Santander
Macroeconomic Research

# BRAZIL MACRO

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## MACRO COMPASS

# WINTER IS COMING

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- In the rolling week ended May 12, once again the BRL stood 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 5.13 (a 2.1% loss). The move took place on the heels of worldwide inflationary pressures, which led monetary authorities to deliver hawkish statements that aggravated fears of a global economic contraction and drove markets into a risk-off mode. Positive surprises regarding local activity indicators were not enough to offset the sour climate, as inflation readings continued to disappoint and underpinned expectations of an extension of the monetary tightening cycle in Brazil.
- While the unfavorable news cycle led the U.S. yield curve to record a bull flattening—regardless of worse-than-expected inflation readings—the local yield curve registered a slight bear flattening on the heels of the global risk-off mode, the negative surprises in local inflation readings, and indications that the Brazilian Central Bank (BCB) may extend the tightening cycle into 2H22.
- Commodity prices plunged in the rolling week ended May 12 on worries about weak global demand. The Bloomberg Commodity Aggregate Index in BRL terms decreased 1.9% in the period, with the BRL selloff cushioning a sharper drop. In USD terms, the index fell 4.0%, with the Agriculture Subindex rising 0.1%, the Energy Subindex plunging 5.9%, and the Industrial Metals Subindex retreating 6.6%.
- The tertiary sector data topped expectations in March, capping the 1Q22 with better-than-expected quarterly figures. Broad retail activity inched up 0.7% MoM-sa and registered an encouraging streak of three consecutive gains, while services' real revenue edged up 1.8% MoM-sa, fully offsetting the previous two weak prints. We are updating our IBC-Br tracking for March to +0.8% MoM-sa (previously at 0.7%), while we maintain our 1Q22 GDP growth tracking at 0.6% QoQ-sa.
- April's IPCA registered a 1.06% MoM (12.1% YoY) change, above our call (0.94%) and the consensus expectation (1.01%). This was another unfavorable print that reinforces our difficult outlook for inflation, but we maintain our view that this was likely to have been the peak of IPCA in YoY terms. Leading indicators and high frequency inflation surveys point to some relief ahead. However, the pace of deceleration should be slow, sticky and risky, as the level and composition of inflation are likely to remain sources of concern.
- In our view, the minutes of the last Copom meeting did little to clarify whether the (intended and signaled) hike at the June gathering will be the last one of the ongoing monetary tightening cycle, with some excerpts suggesting this is likely to be the case and other passages keeping the door open for an eventual continuation of the tightening cycle in 2H22. We continue to see the Selic rate at 13.25% p.a. in YE2022, as we expect inflation readings to show less worrisome signs and the lagged impact of prior hikes to become more visible from now on.

***Most of the information in this report is up to the end of Thursday, May 12, 2022.***

**Figure 1. Brazil Macro Agenda for the Week of May 16 to May 20, 2022**

| Indicators / Events | Source | Reference | Date | Santander Estimate | Prior |
|---|---|---|---|---|---|
| Net Debt (% GDP) | BCB | Mar/22 | Mon, 16-May | 56.7 | 57.1 |
| Primary Budget Balance (BRL billion) | BCB | Mar/22 | Mon, 16-May | 6.5 | 3.5 |
| Inflation: IGP-10 (% MoM) | FGV | Apr/22 | Tue, 17-May | -0.17 | 2.48 |
| Federal Tax Collection (BRL billion) | RFB | Apr/22 | 20 to 26-May | - | 164.1 |
| 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 |

* 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 Update[1].***

[1] **Santander Brazil – Scenario Update:** ***"Surfing an Extended Commodity Wave"*** **–** April 14, 2022- Available on: https://bit.ly/Std-scenupdate-apr22

