Santander
Macroeconomic Research

BRAZIL MACRO

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MACRO COMPASS

ACTIVITY NOT SO STRONG IN 3Q21

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- The USD/BRL pair closed the rolling week ended October 7 at 5.52, the highest level since April 20, 2021. The BRL posted a loss of 2.8%, standing as the worst performer amid a basket of 31 of the most liquid currencies in the world. In our opinion, the performance was driven by both, global and idiosyncratic factors. Paradoxically, the nominal yield curve downshifted at both ends, in a bull-flattening pattern, with the front end impacted by disappointing activity date in August.
- Pandemic relief expenses outside the spending cap totaled BRL14.1 billion in September. Our estimates consider the execution of "extra-cap" spending for 2021 close to BRL115 billion (~1.3% of GDP). The Lower House approved a constitutional amendment to increase federal transfers to municipalities and the rapporteur unveiled the first draft for the legislation on court-debt ordered debt (*precatórios*).
- September's IPCA registered a 1.16% MoM change (10.25% YoY), below the market's median expectation of 1.24% and our call of 1.30%. We believe this reading marks the peak of annual IPCA inflation. However, the scenario is still unfavorable, with an adverse inflation composition and risks around the pace of deceleration. Therefore, we remain cautious on the inflation outlook, which will likely keep the BCB in a tight policy stance (i.e. Selic rate above the neutral level) at least until end of 2023.
- Amid binding global supply constraints, manufacturing output continued to weaken in August, with headline industrial production retreating for the third month in a row and standing at levels below the pre-pandemic mark. Moreover, broad retail sales also disappointed for the month, fully offsetting previous gains. The latter shows the impact of inflation eating into household income, as well as a shift of spending into services as the economy reopens.
- The last batch of August activity data is due to be released in the coming week. On Thursday (October 14), IBGE will release the services sector data, for which we expect a monthly growth of 0.5% MoM-sa. On Friday (October 15), the BCB will release the IBC-Br (sort of a monthly GDP proxy), for which we expect a tepid growth of 0.2% MoM-sa. That result imparts downside risks to our current projection for 3Q21 GDP (+0.7% QoQ-sa).

Most of the information in this report is up to the end of Thursday, October 7, 2021.

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

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
National Holiday	**--**	**--**	**Tue, 12-Oct**	**--**	**--**
Services Volume (% MoM)	**IBGE**	**Aug/21**	**Thu, 14-Oct**	**0.5**	**1.1**
Services Volume (% YoY)	IBGE	Aug/21	Thu, 14-Oct	16.5	17.8
Inflation: IGP-10 (% MoM)	FGV	Oct/21	Fri, 15-Oct	--	-0.37
IBC-Br Activity Index (% MoM)	**BCB**	**Aug/21**	**Fri, 15-Oct**	**0.2**	**0.6**
IBC-Br Activity Index (% YoY)	BCB	Aug/21	Fri, 15-Oct	5.2	5.5

Source: Santander.

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

[1] **Santander Brazil - Macroeconomic Scenario: *"The Inflation Factor...Again"* –** September 16, 2021- Available on: https://bit.ly/Std-scenreview-set21

