BRAZIL MACRO

December 10, 2021

MACRO COMPASS

SOFTENING REAL ACTIVITY, STILL RISING INFLATION, HIGHER INTEREST RATE

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- The USD/BRL pair closed the rolling week ended December 9 at 5.58 (implying a 1.1% gain) and stood among the top performers in a basket of 31 of the most liquid currencies in the world. The BRL strengthening took place on the heels of (preliminarily) soothing news on the features of the omicron variant, and mirroring market perceptions of less uncertainty as the *Precatórios* amendment was (partly) enacted. A hawkish tone in the Copom statement also lent some help to the FX rate. This very combination of factors also prompted the local yield curve to become even more downwardly sloped.
- On Wednesday (December 8), the Copom announced another 150 bp hike in the policy rate, reaching 9.25%. This was the seventh move in this cycle, and the Selic now stands at the highest level since 3Q17. The BCB sees appropriate "to advance the process of monetary tightening significantly into the restrictive territory", and pledges to "persist in its strategy until the disinflation process and the expectation anchoring around its targets consolidate.". We believe this message reinforces our (above-consensus) call of terminal Selic rate at 12.25%.
- On Wednesday (December 8), Congress enacted the consensual parts approved by both houses of the so-called *Precatórios* Amendment (PEC 23/2021). Basically, the concluded part of the legislation modifies the spending cap indexation rules and opens a fiscal margin of BRL70 billion (our calculation) for additional spending in 2022. Next week, Congressional speakers have agreed to vote the Senate changes on the *precatórios* cap that will add BRL45 billion to the fiscal space for 2022.
- Retail activity started 4Q21 on the back foot. The broad index surprised to the downside (-0.9% MoM-sa), with anemic figures seen both for income-led and credit-led segments. October's figure places the index 2.8% below the pre-pandemic mark and implies a -2.7% carryover for 4Q21. Retail spending continues to be impacted by high inflation and a return of consumer spending back into services, as the economy reopens.
- On Tuesday (December 14), IBGE releases the services' real revenue data for October. We expect a sequential increase of 0.1% MoM-sa, favored by services to families and transportation. Moreover, the BCB will release on Wednesday (December 15) its monthly GDP proxy (IBC-Br) for October. We expect a slight decrease of 0.2% MoM-sa. These figures are consistent with a flat number in our 4Q21 GDP tracking.
- November's IPCA registered a 0.95% MoM change (or 10.74% YoY, highest annual reading since 2003). While the headline stood below the market's median expectation of 1.10% and our call of 1.12%, that is the third highest reading for a November since 1996. Despite the downsides surprise, likely led by one-off developments (Black Friday), qualitative measures were, once again, notably unfavorable and we remain our cautious view regarding the inflation outlook.

Most of the information in this report is up to the end of Thursday, December 09, 2021.

Figure 1. Brazil Macro Agenda for the Week of December 13 - 17, 2021

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
Copom minutes	**BCB**	**--**	**Tue, 14-Dec**	**--**	**--**
Services Volume (% MoM)	**IBGE**	**Oct/21**	**Tue, 14-Dec**	**0.1**	**-0.6**
Services Volume (% YoY)	IBGE	Oct/21	Tue, 14-Dec	9.5	11.4
Inflation: IGP-10 (% MoM)	FGV	Dec/21	Wed, 15-Dec	--	1.19
IBC-Br Activity Index (% MoM)	**BCB**	**Oct/21**	**Wed, 15-Dec**	**-0.2**	**-0.27**
IBC-Br Activity Index (% YoY)	BCB	Oct/21	Wed, 15-Dec	-0.3	1.52
Quarterly Inflation Report	**BCB**	**4Q21**	**Thu, 16-Dec**	**--**	**--**