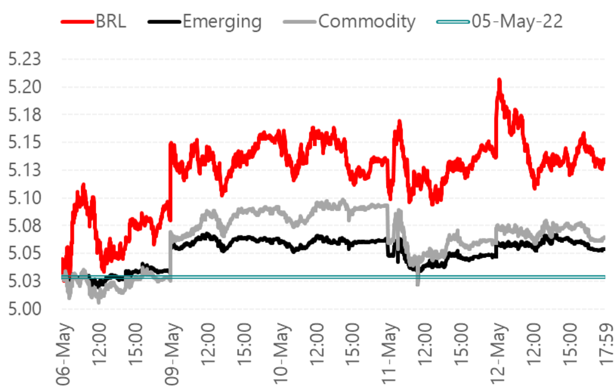
## LOCAL MARKETS—FX

**In the rolling week ended May 12, once again the BRL stood 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 5.13 (a 2.1% loss).** Inflation readings that came in higher than expected led the Fed members to intensify their hawkish wording, thus increasing fears of a steep deceleration in the U.S. economy in the short term, a sentiment that was also observed in Europe and other advanced economies. Abroad, we also saw a strong correction in cryptocurrencies completing the roster of bad news that drove markets to a global risk-off mode that spared only three of the 31 most liquid currencies in the world (the Japanese yen, he Russian ruble and the Peruvian sol). Amid these unfavorable circumstances, the BRL did not profit from the possibility of an extension in the tightening cycle into 2H22 (more details in the “Monetary Policy” section), given the prospect that central banks in advanced economies will move faster than expected, thus leading to lower commodity prices on the heels of slower global economic growth. The FX move of recent days reinforces our view that higher interest rates in Brazil may attenuate the BRL’s weakening but will not prevent it from materializing.

## LOCAL MARKETS—Rates

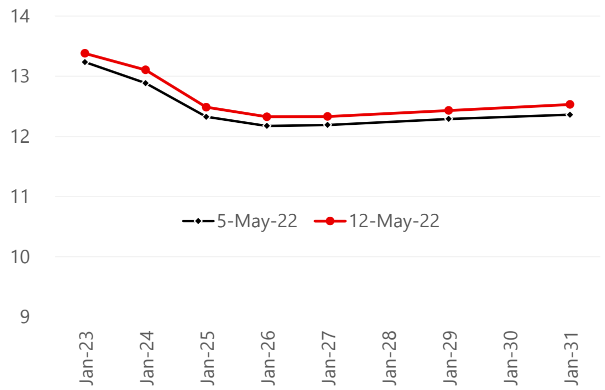
**Once again, local nominal yields sold off in a similar pattern all across the curve.** Since last Thursday (May 5), the front end of the curve (Jan-24 DI future) rose 22 bps, to 13.11%, while the back end of the curve (Jan-27 DI future) gained 14 bps to 12.33%. The curve’s steepness in this segment decreased a bit, increasing the inversion (by 8 bps) to -78 bps. At the front end, the main driver was the April’s IPCA, which came in at 1.06%, surprising the market by about +5 bps and bringing YoY inflation to 12.1%. Another source of upward pressure in the yield curve, in our view, was probably the price of gasoline, as the gap between international and domestic gasoline prices is now at a sizeable 39%, thus suggesting a risk for adjustment in local prices that would push inflation higher in the short term. Earlier in the week, diesel prices were adjusted by 9.8%. These new developments push back a bit further the steepening we expect to see in the yield curve in the medium term, after the BCB stops hiking the Selic rate and the IPCA reaches a peak in annual terms.

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




Sources: Bloomberg, Santander.
Note 1: As of the close on Thursday, May 12, 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, May 12, 2022.

## COMMODITIES

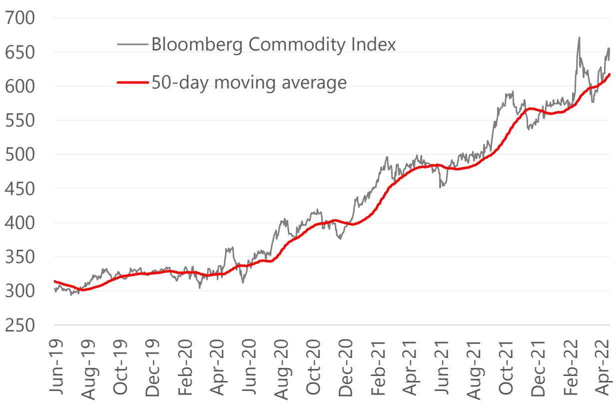
**Commodity prices plunged in the rolling week ended May 12 on worries about weak global demand. The Bloomberg Commodity Aggregate Index in BRL terms decreased 1.9% in the period, with the BRL selloff cushioning a sharper drop. In USD terms, the index fell 4.0%, with the Agriculture Subindex rising 0.1%, the Energy Subindex plunging 5.9%, and the Industrial Metals Subindex retreating 6.6%.**

