BRAZIL MACRO

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MACRO COMPASS

TERTIARY ACTIVITY AND CPI DATA A MIXED BAG

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- The USD/BRL pair closed the rolling week ended January 6 at 5.69 (implying a 2% loss) and stood among the bottom performers in a basket of 31 of the most liquid currencies in the world. In our view, the BRL weakening took place on the heels of still unfavorable global news related to COVID-19 developments (triggering risk aversion) and the hawkish tone seen in the minutes of the last FOMC meeting (setting a globally stronger USD). These were likely reasons to help erase the technical BRL gains seen at the final session of 2021. The hawkish Fed also prevailed as a driver (over weaker-than-expected readings for inflation and activity) on the domestic side, prompting the local yield curve to sell off in a parallel upshift.
- The trade balance registered a US$61.0 billion surplus in 2021, which is now the new historical peak of the Brazilian foreign trade in annual terms. Paradoxically, the contribution of net exports to the GDP in 2021 should be negative as the bulk of the outcome had to do with price effects rather than volume influences. Additionally, net inflows in the commercial segment of the spot FX market have also underperformed last year amid high local uncertainty, in our opinion.
- On the fiscal front, the data published on December 30 by the Brazilian Central Bank (BCB) showed a primary surplus of the public sector in November, boosted by a positive surprise in the regional governments. Our tracking points to a 0.4% of GDP consolidated primary surplus in 2021, to be the first positive reading in eight years. As far as the budget 2022 goes, we highlight two risks: the pressure for higher salaries in the public sector and the compensation for the newly-renewed payroll tax breaks.
- Industrial production retreated 0.2% MoM-sa in November, below our expectations (+1.0% MoM-sa) and market consensus (+0.1% MoM-sa). This result marks the sixth consecutive monthly decline and implies a -1.4% carryover to 4Q21. This suggests another negative contribution from manufacturing to overall activity in 4Q21, after declines in the three previous quarters.
- For the coming week, the IBGE will release the tertiary sector data for November. The services volume data is due out on Thursday (January 13), and we expect a 0.2% MoM sa increase (7.0% YoY). The retail sales data is due out on Friday (January 14): we expect a 0.6% MoM sa decrease for the broad index (-4.7% YoY), and a 0.5% MoM sa decrease for the core index (-6.5% YoY). These numbers are consistent with a flattish reading for November IBC-Br, the BCB's broad monthly activity indicator.
- We expect December IPCA (due on Tuesday, January 11) to rise +0.70% MoM. In YoY terms, this means 10.03%, a slight deceleration from the 10.74% change of November IPCA. Although this small relief in the annual reading can be seen as a peak strictly speaking, we believe inflation will continue hovering around 10% until April 2022, meaning more of a plateau. We remain cautious about the inflation outlook, as we project an above consensus IPCA for 2022 (5.8%).

Most of the information in this report is up to the end of Thursday, January 6, 2022.

Figure 1. Brazil Macro Agenda for the Week of January 10 - 14, 2022

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
IPCA Inflation (% MoM)	**IBGE**	**Dec/21**	**Tue, 11-Jan**	**0.70**	**0.9**
IPCA Inflation (% YoY)	**IBGE**	**Dec/21**	**Tue, 11-Jan**	**10.03**	**10.7**
Services Volume (% MoM)	**IBGE**	**Nov/21**	**Thu,13-Jan**	**0.2**	**-1.2**
Services Volume (% YoY)	IBGE	Nov/21	Thu,13-Jan	7.0	7.5
Core Retail Sales (% MoM)	IBGE	Nov/21	Fri, 14-Jan	-0.5	-0.1
Core Retail Sales (% YoY)	IBGE	Nov/21	Fri, 14-Jan	-6.5	-7.1
Broad Retail Sales (% MoM)	**IBGE**	**Nov/21**	**Fri, 14-Jan**	**-0.6**	**-0.9**
Broad Retail Sales (% YoY)	IBGE	Nov/21	Fri, 14-Jan	-4.7	-7.1

Sources: Bloomberg, IBGE, Santander.

For details on Santander's economic forecasts for Brazil, please refer to our last scenario review[1]. Also refer to our Macro Propositions for Brazil in 2022[2].