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

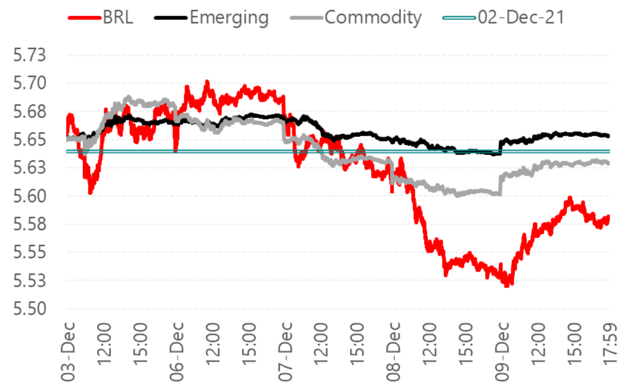
LOCAL MARKETS—FX

The USD/BRL pair closed the rolling week ended December 9 at 5.58 (a 1.1% gain) and the BRL was among the top performers in a basket of 31 of the most liquid currencies in the world during the period. In our view, the constructive performance benefitted from soothing preliminary information on the features of the omicron variant of COVID-19, which triggered a risk-on approach by investors on a global scale. Domestically, as Congress enacted part of the *Precatórios* amendment (more details in the Fiscal Policy section), investors' conjecture about reduced uncertainties regarding fiscal policy outlook for 2022 also contributed for the strengthening of the BRL. Last but not least, the hawkish remarks in the post-decision communiqué released by the Copom on Wednesday (more details in the Monetary Policy section) also favored the BRL. Despite the positive performance in recent days, the USD/BRL pair remains far from the lows seen this year (USD/BRL4.89, seen on June, 25).

LOCAL MARKETS—Rates

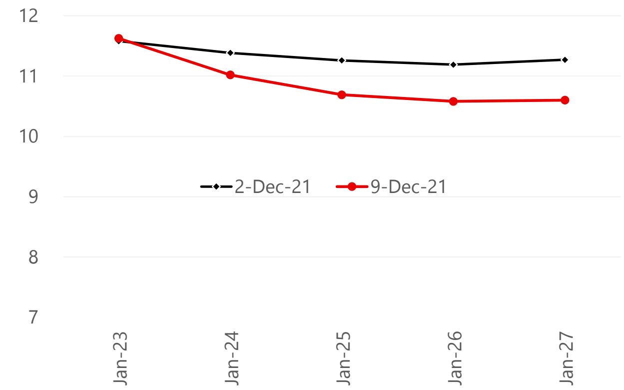
The nominal yield curve flattened significantly, with the long-end continuing the rally seen in recent weeks, and with the front-end selling off after the Copom's statement. Since last Thursday (December 2), the front end of the curve (Jan-23 DI future) rose 4 bps to 11.63%, while the back end of the curve (Jan-27 future) fell 67 bps to 10.60%. As a result, the curve's steepness in this segment fell 72 bps, sinking further into negative territory: -103 bps. This means that the inversion of the curve is now even more pronounced. At the front end, the tone of the Copom's minutes was interpreted by the market as more hawkish (see details in the Monetary Policy section), prompting the market to reverse part of the rally from last week, pricing in a higher probability of bolder Selic moves by the BCB in the next few meetings. At the long end, we continue to see high uncertainties regarding the fiscal consolidation process, but the market continues to trim the premium that has built up of late. In our view, this movement might be more technical rather than based on fundamentals, as the latter has probably not improved during the last few weeks. In our view, only deep macro reforms can undo the damage made to the anchoring power of fiscal policy.

Figure 2. USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note 1: As of the close on Thursday, December 9, 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 9, 2021.

COMMODITIES

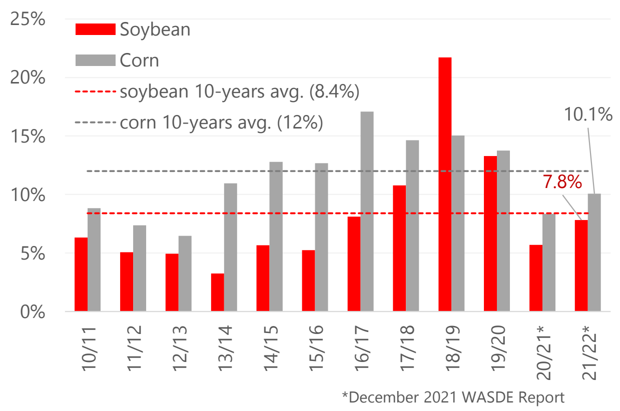
Stable USDA[2] projections for grain inventories in the December report. On Thursday (December 9), the WASDE[3] report maintained its U.S. soybean ending stock forecast at 340 million bushels, compared to the market estimate of 355 million bushels. Meanwhile, U.S. its forecast of corn ending stocks was also unchanged at 1,493 million bushels vs. expectation of 1,475 million bushels. As a result, the stock-to-use ratio for 2021-22 is 7.8% for soybeans and 10.1% for corn. Just for a comparison, the 10-year average is 8.4% and 12.0%, respectively.

