MESSAGE IN A STATEMENT

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- In the rolling week ended June 9, the BRL stood once again among the worst performers in a basket with the 31 most liquid currencies in the world, with the USD/BRL pair closing the period at 4.91 (a 2.3% loss), mainly on the heels of global USD strengthening (given the BRL's high-beta pattern). Domestically, the perception of greater fiscal risks following congressional debates about curbing energy prices via tax breaks could also have played a role in the FX trend. We believe the sell-off in global yields and the relapse in the market perception of fiscal risks also conspired to cause the steepening of the local yield curve in recent days.
- The government announced legislative proposals aimed at curbing inflation via tax breaks. The main pieces of legislation are PLP 18/22 (limiting ICMS VAT tax on "essential" goods/services at 17%, and temporarily exempting federal taxes on gasoline and ethanol by 2022); PLP 1143/21 (anticipating the use of tax credits in electricity); a constitutional amendment (PEC) allowing the federal government to temporarily compensate states for eventual revenue losses (in case they cut ICMS rate below 17%). In the unlikely scenario where all measures are approved with no changes in Congress and with a full pass-through to consumers, annual IPCA inflation could potentially be cut by ~310 bps in 2022. However, that scenario would have the effect of adding 64 bps to the IPCA in 2023. Under the same assumptions, we estimate a total fiscal impact (i.e., revenue loss) of BRL92 billion for the public sector in 2022. For 2023, the impact on the public sector budget result would amount to BRL90 billion (with regional governments bearing the brunt).
- May's IPCA registered a 0.47% MoM change, below our call (0.62%) and the consensus expectation (0.60%). On the bright side, YoY IPCA decelerated to 11.7%, which reinforces our view that inflation likely peaked in April. On the gloomy side, the composition of inflation remains worrisome, as key core measures (such as IPCA EX3, including core services and industrial goods) are trending at a sequential annualized rate of ~14%, with the (seasonally adjusted) diffusion index at around 77%, more than two standard deviations from the historical average (since 2000).
- Based on the April CAGED survey, we estimate that seasonally adjusted net formal job creation decelerated to 132k, from 216k in March. While we continue to see the job market strengthening in the short term, April's CAGED (payrolls) result painted a less robust picture compared to last week's PNAD (household) survey. We calculate the jobless rate is at the lowest level since the 2015-16 recession, but we still expect lower net job creation throughout 2022, especially owing to the lingering effects of a tighter monetary policy stance and the fading effects from the economic reopening.
- Industrial output stayed virtually flat (+0.1% MoM-sa) at the start of 2Q22. April's result reflected tepid monthly figures in mining (+0.4% MoM-sa) and manufacturing (+0.1% MoM-sa). Still, the headline marked a streak of three non-negative prints, and we calculate a carryover for 2Q22 of +0.7% QoQ-sa, implying a possibly positive contribution from industry to broad activity in the period. Moreover, broad retail sales expanded 0.7% MoM-sa, marking a streak of four gains in a row. In the coming week, services' real revenue data for April will be released on Thursday (June 14), and we expect monthly growth of 0.2% MoM-sa.
- The Copom gathers next week (on Wednesday, June 15) to announce its monetary policy decision. In line with market expectations (i.e., both analysts' forecasts and yield-curve pricing), we project another policy rate hike, but this time of 50 bps, with the Selic reaching 13.25%. Amid high uncertainty in current macroeconomic conditions and outlook, we believe the Brazilian Central Bank (BCB) may seek a greater degree of freedom (than usual) for the next steps. Thus, in its policy statement, we think the Copom may send a message leaving the door open for another rate hike of up to 50 bps, but also acknowledging the possibility of staying put in August. We look for a terminal Selic of 13.50% for the cycle, but the risks look skewed to the upside, especially for the path that we envision for 2023 and beyond (10.50% for YE2023; 8.00% for YE2024).

Most of the information in this report is up to the end of Thursday, June 09, 2022.

