# BRAZIL MACRO

February 11, 2022

## MACRO COMPASS

## INFLATION, INTEREST RATES, RISKY ASSETS . . . ALL UP

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- Despite the hawkish expectations about Fed policy, the markets witnessed a global risk-on mode these days, which led to strength in risky currencies, including the BRL, against the greenback. In addition, continued sizeable net FX inflows into the domestic market, a reinterpretation by market participants of the BCB's policy message, and assumptions about economic policy from 2023 onward all helped the USD/BRL pair to close the period at 5.25 (up 0.7%). In line with the uptrend in global yields, the local curve of nominal rates sold off in recent days, led also by adverse inflation developments (e.g., IPCA composition, rising commodities), and a hawkish BCB message.
- January's IPCA registered a 0.54% MoM change, in line with our forecast (0.52%) and market consensus (0.55%). The IPCA accelerated from 10.06% to 10.38% YoY, in line with our call that the peak of the 12-month IPCA will not be clear at least until the end of 1Q22. Core inflation continues to trend at high levels (~9% in annualized sequential terms). We continue to project that the disinflation process will be sticky, difficult and risky, and we look for IPCA 2022 at 6.0% (consensus: 5.4%).
- In our view, the BCB likely used the occasion of the Copom minutes to reaffirm the actual tone of its statement following the recent policy meeting, which had been seen as soft (in our view exaggeratedly) by financial markets. Indeed, despite the indications of a slower pace of hikes and the lack of information about the next move, the authority continues to signal that the Selic path used in inflation simulations (+100 bps in March and 12% terminal rate) is a lower bound for the path the BCB considers necessary to drive IPCA inflation down to the mid-target for the relevant policy horizon (mainly 2023). We continue to project a terminal Selic rate of 12.25% in May.
- We saw mixed signals from the tertiary sector in December. Broad retail activity expanded slightly, +0.3% MoM-sa, short of the consensus (+0.8%) and with tepid figures seen for both credit-led and income-led segments. The recent figures point to virtual stability in retail sales since September, probably mirroring high inflation (eating into consumers' pockets) and the shift of spending back into services (following the post-pandemic reopening). Confirming our thesis, the services sector's real revenue topped market expectations (+0.6%) by climbing 1.4% MoM-sa, the second gain in a row and with widespread growth among segments. However, we will closely monitor the impact of the Omicron variant on mobility-related activities in the coming months. Our proprietary index (IGet) already hints at a slight impact in January.
- The BCB's monthly GDP proxy (IBC-Br) expanded by 0.33% MoM-sa (+1.30% YoY) in December, below marked consensus (+0.5%) but with considerable upward revisions in the series. Regarding 4Q21 GDP growth, we are maintaining our tracking at +0.3% QoQ-sa, consistent with 4.5% GDP growth in 2021 and generating a 0.1% carryover for 2022. We expect a 0.7% growth this year.

***Most of the information in this report is up to the end of Thursday, February 10, 2022.***

**Figure 1. Brazil Macro Agenda for the Week of February 12 - February 18, 2022**

| Indicators / Events | Source | Reference | Date | Santander Estimate | Prior |
|---|---|---|---|---|---|
| Inflation: IGP-10 (% MoM) | FGV | Feb/22 | Tue, 15-Feb | -- | 1.79 |

Sources: Bloomberg, IBGE, Santander.

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

***Also refer to our Macro Propositions for Brazil in 2022[2].***

[1] **Santander Brazil – Scenario Update: *"Inflation Still a Concern"* –** January 20, 2022- Available on: https://bit.ly/Std-scenupdate-jan22