Crude oil rallied as concerns about the severity of the Omicron variant eased (at least for now). Markets have been closely watching the developments on the new coronavirus strain and trying to assess its impact on the global economic reopening and, as a consequence, on fuel demand. The week, oil prices rallied (Brent Crude up 7% up from last week, reaching just below USD 75/bbl), though much still remains unknown about the new coronavirus variant. More information from ongoing research is expected in the coming weeks.

EIA[4] reported another decline in U.S. crude stockpiles. On Wednesday (December 8). The EIA reported that U.S. crude inventories decreased by 241k barrels for the week ending December 3, below the market expectation of a 1,169k 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 December 3).

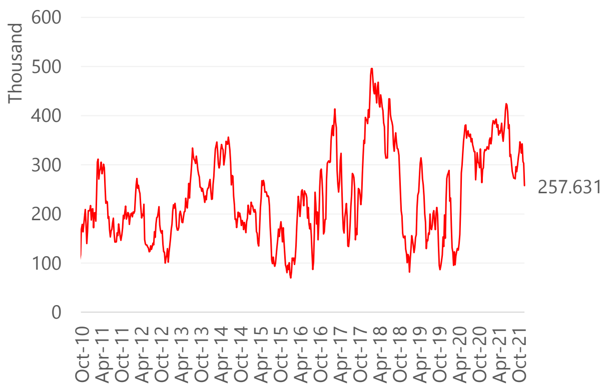
CFTC[5] reports a third decrease in speculative long positions in WTI crude oil. Money managers reduced their net long WTI crude futures and options positions in the week ended November 30, the CFTC reported on Friday (December 3). The positions in futures and options decreased by 45,171 contracts to 257,631.

Figure 4. US: Stock-to-Use Ratio in Grains (%)



Sources: USDA, Santander.

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



Sources: COT, Santander.

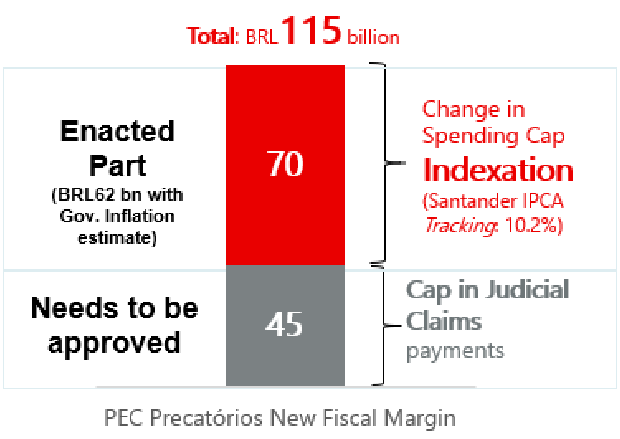
[2] United States Department of Agriculture.
[3] World Agricultural Supply and Demand Estimates.
[4] Energy Information Administration.
[5] U.S. Commodity Futures Trading Commission.