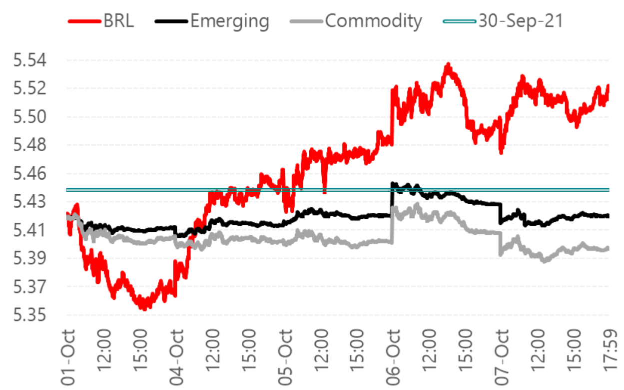
LOCAL MARKETS—FX

The USD/BRL pair closed the rolling week ended October 7 at 5.52, highest level since April 20. The Brazilian currency posted a loss of 2.8%, standing as the worst performer amid a basket of 31 of the most liquid currencies in the world. In our opinion, the performance was driven by both, global and idiosyncratic factors. The complex situation related to dynamics of the energy sector on a global scale increased fears of an eventual slowdown in the world economic pace combined with stronger inflationary pressures. This certainly weighed on markets' mood. On the domestic front, the lack of progress regarding the budget for 2022 kept uncertainties alive. Not only did it continue to feed the BRL's high-beta pattern, but also complemented the roster of reasons that the BRL to remain on the back foot in recent weeks.

LOCAL MARKETS—Rates

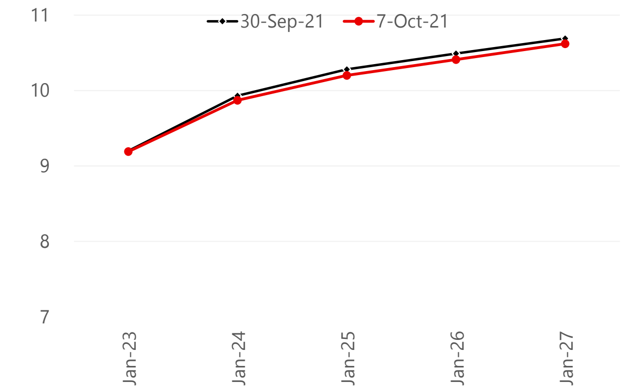
After last week's sell-off, the nominal yield curve downshifted at both ends, in a bull-flattening pattern. Since last Thursday (September 30), the front end of the curve (Jan-23 DI future) fell 1 bps to 9.19%, while the back end of the curve (Jan-27 future) fell 7 bps to 10.62%. As a result, the curve's steepness in this segment fell 6 bps to 143 bps. At the front-end, there was no relevant news regarding inflation, but the disappointment with August retail sales (refer to the Economic Activity section) helped the short-end to see some tightening in rates, with local players seeing lesser probability for rate hikes. At the back end, despite the continuing perception of uncertainty about the fiscal consolidation process, the market reduced a bit of the risk-premium at this segment of the curve.

Figure 2.A. – USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note1: As of the close Thursday, October 7, 2021.
Note2: For other currencies, we use USDBRL values as a base-index

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



Sources: Bloomberg, Santander.
Note: As of the close Thursday, October 7, 2021.

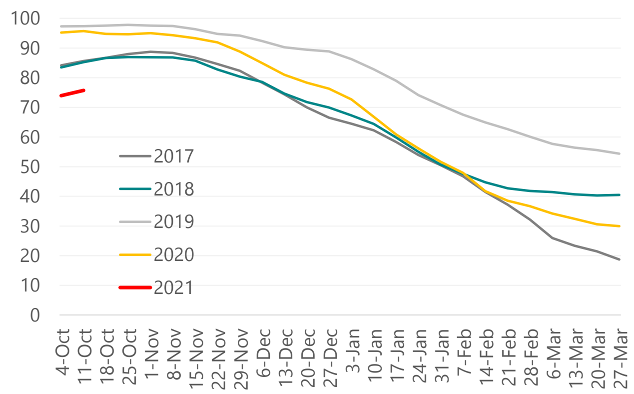
COMMODITIES

OPEC+ agreed to maintain the original schedule of gradual monthly oil-production increases. On Monday (October 4), the organization ratified the 400k b/d supply hike scheduled for November. The agreement comes amid a global shortage of natural gas that has been spurring a switch to oil products, boosting overall demand. In our view, the cartel's production policy will be the main factor influencing prices in the coming months. The next meeting is set for November 4.

