAGED survey, net formal job creation stood at +253.0k, (versus consensus of +265k, Santander estimate of +217k), above the historical average for the month (+90.2k) but below the all-time record for the month (+395.0k in 2020). We estimate that the seasonally adjusted net formal job creation decelerated to +197k in October, from +220k in September. In our view, CAGED shows a slow deceleration, as the end of the formal employment program ("Emergency Benefit for Income and Employment Preservation", or BEm) continues to affect the data, as layoffs remain at recent highs. Furthermore, the positive effects of the reopening process seem to be decreasing, as hiring decelerates.

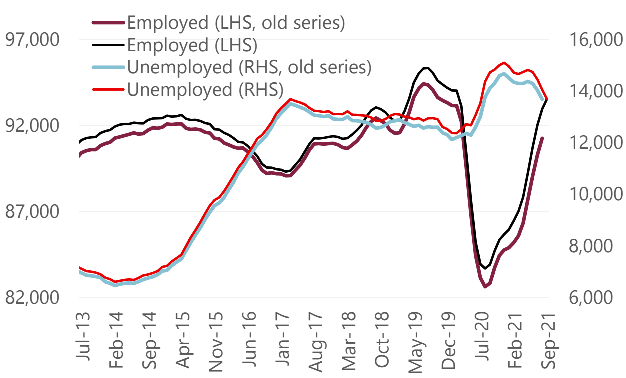
The current batch of labor market data indicates continuity in the recovery, but the economic reopening effect seems to be fading, in our view. The revisions in the PNAD series increased the formal employment and labor force estimates, but had little impact on the unemployment rate. The new picture indicates the labor market much closer to pre-crisis levels, but with higher unemployment rates. The labor force is now above pre-pandemic levels in seasonally-adjusted terms (800k above February 2020), and the employed population is 500k workers below its February 2020 level (sa). See details in the link[7].

Figure 12. Unemployment Rate Revisions



Sources: IBGE, Santander.

Figure 13. Employed and Unemployed (thousands, sa)



Sources: IBGE, Santander.

[7] **Santander Brazil Labor Market - *"Labor Market Decelerates as Reopening Effects Weaken"* –** November 30, 2021 - Available on: https://bit.ly/Std-labor-113021

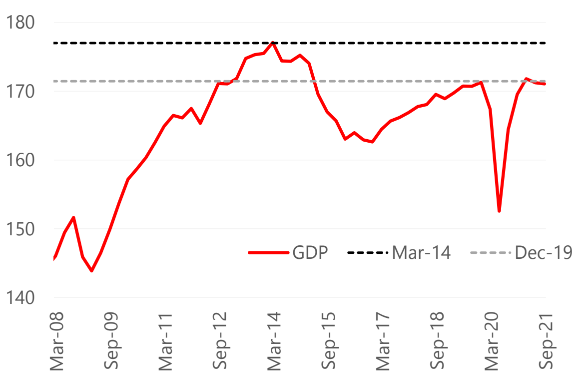
ECONOMIC ACTIVITY

3Q21 GDP data indicate a technical recession but owing mainly from less-cyclical sectors. The headline index retreated slightly (-0.1% QoQ-sa), below market consensus (0%) and our projection (0.1%), but with significant revisions in the series. On the supply side, the services sector continued to strengthen (+1.1% QoQ-sa) and surpassed the pre-pandemic mark (up 0.6% in 4Q19). Among the subsectors, Other Services (+4.4%), Public Services (+0.8%), and Transports (+1.2%) were the highlights, while Retail broke a string of four expansions by retreating 0.4%. Industry surprised positively by showing stability (0% QoQ-sa). Manufacturing continued to weaken (-1.0%), while Mining broke a string of three gains (-0.4%); conversely, Construction continued to strengthen, expanding 3.9%. Farm output, a less cyclical sector, was the lowlight, plummeting 8.0% QoQ-sa and reflecting the weak figures in agriculture, exacerbated by the suspension of Chinese meat imports. On the demand side, household consumption expanded 0.9% QoQ-sa, still showing some idleness relative to the pre-pandemic mark (down 2.1%). Government consumption expanded 0.8%, in line with the gradual recovery of the provision of public services. Conversely, investments retreated slightly (-0.1%) but still stand well above the pre-crisis mark (up 18%). The external sector dragged down overall activity, reflecting the sharp tumble seen in exports (-9.8%, likely reflecting the decline in farm output), which more than offset the decrease in imports (-8.3%). This result implies a 4.8% carryover for 2021 (-0.1% to 2022), and places GDP 0.1% below the pre-pandemic mark. Moreover, the 2020 full-year variation increased to -3.9% from -4.1%. Regarding the current quarter, the negative carryover implied by September's results, high inflation, the weakening in economic confidence, and increasing uncertainty bring challenges for overall activity in 4Q21. However, we still expect sequential GDP growth, stemming mainly from good contributions from mobility-related services segments (e.g., Services to Families), which still show wide idleness relative to the pre-pandemic period, and from a rebound in farm output. See details in the link[8].