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

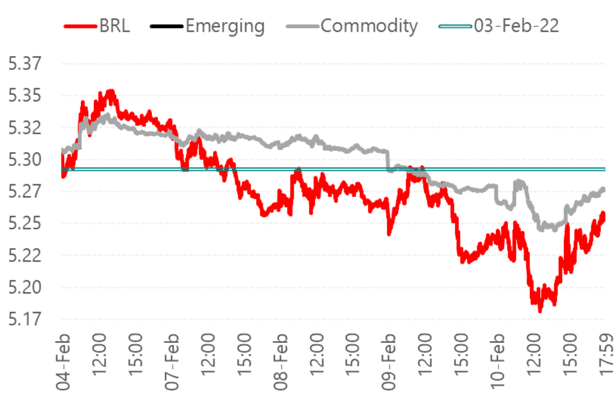
## LOCAL MARKETS—FX

**Despite the hawkish expectations about Fed policy, the markets witnessed a global risk-on mode in recent days, which led to strength in risky currencies, including the BRL, against the greenback. In addition, continued sizeable net FX inflows into the domestic market, a reinterpretation by market participants of the BCB's policy message, and assumptions about economic policy from 2023 onward all helped the USD/BRL pair to close the period at 5.25 (up 0.7%).** Amid a relatively light calendar of events on the international front, whose highlights were the Chinese credit figures and the U.S. CPI reading (both exceeding expectations), financial assets in general rallied in the last few days, indicating a risk-on environment. This global backdrop, together with the maintenance of market assumptions about economic policy ahead, helped the BRL to strengthen. Moreover, markets learned that Brazil has received sizeable net FX inflows into the country this year (figures through February 4 indicate net inflows of nearly US$6.0 billion, chiefly related to financial operations) on the heels of a more attractive interest rate differential and plenty of (perceived) opportunities in the equity market. Last but not least, both the minutes of the last Copom meeting and public statements delivered by BCB board members helped reverse the markets' perceptions of the authority's tone, leading to expectations that the tightening cycle could go further than previously expected (more details in the "Monetary Policy" section). Despite these constructive short-term dynamics for the BRL, we remain cautious about the trajectory of the BRL further down the road on the heels of political and fiscal uncertainties amid a scenario of tighter global financial conditions in 2H22.

## LOCAL MARKETS—Rates

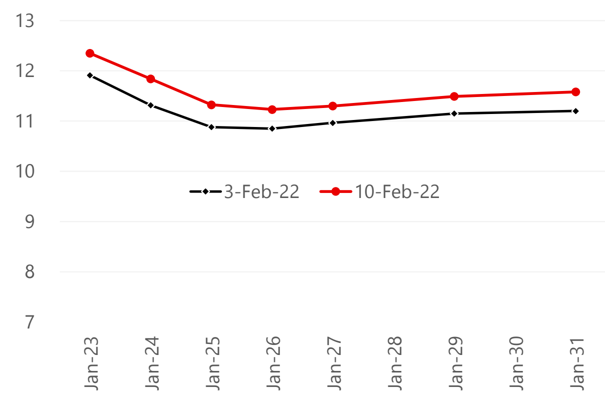
**The local yield curve sold off in recent days on the heels of adverse inflation developments (e.g., IPCA composition, rising commodities), hawkish language from the BCB , and an uptrend in global yields.** Since last Thursday (February 3), the front end of the curve (Jan-24 DI future) rose 53 bps to 11.84%, while the back end of the curve (Jan-27 DI future) rose 34 bps to 11.30%. At the same time, the curve's steepness in this segment decreased by 19 bps to -54 bps, making the inversion of the curve even more pronounced in this segment. At the front end, the movement was driven by market perceptions of a slightly more hawkish BCB tone in the Copom minutes than in the statement following the February 1-2 policy meeting (see details in the "Monetary Policy" section). The adverse composition of January IPCA (see details in the "Inflation" section) and the surprising strength in commodity prices in recent weeks (see details in the "Commodities" section) are likely additional drivers, in our view. At the back end, we see the sell-off as likely driven by the upward movement in longer U.S. Treasury yields. Fundamentally speaking, we continue to see an environment of high uncertainties for the domestic economy, particularly regarding the fiscal consolidation process. All that said, we continue to see room for domestic yields to re-steepen, which could occur after both IPCA inflation and the Selic rate see a peak.

**Figure 2. USD/BRL Intraday Trends**




Sources: Bloomberg, Santander.
Note 1: As of the close on Thursday, February 10, 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, February 10, 2022.

## COMMODITIES

**Commodities prices saw another bullish week. Again. The Bloomberg Commodity Aggregate Index rose 0.1% in the rolling week ended February 10: the Agriculture Subindex rose 2.2% and the Industrial Metals Subindex gained 4.3%, whereas the Energy Subindex receded 5.4%.** In our view, idiosyncratic factors (adverse weather, low inventories, and rising costs of production) continue to feed the commodity rally early in 2022.