FISCAL POLICY AND LEGISLATION

On Wednesday (December 8), the National Congress enacted the consensual parts approved by both Houses of the so-called *Precatórios* Amendment (PEC 23/2021). Basically, the enacted text opens fiscal room of BRL15 billion for **2021**. Half of this value is expected to be used to increase the new welfare program benefit to BRL400, paving the way to start the new payments on December 10 (in November, the installment was BRL 220). The other half should be used for purchases of COVID-19 vaccines, including the booster shots. For **2022**, the change in federal expenditure ceiling indexation was sanctioned, which will open BRL62 billion of fiscal space, according to the government official estimates (BRL70 billion considering our inflation numbers). Therefore, this value is below the government's expectation to reach the BRL 106 billion projected to accommodate all the expenditures and the necessary amount to approve the 2022 budget. In light of that, to endorse the changes made by the Senate, the Congressional speakers reached an agreement for a fast-track voting of these changes in other constitutional amendment, which must be voted in both Houses again (two rounds in each) next week. The main points that will be voted are: (i) court-ordered debt payments cap until 2026 (instead of 2036), which will open an extra fiscal space of BRL45 billion; (ii) removal of the *precatórios* in favor of the *Fundef* (educational fund) from the constitutional spending cap; and (iii) earmarking the fiscal margin generated by the PEC 23/2021 exclusively with payments for social expenditures (welfare, pensions, and healthcare). According to Lower House Speaker, Arthur Lira, after concluding the voting on the *Precatórios/*spending cap legislation, the Lower House will vote on the budget and start a year-end recess on December 18. In a separate bill, Senators passed the extension of payroll tax breaks to 17 labor-intensive sectors (PL 2541/21)—this will cost ~BRL6 billion (and use space in the constitutional spending cap) and should be budgeted for next year.

We estimate that pandemic relief expenses, specifically those that were exempted from compliance with the constitutional spending cap (so-called "extra-cap" spending), totaled BRL4.0 billion in November. Most of that is related to spending on vaccines, totaling BRL3.1 billion. The monthly average spending on vaccines has been around BRL2 billion per month, reaching a total of BRL19.1 billion in 2021. Regarding the fiscal transfers, the emergency aid program ended in October. Starting in November was the new welfare program, the *Auxílio Brasil*. We estimate that in November there was a monthly expenditure of ~BRL3.2 billion (14.7 million families with a benefit of BRL 220), lower than the monthly average disbursement of BRL8.5 billion with the emergency aid in the year. Health expenses totaled BRL20.2 billion this year up to November; the monthly cost has been decreasing with the improvement in health conditions as the vaccination progresses. We believe that part of the spending for the acquisition of vaccines can be extended to 2022, and we estimate a total budget around BRL5-10 billion, outside the spending cap. For the time being, the total of "extra-cap" expenses budgeted for 2021 is BRL138.2 billion, and *PEC of Precatórios* will add BRL15 billion to that total. Our estimate considers the actual execution of extra-cap spending of ~BRL120 billion (1.4% of GDP).

Figure 6. Fiscal Margin for New Expenditures 2022



Sources: National Congress, Santander.

Figure 7. 2021 "Extra-Cap" Spending Tracker

BRL Billion - Accumulated	Sep-21	Oct-21	Nov-21	Total Budgeted	Executed
Emergency Aid (MP 1.037 and 1.056/2021)	52.5	60.5	60.5	64.9	93.2%
Health expenditures	17.8	19.3	20.2	28.5	71.0%
BEm - Employment Program (MP 935/220 and MP 1.044/2021)	7.7	7.7	7.7	11.7	66.0%
Turism Infraestructure (MP 963/2020)	0.5	0.5	0.5	1.9	27.6%
Vaccine Acquisition (MP 994, 1,004 and 1,015/2020)	13.8	16.1	19.1	26.2	73.1%
Pronampe (credit support for SMEs) (MP 1,053/2021)	5.0	5.0	5.0	5.0	100.0%
Accumulated Total	97.3	109.1	113.1	138.2	81.9%

Last update: 12/09/2021

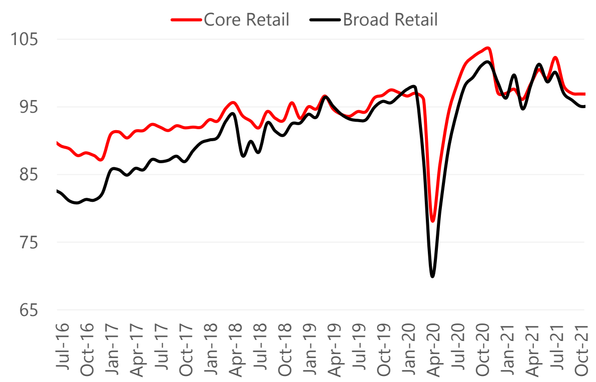
Sources: National Treasury, Santander.