Aggregated business confidence retreated 3.3% in November[9]. This result reflects a widespread drop of economic confidence among the subsectors, marking the second drop in three months. Moreover, the index still stands 1.3% above the pre-pandemic mark but retraced to levels below the 100 points neutral threshold, entering the pessimism zone. Moreover, industrial production disappointed by retreating 0.6% MoM-sa, stemming mainly from the sharp tumble seen in mining (-8.6%), while manufacturing posted virtual stability (-0.1%). This result was the fifth decline in a row and marked a weak start of 4Q21 for industrial output.

On Wednesday (December 8), the IBGE will release the retail sales data for October. We expect a sequential increase of 0.8% MoM-sa, marking the first positive figure since August-2021.

Figure 14. GDP (sa, index average 1995=100)



Sources: IBGE, Santander.

Figure 15. GDP Breakdown

	2Q21		3Q21	
	% YoY	% QoQ	% YoY	% QoQ
GDP	12.3	-0.3	4.0	-0.1
Supply				
Agriculture	0.1	-2.8	-9.0	-8.0
Industry	16.6	-0.6	1.3	0.0
Services	11.0	0.6	5.8	1.1
Demand				
Consumption	10.6	-0.2	4.2	0.9
Government	5.8	0.9	3.5	0.8
Investments	33.1	-3.0	18.8	-0.1
Exports	14.2	13.7	4.0	-9.8
Imports	20.3	-1.2	20.6	-8.3

Sources: IBGE, Santander.

[8] **Santander Brazil Economic Activity - *"The Second GDP Retreat in a Row"* –** December 2, 2021 – Available on: https://bit.ly/Std-GDP-120221
[9] **Santander Brazil Economic Activity - *"Widespread Drop in November"* –** December 1, 2021 – Available on: https://bit.ly/Std-Econact-120121

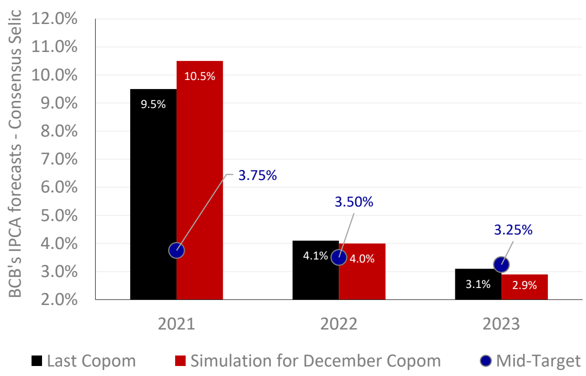
MONETARY POLICY

On Wednesday (December 8), the Copom announces its monetary policy decision. We project another policy rate hike of 150bps to 9.25%. Amid market discussions about the need to accelerate and intensify the tightening of monetary conditions, we believe that the Copom will keep the pace, signaling a similar adjustment for February (if the BCB's scenario remains valid then). We see the BCB signaling that monetary policy will advance further in contractionary territory, amid an upwardly skewed balance of risks (about unchanged since the last meeting).

Since the last Copom meeting[10], held on October 26-27, incoming data confirm an anemic level of economic activity in 3Q21 and point to a deteriorating inflationary picture, amid a continued increase in headline inflation and a worsening composition (i.e., spreading of price pressures, higher underlying CPI). Cost push inflation at a global scale, amid supply chain disruptions and other shocks around the world, have not given any signs of abating in recent weeks. But even more noteworthy was the fact that the changes in the fiscal framework signaled by the Precatórios amendment (PEC, in Portuguese acronym), announced before the October Copom meeting, continued to produce an upward effect on inflation expectations in recent weeks. Since the last Copom (October 26-27), median IPCA forecasts rose 60bps for 2022 (to 5.00%; target: 3.50%), 15bps for 2023 (to 3.42%; target: 3.25%), and 8bps for 2024 (to 3.10%; target: 3.00%). This signals a possible de-anchoring of expectations due to the higher fiscal risk, which contrasts with the BCB efforts to rein in inflation expectations and avoid the inflation contagion for longer term horizons.