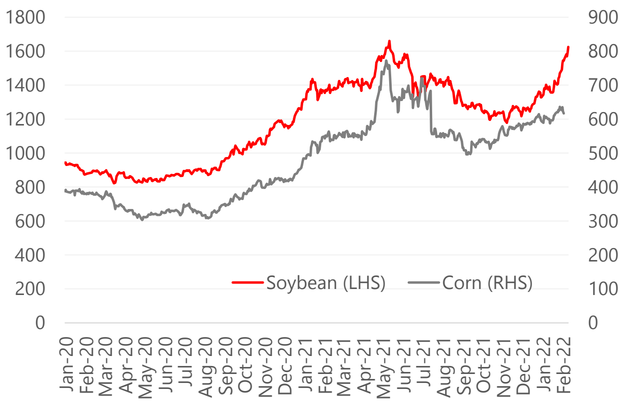
**USDA[3] cuts estimate for South America soybean output.** According to the WASDE[4] report, the production estimate for oilseed in Brazil was cut to 134 million tons (consensus: 133 million tons), down from the 139 million tons estimated in January. The agency reduced its estimate for Argentina's production from 46 million tons to 45 million tons, as well as reducing its forecasts for U.S. and global inventories. Additionally, the monthly report left its prior estimate for U.S. soybean exports unchanged, which we see as unlikely, as drought conditions have led to a continued deterioration in the crop outlook for South America. The surge in soybean prices has likewise pulled up prices for its byproducts, such as cooking oils and animal feed (soymeal is at the highest level since 2014). Thus, food inflation might take (even) longer to cool down.

**Oil markets drifts sideways with mixed signals.** On the one hand, geopolitical tensions seem to have eased, as European powers agreed not to escalate their responses to the Russia-Ukraine crisis, and signals of progress in U.S.-Iran nuclear talks could potentially mean additional barrels in the market. On the other hand, EIA reported on Wednesday (February 9) a decline in U.S. crude stockpiles, sending inventories to the lowest level since October 2018. We still see output shortages in the oil market, as global inventories are low and producers (ranging from OPEC+ members to independent U.S. shale companies) struggle with the underinvestment in recent years.

**Iron ore rises past $150 as China eases carbon emissions target.** The steel industry in China gained five extra years as the government set 2030 (instead of 2025, the previous deadline) as the new deadline for peak emissions for the sector (steelmaking accounts for 15% of China's carbon emissions). The rally continues despite the recent crackdown on speculation in commodities markets, as regulators in China seek to curb price speculation in line with government vows to keep iron ore prices stable. Iron ore has strongly rebounded since December on expectations that consumption will pick up this year due to Chinese government stimulus.

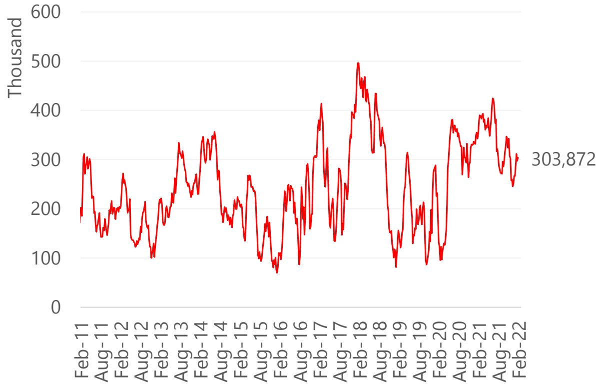
**CFTC[5] reports an increase in speculative long positions in WTI crude oil.** Money managers reduced their net long WTI crude futures and options positions in the week ended February 1, the CFTC reported on Friday (February 4). The positions in futures and options increased by 6,430 contracts to 303,872.

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




Sources: CBOT, Santander.

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




Sources: COT, Santander.

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

## MONETARY POLICY

**In our view, the BCB likely used the occasion of the Copom minutes to reaffirm the actual tone of the statement from its policy meeting, which had been seen as soft (in our view exaggeratedly) by financial markets. Indeed, despite the indications of a slower pace of hikes and a lack of information about the next move, the authority continues to signal that the Selic path used in inflation simulations (+100 bps in March and 12% terminal rate) is a lower bound for the path the BCB considers necessary to drive IPCA inflation down to the mid-target for the relevant policy horizon (mainly 2023).**

The BCB published the minutes of its February 1-2 policy meeting, when the authority once again hiked interest rates (for an eighth time running), in this case by 150 bps to 10.75%. The overall message does not look much different from the statement, and we still find the BCB's tone (and stance) not as soft as the markets read it in the wake of the communiqué's publication.

The Copom did seek to keep the range of possibilities somewhat open with respect to subsequent moves, especially regarding the speed of hikes going forward, amid uncertainties in the inflation outlook (namely commodities, FX) and considering the policy lags, given the tightening already implemented.