Natural gas prices retreated after Russian authorities said the country is ready to help stabilize global energy markets. A strong rally over the past week in European gas prices was followed by a pullback on the heels of statements that Russia would increase gas flows to Europe, easing shortage concerns a bit. At 75%, European storage is lower than in recent years (90% in average for the last 5 years), but the gas price spike likely triggered some demand destruction, which should help storage to cover the expected winter draw this year.

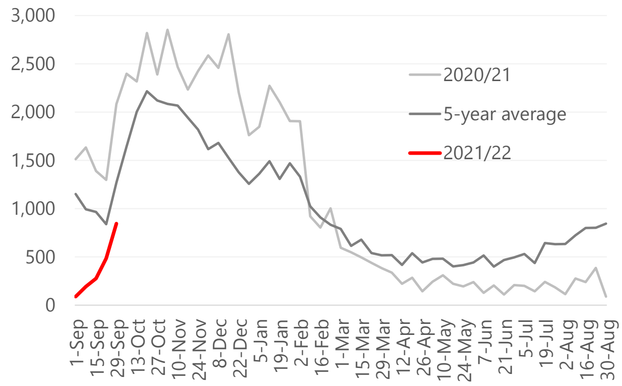
In agriculture, US soybean weekly inspections for exports have been improving but are still down from year-ago levels. Growing concerns about Chinese weak demand add to an already pressured market after USDA estimates of larger US soybean inventories published last week. Next WASDE report will be published on Tuesday (October 12).

Figure 3.A. – European Gas Storage Utilization - %



Sources: Bloomberg, Santander.

Figure 3.B. – US Soybeans Weekly Export Inspections (1000 metric tons)



Sources: USDA, Santander.

COVID-19 MONITORING

Brazil's daily vaccination rate continues to hold an average of 1.4 million doses, as of Wednesday (October 6). We expect the average pace to hold up close to that number throughout 2H21, as vaccine inventories remain high and deliveries are expected to remain above the levels of vaccine administration.

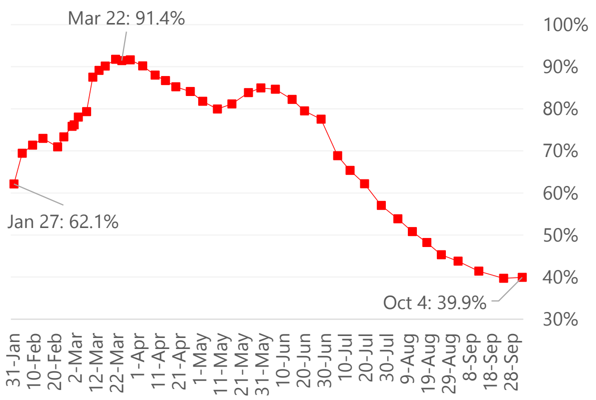
With nearly 45% of the population now fully immunized, infections and deaths remain at tamer levels. Based on the last available data (October 4), our proxy for a nationwide average ICU occupancy rate increased a bit to ~40%, close to the lowest level in our series (begun in January). That number compares to a previous peak of 92% (late March). Data from Brazil's Health Ministry showed that the 7-day average of infections stood at ~16k as of Thursday (October 7), up 1% from last week. As for casualties, the 7-day average stood at ~462, down 14% from last week.

Urban mobility continues to recover and is virtually back to the pre-pandemic levels. Data so far indicates a consistent return of urban mobility to pre-pandemic readings, with our lockdown index standing at 0.1 point (as of October 01, 2021), the same level seen 7 days ago (as of September 24, 2021). This recent recovery stems mainly from a solid increase of mobility in the Transit Station segment, with Retail and Parks segments still showing some idleness regarding the pre-crisis mark. The workplaces segment still shows high levels of mobility and has been running above the pre-pandemic mark since June. We expect the index to consistently stand at "normal" levels ahead, as vaccinations advance.