**Oil prices fall as the EU is set to weaken its sanctions package on Russian oil.** The bloc dropped a proposed ban on EU vessels from transporting Russian oil to third countries, though it kept its plan to prohibit European companies from providing insurance for those shipments. Adding to the downward pressure on prices, the outlook for China's virus lockdowns remains foggy. Meanwhile, fuel (gasoline and diesel) stockpiles continue to tighten in the U.S., with East Coast diesel supply at a record low. The U.S. has become an important supplier of fuel in the global market as buyers struggle to replace Russian imports.

**USDA[2] keeps estimates unchanged for Brazilian corn and soybean crops.** According to the WASDE[3] report, the projection for the Brazilian corn crop in the 2021-22 season was kept unchanged at 116 million tons, while the first forecast for the 2022-23 season came in at 126 million tons. The projection for the soybean harvest was also kept unchanged at 125 million tons for the 2021-22 season, and the first forecast for the 2022-23 season came in at 149 million tons. The highlight of the report was the estimate for Ukraine's wheat crop, which was cut by one-third compared to the last season. The war is restricting harvesting and sowing, which turns into a risk for the global supply/demand balance, as the country is one of the main producers of wheat, corn, and vegetable oil.

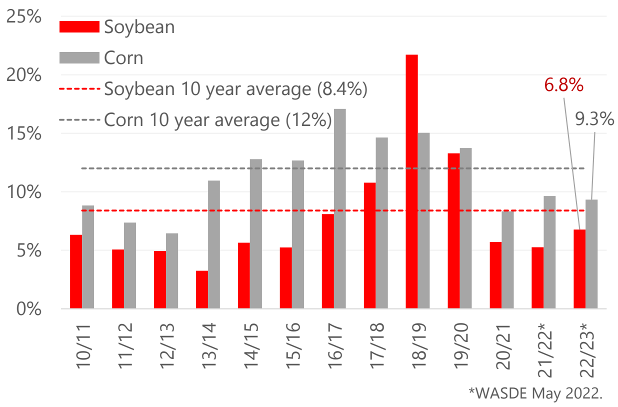
**Iron ore and base metals prices plunge on mounting concerns about weak global demand.** Iron ore prices continued to decline with signs that lockdowns in China are continuing in Shanghai. In an attempt to counter the economic slowdown, the Chinese government urged officials to use fiscal and monetary policies to stabilize employment and the economy. Global macro headwinds such as rising U.S. interest rates and USD strengthening have also helped to bolster the case that metals demand is being dragged down.

**Figure 4. Bloomberg Commodity Index in BRL**




Sources: Bloomberg, Santander.

**Figure 5. US: Stock-to-Use Ratio in Grains - %**




Sources: USDA, Santander.

[2] United States Department of Agriculture.
[3] World Agricultural Supply and Demand Estimates.