ECONOMIC ACTIVITY

Retail activity marked the start of 4Q21 with new weak figures. Broad retail sales surprised to the downside, retreating 0.9% MoM-sa — well below market consensus (-0.2%) and our estimate (+0.5%). Core retail sales (ex building material and vehicle sales) also posted a sequential decrease (-0.1% MoM-sa), below market consensus (+0.6%) and our estimate (+0.2%). October's figure marked the third decline in a row for broad retail sales, placing the index 2.8% below the pre-pandemic mark (February 2020). Regarding core retail sales, the index is 0.1% below the pre-pandemic mark. Zooming in on the details, both income-led and credit-led segments posted weak figures. Supermarkets (-0.30%) and Fuels (-0.29%) were the lowlights in the income-led segments, while Other Retail Segments expanded 1.44%. Regarding the credit-led segments, Vehicles (-0.54%), Building Materials (-0.92%) and Furniture (-0.47%) were the lowlights. All in all, only 3 out of 10 retail segments printed growth, marking a widespread decline in the month. The biggest positive contributions came from Other retail segments (+0.11 p.p) and Office equipment (+0.05 p.p). Conversely, the biggest negative contributions came from Vehicles (-0.13 p.p), Supermarkets (-0.09) and Building Materials (-0.08 p.p). Moreover, only 3 out of 10 retail segments remain above the pre-crisis levels, notably Pharmaceutical products (+11.7%), Other (+7.6%) and Building Materials (+10.9%). In quarterly terms, for broad retail sales, October's figure implies a -2.7% carryover for 4Q21. Regarding core retail sales, October's result implies a -2.3% carryover for 4Q21. Moreover, according to FGV, retail confidence fell[6] (-6.6%) in November, which, along with high inflation and increased household spending for services, still brings challenges to retail sales in 4Q21. See details in the link[7]

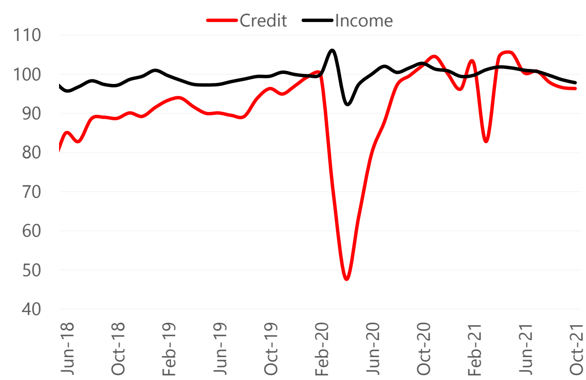
On Tuesday (December 14), IBGE will release data on real services revenues for October. We expect a sequential increase of 0.1% MoM-sa, stemming mainly from positive contributions of services to families and transportation, mostly reflecting the economic reopening allowed by the greater vaccination rates. Moreover, the BCB will release on Wednesday (December 15) its monthly GDP proxy (IBC-Br) for October. We expect a slight decrease of 0.2% MoM-sa. These figures are consistent with our 4Q21 GDP tracking at 0% QoQ-sa. **For details on Santander's activity outlook, please refer to our last chartbooks[8].**

Figure 8. Retail Sales (sa, average 2014=100)



Sources: IBGE, Santander.

Figure 9. Credit x Income Segments (sa, average 2011= 100)



Sources: IBGE, Santander.