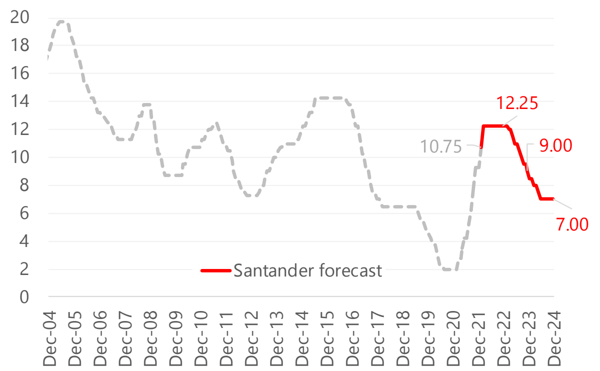
Yet the committee confirmed that the reference scenario (with a terminal Selic at 12.00%) is a lower bound for the actual paths the BCB has in mind in order to bring inflation back to the center target. In our view, this signal itself also puts the speed of hikes at no less than 100 bps for the March meeting.

The Copom concluded that "additional adjustments at a slower pace [than 150bps] in the next meetings, is the most appropriate strategy to achieve sufficient monetary tightening and ensure inflation convergence over the relevant horizon, as well as the anchoring of long-term inflation expectations."

In our view, the BCB likely used the occasion of the Copom minutes to reaffirm the actual tone of the statement issued after the policy meeting, which had been seen as soft (in our view exaggeratedly) by financial markets. Indeed, despite the indications of a slower pace of hikes and the lack of a pre-commitment to a definite speed in the short term, the authority continues to signal that it will do no less than the consensus path. Importantly, the BCB continues to identify inflationary risks emerging from imported inflation (i.e., commodity prices, FX), but especially from domestic fiscal developments and the associated risks of de-anchoring inflation expectations.

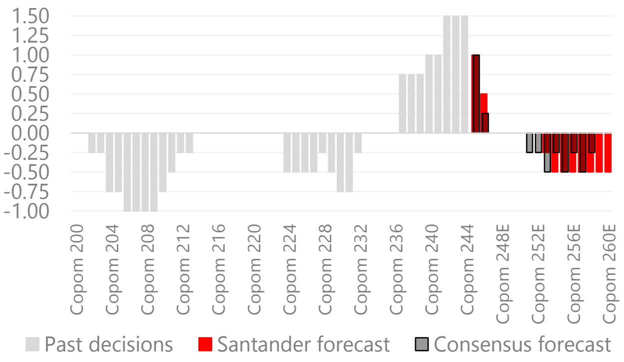
On that basis, we forecast a 100-bp hike in March and another move of 50 bps in May, and maintain our terminal Selic rate estimate of 12.25% for this cycle. While we interpret the BCB's language as suggesting that the hiking cycle is near completion, there is little doubt, in our view, that the next steps (and the total cumulative size of the adjustment) will be data dependent. See details in the link.[6]

**Figure 6. Path for the Selic Policy Rate (monthly average, % p.a.)**




Sources: Brazilian Central Bank, Santander.

**Figure 7. Selic Rate Moves in Copom Meetings: History and Forecast (in percentage points)**




Sources: Brazilian Central Bank, Santander.

[6] **Santander Brazil – Monetary Policy: *"Copom Minutes: Ratifying the Tone"* –** February 8, 2022- Available on: https://bit.ly/Std-COPOM-min-feb22

## INFLATION

**January's IPCA registered a 0.54% MoM change, in line with our forecast (0.52%) and market consensus (0.55%).** The IPCA accelerated from 10.06% to 10.38% YoY, in line with our call that the peak of the 12-month IPCA will be not be clear at least until the end of 1Q22. As for the trend at the margin, it decelerated from 10.3% 3MMA-saar to 7.4%.

**Industrial goods and food-at-home surprised to the upside, while services and regulated prices surprised to the downside, but we downplay most of the downside surprises.** Industrial goods continued to be a negative highlight, with their inflationary process proving to be much stronger and stickier than previously anticipated. Moreover, the core industrial goods gauge accelerated sharply, rising from 10.1% to 12.7% 3MMA-saar. The services group rose 0.39% MoM (vs. 0.49% expected), contributing -3 bps to the headline forecast error. Its trend decelerated from 5.9% to 3.7% 3MMA-saar, but mostly driven by volatile items (particularly airline tickets). As a result, the services core gauge still stood at 6.6% 3MMA-saar, a high level implying that the YoY change in core services should continue to accelerate in the next releases.

