BRAZIL MACRO

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MACRO COMPASS

ACTIVITY CAPS Q2 ON A POSITIVE NOTE

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

- While the USD strengthened against all major currencies in the rolling week ended on August 12, the BRL remained relatively stable at USD/5.25 (-0.1%) and registered one of the best performances in the basket. We believe the BRL resilience stemmed from the hawkish wording in the Copom minutes. In fixed income, a cocktail of hawkish BCB remarks, unfavorable underlying inflation and a US Treasuries sell off prompted the local yield curve to bear-steepen.
- Health conditions continue to gradually improve in Brazil. Our proxy for a nationwide average of ICU occupancy is close to 51%, the lowest level since January. The daily average of vaccination reached 1.5 million shots (as of Wednesday, August 11), reaffirming our scenario of full immunization of adults by year-end.
- On Monday (August 9), the government submitted to congress a provisional measure to create a new welfare program named “Auxílio Brasil”. The government also presented a constitutional amendment proposal (PEC, in Portuguese acronym) to stagger court-mandated debts (the so-called “Precatórios”). The voting of the income tax reform on the Lower House was postponed for the coming week.
- The Brazilian Central Bank (BCB) published the minutes from its August 3-4 COPOM policy meeting. The authority kept a hawkish tone—in line with the statement, in our view. The committee believes that a path of rate hikes going faster and/or farther than the projection of analysts (before the last meeting) is appropriate. This means that a terminal Selic of 7.00% in the cycle is a lower bound for the tightening considered ahead. We look for terminal rate of 7.50% this year, with risks slightly skewed to the upside.
- July's IPCA registered a 0.96% MoM change (8.99% YoY), in line with our call and consensus, both at 0.95%. The inflation composition worsened further, in our view, with industrial goods still under pressure and services gathering momentum. This adverse combination is causing underlying inflation gauges to speed up to risky levels.
- This week’s activity reports brought mixed signals from the tertiary sector in June. On a sequential basis, retail sales plummeted 2.3% MoM-sa, while the real services revenues lept 1.7% MoM-sa. Yet June was a good month for the broad economy, as the IBC-BR (the BCB’s monthly GDP proxy) rose 1.1% (consensus: 0.5%). This imparts upside risk to our forecast of a flattish GDP for 2Q21 in sequential terms.

Most of the information in this report is up to the end of Thursday, August 12, 2021.

Figure 1. Brazil Macro Agenda for the Week of August 16-20, 2021

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
Inflation: IGP-10 (% MoM)	FGV	Aug/21	Tue,17-Aug	--	0.18
Federal Tax Collection (BRL billion)	RFB	Jul/21	20 a 25-Aug	154.8	137.2

Source: Santander.

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

[1] **Santander Brazil - Macroeconomic Scenario:** ***"Advances in Controlling the Pandemic, Setbacks in Quelling Inflation"* –** Aug 12, 2021- Available on: http://bit.ly/Std-scenrev-081221