[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

[2] **Santander Brazil – Macro Propositions 2022: *"Navigating the Uncertainties"* –** January 07, 2022- Available on: https://bit.ly/Std-Macroprop22

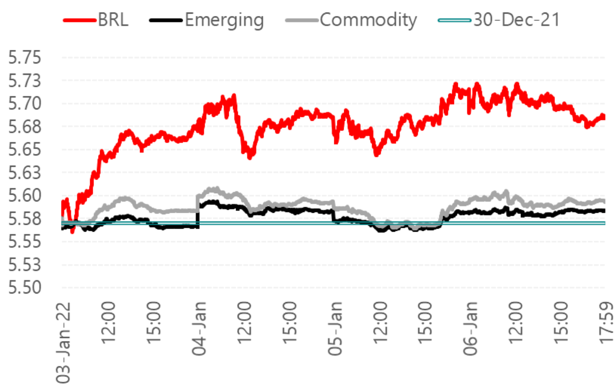
LOCAL MARKETS—FX

In the rolling week ended January 6, the USD/BRL pair revisited the 5.70 echelon and closed the period at 5.69 (a 2% loss). It was the third-worst performance in a basket of 31 of the most liquid currencies in the world. In our opinion, the worldwide wariness regarding new variants of the COVID-19 and the emergence of a new variety of the Influenza (H3N2) kept markets on a risk-off mode, which weighed on the performance of the BRL in the period. In addition to that, the hawkish tone seen in the minutes of the last FOMC meeting has also contributed for the weakening of the BRL (and most currencies of the basket), as the document displayed not only that the US monetary authority may start to hike the Fed Funds Target Rate earlier than expected by markets, but that the pace of implementation may also be faster than previously thought. That is, international monetary conditions should become less favorable than they have been for the last couple of years and this backdrop does not bode well for the BRL. As a result, the BRL started 2022 reversing the strengthening seen in the last day of 2021, which had probably been led by technical factors.

LOCAL MARKETS—Rates

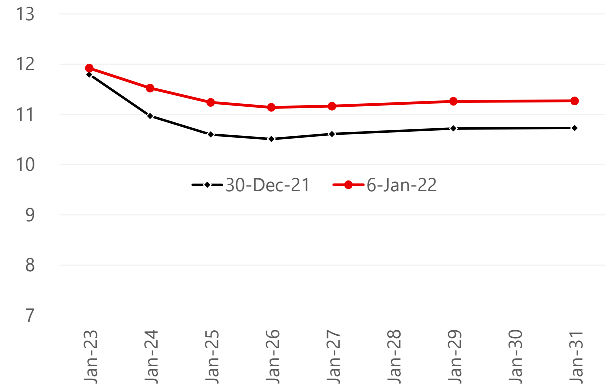
The nominal yield curve observed a major sell-in the first week of the year, with almost a parallel upshift, keeping the curve inverted. Since last Thursday (December 30), the front end of the curve (Jan-24 DI future[3]) rose 62 bps to 11.59%, while the back end of the curve (Jan-27 future) rose 62 bps to 11.23%. As a result, the curve's steepness in this segment remained stable at -37 bps. At the front end, the rise in relevant commodity prices in BRL terms—grains (soybean and corn), cattle, oil and metals—contributed to push the front-end yield higher. However, in terms of Copom's market expectation, the curve continues to price in basically a 150 bps Selic hike for the next meeting (February) and 100 bps for the subsequent one (March). At the long end, we were arguing that the rally seen since the end of November 2021 was not backed up by the domestic economic fundamentals, in our view. As a result, we see this recent sell-off as an adjustment of risk premia to levels more aligned to the high uncertainties we envision for the fiscal consolidation process. As for the shape of the curve, we believe the flattening might still continue on the short-term until it becomes clear that inflation has peaked and that the Selic hiking cycle has finished. After that, we look for the curve to start to steepening considerably.

Figure 2. USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note 1: As of the close on Thursday, January 6, 2022.
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, January 6, 2022.

[3] We are changing the usual short-end tenor used in the analysis from Jan-23 to Jan-24 to better capture a 2-year horizon, which is more aligned with the monetary policy horizon.