**In general, qualitative measures are still unfavorable, with the average of the main core gauges remaining almost stable at 8.7% 3MMA-saar, and the diffusion index returning to recent highs.** Moreover, the diffusion index continued to rebound, reaching 71.1% (seasonally adjusted), a return to levels close to the recent high (74.8%), compatible with YoY inflation running around 10.0% a few months from now.

**All in all, there was not much news in this reading, and it simply reinforces our concerns about the inflation outlook.** In our view, the disinflation process afterward will be difficult and sticky, absent a sharp deceleration.

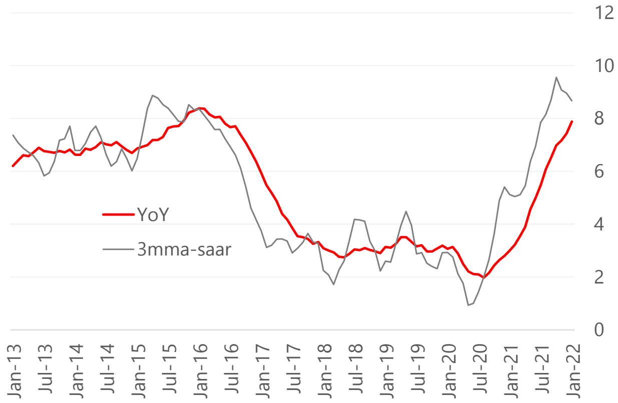
**We still see upside risks from the usual drivers of inflation (commodities, expectations, and inertia), and this reading itself does not change this view.** However, we see an ad hoc downside bias coming from possible approval of tax reduction measures that basically counterbalances the upside risks we see, leaving the balance of risks for our 6.0% high-frequency tracking for IPCA 2022 reasonably symmetric. It is worth noting that although this possible tax cut could reduce IPCA in the short term (2022), we believe a rebound is highly likely from 2023 onward, posing upside risks for IPCA 2023 and 2024. See details in the link.[7]

**Figure 8. January's IPCA Details (%)**

| | MoM | | | YoY | |
|---|---|---|---|---|---|
| | Jan-22 | Santander | Dev. | Dec-21 | Jan-22 |
| IPCA | 0.54 | 0.52 | 0.02 | 10.1 | 10.4 |
| Administered | -0.35 | -0.24 | -0.03 | 16.9 | 16.8 |
| Free | 0.87 | 0.82 | 0.04 | 7.7 | 8.2 |
| Food-at-home | 1.44 | 1.25 | 0.03 | 8.2 | 8.6 |
| Industrial goods | 1.22 | 1.02 | 0.05 | 12.0 | 12.7 |
| Services | 0.39 | 0.49 | -0.03 | 4.8 | 5.1 |
| EX3 Core | 1.04 | 1.01 | 0.01 | 7.1 | 7.6 |

Sources: IBGE, Santander.

**Figure 9. Core Average Inflation (EX0, EX3, DP, MS, P55, % annual)**




Sources: IBGE, Santander.

[7] **Santander Brazil Inflation: *"January's IPCA: No News Is Bad News"* –** February 09, 2022 –Available on: https://bit.ly/Std-IPCA-jan22