Our daily activity index seems to have gained momentum in September. The index—based on daily data on energy consumption, car sales, and mobility—seems to have started 3Q21 at a slower pace, with a 0.8% drop in July, but August's figure showed a solid 1.7% expansion, more than offsetting the previous month's fall. Considering the average so far in September (up to the 30th), we calculate a strong 4.4% expansion, fully offsetting March's losses and placing the index 1.5% above February 2021 levels (i.e., before the pandemic's resurgence seen earlier this year).

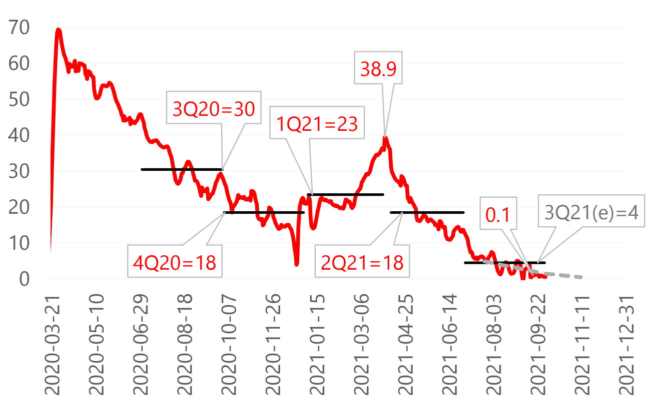
NOTE: This COVID-19 section will be discontinued in our upcoming weekly reports, owing to the fact that the advance of vaccinations and the consequent drop in contagion in Brazil are further limiting the economic and financial impact of COVID -19, making it a less high-frequency topic for financial-market economists and market participants. We will definitely watch out for how the pandemic evolves (e.g., new variants, vaccines and treatments, as well as cases, hospitalizations and casualties). For now, we plan to keep lower frequency updates and dedicate a section for this topic only in our scenario revision report, until the end of year. Hopefully, economists will talk less and less about the pandemic in 2022.

Figure 4.A. – Our Proxy for a Nationwide ICU Occupancy Rate (%)



Sources: @coronavirusbra1, Santander.

Figure 4.B. – Lockdown Index*, Mobility Forecasts (Feb/20=0, 7-day average)



Sources: Google, Santander.

* This index is built as an average of selected segments from Google Mobility Report with inverted scales. Data are available until October 01, 2021.

FISCAL POLICY AND LEGISLATION

We estimate that pandemic relief expenses that were exempted from compliance with the constitutional spending cap (so-called "extra-cap" spending) totaled BRL14.1 billion in September, most of which was spending on the emergency aid totaling BRL8.2 billion. According to the government, nearly 3.8 million beneficiaries were canceled or blocked since April, reducing in BRL0.8 billion the monthly disbursement, reaching around 36 million beneficiaries. It is noteworthy that the emergency aid is programmed to end in October. The government plans to introduce the new welfare program (named *Auxílio Brasil*) for November or December. For the new welfare program, there is a total of BRL9 billion that were budgeted for *Bolsa Família* which could be used. This leftover follows the migration of beneficiaries from Bolsa Familia to emergency aid program from April to October, which reduced the disbursements of the regular program. The new welfare program needs to be approved by Congress and enacted by December, given that increases in this class of expenditures are legally forbidden in election years. Health expenses totaled BRL14.2 billion in the year up to September, the monthly values are decreasing with the improvement in the numbers of the pandemic and the advance in the vaccination process. The monthly average of spending on vaccines acquisition has been around BRL2 billion per month, reaching a total of BRL13.8 billion. We believe that part of the values for the acquisition of vaccines can be extended to 2022, we estimate around BRL5-10 billion "extra-cap". For the time being, the total of "extra-cap" expenses budgeted for 2021 is BRL135.6 billion. Our estimates consider the execution of extra-cap spending close to BRL115 billion (~1.3% of GDP).