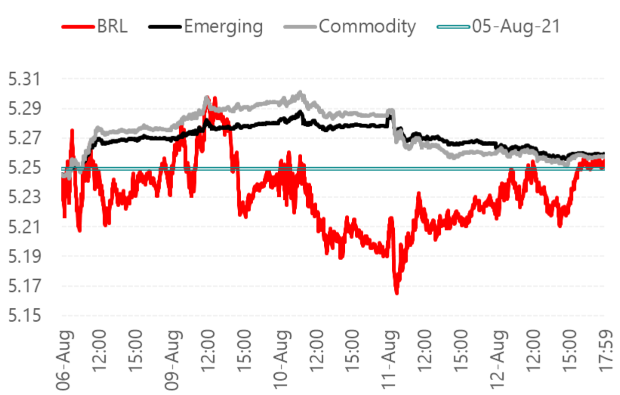
LOCAL MARKETS—FX

The BRL stood out among major currencies in the rolling week ended August 12, as it remained relatively stable against the USD on the heels of the hawkish wording seen in the minutes of the last Copom meeting (more details in the Monetary Policy section). In our view, the hawkish message conveyed by the Brazilian Central Bank (BCB) helped the USD/BRL pair to remain at 5.25 (a 0.1% loss), despite the strengthening of the USD and the steepening of the US yield curve. The developments in the US markets took place as July PPI showed that cost push inflation is still not abating and the US Senate passed legislation for new fiscal incentives. These factors help feed markets conjecture about an earlier removal of monetary stimulus. Although we surmise the prospects for a tighter monetary grip by the BCB should offset some weakening pressures on the BRL in the short term, we continue to see limited room for any substantial and perennial strengthening of the currency in the absence of progress regarding the reformist agenda in Brazil, which should weigh on its performance over the medium run. And that is even more true if global financial conditions deteriorate on less accommodation from key DM central banks. See details in the ink[2].

LOCAL MARKETS—Rates

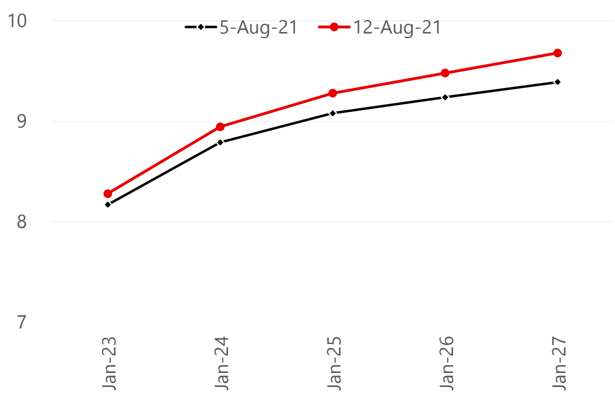
The nominal yield has shifted higher again, with a bear-steepening pattern. Since last Thursday (August 5), the front end of the curve (Jan-23 DI future) rose by 11 bps to 8.28%, while the back end of the curve (Jan-27 future) rose 29 bps to 9.68%. As a result, the curve's steepness in this segment rose 18 bps to 140 bps. At the front end, the market seems to have read the COPOM minutes as more hawkish than last week's statement, a view we do not subscribe to (see more on the Monetary Policy section). Moreover, July's IPCA inflation showed, once again, an unfavorable outlook for inflation (see more on the Inflation section). As a result, short yields rose. The options market has priced in an implied probability of 75% of a 100-bps hike for the next COPOM meeting in September (higher than the 70% probability of last week), in line with our forecast. Indeed the implied Selic for December 2022 embedded in the curve is currently 8.15%, compared to 7.99% last week. At the long end, on top of the continuation of the uncertainty regarding the path of the fiscal policy and the consolidation process, this time the 10 year US Treasury rate also rose, adding further pressure to the back end of the Brazilian curve.

Figure 2.A. – USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note1: As of the close Thursday, August 12, 2021.
Note2: For other currencies, we use USDBRL values as a base-index

Figure 2.B. – Brazilian Domestic Yield Curve (% p.a.)



Sources: Bloomberg, Santander.
Note: As of the close Thursday, August 12, 2021.

[2] **Santander Brazil - Macroeconomic Scenario: *"Advances in Controlling the Pandemic, Setbacks in Quelling Inflation"* –** August 12, 2021- Available on: http://bit.ly/Std-scr-review-aug21

COVID-19 MONITORING

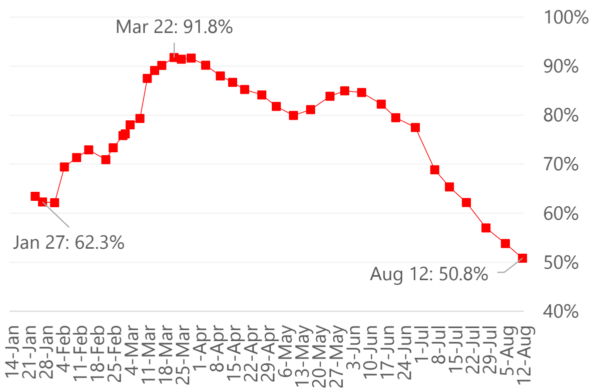
Brazil's vaccination pace reaches 1.5 million doses a day on average as of Wednesday, August 11. We expect this average pace to hold throughout 2H21, as vaccine inventories remain high (42 million doses) and deliveries are expected to remain above the levels of vaccine administration. With nearly all adults partially immunized with the first dose, the national schedule is set to resume the roll out among children. This is the case of São Paulo state, where children ages 16 to 17 could begin receiving shots as soon as August 18.