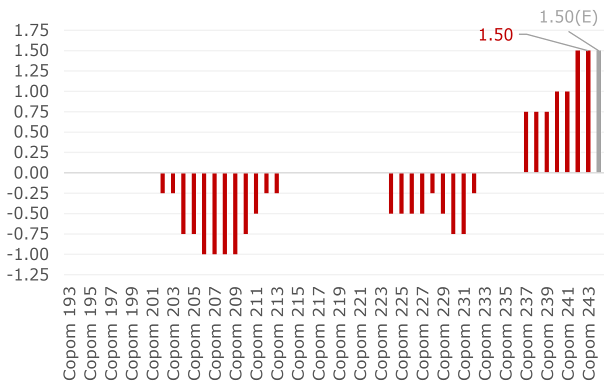
Using data up to November 26, we estimate that the BCB might forecast IPCA at ~4.0% for 2022 (-0.1 p.p. since the last Copom) and ~2.8% for 2023 (-0.3 p.p.) in the December Copom. These relatively contained change in the inflation projections for relevant horizons follow the rise in analyst expectations for the Selic rate. The latter rose around 200bps since the last Copom, for horizons up to 1 year. This factor offsets a greater expected contribution of higher inflation expectations and IPCA inertia (the latter generated by higher estimates for 2021 and 2022, respectively). We calculate that the BCB baseline scenario could implicitly point to a terminal Selic rate of 13.0% as necessary to bring the official IPCA projection down to 3.5% in 2022. That would indicate an even longer flight plan compared with the last meeting, if the BCB kept focusing on this horizon. Even considering the growing relevance of 2023 (which will be the dominant horizon as of 1Q22), we believe that this it may be too early for the BCB to extend the inflation convergence period, given the risk of contaminating expectations for longer horizons. Especially under the current fiscal conditions. Therefore, in recent speeches, BCB officials indicated they will set interest rates taking into account both 2022 and 2023 as policy horizons, which would entail a flight plan with terminal Selic closer to 12.00-12.50%, based on our calculations. This would favor the maintenance of the current pace of hikes. To be true, we recognize that 150bps it is quick pace of adjustment of monetary conditions, in historical terms. Our scenario projects interest rates closing 2021 at 9.25%, 2022 at 12.25% and 2023 at 9.00%, and still with upside risks.

Figure 16. Simulating the BCB's IPCA Model



Sources: Brazilian Central Bank, Santander.

Figure 17. Copom: Selic Rate Decision (% p.a.)



Sources: Brazilian Central Bank, Santander.

[10] **Santander Brazil Monetary Policy - *"The Greatest Hike Since 2002 (…)"* –** October 27, 2021 – Available on: https://bit.ly/Std-COPOM-oct21.

INFLATION

We expect the November IPCA (due on Friday, December 10) to rise +1.12% MoM. Contrary to what we expected a month ago, October's IPCA was probably not the peak of year-on-year IPCA inflation, as our numbers are consistent with a "plateau" of ~10.5% for the coming months. In terms of trends for headline IPCA—the three-month moving average seasonally adjusted and annualized—should also accelerate, to +13.9% in November from +13.8% 3MMA-saar in October.

Compared to the October IPCA (+1.25% MoM), November data should slightly decelerate, driven by free market prices that should decelerate (0.76% MoM vs. 1.21% last month), mainly driven by goods. On the other hand, regulated prices should accelerate (+2.40% MoM vs. +1.35% in October). In particular, we estimate the services core gauge will accelerate to 7.9% 3MMA-saar from 7.8%. The acceleration in services inflation is a source of concern as the group has high inertia, making the disinflation process (that we envision ahead) more difficult or stickier. Food-at-home should remain under pressure at the margin, with the trend decreasing to 16% 3MMA-saar. Finally, industrial goods should accelerate, with the headline increasing from 11.3% to 12.8% 3MMA-saar and its core gauge from 8.4% to 7.6% 3MMA-saar.

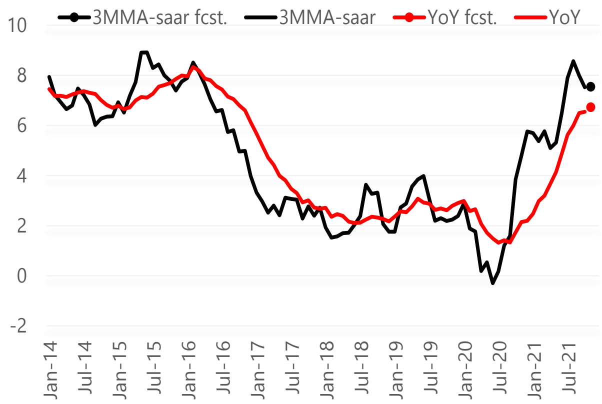
In terms of broad underlying inflation measures, we estimate the EX3 core will rise around +0.74% MoM, which would represent an acceleration to a hefty level of +7.54% 3MMA-saar (from +7.52%). This will be the fourteenth consecutive month that the EX3 core has run above the BCB's mid-target in 3MMA-saar terms (headline CPI target is 3.75% for 2021 and 3.50% for 2022). We remain cautious regarding the inflation outlook, especially after the recent rise of domestic fiscal risks, which might push expectations even higher and make inertia even stronger, leading to a more difficult disinflation process.

Figure 18 – IPCA: Forecast Details (%)

	MoM		YoY	
	Nov-21	Contrib.	Oct-21	Nov-21
IPCA	1.12	1.12	10.6	10.9
Administered	2.40	0.30	17.0	19.3
Free	0.76	0.82	8.5	8.2
Food-at-home	0.58	0.17	13.2	10.2
Industrial goods	1.37	0.26	11.0	11.9
Services	0.44	0.39	4,9	5,0
EX3 Core	0.74	0.30	6.6	7.0

Sources: Brazilian Central Bank, Santander.

Figure 19 – Core Inflation Forecast (EX3 %)



Sources: Brazilian Central Bank, Santander.

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