COMMODITIES

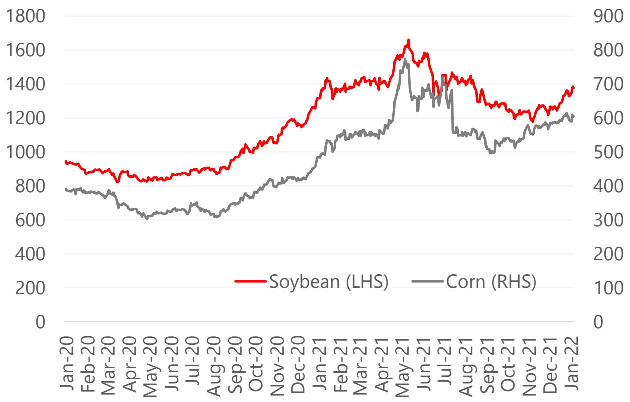
Grains rally as dry and hot weather hit South American crops. Soybeans (up 15% since October) and corn (up 20% since September) are rising to levels not seen since July 2021. Warm and dry weather (owing to La Niña) is reducing the prospects for Brazil and Argentina production, with several think tanks cutting their estimates recently. Meanwhile, farmers in the US are likely to increase planting area for soybeans to take advantage of high prices. The USDA WASDE report is due next week (January 12).

Iron ore rises as China policies are poised to become expansionary. Iron ore (up 40% since November) continues to climb on expectations that macro policies in China will counter a property-driven slowdown in the world largest steelmaker. The Chinese Central Bank is expected to ease monetary policy before the new year holiday that starts in January 31. Tax cuts are also being considered as the government seeks to use different instruments to stimulate economic growth.

Brent oil jumps back to pre-Omicron levels. Brent crude oil rose to $82/bbl, the highest since end-November when markets were hit by Omicron worries. We still see the oil market in deficit, as global inventories are low and producers (from OPEC+ members to independent US shale companies) struggle with underinvestment in previous years.

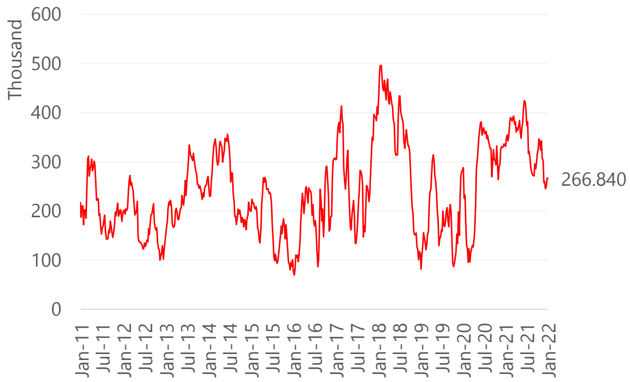
CFTC[4] reports an increase in speculative long positions in WTI crude oil. Money managers increased their net long WTI crude futures and options positions in the week ended December 28, the CFTC reported on Friday (December 31). The positions in futures and options increased by 16,470 contracts to 266,840.

Figure 4. Chicago Board of Trade - Grains (USD cents)



Sources: Bloomberg, Santander.

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



Sources: COT, Santander.

[4] U.S. Commodity Futures Trading Commission.