Health conditions continue to improve gradually. Our proxy for a nationwide average ICU occupancy rate continues to decline, now close to 51%, the lowest level in our series (begun in January). That number compares to a previous peak of 92% (late March). Data from Brazil's Health Ministry showed that the 7-day average of infections stood at 31k as of Wednesday (August 11), down 4% from last week; as for casualties, the 7-day average stood at 877, down 4%.

Urban mobility back to its trend of recovery. August's data so far indicates a recovery of mobility since last week, with our lockdown index now moving to 4.6 points (as of August 5, 2021) from 7.0 points (as of July 31, 2021). This move stems from increases in all the main categories, with Workplaces running above the pre-pandemic levels and Retail posting the best figures since December-2020. Mobility runs at low levels, especially if we exclude the 2020 Christmas period (December 22 to 24), meaning a fast convergence to a "normality" in coming months (as vaccination advances).

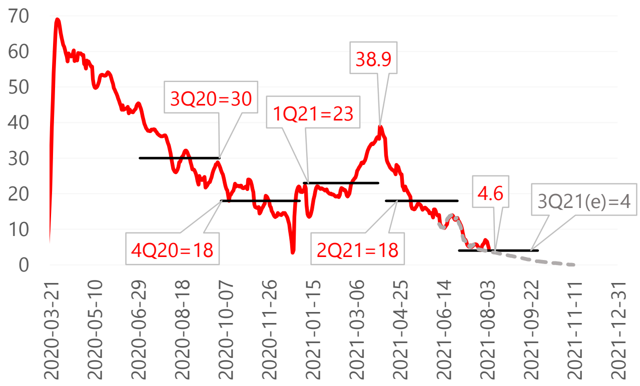
Our daily activity index has maintained a slower pace across 3Q21. The index—based on daily data on energy consumption, car sales, and mobility—showed an upward trend from April to June; on a monthly basis adjusted for seasonality, the index expanded by 5.6%, 3.0% and 4.2% in April, May and June, respectively. However, the index seems to have started 3Q21 at a slower pace, with a 0.8% drop in July, and considering the daily average of August (up to the 5th) we calculate a 0.1% contraction. The index is at levels 4.5% below February-21 (before the pandemics resurgence period this year).

Figure 3.A. – Nationwide Average ICU Occupancy Proxy (%)



Sources: @coronavirusbra1, Santander.

Figure 3.B. – Lockdown Index*, Mobility Forecasts (Feb/20=0, 7-day average)



Sources: Google, Santander.
* This index is built as an average of selected segments from Google Mobility Report with inverted scales. Data are available until August 05, 2021.

FISCAL POLICY AND POLITICS

On Monday (August 9), the government submitted to congress a provisional measure to create a new welfare program named as *Auxílio Brasil*, in replacement of the *Bolsa Família* program. The proposed text does not establish the value of the new benefit and, according to the government, the total budget and parameters will be decided by early 4Q21. President Bolsonaro suggested that the average monthly benefit of the new welfare program will be raised at least 50%, which means going from the current ~BRL190 to BRL 300. In addition, Joao Roma, the Minister of Citizenship, said payments will start in November (the Emergency Aid is expected to end in October) and should be expanded to cover more 16 million families from 14.6 million at present. Importantly, the program will be subjected to the constitutional spending cap limit. It is important to notice that *Auxílio Brasil* needs to be approved by Congress and enacted by December, given that increases in this type of expenditure are legally forbidden in election years. In our view, the program size will be contingent on the spending cap margin for 2022 (we estimate at BRL22 billion) as well as the approval of a new framework for the settlement of judicial claims (*PEC dos Precatórios,* see details below). In our scenario, we consider a total budget of BRL55-60 billion, reaching ~17 million families with monthly pay of BRL270-300.