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.
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Figure 1. Brazil Macro Agenda for the Week of June 13-17, 2022

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
Services Volume (% MoM)	**IBGE**	**Apr/22**	**Tue, 14-Jun**	**0.2**	**1.7**
Services Volume (% YoY)	IBGE	Apr/22	Tue, 14-Jun	10.4	11.4
Inflation: IGP-10 (% MoM)	FGV	Apr/22	Wed, 15-Jun	0.62	0.1
Copom Meeting - Selic Rate (%)	**BCB**	**Jun/22**	**Wed, 15-jun**	**13.25**	**12.75**
National Holiday (Corpus Christi)			**Thu, 16-jun**		
Federal Debt Report (BRL trillion)	STN	Apr/22	n.a.*	-	5.6
Central Gov. Prim. Balance (BRL billion)	STN	Apr/22	n.a.*	29	-6.3
IBC-Br Activity Index (% MoM)	BCB	Mar/22	n.a.*	-	0.34
IBC-Br Activity Index (% YoY)	BCB	Mar/22	n.a.*	-	0.66
Bank Lending Report	BCB	Mar/22	n.a.*	-	471.1
Current Account Balance (USD billion)	BCB	Mar/22	n.a.*	-	-2.4
Foreign Direct Investment (USD billion)	BCB	Mar/22	n.a.*	-	11.8
Trade Balance (USD billion)	SECINT	May/22	n.a.*	3.8	8.2

* Owing to a strike of federal workers, these data releases have been postponed with no specific publication date scheduled for now.

Sources: Bloomberg, IBGE, Santander.

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

[1] **Santander Brazil – Scenario Review: *"A Bittersweet Scenario"* –** June 02, 2022- Available on: https://bit.ly/Std-scenreview-jun22

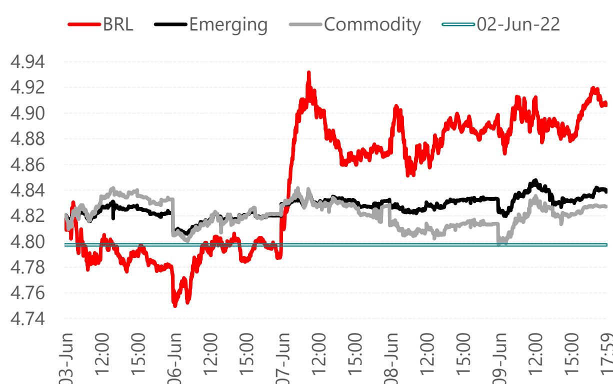
LOCAL MARKETS—FX

In the rolling week ended June 9, the BRL remained among the bottom performers in a basket with the 31 most liquid currencies in the world, with the USD/BRL pair closing the period at 4.91 (a 2.3% loss) on the heels of global USD strengthening (given the BRL's high-beta pattern). The performance contrasted with favorable readings shown by Chinese foreign trade—which implied a lower probability of a severe economic slowdown in China—and rising commodity prices, a backdrop that usually favors the BRL. We believe that this constructive effect was offset by the combination of the European Central Bank's (ECB's) message that monetary conditions in the region will become more restrictive in the coming months and the apprehension about additional inflationary pressures in the U.S. ahead of the release of May CPI due on Friday (June 10), which fostered a sell-off in the U.S. Treasuries yield curve and global USD strengthening. In addition to these negative factors from abroad, the perception of worsening fiscal risks accompanying the progress of congressional measures to curb energy prices via tax breaks that could weigh on government debt also played an important role in the BRL performance in this period. All in all, we continue to see less favorable monetary conditions abroad and doubts regarding local economic policy in the medium term as hindering a sound performance of the BRL (we project the USD/BRL pair to reach 5.15 in YE2022).

