Santander Corporate & Investment Banking

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Brazil Macro Compass

Watching the Final Economic Events of the Year

Ana Paula Vescovi* and
Brazil Macroeconomics Team
anavescovi@santander.com.br
+5511 3553 8567

- **Despite the still constructive global financial conditions for EMs, the BRL hovered near the level where it closed a week ago, in another week of globally weaker USD. This puts the Brazilian currency among the worst performers among emerging currencies in recent days, possibly reflecting fears about the "over hedge" theme.**
- **The USD0.2 billion current account surplus observed in November 2020 came in close to our estimate (USD0.1 billion), and, in tandem with the net inflow of USD7.0 billion in portfolio deals, reinforced the perception that the Brazilian balance of payments should remain off market participants' radars.**
- **In fixed income, the week saw a steepening pattern in nominal yields, with downward pressures in the front end, possibly reflecting a recalibration in the tone of the BCB in the COPOM minutes (seen by market participants as overly hawkish in the statement). In our view, the selling in the back end may have reflected an elevation of political noise just before Congress begins its recess. We still see value receiving the very front end of the nominal yield curve, for we see "virtually zero" likelihood of a rate hike by the BCB in 1Q21, as well as limited probability of a move in 1H21.**
- **In a rather eventful week on the monetary policy front, the Brazilian Central Bank (BCB) published the minutes of its December 8-9 policy meeting on Tuesday (December 15) and the 4Q20 inflation report on Thursday (December 17). From the BCB's communications, we got the strong impression that March is the strongest candidate for when the BCB will announce the end of the forward guidance (i.e., flight plan of stable interest rates). Given our own view on the inflation fundamentals (which do not look much different from the BCB's views, in general), we see the policy signals as consistent with hikes starting in October, at a pace of 25 bps per meeting. We project the Selic rate at 2.50% for end-2021 and 4.50% for end-2022.**
- **The BCB published on Monday (December 14) its monthly general activity index (the IBC-Br), capping the batch of activity index releases for October. Despite a figure below the market's expectations, October's IBC-Br underlines economic activity's sequential recovery at the start of 4Q20, supporting the likelihood of solid quarterly growth ahead, in our view. Based on the information set available, our tracking for 4Q20 GDP stands at 1.9% QoQ s.a. (-2.8% YoY).**
- **In fiscal policy, on December 16 Congress approved the Budgetary Guidelines Law (LDO), an essential law for maintaining the execution of public spending in the first months of 2021, before the final budget approval, expected only after February.**
- **In a week when the economic calendar is thin, on Tuesday (December 22), IBGE is scheduled to release IPCA-15 inflation for December, and we expect another hefty gain: +1.20% MoM (4.38% YoY). Besides the upward pressure from food-at-home, electricity costs should also be a key driver, in our view. We estimate those two groups alone will account for more than half of the IPCA monthly change. We maintain our benign view for inflation in the medium term.**

Local markets—FX: The last few days have brought little news on the international front, with the risk-on mode continuing among market participants on the heels of the beginning of immunization campaigns in some countries and the imminent approval of more vaccines on the horizon. On the domestic front, although the approval of the budget guidelines passed Congress without surprises, averting the risk of a government shutdown before Budget 2021 approval (only expected in February or after), the bill reinforced our perception that the conduct of fiscal policy will be challenging next year (for more details, see the "Fiscal policy" section of this report).

The USD/BRL pair hovered around the 5.06 level observed at the end of last week and seems poised to end this week within an interval between 5.05-5.10, which we think is likely to put it among the worst performers among emerging currencies, in another weak of a globally weak USD. We believe that part of the pressure has to do with the so-called "over hedge" theme, which basically refers to the need for banks to reduce their short USD in FX derivatives, given changes in taxation announced early this year.