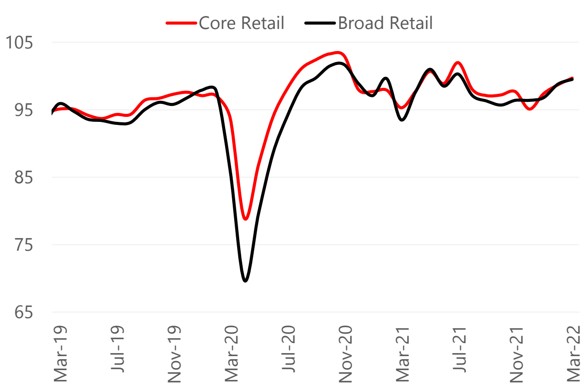
## ECONOMIC ACTIVITY

**Retail activity beat expectations (again) and marked a solid 1Q22.** Broad retail sales inched up 0.7% MoM-sa (+4.5% YoY) in March, topping our expectations and market consensus (at -0.4% MoM-sa and -0.1% MoM-sa, respectively) and marking an encouraging streak of three consecutive gains. At the same time, core retail sales (which exclude Building Materials and Vehicles sales) inched up 1.0% MoM-sa (+4.1% YoY), also beating our expectations and market forecasts (at +0.4% MoM-sa and +0.5% MoM-sa, respectively) and recording the third gain in a row. March's growth stemmed mainly from other personal items (+3.3%)—a notably heterogeneous and volatile retail component—and building materials (+2.1%). Office equipment (+14%) and books (+4.7%) strongly increased at the margin, but their low weights limited their contribution. Moreover, 5 of 10 retail activities posted results close to stable, while pharmaceutical products inched down (-5.9%), a continued reversal from January's steep growth (due to the Omicron variant outbreak). After the continued weakening seen in 2H21, both indexes surpassed their pre-pandemic benchmarks and reached levels 1.6% and 2.7%, respectively, above the readings seen in February 2020. See details in the link[4].

**Services topped expectations and capped 1Q22 with solid growth.** Services output rebounded in March (+1.8% MoM-sa), above market expectations (+0.8% MoM-sa) and in line with our estimate (+1.2% MoM-sa). Regarding post-COVID dynamics, March's print placed the headline index 7.3% above the pre-pandemic benchmark (February 2020) and marked 1.8% QoQ-sa growth (+0.8% in 4Q21), a healthy streak of seven consecutive gains. Among services activities, widespread growth: the diffusion index rose to 75% (vs. 50% in February), with 9 of 12 activities inching up at the margin. The biggest positive contributions came from air transport (+0.42 p.p.), ground transportation (+0.39 p.p.), and professional services (+0.30 p.p.), while administrative services (-0.18 p.p.) and water transportation (-0.14 p.p.) contributed the least. Regarding post-COVID dynamics, only 5 of 12 activities remain below their pre-pandemic marks, notably food and accommodation (down 13.3%), which leaves room for a further contribution from services to overall activity as the economy's reopening consolidates. See details in the link[5].

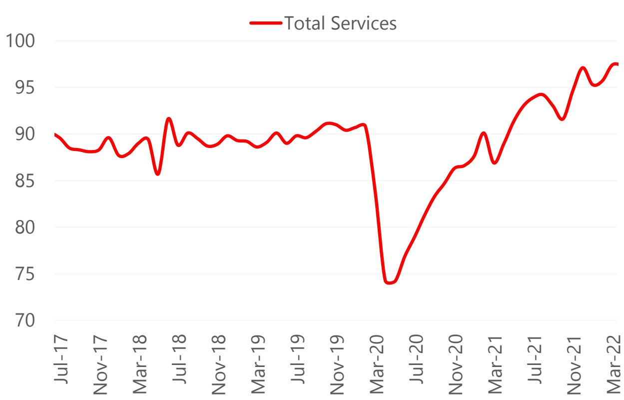
**March's data releases capped the batch of activity indices for 1Q22, and we saw positive surprises in the three key sectors.** This last surprise in the performance of the services segment prompted us to revise our tracking of March IBC-Br to +0.8% MoM-sa (+0.7% previously), while we are maintaining our 1Q22 GDP growth tracking at +0.6% QoQ-sa. We keep warning that the Omicron variant outbreak in January hit not only cyclical activities, but also non-cyclical services that drove GDP recovery in 2H21. We forecast GDP to grow 0.7% in 2022 (with significant upside risks) and to contract 0.3% in 2023. **For details on Santander's activity outlook, please refer to our last chartbook[6].**

**Figure 6. Retail Sales (2003=100, sa)**




Sources: IBGE, Santander

**Figure 7. Services Output (2014=100, sa)**




Sources: IBGE, Santander.