[6] **Santander Brazil Economic Activity - *"Widespread Drop in November"* –** December 1, 2021 – Available on: https://bit.ly/Std-Econact-120121
[7] **Santander Brazil Economic Activity - *"Weak Figure (Once Again) For Retail Activity"* –** December 8, 2021 – Available on: https://bit.ly/Std-Econact-120821
[8] **Santander Brazil Economic Activity - *"Chartbook – Lowering (Again) Our GDP Estimates"* –** December 8, 2021 – Available on: https://bit.ly/Std-chart-econact-dec21
Santander Brazil Economic Activity - *"Chartbook – Household Debt is a Risk for Loan Growth and Delinquencies"* – December 2, 2021 – Available on: https://bit.ly/Std-chart-credit-dec21

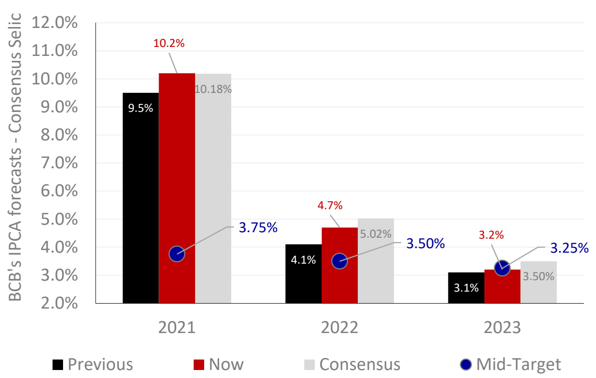
MONETARY POLICY

On Wednesday (December 8), the Copom once again announced a Selic rate hike of 150 bps, reaching 9.25%. This was the seventh move in the policy rate in this cycle, and the Selic now stands at the highest level since 3Q17. The decision itself was in line with the consensus of macro analysts and the yield-curve pricing, even though some market participants seem to have been surprised by the more hawkish than expected tone from the BCB (which we saw as warranted).

In a communiqué with few changes from the previous one, the Copom claims that “given the increase in its inflation projections and in the risk of a deanchoring of long-term expectations, it is appropriate to advance the process of monetary tightening significantly into the restrictive territory.” Importantly, the BCB board also pledges to “persist in its strategy until the disinflation process and the expectation anchoring around its targets consolidate.” The focus on expectations is quite clear. In our view, the Copom came up with a classical response by a central bank operating under an inflation targeting regime: as inflation expectations keep diverging from the targets for the short, medium and longer horizons, the authority suggests it will not tolerate the fading of its main policy objective, which is to put inflation expectations at the target. With the slowing activity having limited influence on expectations for now, we believe the BCB focused on the right elements. Yet, given the different (i.e., expansionary) gears seen from the fiscal levers, it will not be an easy task for the BCB to rein in inflation expectations. But they are trying, as they should. The inflation simulations provide a clue as per how deep into “restrictive territory” the BCB could be planning to reach, and for how long the pace of 150bps could remain in place. Judging from the numbers, we estimate the Copom’s flight plan could include a terminal Selic rate above 12%. The BCB inflation simulations use as main inputs an FX rate starting at 5.65 (as per the rounded average of last week) and moving along with PPP afterward, as well as a path of Selic rate hikes (as projected by economists[9]) to 9.25% for YE2021 and a terminal rate of 11.75%, prevailing for most of 2022, and then landing at 11.25% by YE2022, and falling to 8.00% for YE2023. According to the BCB’s own models, the aforementioned monetary policy path would produce the following IPCA inflation trajectory: 4.7% for 2022 (previously: 4.1%; mid target: 3.50%; upper target: 5.00%) and 3.2% for 2023 (previously: 3.1%; mid target: 3.25%). As per our scenario, we continue to forecast two more hikes of 150bps for the Copom meetings in 1Q22, as we interpret the BCB models signaling room for a rate tightening through 12%. Especially if one considers the upwardly skewed balance of risks. For now, we look for a terminal Selic of 12.25% for the cycle. But that forecast hinges on inflation expectations, especially the ones seen in the BCB’s Focus survey, which takes on added relevance for the coming weeks and months. See details in the link[10]