The Brazilian Central Bank (BCB) has tendered USD swaps that should partially meet the expected increase in net USD long positions in FX derivatives, in our view. We estimate the total should amount to approximately USD10 billion until the end of the year, whereas the *ad hoc* demand should reach USD15 billion. This mismatch has prevented the USD/BRL from breaching the 5.00 threshold, in our opinion. As this theme is due to move to the back burner after the turn of the year, we believe the BRL will once again swing in accordance with global financial conditions and the local fiscal outlook. Under our key assumption that global risk appetite will remain positive and the government will abide by the spending cap rule in 2021, we continue to see room for the strengthening of the BRL over the medium term.

Local markets—rates: At the time of this writing, the weekly change in nominal yields pointed to a steepening pattern. In the front end, the Jan-22 DI future was trading at 3.00% (-2 bps from last Friday). In the back end, the Jan-27 DI was trading at 6.81% (+9 bps from last Friday). The steepness in this segment is poised to end the week at ~381 bps, compared to 370 bps in the previous week and ~150 bps early this year before the arrival of the pandemic in Brazil (late February).

This movement comes despite an EM-friendly global market environment. At the local level, the front-end yields seemed slightly downwardly influenced by the COPOM minutes early on Tuesday, in our view, as the authority recalibrated slightly what had been seen as a hawkish tone in the statement (see the "Monetary policy" section of this report). In the back end, we think political noise related to the state of affairs between the executive and legislative branches probably contributed to push yields a bit higher late in the week.

We continue to see potential for volatility ahead, amid lingering uncertainties about the next fiscal policy steps. Even though a fiscal solution is not expected until late 1Q21, we still see some value receiving in the very front end of the nominal yield curve, for we see the likelihood of a rate hike by the BCB in 1Q21 at "virtually zero", and limited probability for a move in 1H21.

Fiscal policy: On December 15, Congress approved a new framework allowing for debt negotiations among the states and the federal government. We see the bill as another positive step for steering subnational governments in the direction of more fiscal responsibility. According to this framework, states would be eligible for a grace period and access to credit, in exchange for a commitment to some fiscal control measures, such as selling state-owned companies, reducing subsidies, and reforming their pension systems.

On December 16, Congress approved the Budget Guidelines Law (LDO, in the Portuguese acronym) of 2021. The government committed to a BRL247 billion deficit in 2021, following the recommendation of the federal budget watchdog (TCU, in the Portuguese acronym). In the previous draft, the LDO considered a "flexible" primary target, given uncertainties related to economic activity and tax collection. The deficit target is close to our forecast for 2021 of BRL237 billion.

In the proposal, next year's discretionary expenses are expected to reach ~BRL100 billion, BRL12 billion below the level considered in the annual budget proposal (PLOA) for 2021 sent on August 31. In our view, this level is close to the minimum needed for discretionary expenses without risking stoppages in government services. Thus, we see room for possible friction within the government, with the possibility of partial shutdowns of some public administration services in 2021. The LDO includes BRL20 billion to be used to immunize the population from COVID-19, a key element to enabling a safer reopening of the economy next year.

The approval of the LDO would allow the government to authorize temporarily at least one twelfth of the amount forecast for the year until Congress approves the final budget. After voting on the LDO, we think Congress is likely to leave for its recess next week. Consequently, we expect further advances in the agenda and in the debate over the budget for 2021 only after the elections for speakers of the Lower House and Senate in the first days of February 2021.

Balance of payments: The release of the balance of payment data for November 2020 showed that the current account balance registered a USD0.2 billion surplus in the period, which was slightly higher than our estimate (USD0.1 billion). Once again, the low remittances of profit and dividends, combined with tame outlays in services and a positive outcome in the trade balance, reinforced our perception that the country is in a sound situation regarding its external sector. This is especially so when we see that direct investments in the country continued to flow in (USD1.5 billion vs. the USD1.0 billion that we expected) and that portfolio flows have remained positive for the sixth month in a row (USD7.0 billion), which illustrates that there are plenty of resources to fund the deficit in the current account balance at normal levels, assuming no fiscal policy disruption. Based upon the preliminary data provided by the BCB for December 2020, we believe there is a good likelihood that the annual current account deficit in 2020 may be even smaller than our projection of USD10.2 billion (the imbalance is at USD12.0 billion in 12M-to-date terms in November 2020, for details see our report[1]).