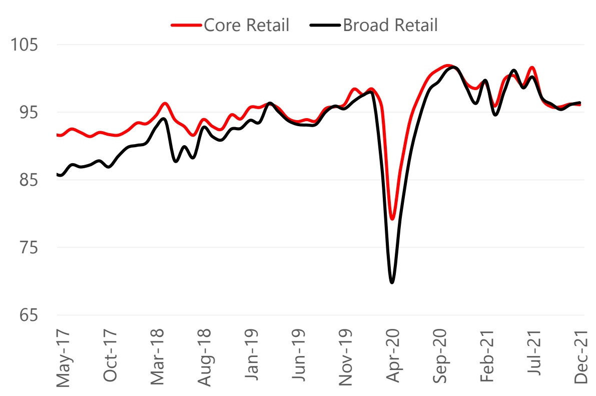
## ECONOMIC ACTIVITY

**Tepid retail sales figures in December.** Broad retail activity expanded 0.3% MoM-sa, between market consensus of +0.8% and our estimate of -0.2%. At the same time, core retail sales (ex building material and vehicles sales) dropped 0.1% MoM-sa. Both indexes remain below the pre-pandemic mark (down 1.3% and 2.3%, respectively). Zooming in on the details, five of ten retail activities printed growth, with sales of vehicles (+1.2% MoM-sa) and pharmaceutical products (+3.2% MoM-sa) as the highlights. Sales in credit-led segments like building materials (-1.4% MoM-sa) and furniture and home appliances (+0.4% MoM-sa) shrank at the margin, while important income-led segments like supermarkets (-0.4% MoM-sa) and other personal items (-5.7% MoM-sa) also contributed negatively. The biggest positive contributions came from vehicle sales (+0.29 p.p.) and pharmaceutical products (+0.16 p.p.), with the latter likely reflecting the increasing demand for COVID-19 tests due to the Omicron variant outbreak. Moreover, only three retail activities remain above the pre-pandemic mark, notably supermarkets (up 1.0%), pharmaceutical products (up 18.8%), and building materials (up 10.2%). For January, our proprietary index IGet pointed to a sharp tumble. See details in the link[8].

**Services output topped expectations in December.** The headline index jumped 1.4% MoM-sa, considerably above market consensus of +0.6% and close to our estimate of +1.2%. This performance marked the second gain in a row and placed the index 6.6% above the pre-pandemic mark (February 2020). Zooming in on the details, mobility-related segments drove the climb. Transportation was in the spotlight (+1.8% MoM-sa), mainly owing to expansion in ground transportation (+2.6% MoM-sa) and air transportation (+10.6% MoM-sa). Professional services continued to strengthen (+2.6% MoM-sa), while services to families marked the ninth gain in a row (+0.9% MoM-sa) but was below the estimate pointed to by our proprietary index IGet (+2.2% MoM-sa). This segment remains 11.2% below the pre-pandemic mark. Other services contributed positively (+1.4% MoM-sa), while information services was the only subsector to print a retreat (-0.2% MoM-sa). That said, we should monitor the impact of the Omicron variant outbreak, mainly in those segments related to mobility. IGet already points to some impact in January[9], with a higher than expected decrease in services to families. See details in the link[10].

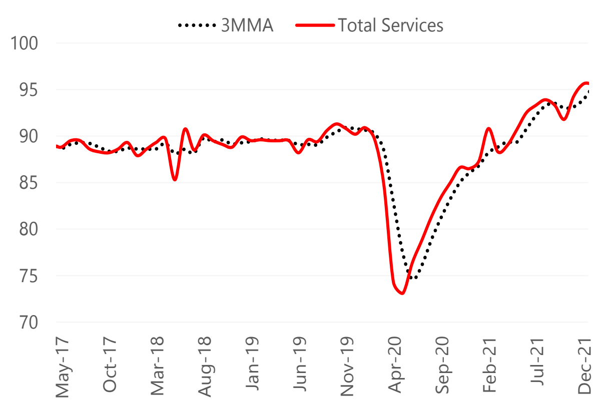
**The BCB's broad activity index (IBC-Br) — a monthly GDP proxy — expanded by 0.33% MoM-sa (+1.30% YoY), between market consensus of 0.5% MoM-sa and our estimate of 0.1% MoM-sa. The series was considerably revised higher.** This result was the second gain in a row and marked a quarterly stability (0% QoQ-sa). Regarding 4Q21 GDP growth (the official reading by IBGE), we are maintaining our tracking at +0.3% QoQ-sa, consistent with 4.5% GDP growth in 2021. For details on Santander's activity outlook, please refer to our last chartbook[11].

**Figure 10. Retail Sales (sa, 2012=100)**




Sources: IBGE, Santander.

**Figure 11. Real Services Revenues (sa, 2014=100)**




Sources: IBGE, Santander.

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[8] **Santander Brazil Economic Activity:** ***"Tepid Retail Sales Figures in December"*** **–** February 09, 2022 –Available on: https://bit.ly/Std-econact-020922

**Santander Brazil Economic Activity -** ***"IGET Janeiro: Varejo segue enfraquecendo na margem"*** **–** February 7, 2022 – Available (in Portuguese) on: https://bit.ly/Std-IGET-jan22. For an English version, please see: https://bit.ly/Std-IGET-EN-jan22

[9] **Santander Brazil Economic Activity:** ***"IGET Janeiro: Serviços desaceleram na margem"*** **–** February 4, 2022 – Available (in Portuguese) on: https://bit.ly/Std-IGETser-jan22.

[10] **Santander Brazil Economic Activity:** ***"Services Output Surprised to the Upside in December"*** **–** February 10, 2022 – Available on: https://bit.ly/Std-econact-021022

[11] **Santander Brazil Economic Activity:** ***"Chartbook – Maintaining the Main Growth Drivers for 2022"*** **–** February 01, 2021 – Available on: https://bit.ly/Std-chart-econact-feb22

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