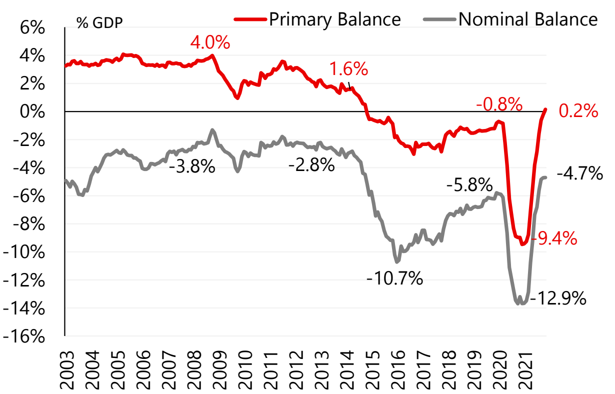
FISCAL POLICY AND LEGISLATION

According to data published on December 30 by the BCB, the consolidated public sector posted a primary surplus of BRL15.0 billion in November, better than our forecast (BRL9.5 billion) and the market's median estimate (+BRL7.5 billion). This was the best result for November since 2013. The main surprise came from the regional governments' surplus of +BRL11.7 billion (higher than our estimate: +BRL6 billion). In YTD terms, the public sector reached a BRL64.6 billion (0.8% of GDP) surplus. In the 12-month reading, the primary result reached +BRL12.8 billion (0.2% of GDP), compared to -BRL20.4 billion (-0.6% of GDP) in October, maintaining an upward trajectory after a sharp reduction in the fiscal stimulus in 2020 vs. 2021. In light of this, our tracking points to a consolidated public sector surplus close to BRL40 billion (0.4% of GDP) in 2021, led by a surplus of 1.1% of GDP for the subnational entities. This is the first primary budget surplus after seven years in red ink. However, we continue to estimate the primary deficits for the coming years, mainly due to impact of inflation on expenditures and with the effect of disinflation process on revenues.

We estimate that pandemic relief expenses, specifically those that were exempted from compliance with the constitutional spending cap (so-called "extra-cap" spending), totaled BRL8.3 billion in December and BRL121.4 billion (1.4% of GDP) in 2021. In the month, most part was related to health expenditures (BRL5.5 billion), reaching BRL25.8 billion in the year. The vaccine acquisition totaled BRL21.8 billion in 2021, with a monthly average spending around BRL2 billion. We believe that part of the spending for the acquisition of vaccines can be extended to 2022, we estimate it around BRL5-10 billion (not included in the spending cap limit). The total amount for vaccines into 2022 budget (under the cap) is BRL3.9 billion, which we believe will be expanded due necessity for booster vaccines. Regarding the fiscal transfers, the emergency aid program ended in October, with a monthly average disbursement of BRL8.5 billion and BRL60.6 billion in the year. Thus, the "extra-cap" expenses reachedBRL121.4 billion (80.8% of budget execution) or 1.4% of GDP in 2021. This means a reduction in the fiscal stimulus compared to 2020, that hit BRL524 billion (7.0% of GDP).

Regarding the fiscal risks in the short-term to monitor, we highlight the pressure to raise wages in the public sector and the debate over compensatory measures for the (recently-extended) payroll tax breaks. In the first, the government pledged to increase wages for the Federal Police, offsetting aside BRL1.7 billion on budget 2022 (under the spending cap) to fund this hike. Yet, we have seen pressure in other public servants' categories for a salary increase. Strikes could take place in the coming weeks eventually, posing a challenge for the administration as it deals with almost no fiscal margin to accommodate these expenses. The second risk is related to the payroll tax break extension (for 17 sectors) that was signed into law on December 31. In the bill, the government decided not to compensate the social security system for the payroll tax break (which represent an "intra-budget" expense under the spending cap). But that decision was not included in the 2022 budget and is now being questioned by the federal budget watchdog (TCU). If TCU rules for the necessity of compensatory measures, the administration will need to find BRL 9.1 billion in new revenues or spending cuts this year in order to comply to the Fiscal responsibility Law. It will also have to accommodate the additional value for 2022 extension into the spending cap limit (BRL6 billion).

Figure 6. Public Sector Fiscal Balance (12m)



Sources: Brazilian Central Bank, Santander.

Figure 7. 2021 "Extra-Cap" Spending Tracker

BRL Billion - Accumulated	Oct-21	Nov-21	Dec-21	Total Budgeted	Executed
Emergency Aid (MP 1.037 and 1.056/2021)	60.5	60.5	60.6	63.9	94.8%
Health expenditures	19.3	20.2	25.8	43.2	59.7%
BEm - Employment Program (MP 935/220 and MP 1.044/2021)	7.7	7.7	7.7	10.7	72.3%
Turism Infraestructure (MP 963/2020)	0.5	0.5	0.6	1.3	44.7%
Vaccine Acquisition (MP 994, 1,004 and 1,015/2020)	16.1	19.1	21.8	26.2	83.3%
Pronampe (credit support for SMEs) (MP 1,053/2021)	5.0	5.0	5.0	5.0	100.0%
Accumulated Total	109.1	113.1	121.4	150.2	80.8%

Last update: 01/06/2022

Sources: National Treasury, Santander.