On the same day, the administration unveiled a constitutional amendment proposal to stagger court-mandated debts (so-called "*Precatórios*"), after the official estimate soared to BRL90 billion. The legislation proposes that court orders in excess of BRL66 million may be paid in ten installments, 15% in advance and the remainder in annual installments. There will be a cap on yearly disbursements with judicial claims through 2029, with the limit set at 2.6% of "current net revenue" of the previous year. According to the government economic team: "the bill brings predictability and is a better proposal than excluding such expenses from the spending cap". The proposal would postpone BRL33.5 billion in expenses in 2022, with judicial claims liabilities estimate for next year falling to ~BRL55.6 billion in, close to the government's initial expectation. The bill can also include provisions on a special purpose fund exempt from the spending cap, for debt relief and judicial claims payment. The funding would be originated by privatization receipts, anticipated oil revenues, sales of government real estate and SOE dividends. In our view, the pushing back of judicial claims is a hedge against a more dramatic narrowing of the spending cap margin for 2022.

The income tax reform vote in the Lower House was postponed and is initially scheduled for Tuesday (August 17). There is still no agreement among party leaders to vote on the proposal. The rapporteur, Celso Sabino (PSDB-PA), proposed another draft bill for congressional analysis (with a more neutral revenue effect for subnational entities). The Lower House approved last week a procedural vote to expedite voting on the house floor. In our view, further discussions and negotiations ought to take place before the matter is ready to be put to vote.

Next week, July federal tax collection could be published by the Brazilian Revenue Service. Our preliminary estimate is BRL154.8 billion (or ~24% YoY, in real terms), the best result for the month since 2011, in real terms.

Figure 4.A. – Fiscal Margin and Budget Simulations

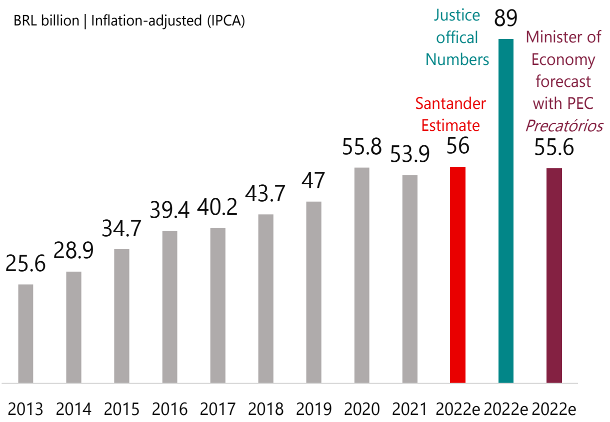
2022 Budget: Spending Cap Margin - BRL bn						
	Court-oredered debts Budget (*"Precatórios"*)					
	BRL bn	30	40	55	65	90
Year-end Inflation (INPC | Dec-21)	6.5%	60	50	35	25	0
	7.0%	55	45	30	20	-5
	7.8%	47	37	22	12	-13
	8.5%	41	31	16	6	-19
	9.0%	37	27	12	2	-23
	10.0%	28	18	3	-7	-32

New Welfare Program Budget - BRL bn						
	Monthly Average Benefit (BRL/month)					
		250	270	300	350	400
Families (millions)	17	51	55	61	71	82
	16	48	52	58	67	77

Bolsa Família's current budget (2021): BRL35 billion/year | Total: 14.6 million families

Sources: National Treasury, Santander.

Figure 4.B. – Judicial Claims Budget ("*Precatórios*")



Sources: Minister of Economy, National Treasury, Santander.