On October 6, the Lower House approved in the second round by 456 votes in favor (out of 513 deputies) of the constitutional amendment (PEC) that increases the federal transfers to municipalities through the Municipal Participation Funds (FPM). The first round was approved in December 2019. The legislation increases transfers of shared revenues from income tax and the (IPI) tax on industrial goods gradually by 1 pp until 2025. For the fiscal accounts, the new legislation will not affect compliance with the constitutional spending cap. Yet, it can potentially impact the public sector's primary fiscal result, given the regional government's larger propensity to spend: we estimate an impact of ~BRL4 billion/year.

On October 7, the rapporteur unveiled his first draft for the new legislation for unpaid judicial claims (*precatórios) at the Lower House*. The text of the PEC 23/21 came without major surprises, not meaningfully changing the administration's initial proposal. The controversial "extra-cap" fund to pay future judicial claims was removed from the proposal. The draft established that court-ordered debt disbursements would be capped at 2016 levels adjusted for inflation, while amounts topping that threshold would either be deferred or submitted to compensation agreements. A total of BRL40 billion (out of BRL89 billion) will be paid within the constitutional spending cap. The remaining BRL49 billion will be postponed, making room for the introduction of the expanded new welfare program (as well as other expenses). In our view, the voting in the Lower House's Special Commission may take place in about two weeks. Thus, a House floor voting could only take place in November. For details on Santander's Fiscal outlook, please refer to our last chartbook. See details in the link[2].

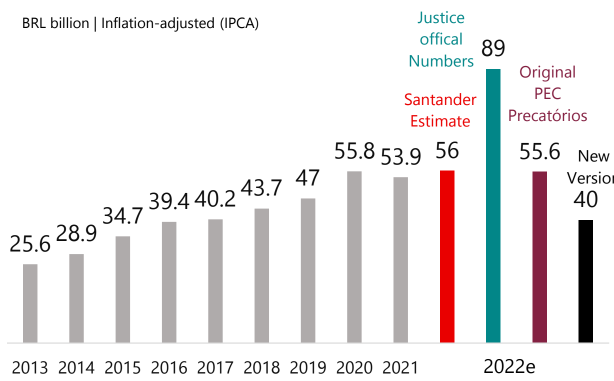
Figure 5.A. – 2021 "Extra-Cap" Spending Tracker

BRL Billion - Accumulated	Jul-21	Aug-21	Sep-21	Total Budgeted	Executed
Emergency Aid (MP 1.037 and 1.056/2021)	35.8	44.3	52.5	64.9	**80.8%**
Health expenditures	11.4	14.2	17.8	26.0	**68.7%**
BEm - Employment Program (MP 935/220 and MP 1.044/2021)	6.4	7.6	7.7	11.7	**66.0%**
Turism Infraestructure (MP 963/2020)	0.4	0.5	0.5	1.9	26.0%
Vaccine Acquisition (MP 994, 1,004 and 1,015/2020)	9.6	11.7	13.8	26.2	52.7%
Pronampe (credit support for SMEs) (MP 1,053/2021)	5.0	5.0	5.0	5.0	100.0%
Accumulated Total	68.7	83.2	97.3	135.6	71.7%

Last update: 10/06/2021

Sources: National Treasury, Santander.

Figure 5.B. – Payments of Court-ordered Debts



Sources: National Congress, Ministry of Economy, Santander.

[2] **Santander Brazil Fiscal - *"Chartbook – Inflation Effects - Two Sides of the Same Coin"* –** September 27, 2021 - Available on: https://bit.ly/Std-chart-fiscal-Sep21

INFLATION

September's IPCA registered a 1.16% MoM change (10.25% YoY), below the market's median expectation of 1.24% and our call of 1.30%. In the 3Q21 inflation report, the BCB projected September IPCA at 1.11% m/m. The headline trend accelerated to 13.3% in 3MMA-saar terms in September from 11.6% in August.