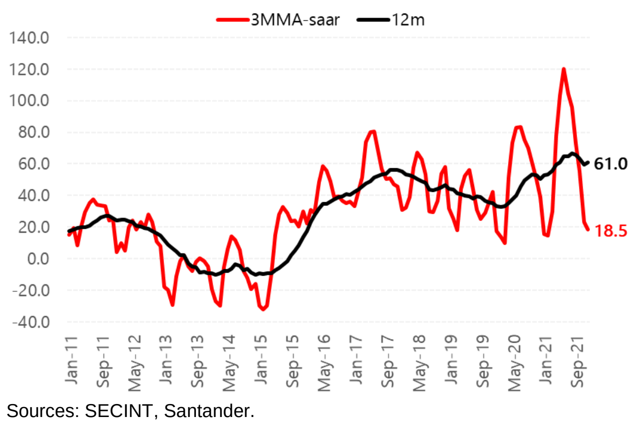
BALANCE OF PAYMENTS

The Brazilian foreign trade managed to deliver a fairly expressive outcome in 2021 as it recorded a US$61.0 billion trade surplus, which has become the new historical peak of the time series. Ironically, the result does not mean a positive contribution for last year's GDP growth (from the standpoint of volumes), as the bulk of it had to do with price effects. Moreover, the unprecedented outcome has also failed to translate into sizeable inflows in the commercial segment of the spot FX market. In our opinion, this backdrop indicates exporters decision not to repatriate part of their proceeds amid a high level of uncertainty on the domestic political and fiscal fronts.

The December 2021 trade surplus of US$3.9 billion fell slightly short of our forecast of US$4.3 billion, as both export proceeds and import outlays came stronger than what we anticipated. Export proceeds were US$24.4 billion vs. our estimate of US$24.1 billion, and import outlays were US$20.4 billion vs. our US$19.7 billion estimate. After decreasing 5.3% on a MoM seasonally adjusted basis in November 2021, daily average exports remained nearly stable last month (-0.3%). With respect to imports, the 20.5% MoM sa drop in the daily average was the first one since July and it underpins our view that the problems in the domestic supply chains that boosted purchases abroad are being addressed and, consequently, they should lead imports to lose steam in the coming months. In December 2021, the trade surplus reached US$61.0 billion on a 12-month basis, which is now the new top of annual trade surpluses, as it stood above the US$56.0 billion observed in 2017. See details in the link[5].

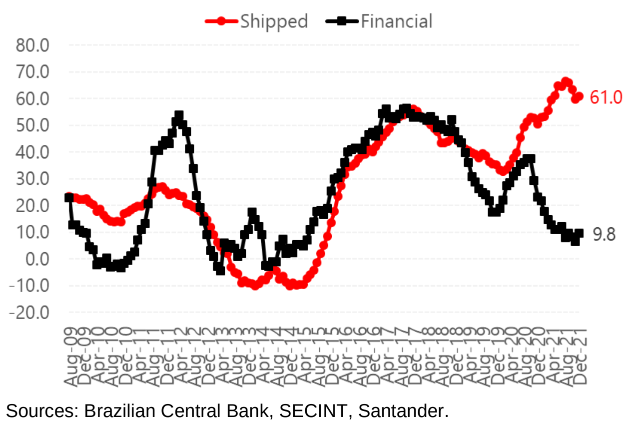
Curiously, the commercial segment's net inflows (US$9.8 billion) in 2021 in the spot FX market were less than the inflows since 2014 (US$4.1 billion), despite the fact that trade balance recorded its historical annual peak last year, which translated into a gap of US$51.2 billion between the net outcome of products shipped in and out of the country and their financial settlements. It is true that the gap has declined lately, but that has had to mainly to do with the decline we have observed in the "shipped" trade balance. The Brazilian Central Bank has already stated that part of this difference has been used to pay other items such as freights, cargo insurance, equipment rental, etc. Nonetheless, we think the gap may also indicate the resistance of Brazilian exporters to repatriate a larger part of their profits while uncertainty on the political and fiscal policy fronts remains high. See details in the link[6].

Figure 8. Trade Balance (USD billion)



Sources: SECINT, Santander.