[4] **Santander Brazil Economic Activity: "*Retail Sales Beat Expectations (again) in March*"** – May 10, 2022 – Available on: https://bit.ly/Std-econact-051022

[5] **Santander Brazil Economic Activity: "*Services Capped 1Q22 with Widespread Growth*"** – May 12, 2022 – Available on: https://bit.ly/Std-econact-051222

[6] **Santander Brazil Economic Activity: *"Resilience in 2022, but with Concerns Regarding 2023"* –** April 19, 2022 – Available on: https://bit.ly/Std-chart-Econact-apr22

## INFLATION

**April's IPCA registered a 1.06% MoM change, above our call (0.94%) and the consensus expectation (1.01%).** In YoY terms, the IPCA accelerated to 12.1%, which should be the peak of IPCA inflation, in our view.

**The main upward surprises relative to our forecast came from food prices (+4 bps) and industrial goods (+4 bps).** More specifically, food-at-home rose 2.6% MoM (vs 2.3% estimated), spread across many items (e.g., meat and milk, among others). Meanwhile, industrial goods rose 1.22% MoM (vs. our estimate of 1.0%), with medicines alone contributing +3 bps to the headline forecast error. Services also accelerated considerably, with its core running at 9.7% from 9.0% 3mma-saar. Though industrial goods stopped accelerating, they are at a very high level (headline at 15.5% from 15.8% 3mma-saar and core at 17.4% from 18.6% 3mma-saar).

**Broad qualitative measures were solidly unfavorable.** The average of the main core measures accelerated to 12.4% from 11.4% 3MMA-saar, reaching a new high. Moreover, the diffusion index continued to rise, reaching 77.1% (seasonally adjusted), quite close to the highs.

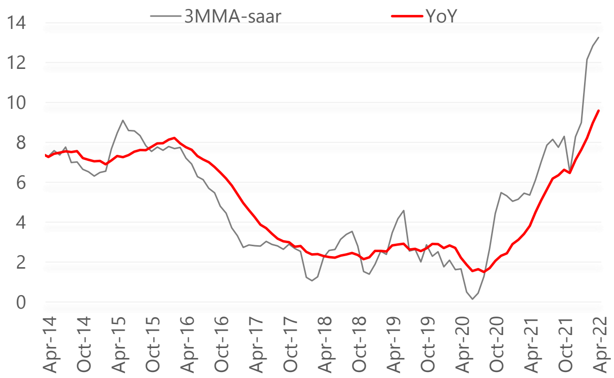
**All in all, this is another unfavorable print that reinforces our difficult outlook for inflation, but we maintain our view that this was likely the peak of IPCA in YoY terms.** Leading indicators and high frequency inflation surveys point to some relief ahead. However, the pace of deceleration should be slow, sticky and risky, as the level and composition of inflation are likely to remain sources of concern, just as the latest shock from commodity prices is a new risk, keeping the balance of risks tilted to the upside (i.e., higher inflation). IPCA 2022 tracking is now at 8.8% (from 8.3% before). We also revised IPCA 2023 tracking to 4.5% (from 4.2%), on the back of inertial effects. See details in the link[7].

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

| | MoM | | | YoY | |
|---|---|---|---|---|---|
| | Apr-22 | Santander | Dev. | Mar-22 | Apr-22 |
| IPCA | 1.06 | 0.94 | 0.12 | 11.3 | 12.1 |
| Administered | 0.55 | 0.46 | 0.03 | 14.8 | 15.0 |
| Free | 1.25 | 1.11 | 0.10 | 10.0 | 11.1 |
| Food-at-home | 2.59 | 2.33 | 0.04 | 13.7 | 16.1 |
| Industrial good: | 1.22 | 1.05 | 0.04 | 13.4 | 14.2 |
| Services | 0.66 | 0.62 | 0.01 | 6.3 | 6.9 |
| EX3 Core | 0.94 | 0.87 | 0.03 | 9.0 | 9.6 |

Sources: IBGE, Santander.

**Figure 9. Core Inflation IPCA EX3 (%)**




Sources: IBGE, Santander.