The balance of payments figures also indicated that Brazilian banks repatriated a small portion of their capital invested in offshore branches (USD1.7 billion), which means that the bulk of the unwinding of over-hedge operations may take place in December, in our view. However, as mentioned in the "Local markets—FX" section of this report, we believe a good chunk of the augmented long USD positions in FX derivatives should be satisfied by the supply from the BCB. All in all, the Brazilian external sector data continue to imply considerable room for the strengthening of the BRL over the medium term.

Economic activity: On Monday (December 14), the BCB published its monthly activity indicator for October, capping the batch of activity index releases for that month. The IBC-Br posted a gain of 0.9% MoM s.a. (-2.6 YoY), below the market's expectations (1.0%) and with the series revised downward. Although it was the sixth gain in a row, the growth was not enough to offset the drop registered during the COVID-19 crisis, with the index still down by 2.4% since February's reading (pre-crisis mark).

This monthly gain is consistent with the resumption of activity seen for other key sector-based indicators in October (e.g., industrial production, retail sales, and the services sector), underlining economic activity's sequential recovery at the start of 4Q20. In our view, these figures support the likelihood of solid sequential growth in 4Q20. In a preliminary exercise based on the YoY correlation of IBC-Br and GDP, our tracking for 4Q20 GDP stands at 1.9% QoQ s.a. (-2.8% YoY). For details see our report[2]

According to FGV's preview of confidence surveys released on Monday (December 14), in December the aggregate business index should register the third fall in a row (-0.9 p.p.). Among the sectors, as in the previous months, mixed signals were sent: Industry picked up in the month (1.9 p.p.), while the remaining sectors all posted sequential declines, especially Consumer (-4.1 p.p.) and Retail Sales (-2.9 p.p.). If the preview's data is confirmed, Industry should reach the highest reading since 2010, while Retail Sales and Consumer should end the quarter with a sequential decline. It is possible that the most recent figures of confidence in the tertiary sector are slightly influenced by the second wave of COVID-19 contagion under way in Brazil. The latter has already resulted in slight rollbacks in the reopening process in some regions.

Monetary policy: This was a rather eventful week on the monetary policy front, as the Brazilian Central Bank (BCB) published the minutes of its December 8-9 policy meeting on Tuesday (December 15) and the 4Q20 inflation report on Thursday (December 17).

In the COPOM minutes, the authority provided more information on the conditions for the planned dropping of the forward guidance (of stable interest rates under certain conditions), as signaled in the last COPOM statement. According to the BCB, the end of the forward guidance could follow: (i) an eventual increase of 2021 inflation expectations toward the mid-target; or (ii) the switching of the policy horizon from YE2021 (when inflation is seen below the target with a stable Selic next year) to YE2022 (when inflation is seen at the target, but only with Selic hikes).

Since we believe the natural (i.e., calendar-driven) change of policy horizon is the most likely candidate to prompt an adjustment in the BCB's flight plan, and given that the first meeting of the year is historically too soon to change the policy horizon, we believe the March COPOM meeting is the strongest candidate for the BCB to announce the end of the forward guidance.

[1] **Santander Macro External Sector – *Balance of Payments: November 2020* –** December 18, 2020- Available on: http://bit.ly/Sant-bop-20
[2] **Santander Macro Economic Activity - *IBC-BR October: Solid Sequential Growth Outlook for 4Q20* –** December 14, 2020- Available on: https://bit.ly/Sant-IBCBr-dez-20

Our impression has been confirmed by remarks from BCB officials during the press conference following the publication of the 4Q20 inflation report. According to the BCB's economic policy director Fabio Kanczuk, speaking at the occasion, in 1Q21 the weight of the 2022 calendar year for the relevant monetary policy horizon begins to exceed that of 2021. The authority also added that, in 2Q21, the focus of COPOM's decisions will be entirely on inflation for 2022.