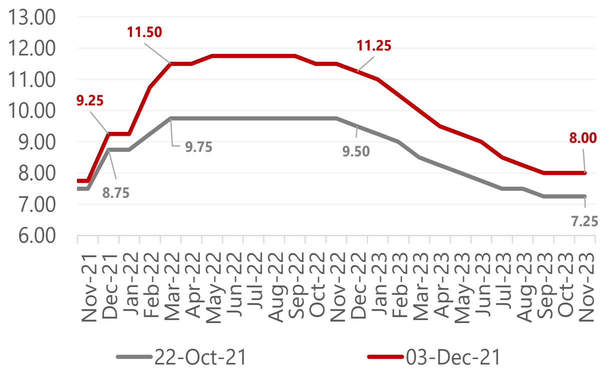
This week the BCB will have a couple of opportunities to (re-)calibrate its communication, with the Copom minutes (due on Tuesday) and the Q4 inflation report (due on Thursday).

Figure 10. BCB’s Inflation Simulations



Sources: Brazilian Central Bank, Santander.
Note: Assumes Selic rate from the Focus survey and USD/BRL starting at 5.65 and evolving according to purchase power parity.

Figure 11. Median Selic Rate Forecasts (Monthly)



Sources: Brazilian Central Bank, Santander.

[9] Refer to the BCB’s weekly survey of professional forecasters for December 3, 2021 (https://www.bcb.gov.br/en/publications/focusmarketreadout)
[10] **Santander Brazil Monetary Policy - *“Inflation Expectations, Target, and (Almost) Nothing Else Matters”* –** December 8, 2021 – Available on: https://bit.ly/Std-COPOM-dec21

INFLATION

November's IPCA registered a 0.95% MoM change (or 10.74% YoY, highest annual reading since 2003). While the headline stood below the market's median expectation of 1.10% and our call of 1.12%, that is the third highest reading for a November since 1996. Furthermore, the headline trend remained at 13.5% in 3MMA-saar terms, showing that the upward pressure at the margin remains strong.

The bulk of the surprise was concentrated on volatile items usually related to Black Friday sales, but indeed some qualitative measures showed some relief at the margin. The average of core measures receded from the high level of 9.6% to 9.1% in 3MMA-saar terms. The trend pace of the EX3 core (including underlying services and industrialized goods prices) slowed to 6.5% from 7.9% in October. Yet this number is also slightly influenced by one-off developments such as the Black Friday markdowns, so that one should take this number with some caution. In any case, this was 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). Diffusion index fell to 61.3% (seasonally adjusted).

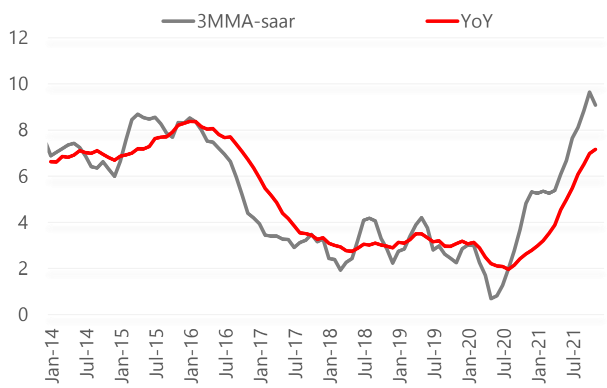
We remain cautious regarding the inflation outlook, and would not take this downside surprise as a clear sign of an inflexion point as yet, particularly because of the one-off effects from the Black Friday. And with the recent rise of domestic fiscal risks, which might push expectations even higher and make inertia even stronger, we still envision a difficult disinflation process ahead.

Figure 12. November's IPCA Details (%)

	MoM			YoY	
	Nov-21	Santander	Dev.	Oct-21	Nov-21
IPCA	0.95	1.12	-0.17	10.7	10.7
Administered	2.30	2.33	-0.01	17.0	19.2
Free	0.45	0.67	-0.16	8.5	7.8
Food-at-home	0.04	0.42	-0.06	13.3	9.7
Industrial goods	0.98	1.24	-0.06	11.1	11.4
Services	0.27	0.39	-0.04	4.9	4.8
EX3 Core	0.24	0.60	-0.13	6.6	6.5

Sources: IBGE, Santander.

Figure 13. Core Inflation (%)



Sources: IBGE, Santander.

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