LOCAL MARKETS—Rates

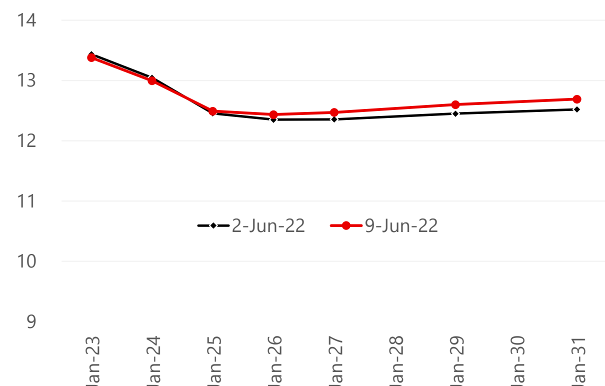
The local yield curve (nominal rates) closed June 9 with a steepening in the 2s/5s segment. Since last Thursday (June 2), the front end of the curve (Jan-24 DI future) fell 5 bps, to 13.00%, while the back end of the curve (Jan-27 DI future) gained 12 bps, to 12.47%. The curve's steepness in this segment increased 14 bps, reducing the inversion to -56 bps. At the front end, the May IPCA report (showing a below-expected headline and a likely peak to annual inflation, despite a still ugly composition) and May IGP-DI (which also surprised the market to the downside) may have helped avert a sell-off, as the numbers could marginally favor the thesis that there will be an imminent end to the BCB's tightening cycle. The market pricing for the next Copom remains in line with our (and consensus) forecast of a 50-bp hike at next week's meeting: the probability of a 50-bp hike is currently at 84%. For the August meeting, we expect a 25-bp hike (ending the cycle at 13.50%). At the long end, the movement may have been influenced by the sell-off in global yields (given the hawkish ECB message and jitters about May CPI in the U.S.), as well as possible concerns about the fiscal outlook given the substantial loss of revenue that could result from the government's initiatives to curb energy costs. We continue to believe that the BCB is close to the end of the hiking cycle, and with IPCA inflation likely off its peak in annual terms, we continue to see room for a steepening pattern in the local yield curve in the coming months.

Figure 2. USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note 1: As of the close on Thursday, June 9, 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 on Thursday, June 9, 2022.

COMMODITIES

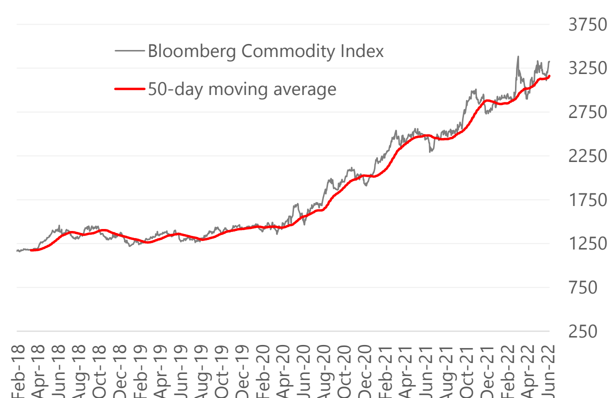
Commodity prices rose in the rolling week ended June 9, driven by (ever-)rising energy prices. The Bloomberg Commodity Index in BRL terms increased 3.5% in the period as the BRL sold off. In USD terms, the index gained 1.2%, with the Agriculture Subindex up 0.3%, the Energy Subindex climbing 3.9%, and the Industrial Metals Subindex falling 1.5%.

Oil prices rose to the highest level since March on the back of U.S. demand for gasoline and easing restrictions in China. According to EIA, the U.S. Strategic Petroleum Reserve fell by a record amount as refiners' inputs rose in response to higher demand for gasoline. Inventories of the fuel have been below markets' expectations despite record high prices at the pump. In addition, prices have been supported by expectations that the easing in mobility restrictions in China will boost demand for fuel. Domestically, the diesel shortage risk continues to loom. Brazil imports nearly 30% of its domestic demand for diesel, of which 80% comes from the U.S. Gulf Coast. According to recent news[2], Argentina is already struggling with higher diesel prices and shortages of fuel in some regions. A hypothetical shortage of fuel could quickly exacerbate domestic inflation pressures and dent economic activity.