As usually the case, the inflation report shed more light on the BCB's inflation forecasts and policy discussions. Having already published its inflation simulations in the statement and minutes, we learned from the inflation report that the authority is projecting 2020 GDP at -4.4% (previously -5.0%) and 2021 GDP at +3.8% (previously +3.9%). According to the BCB, these numbers would leave the economy about 3.9% below its potential at the end of 4Q20. The output gap is expected to close in 2022. In our view, the latter implicitly reveals a notably sanguine BCB forecast for the economy in 2022, and we see this as leaving little room for disappointment with activity and downside risk for the BCB's 2022 inflation forecast.

Also, as is the norm, the inflation report brought interesting policy-related studies (boxes). One of the boxes shows BCB inflation forecasts for alternative scenarios, in which the authority tests the impact of an aggravation in fiscal risks (inflationary) and an extension of the pandemic effects (deflationary). For end-2021, the BCB estimates an inflationary impact of 3.0 p.p. for the former and a deflationary effect of 1.0 p.p. for the latter (vis-à-vis the baseline), which provides an indication of the possible policy reaction before a hypothetical materialization of these risks. In another box, BCB estimates the effects of the forward guidance on the yield curve: according to its estimates, the effect was equivalent to a cut of 25 bps in the Selic rate, confirming that the BCB sees the rollback of the forward guidance as implying the removal of a small amount of monetary stimuli.

Other boxes deal with themes related to the economic impact of the pandemic. The BCB digs deeper into the inflation items with greater weight on low-income families' budgets, and concludes that these items saw greater inflation pressures than prices with historically similar co-movements. The conclusion is that emergency government transfers could have temporarily added pressure to this year's IPCA. Another box focuses on the increase in the personal savings rate during the pandemic, concluding that precautionary savings are gaining importance of late as a mechanism slowing consumer expenses, an impact that may not fade soon amid perceived risks from the job market. That could potentially soften the pace of improvement in household spending even after medical advances in the fight against COVID-19, according to the BCB. Lastly, in another box, the BCB estimates no major permanent bankruptcies during the pandemic, meaning that the supply side of the economy may not have been considerably harmed. In other words, the BCB sees limited damage to potential GDP from the pandemic.

Overall, the messages from the BCB's policy-related studies seem aligned with a scenario of downside risks for activity, remaining economic slack, and softening inflation pressure for the coming quarters. In qualitative terms, this is relatively in line with our own views.

All in all, we see the BCB setting the stage for dropping the forward guidance sometime in the coming months, but that does not mean the authority is getting ready to kick off the normalization (i.e., hiking) process. Given this policy signal, as well as our view on inflation and activity developments throughout 2021, we see the normalization process for interest rates starting only in October, with hikes at a pace of 25 bps per meeting. We project the Selic rate at 2.50% for end-2021 and 4.50% for end-2022.For details see our report[3]

Inflation: On Tuesday (December 22), IBGE is scheduled to release IPCA-15 inflation (preview) for December. We expect another high reading of +1.20% MoM (4.38% YoY). Once again, we expect one of the main sources of upward pressure to be food-at-home. The shock is taking longer than we expected to fade, and we expect to see another high monthly print at 3.07% MoM. Another item likely creating upward pressure for this reading will be electricity (+5.19% MoM), affected by Aneel's (regulatory agency) decision to implement the Red 2 flag for extra changes in electricity bills. We expect those two groups alone to account for more than half of the IPCA monthly change. Industrial goods are likely to continue to decelerate, reaching 0.49% MoM, while services should settle at a high inflationary level (0.85% MoM), in our view, owing to two specific pressures: airline tickets (29.00% MoM) – in line with seasonality – and education, with some of the discounts given at the worst phase of the first wave of the pandemic being partially reversed.