Qualitative measures were notably unfavorable once again, with core trends and diffusion index still on high levels. The average of core measures rose 8.7% in 3MMA-saar terms. Core measures have been running above the BCB's mid-target in 3MMA-saar terms for a year now (headline CPI target is 3.75% for 2021 and 3.50% for 2022). We believe this signals a risky spread of primary shocks to general prices.

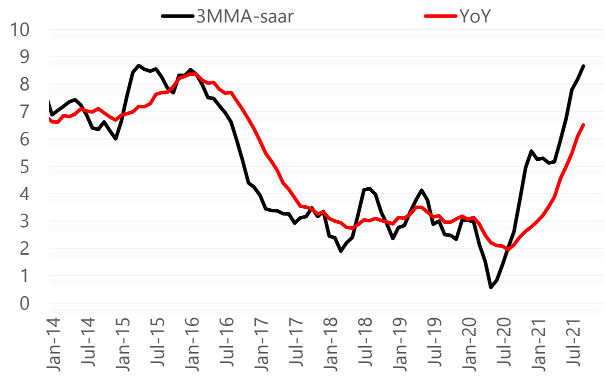
We estimate this reading marks the peak of annual IPCA inflation. Although we welcome the fact that annual inflation is poised to head south for the coming months (and years, maybe), the inflation scenario is still unfavorable, with an adverse CPI composition and risks around the pace of deceleration. Therefore, we are still cautious about the inflation outlook, which will likely keep the BCB in a tight policy stance (i.e. Selic rate above the neutral level) at least until end of 2023.

Figure 6.A. – September's IPCA Details (%)

	MoM			YoY	
	Sep-21	Santander	Contrib.	Aug-21	Sep-22
IPCA	1.16	1.30	-0.14	9.7	10.2
Administered	1.93	2.09	-0.04	13.7	15.7
Free	0.88	1.01	-0.10	8.3	8.3
Food-at-home	1.19	1.62	-0.07	16.6	14.7
Industrial goods	1.04	1.07	-0.01	10.1	10.6
Services	0.63	0.71	-0.03	3.9	4.4
EX3 Core	0.52	0.61	-0.10	6.2	6.4

Sources: Brazilian Central Bank, Santander.

Figure 6.B. – Average Core Inflation (IPCA %)



Sources: Brazilian Central Bank, Santander.

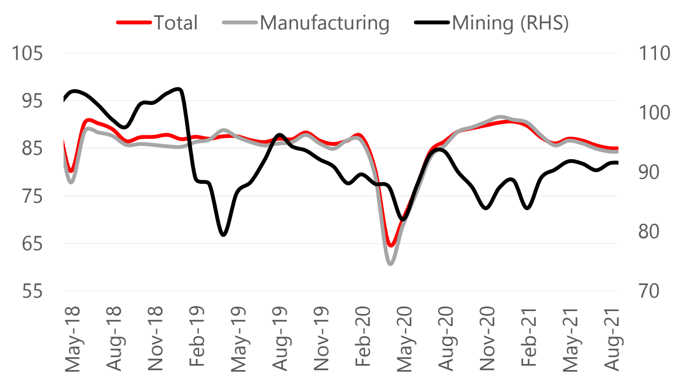
ECONOMIC ACTIVITY

Industrial production continued weakening in August. The headline index retreated 0.7%, below market consensus (-0.4%) and our call (0%), standing now roughly 2.9% below the pre-pandemic mark. In the breakdown, August's figure stems mainly from a decrease in manufacturing (down 0.7%), the third decline in a row and the seventh drop in 2021. Conversely, mining contributed positively (up 1.3%). Among economic categories, there was a widespread drop, with durable goods standing out by retreating 3.4%, the eighth consecutive decline. Moreover, capital goods broke a string of four successive gains (down 0.8%), while intermediate goods were down by 0.6%, having posted weak figures since March 2021 and returning to pre-crisis readings. After a weak start to the quarter, industrial output retreated for the third month in a row, implying a carryover of -1.5% for 3Q21. This figure reinforces our view that industry will continue to weigh on activity in the short term, as the former is still suffering from supply constraints. See details in the link[3].