LNG plant blast to constrain global supplies. One of the largest U.S. export plants producing LNG will close for at least three weeks after an explosion occurred at one of its facilities on Wednesday, June 8. European gas prices have soared in the wake of the explosion, as the accident will likely reduce U.S. liquefaction capacity by 20%. The European Union has been increasing LNG imports as it seeks to cut its dependence on Russian gas, with the U.S. recently pledging to ensure that more vessels would arrive in Europe this year.

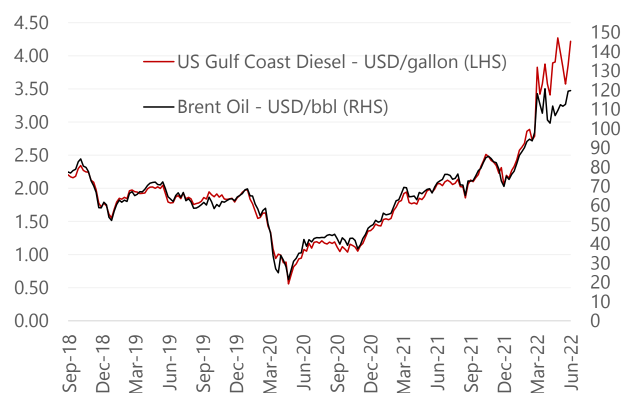
Corn prices rose amid concerns about logistics issues in the Black Sea. Following hopeful signs last week, talks between Russia and Turkey for a sea corridor to export Ukrainian grain have stalled. Markets have also started to consider the possible inability of Ukraine to export much of its grain owing to infrastructure damage resulting from the conflict with Russia. Meanwhile, soybean prices climbed as a result of rising soybean oil prices, as Brazil could increase its biodiesel blend to 15% (from 10%).

Figure 4. Bloomberg Commodity Index in BRL



Sources: Bloomberg, Santander.

Figure 5. Price Gap: Crude Oil and Refined Products



Sources: Bloomberg, Santander.

[2] https://www.agrolink.com.br/noticias/alerta--ja-esta-faltando-diesel-na-argentina_466513.html

FISCAL POLICY AND INFLATION

The government announced proposals for legislation in order to curb rising inflation (beyond the BCB's ongoing interest rate hiking cycle), using fiscal stimulus created by a reduction in tax revenue. The main measures are: PLP 18/22, a law to reduce the ICMS tax, PLP 1143/21, regarding the use of tax credits in electricity, and a constitutional amendment (PEC) to compensate the states for reducing the ICMS tax to below 17% by the end of the year. Since March 2020 (pre-pandemic), fuel prices are up 62%, while electricity prices are up 25% at the consumer level. Moreover, the global energy shortage continues to pose upward risks for fuel and electricity prices (particularly fuel) in Brazil. As a result, the government is seeking measures (beyond the ongoing interest rate hiking cycle by BCB) to curb the pressure arising from inflation. Several measures are being discussed in Congress that imply short-term downward risks for inflation (although with a potential rebound in 2023 and beyond), but also imply a worsening of fiscal accounts.

PLP 18/22 aims at permanently capping the VAT tax (ICMS state tax) on fuel, electricity, telecom and transportation, which are levied at the state level. Adding up the temporary reduction (until December 31) in federal taxes (PIS/Cofins and Cide taxes), we estimate a potential fiscal loss of BRL65 billion in 2022 from the measure and a potential drop of close to 250 bps in the IPCA index in 2022. We also highlight that there is a debate about accelerating the use of tax credits from electricity distribution companies, which, according to Aneel (national energy agency), could reduce tariff adjustments by 8% on average, potentially leading to a 32-bp decline in the IPCA index in 2022 (but adding upward risks in 2023 and beyond). Everything considered, in a scenario we see as unlikely—assuming all measures and full pass-through of the tax cut to consumers are approved—the IPCA index could potentially register an annual reduction of ~310 bps in 2022 (with a +64-bp rebound in the IPCA index in 2023) and a BRL93 billion fiscal loss in 2022 for the public sector (and a loss of BRL90 billion in 2023 for regional governments).