Figure 9. Trade Balance Shipped vs Financial (USD billion, 12m)



Sources: Brazilian Central Bank, SECINT, Santander.

[5] **Santander Brazil – External Sector – Data Analysis: *"A New Historical Top"* –** January 03, 2022- Available on: https://bit.ly/Std-extsec-010322
[6] **Santander Brazil – External Sector – Data Analysis: *"Don't Blame the Flows"* –** January 05, 2022- Available on: https://bit.ly/Std-extsec-010522

ECONOMIC ACTIVITY

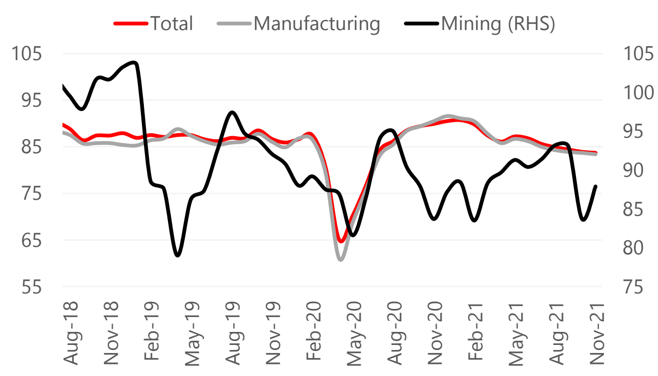
Industrial production retreated 0.2% MoM-sa in November, below our expectations (+1.0% MoM-sa) and market consensus (+0.1% MoM-sa). This result marks the sixth consecutive monthly decline, as the last positive result for industrial production was in May 2021. November's figure places industrial output 4.3% below the pre-pandemic mark (February 2020). In the breakdown, manufacturing dropped 0.4% MoM-sa, also the sixth consecutive negative result. The less cyclical mining industry, which includes mainly iron ore and oil production, climbed 5.0% MoM-sa, partially offsetting the sharp drop in October (-10.0%).

Among industrial activities, more widespread growth. The diffusion index (which captures the percentage of industrial activities that show monthly expansion) reached 50% (vs. 27% in October). In comparison to the pre-pandemic mark, 17 of 26 activities remain below the levels seen in February 2020. Among economic categories, capital goods were in the spotlight, retreating 3.0% MoM-sa, fully offsetting October's increase (+1.8%). Intermediate goods (which account for nearly 60% of industrial output) remained stable, the first non-negative figure since February 2021. Conversely, consumption goods production increased by 0.1%, driven mainly by durable goods (+0.5%). The biggest contribution came from food products (+0.95 p.p.) and mining (+0.56 p.p.). Vehicles also contributed positively (+0.30 p.p.). Conversely, rubber and plastic products (-0.17 p.p.) and metallurgy (-0.16 p.p.) posted the worst contributions.

November's result implies a -1.4% carryover to 4Q21. Following three quarterly declines, we think this suggests another negative contribution from industrial output to overall activity in the remaining quarter of 2021. See details in the link.[7]

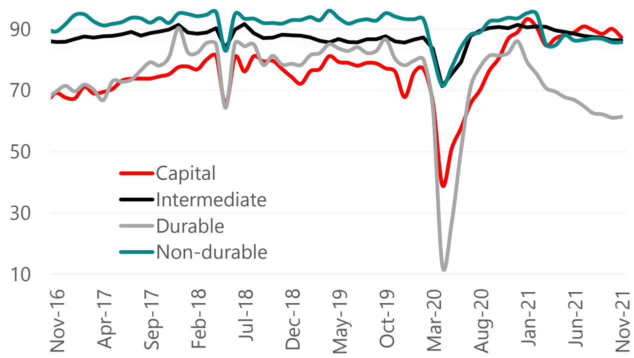
For the coming week, the IBGE will release the tertiary sector data for November. The services volume data is due out on Thursday (January 13), and we expect a 0.2% MoM sa increase (7.0% YoY). The retail sales data is due out on Friday (January 14). We expect a 0.6% MoM sa decrease for the broad index (-4.7% YoY), and a 0.5% MoM sa decrease for the core index (-6.5% YoY). These numbers are consistent with a flattish reading for November IBC-Br, the BCB's broad monthly activity indicator. **For details on Santander's activity outlook, please refer to our last chartbook[8].**

Figure 10. Industrial Production Index (sa, 2012=100)



Sources: IBGE, Santander.