MONETARY POLICY

The Brazilian Central Bank (BCB) published the minutes from its August 3-4 COPOM policy meeting, where the authority raised the Selic rate by 100 bps (for a fourth time running) to 5.25% p.a. Overall, the BCB kept a hawkish tone, but in line with the policy statement, in our view.

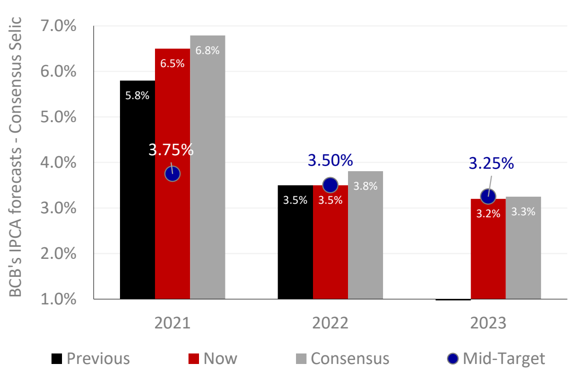
While the BCB indicated that "the inflation projections are aligned to the targets for 2022 and 2023" (assuming Selic at 7%), it kept the message that "the fiscal risks continue to imply an upward bias in the projections", which justify "a path for monetary policy that is more restrictive than the one used in the baseline scenario." The BCB also went on to say that its models indicate that "subsequent uninterrupted interest rate increases are required up to a level above the neutral rate, to obtain projections around the inflation targets in the relevant horizon" (Paragraphs #13 and #14).

The BCB reaffirmed the message in the communiqué, as it believes that "the recent worsening in inertial components of inflation, amid the reopening of the service sector, could cause a further deterioration in inflation expectations," which could increase "the costs for its future convergence", according to the BCB. The authority concluded that "a quicker adjustment of monetary policy is the most appropriate strategy at this time to assure the convergence of inflation to its targets for 2022 and 2023". The board also emphasized on "its unequivocal commitment to the pursuit of its inflation targets over the relevant horizon for monetary policy, guided by its baseline scenario as well as its assessment of the balance of risks." (Paragraphs #16 and #17).

In our view, the BCB is signaling that a trajectory of hikes of 100 bps in September and further moves leading to a terminal Selic of 7.00% in the cycle is a lower bound for the tightening being considered ahead by the BCB (conditional on the scenario). Thus, we believe the BCB used the minutes to further strengthen the message that it will do what is necessary (i.e., faster and/or greater hikes) to bring inflation down to the 3.50% mid-target next year, however elusive that task may prove ahead.

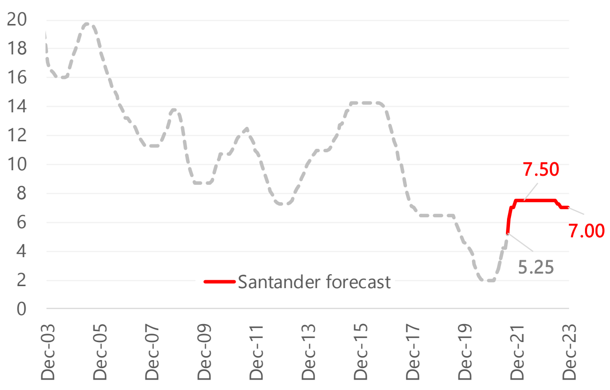
We continue to look for another hike of 100 bps (to 6.25%) in September, a subsequent move of 75 bps in October and 50 bps in December, with our terminal rate expectation at 7.50%. We expect the Selic rate to remain at this level throughout 2022, with an expected reduction towards (our hypothesis of) the neutral level of 7.00% only in 2023. That's the horizon when we finally expect IPCA inflation to converge to the mid-target (3.25%), declining from a likely reading of 4.1% (our expectation for the IPCA next year). See details in the link[3].

Figure 5.A. – BCB's Inflation Simulations



Sources: Brazilian Central Bank, Santander.
Note: BCB simulations assume Selic rate from Focus survey and USD/BRL starting at 5.15 and evolving with purchase power parity.