Our current fiscal scenario does not include the measures to curb inflation, as there is uncertainty about the final outcome of the proposals. We estimate a BRL35 billion (0.4% of GDP) primary surplus for the public sector for 2022. In a simulation, considering all measures are approved, this would lead to a deficit close to BRL60 billion (0.6% of GDP), yet we believe that partial approval is more likely, implying a balanced result (0% of GDP) for the year. On inflation, our baseline scenario also does not yet include the approval of any measures, and we project the IPCA index to reach 9.5% at YE2022 and 5.3% at YE2023—the risk of the new legislation is for lower inflation in 2022 and higher in 2023. We did not include this in our scenario, as the timing and the overall impact are still unclear. In our view, this debate does not materially affect our monetary policy outlook. We believe that even if these measures reduce 2022 inflation and the inertia for 2023, the associated fiscal risks and the pressure to maintain the stimulus in 2023 will worsen the balance of risks for the BCB's inflation-targeting regime. See details in the link[3].

Figure 6. Potential Fiscal Impacts (BRL billion)

Fiscal Scenarios	2022			2023
	Full	Most Likely	Low effect	Most Likely
I. PLP 18/22 ICMS Cap (Impact)	**65**	**35**	**13**	**37**
1. Fuels ICMS Cap 17-18%	20	16	5	30
Gasoline	14	10	0	20
Diesel	5	5	5	10
Ethanol	1	1	0	2
2. Telecom cap	5	0	0	0
3. Electricity	20	0	0	0
ICMS cap to 17-18%	5	0	0	0
Changing the ICMS base (TUSD/TUST)	15	0	0	0
4. Zeroing PIS/Cofins and CIDE Gasoline	16	16	8	0
5. Zeroing PIS/Cofins Ethanol	4	3	0	7
II. PEC Fuel (Compensation)	**28**	**0**	**0**	**0**
Zeroing ICMS Diesel	23	0	0	0
Zeroing ICMS LPG	3	0	0	0
Reducing ICMS Ethanol to 12%	2	0	0	0
Total Impact (I + II)	**93**	**35**	**13**	**37**
Primary Balance Public Sector (BRL bn)	**-58**	**0**	**22**	**-85**

Sources: National Congress, Santander.

Figure 7. Potential Inflation Effects (bps)

Inflation Scenarios	2022			2023
	Full	Most likely	Low effect	Most likely
I. PLP 18/22 ICMS Cap (Impact)	**-253**	**-104**	**-2**	**45**
Fuels ICMS Cap 17-18%	-85	-59	-2	0
Gasoline	*-80*	*-56*	*0*	*0*
Diesel	*-2*	*-2*	*-2*	*0*
Ethanol	*-3*	*-1*	*0*	*0*
Zeroing PIS-Cofins and CIDE Gasoline	-64	-45	0	45
Telecom cap	-30	0	0	0
Electricity	-74	0	0	0
ICMS cap to 17-18%	*-40*	*0*	*0*	*0*
Changing the ICMS base (TUSD/TUST)	*-34*	*0*	*0*	*0*
II. PEC Fuel (Compensation)	**-25**	**0**	**0**	**0**
Zeroing ICMS Diesel	-4	0	0	0
Zeroing ICMS LPG	-17	0	0	0
Reducing ICMS Ethanol to 12%	-4	0	0	0
III. Tax Credits	**-32**	**-32**	**-32**	**10**
Electricity	-32	-32	-32	10
Total Impact (I + II + III)	**-310**	**-136**	**-34**	**55**
IPCA	**6.4**	**8.1**	**9.2**	**5.9**

Sources: National Congress, Santander.

[3] **Santander Brazil – Special Report: "*Measures to Curb The Rise in Prices*"** – June 09, 2022 – Available on: https://bit.ly/Std-special-060922

INFLATION

May's IPCA registered a 0.47% MoM change, below our call (0.62%) and the consensus expectation (0.60%). In YoY terms, the IPCA decelerated to 11.7%, which reinforces our view that April was likely to have been the peak of IPCA inflation.