Broad retail sales posted a weak August figure, fully giving back the previous (surprising) gain. The headline index retreated 2.5% MoM-sa, well below market consensus (-0.5%) and our estimate (-0.9%). Regarding the core index (excluding building material and vehicles sales), sales were down 3.1%, also giving back the previous gain. Despite the steep decline, August's figure still places the core index above the pre-pandemic mark (up 2.2%), while the broad index stands virtually at its pre-crisis mark. Zooming in on the details, this drop reflects the plummet seen in Other Retail segment (down 16%). This segment, which includes various heterogeneous goods like jewelry, watches, and bicycles, among others, posted steep (and unexpected) growth in July (up 19.1%), partially giving back this gain in August. Supermarkets also posted a weak figure (down 0.9%), while Vehicles showed resilience, expanding 0.7% and likely reflecting healthy figures in auto parts and used cars sales. Credit-led segments like Furniture and Building Materials decreased, in line with credit granted to households' tepid figure. In quarterly terms, August's figure implies a -0.7% carryover for 3Q21, in line with our scenario of a tepid figure for the goods sector in the quarter, as consumption gradually shifts toward a pre-pandemic pattern, with the predominance of services. See details in the link[4].

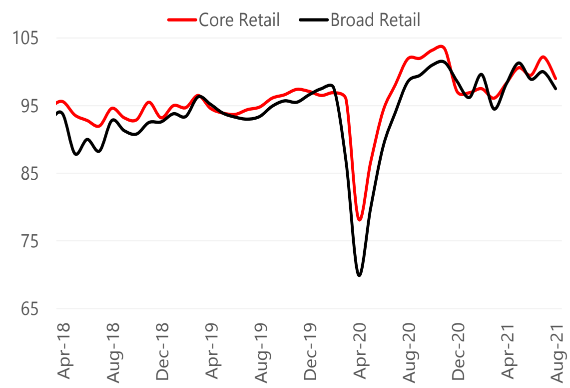
Next week, the last batch of activity data for August is due to be released. On Thursday (October 14), IBGE will release the August services sector data, for which we expect monthly growth of 0.5% MoM-sa. Moreover, on Friday (October 15), the BCB will release the broad activity index (monthly GDP proxy), for which we expect a tepid growth of 0.2% MoM-sa. This result imparts downside risks to our current 3Q21 GDP projection (+0.7% QoQ-sa), with our tracking pointing to a 0.5% QoQ-sa growth. For details on Santander's activity outlook, please refer to our last chartbooks[5].

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



Sources: IBGE, Santander.

Figure 7.B. – Retail Sales Indexes (sa, 2014=100)



Sources: IBGE, Santander.

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[3] **Santander Brazil Economic Activity - *"New Weak Figure for Industrial Output"* –** October 05, 2021 - Available on: https://bit.ly/Std-Econact-100521

[4] **Santander Brazil Economic Activity - *"Other Retail Segment Plummets in August"* –** October 06, 2021 - Available on: https://bit.ly/Std-Econact-100621

Santander Brazil Economic Activity - *"IGet: Varejo Arrefece no 3T21"* – October 05, 2021 – Available (in Portuguese) on: https://bit.ly/Std-IGET-set21

Santander Brazil Economic Activity - *"IGet Serviços: Serviços Terminam o Trimestre com Queda"* – October 06, 2021 – Available (in Portuguese) on: https://bit.ly/Std-IGETser-set21

[5] **Santander Brazil Economic Activity - *"Chartbook – Downgrading the Estimate for 2022"* –** September 20, 2021 – Available on: https://bit.ly/Std-chart-econact-set21

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