Figure 5.B. – The Selic Rate Path (% p.a.)



Sources: Brazilian Central Bank, Santander.
Note: This path shows monthly averages.

[3] **Santander Brazil Monetary Policy - *"More Than the Simulations"* –** August 10, 2021 – Available on: https://bit.ly/Std-Copom-min-aug21

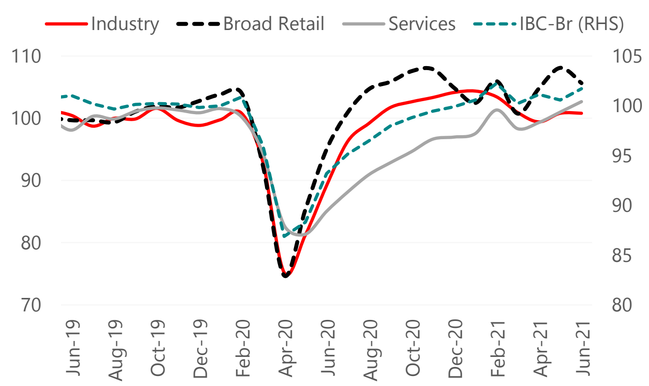
ECONOMIC ACTIVITY

Retail activity retreated in June but recorded a quarterly expansion. Following two gains in a row, broad retail sales fell 2.3% MoM-sa, below market consensus (-1.8%) and in line with our estimate (-2.0%). Regarding core retail sales (ex-building materials and vehicles sales), the index surprised negatively by retreating 1.7%, well below the market's lower estimate (-1.0%), but with upward revisions in the series. Despite June's drop, both indexes remain above the pre-pandemic level. Zooming in on the details, this retreat was less widespread than our expectations, with six of the ten retail segments posting monthly declines, with income-led segments as a drag and credit-led segments as a cushion. Clothing stood out by retreating 3.6%, while Supermarkets fell slightly, -0.5%. Furniture and Building Materials showed resilience by expanding 1.6% and 1.9%, respectively, while Vehicles surprised positively by retreating only 0.2%, amid disruptions in the supply chain due to cost increases and a widespread shortage of inputs. Looking ahead, our proprietary indicator (IGet) points to broad retail sales sequentially retreating in July: our tracking stands at -0.2% MoM (4.6% YoY). See details in the link[4].

Real revenue of services surprised to the upside again, reinforcing a solid quarterly expansion. The headline index was up by 1.7% MoM-sa (+21.2% YoY), well above the market consensus of +18.2% YoY and the third gain in a row, fully erasing March's loss (-3.4%). After returning to pre-pandemic levels in May, the headline index now remains 2.4% above that mark. Among subsectors, widespread growth, with mobility-related services in the spotlight. Services to families climbed 8.1%, above the +6.4% pointed to by our proprietary index and fully offsetting March's tumble (-28%). Transport services also posted a considerable expansion (up by 1.7%), stemming mainly from the sharp climb of 21.2% for Air Transport. All the remaining sectors also posted sequential gains in June. In quarterly terms, with June's figure, 2Q21 ended with an expansion of 2.0%, leaving a 1.7% carryover for 3Q21. See details in the link[5].

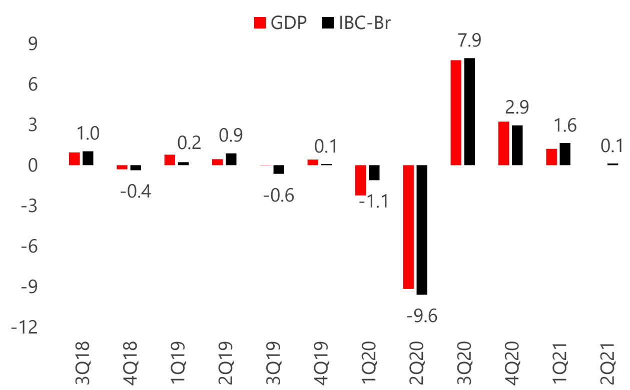
The IBC-Br (monthly GDP proxy) was up by 1.1% in June (we estimated 0.8%), ending 2Q21 with a slight growth of 0.1%. While in qualitative terms this is still in line with our expectations of a modest GDP figure in 2Q21, the result imparts a little upside risk to our current projection (0.0% QoQ-sa). In our scenario, we expect some heterogeneity in the composition of economic activity. As highlighted in the official releases, the tertiary sector contributed positively, on the heels of the faster-than-expected recovery of urban mobility and the new round of Emergency Aid. On the other hand, we expect farm output to partially give back its positive GDP contribution (around 0.6 in 1Q21) and industry, as highlighted in the official releases, to be a short-term drag on the recovery, likely reflecting cost increases and the widespread shortage of inputs seen in manufacturing and construction.