Surprises relative to our forecast were spread among the main groups, with the following contributions: regulated prices -4 bps, food-at-home -4 bps, services -3 bps, and industrial goods -4 bps. We highlight that in industrial goods, much of the relief came from volatile items such as perfumes and ethanol.

In qualitative terms the reading continued to be quite unfavorable. All core measures accelerated at the margin, with their average reaching 13% 3mma-saar. Moreover, diffusion was basically stable at 76.6% (s.a.). Finally, services headline and core accelerated to 11.1% 3mma-saar and 10.7%, respectively; both are now running above the 2015-16 period. Additionally, industrial goods headline and core did not accelerate but remained extremely high: 15.6% and 17.7% 3mma-saar, respectively.

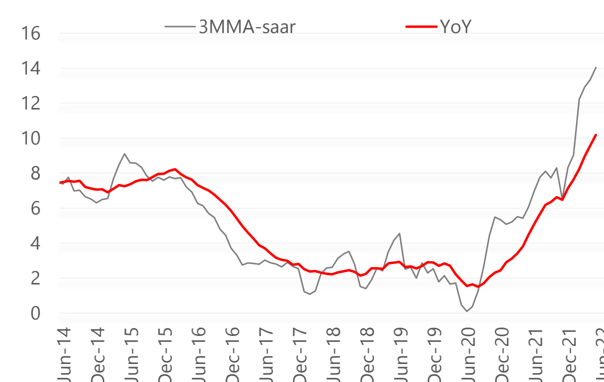
All in all, we believe the reading reinforces our view that inflation has peaked in YoY terms, but underlying metrics remain quite unfavorable, suggesting upward risks. However, we highlight that the possible tax cut measures are a major downward risk for the short term (with a likely rebound in 2023), which makes the outlook even more uncertain. See details in the link[4].

Figure 8. May's IPCA Details (%)

	MoM			YoY	
	May-22	Santander	Dev.	Apr-22	May-22
IPCA	0.47	0.62	-0.15	12.1	11.7
Administered	-0.51	-0.37	-0.04	15.0	12.1
Free	0.83	0.99	-0.12	11.1	11.6
Food-at-home	0.43	0.68	-0.04	16.1	16.3
Industrial goods	1.06	1.25	-0.04	14.2	14.0
Services	0.85	0.94	-0.03	6.9	8.0
EX3 Core	1.06	1.15	-0.03	9.6	10.2

Sources: IBGE, Santander.

Figure 9. Core Inflation IPCA EX3 (%)



Sources: IBGE, Santander.

[4] **Santander Brazil Inflation: "May's IPCA: Inflation Peak Finally Behind?"** – June 9, 2022 – Available on: https://bit.ly/Std-IPCA-may22

ECONOMIC ACTIVITY

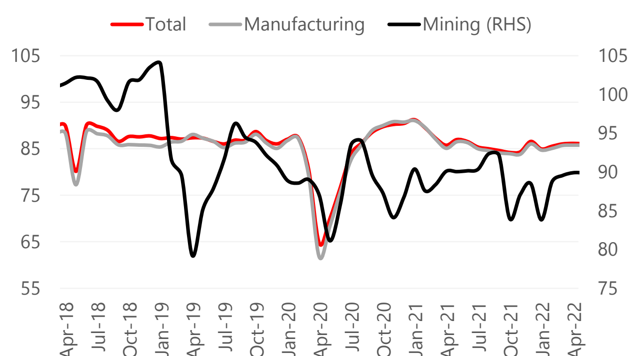
A flat figure for industrial output in April. Industrial output's weak figure (+0.1% MoM-sa) came in between our expectations (-0.2% MoM-sa) and market consensus (+0.2% MoM-sa); compared to the same month of 2021, industrial output shrank 0.5% YoY, also below our estimate (-1.2% YoY) and market consensus (-0.8% YoY). April's figure is due to a continued strengthening of mining (+0.4% MoM-sa), while manufacturing stayed virtually flat (+0.1% MoM-sa), and it marked the third non-negative print in a row, but with the index continuing to show idleness (for the 14th month in a row) compared with the figures observed before the initial COVID-19 outbreak (down 1.5% since February 2020). Moreover, we calculate a 0.7% QoQ-sa carryover to 2Q22, led by April's print, which suggests a positive contribution from industry to overall activity in this period. See details in the link[5].