Looking beyond December, our view for IPCA inflation has improved, and we have reduced our short-term forecasts to 0.07% MoM for January (from 0.15%), 0.33% for February (from 0.39%), 0.30% for March (from 0.34%), and 0.30% for

[3] **Santander Macro Monetary Policy - *COPOM Minutes: Clues on When to Drop the Forward Guidance* –** December 15, 2020- Available on: https://bit.ly/Sant-copom-minutes-dec-20

April (from 0.31%). This movement was triggered by the deceleration (or even decline) in the prices of many food items at the wholesale level, alongside the better performance of the currency, which has appreciated around 15% since the end of October. Our IPCA trackings are stable at 4.50% for 2020 and 3.00% for 2021. In qualitative terms, we continue to see a benign scenario for inflation, with fading shocks, a negative output gap, and anchored inflation expectations, so we believe inflation should continue below the target, with a benign composition (low core measures) in the medium term.

Also next week: On economic activity, FGV will release the final December results of its confidence surveys, for consumers (December 22) and for retail and construction (December 23). If the previews' results are confirmed, consumer and retail sales will end 4Q20 with sequential declines after a sharp increase in the previous quarter, on the heels of the reduction in the amount of emergency aid to households, higher inflation for essential goods (e.g., Food), and a deteriorating outlook for employment conditions ahead.

On the fiscal side, sometime next week the Brazilian internal revenue service will publish federal tax collection data for November 2020. Our estimate is BRL139.4 billion, which would mean an increase of ~6.5% compared to November 2019, in real terms. The result will be affected by the proceeds from deferred taxes in June (~BRL15 billion in our estimate); those tax deferrals were a measure to mitigate the effects of COVID-19 in 2Q20. Tax collection has been recovering gradually, driven by the better performance of economic activity.

November's bank lending data from the BCB will be released on Wednesday (December 23). We expect new loans for households to maintain their pace of recovery, driven by credit card and real estate financing. As for non-financial corporations, we expect pandemic-related new loans to decelerate.

MACRO AGENDA

Indicator	Reference	Date	Estimate	Prior
Federal Tax Collection (BRL billion)	Nov	?	139.4	153.9
FGV Consumer Confidence (index)	Dec	Tue, 22-Dec	--	81.7
IPCA Inflation IBGE (% MoM)	Dec	Tue, 22-Dec	1.20	0.81
IPCA Inflation IBGE (% YoY)	Dec	Tue, 22-Dec	4.38	4.22
FGV Construction Costs (% MoM)	Dec	Wed, 23-Dec	--	1.29
FGV Construction Confidence (index)	Dec	Wed, 23-Dec	--	93.8
FGV Retail Sales Confidence (index)	Dec	Wed, 23-Dec	--	93.5
BCB Total Outstanding Loans Growth (% YoY)	Nov	Wed, 23-Dec	15.0	14.5
BCB Total Outstanding Loans (BRL billion)	Nov	Wed, 23-Dec	3,935	3,872
Federal Debt Report (BRL billion)	Nov	Wed, 23-Dec	--	4,639

Sources: Bloomberg, Santander.

For details on Santander's economic forecasts for Brazil, please refer to our latest scenario review[4].

[4] **Santander Brazil - *Macroeconomic Scenario: (Another) Challenging Year Ahead* –** December 17, 2020- Available on: https://bit.ly/Sant-Scenario-Rev-Dec-20

CONTACTS / IMPORTANT DISCLOSURES

Brazil Macro Research			
Ana Paula Vescovi*	Chief Economist	anavescovi@santander.com.br	5511-3553-8567
Mauricio Oreng*	Head of Macro Research	mauricio.oreng@santander.com.br	5511-3553-5404
Jankiel Santos*	Economist – External Sector	jankiel.santos@santander.com.br	5511-3012-5726
Ítalo Franca*	Economist – Fiscal Policy	italo.franca@santander.com.br	5511-3553-5235
Daniel Karp Vasquez*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Lucas Maynard*	Economist – Economic Activity	lucas.maynard.da.silva@santander.com.br	5511-3553-7495
Felipe Kotinda*	Economist – Credit	felipe.kotinda@santander.com.br	5511-3553-8071
Global Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Mike Moran	Head of Macro Research, US	mike.moran@santander.us	212-350-3500
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Equity Research			
Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Daniel Gewehr*	Head, Brazil	dhgewehr@santander.com.br	5511-3012-5787
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