[7] **Santander Brazil Inflation: "*April's IPCA: Qualitative Measures Still Solidly Unfavorable*"** – May 11, 2022 – Available on: https://bit.ly/Std-IPCA-apr22

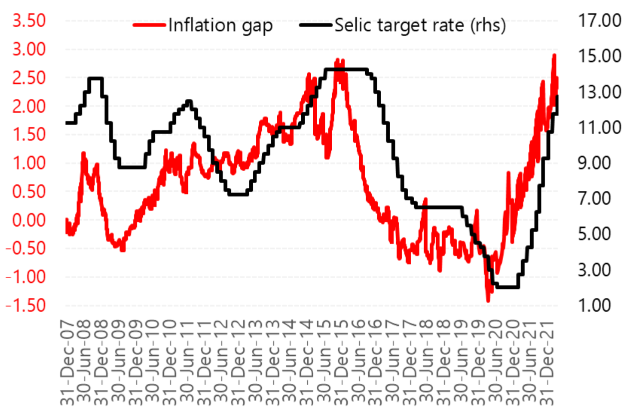
## MONETARY POLICY

**In our view, the minutes of the last Copom meeting did little to clarify whether the (intended and signaled) hike at the June gathering will be the last one of the ongoing monetary tightening cycle, with some excerpts suggesting this is likely to be the case and other passages keeping the door open for an eventual continuation of the tightening cycle in 2H22. We continue to see the Selic rate at 13.25% p.a. in YE2022, as we expect inflation readings to show less worrisome signs and the lagged impact of prior hikes to become more visible from now on.** See details in the link[8].

Likewise as seen in the post-decision communiqué, Copom members acknowledged in the minutes of their last meeting that there has been marginal deterioration in both the short-term inflation dynamics and in their long-term forecasts, which justified their decision to deliver a 100-bp hike last week and to signal another move of a smaller magnitude at the next meeting (June 14-15). The Brazilian monetary authority expected this approach (to extend the cycle at a slower pace) to reflect the magnitude of hikes already delivered, to reinforce the cautious nature of monetary policy, and to underline the high uncertainty surrounding the current scenario. Additionally, the authority assesses that this strategy should ensure the convergence of inflation to the targeted level over the relevant time horizon for monetary policy (the focus is 2023 for now), as well as to anchor inflation expectations over the long term.

Despite anticipating the next move, the BCB stated that it considers it appropriate to extend the tightening cycle until the consolidation of a disinflation process materializes and expectations become anchored, which, in our view, opens room for an eventual extension beyond June's Copom meeting, given the many uncertainties still present. On the other hand, the BCB also called attention to the fact that the monetary tightening carried out hitherto has been intense and timely, and that its effects have not fully worked their way through the economy. In our opinion, this seems an indication that Copom members think that monetary policy has already gone quite far in a contractionary direction, which may make it difficult for the BCB to implement further hikes after June's Copom gathering.

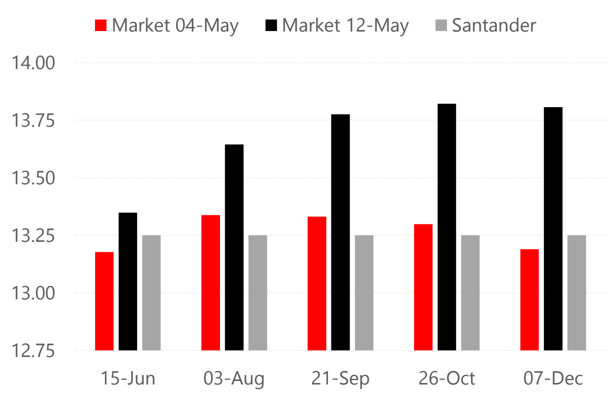
**Figure 10. Inflation Gap* vs. Selic Target Rate (% annual)**




Sources: Brazilian Central Bank, Santander.

* - Inflation gap refers to the difference between markets' median inflation expectation 12-month ahead and the targeted level of inflation for the same period based upon a weighted moving average of annual goals.

**Figure 11. Outlook for Upcoming Copom Decisions (% annual)**




Sources: Bloomberg, Santander.

[8] **Santander Brazil – Monetary Policy:** ***"Keeping All Degrees of Freedom"*** **–** May 10, 2022- Available on: https://bit.ly/Std-COPOM-min-may22

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