Payroll expansion above market expectations but indicating deceleration. According to the April 2022 CAGED survey, net formal job creation stood at 197k (vs. consensus 174k, Santander estimate 276k), above the historical average (111k) and the figure observed in April 2021 (114k). After our seasonal adjustment, net formal job creation decelerated to 132k, from 216k in March. The number of hirings decreased 1.3% MoM-sa, while layoffs increased 3.7% MoM-sa. The three-month average now points to a payroll expansion of 181k jobs, from 191k in March. In our view, the April CAGED result painted a less positive picture than last week's PNAD survey. Hirings have decreased and layoffs increased at the margin, and the net result has resumed its deceleration trend. The layoffs still reflect the end of the formal employment program ("Emergency Benefit for Income and Employment Preservation", or BEm), but April should be the last month with workers under the temporary job guarantee. We still expect lower net job creation throughout 2022 compared to 2021, especially considering the lingering effects of a tighter monetary policy and the fading effects of the economic reopening.

Probability of recession in Brazil rises throughout 1H23. Despite recent upwardly revised GDP forecasts, we must bear in mind that the fundamentals creating a drag on economic activity have not vanished. Indeed, the lag with which monetary policy operates, along with positive commodity price cycles, help to explain domestic activity's resilience in 2022, postponing the probability of recession to the end of this year and beyond. In the absence of additional drivers and using the assumptions presented in this report, we believe domestic activity is unlikely to avoid a gloomy recessionary outlook in the coming year, as the delayed effects of a tight monetary policy materialize and the commodity price cycle cools down. See details in the link[6].

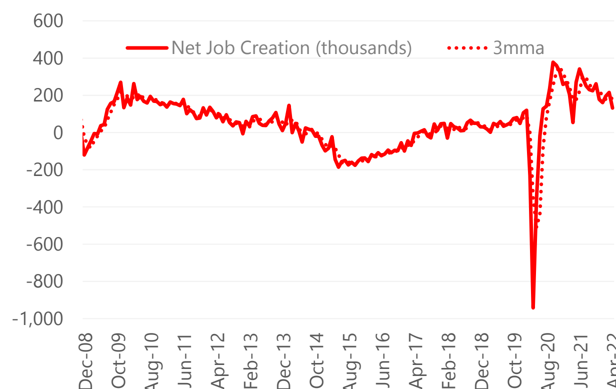
According to IBGE, broad retail sales expanded 0.7% MoM-sa in April. This result marked a streak of four gains in a row, placing the index 1.6% above the pre-pandemic mark (February 2020) and implying a 1.6% carryover to 2Q22. In the coming week, services' real revenue data for April will be released on Thursday (June 14), and we expect monthly growth of 0.2% MoM-sa.

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



Sources: IBGE, Santander.

Figure 11. Net Formal Job Creation (thousands, sa)



Sources: Ministry of Labor, Santander.

[5] **Santander Brazil Economic Activity: "*Flattening Print at the Start of 2Q*"** – June 03, 2022 – Available on: https://bit.ly/Std-econact-060322
[6] **Santander Brazil – Special Report: "*A Model to Forecast Probability of Recession in Brazil*"** – June 08, 2022 – Available on: https://bit.ly/Std-special-060822

MONETARY POLICY

The Copom gathers next week (on Wednesday, June 15) to announce its monetary policy decision.

Analyzing the scenario dynamics since the last meeting (May 3-4), we note further deterioration in inflation conditions and the news cycle. This follows the continued rise in inflation expectations for the policy horizon, the signs of spreading price pressures in the IPCA reports, the persistence of exogenous shocks (e.g., commodities, supply chains), the signs of narrower domestic economic slack (from the standpoint of both GDP and job market), and, last but not least, the recent focus of fiscal policy discussions (with a view to temporarily reduce inflation). The latter could have a further impact on the anchoring of expectations and balance of risks in the medium term.