Figure 11. Economic Categories (sa, 2012=100)



Sources: IBGE, Santander.

[7] **Santander Brazil Economic Activity - *"Industrial Output Declines for the Sixth Month in a Row"* –** January 06, 2022 – Available on: https://bit.ly/Std-econact-060122
[8] **Santander Brazil Economic Activity - *"Chartbook – Lowering (Again) Our GDP Estimates"* –** December 8, 2021 – Available on: https://bit.ly/Std-chart-econact-dec21

INFLATION

We expect December IPCA (due on Tuesday, January 11) to rise +0.70% MoM. In YoY terms, means 10.03%, a slight deceleration from the 10.74% change of November IPCA. Although this small annual relief can be seen as a peak strictly speaking, we believe inflation will continue hovering around 10% until April 2022, meaning a plateau rather than a clear peak. In terms of trends for headline IPCA—the three-month moving average seasonally adjusted and annualized—should moderate from 13.1% to 10.9% 3MMA-saar, but it is to tell how long lasting is the trend in this volatile series.

Compared to the November IPCA (+0.95% MoM), December data should decelerate in monthly terms, driven mostly by regulated prices (0.28% MoM vs. 2.30% last month), given the considerable relief in gasoline (-0.60% MoM vs. +7.38% in November). In market-prices, services should accelerate in monthly terms to 0.80% MoM (from 0.27% before)—although this translates into a (short-lived) deceleration of the headline services trend to 6.2% 3MMA-saar (from 7.4%), core-services trend should accelerate to 7.0% 3MMA-saar (from 6.2%). Moreover, industrial goods should post a similar change compared to last month, 1.00% MoM (from 0.98%), meaning that the trend should continue under pressure at the high level of 12.2% 3MMA-saar—while the core industrial goods gauge should accelerate a bit from 6.8% to 7.1% 3MMA-saar. Finally, food-at-home should accelerate in monthly terms to 0.75% MoM (from 0.04%), but this is still enough to keep the downward trend: 2.0% 3MMA-saar (from 8.0%).

In terms of broad underlying inflation measures, we estimate the EX3 core will rise around +0.94% MoM, which would represent an acceleration to 6.9% in 3MMA-saar terms (from 6.3%). This will be the fifteenth 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).

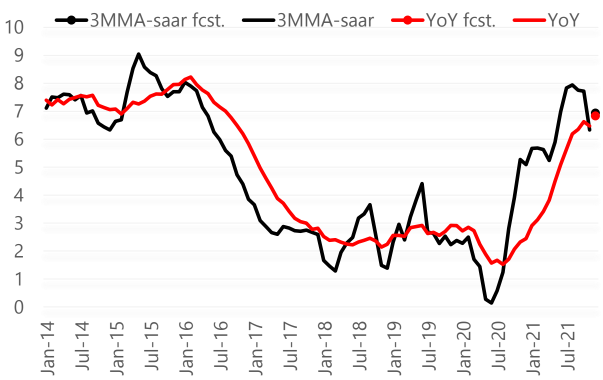
We remain cautious regarding the inflation outlook and believe some marginal reliefs that might appear at this reading should be still too preliminary to draw any major conclusions about a consistent deceleration pattern for inflation. We continue particularly worried with the recent rise of domestic fiscal risks, which might push expectations even higher and make inertia even stronger, leading to a more difficult disinflation process.

Figure 12. IPCA: Forecast Details (%)

	MoM		YoY	
	Dec-21	Contrib.	Nov-21	Dec-21
IPCA	0.70	0.70	10.7	10.0
Administered	0.28	0.08	19.2	17.2
Free	0.85	0.62	7.8	7.6
Food-at-home	0.75	0.11	9.7	8.2
Industrial goods	1.00	0.23	11.4	11.5
Services	0.80	0.28	4.8	4.8
EX3 Core	0.94	0.33	6.5	6.8

Sources: IBGE, Santander.

Figure 13. Core Inflation Forecast (EX3 %)



Sources: IBGE, Santander.

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