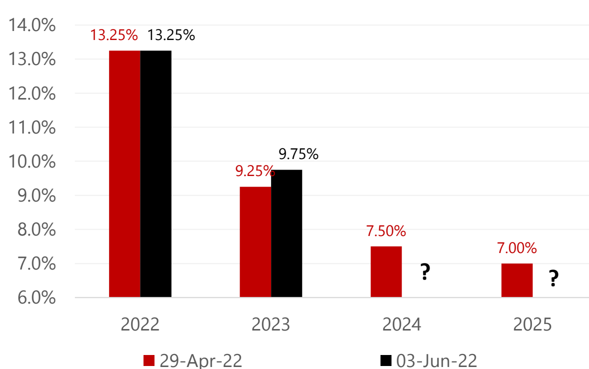
In line with market expectations (i.e., both analysts' forecasts and yield-curve pricing), we project another policy rate hike, but this time of 50 bps, with the Selic reaching 13.25%. We still see the evolution of the macroeconomic scenario and inflation outlook as consistent with the BCB's guidance (i.e., for "an adjustment of lower magnitude") announced during the May policy meeting. The deceleration in Selic hikes largely reflects the late stage of the tightening cycle and the expected policy lags, as signaled by the BCB.

In its statement, we believe the monetary authority may reiterate its signal that the cycle is near completion, further highlighting its message that the process of monetary tightening has so far been strong, rapid, and is already at a well-advanced stage. In this context, the BCB may reaffirm the expectation that economic and inflationary effects from the rate tightening should materialize, with the due policy lags, from 2H22 onward.

Yet, amid tremendous uncertainty in current macroeconomic conditions and outlook, we believe the BCB may seek to retain some degree of freedom for the next steps. As we see the BCB trying to calibrate the final dose of tightening necessary to achieve its goal (inflation convergence to the mid-target of 3.25% in 2023), given its own inflation scenario, forecasts, and balance of risks, the Copom may leave the door open for another rate hike of up to 50 bps, but also acknowledge the possibility of staying put in August.

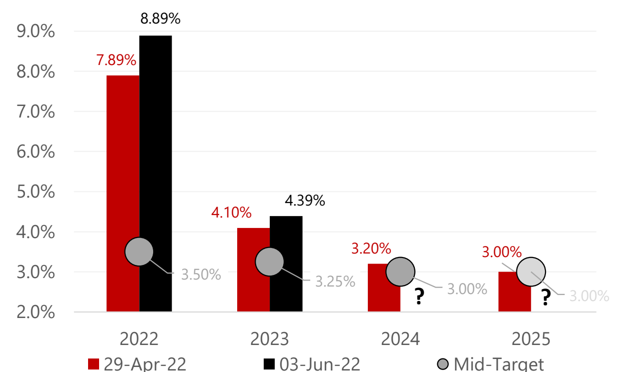
We project another move of 25 bps in August (last one in the cycle), with the Selic likely remaining stable at 13.50% until 3Q22. While our scenario of higher rates for longer has the Selic at 10.50% for YE2023 and at 8.00% for YE2024 (above the consensus call), we see risks skewed to the upside, especially for 2023 and beyond. See details in the link[7].

Figure 12. Median Selic Rate Expectations (% annual)



Sources: Brazilian Central Bank, Santander.
Note: As of the most recent BCB Focus update: June 03, 2022. The full numbers have not been published owing to the strike of federal workers.

Figure 13. Median IPCA Inflation Expectations (% annual)



Sources: Brazilian Central Bank, Santander.
Note 1: As of the most recent BCB Focus update: June 03, 2022. The full numbers have not been published owing to the strike of federal workers.
Note 2: Assumes the maintenance of the 2024 inflation target for 2025

[7] **Santander Brazil Monetary Policy: "*COPOM PREVIEW: A Little Flexibility for The Final Chapters?*"** – June 09, 2022 – Available on: https://bit.ly/Std-COPOM-p-jun22

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