Figure 6.A. – Economic Activity Breakdown (sa, Jan-19=100)



Sources: IBGE, Brazilian Central Bank, Santander.

Figure 6.B. – IBC-Br and GDP (sa, QoQ %)



Sources: IBGE, Brazilian Central Bank, Santander.

[4] **Santander Brazil Economic Activity - *"Retail Sales Post Monthly Drop, Quarterly Expansion"* –** August 11, 2021 - Available on: https://bit.ly/Std-Econact-081121

[5] **Santander Brazil Economic Activity - *"Solid Growth for Services at the End of 2Q21"* –** August 12, 2021 - Available on: https://bit.ly/Std-Econact-081221

INFLATION

July's IPCA registered a 0.96% MoM change (8.99% YoY), in line with our call and consensus, both at 0.95%. The headline accelerated further to 10.6% in 3MMA-saar terms, providing evidence of the upward pressure remaining strong at the margin.

There were no major surprises in the main groups. Services contributed just -1 bp to the headline forecast error, while food contributed +1 bp, industrial goods -1 bp and regulated prices +3 bps. However, this does not mean that results were favorable in terms of inflation dynamics for each group. Industrial goods remained under strong pressure, accelerating from 12.1% to 12.5% 3MMA-saar, while services — that used to be the bright side a few months ago — accelerated from 2.7% to 5.1% 3MMA-saar. More importantly, despite a small downside surprise (driven by food services), services' core also accelerated to the considerably high level of 6.1% from 4.2% 3MMA-saar.

Qualitative measures deteriorated further at the margin, reinforcing our view of an unfavorable inflation outlook for the short term (and our call for another 100-bp Selic hike in the next Copom meeting). All of the five main core gauges rose further at the margin, with the average of them going from the already high level of 6.7% to 7.6% in 3MMA-saar terms, and it has been hovering above the target (and distancing further from it) for 10 months now. This is evidence of primary shocks spreading (commodities, FX, supply chain disruption, etc.) to the general prices and the persistency at these high levels is risky.

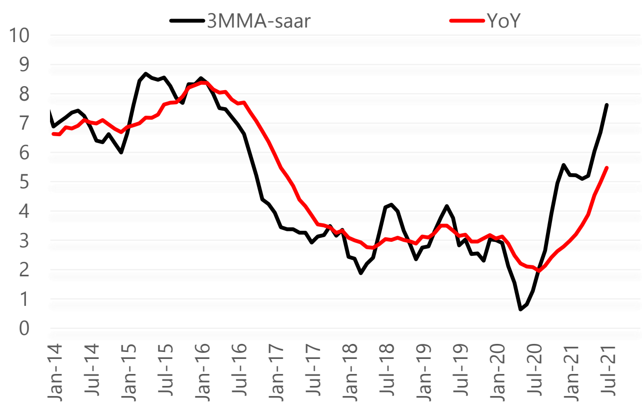
Our worries regarding the inflation outlook keep piling up for two key reasons: (i) We see a large backlog of prices at the wholesale level that should still come to the consumers; and (ii) we are seeing the second-order effects (primary shocks spreading to general prices) getting stronger, which could worsen once the economy picks up as the pandemic starts to fade (especially in services). In particular, we are already seeing services inflation picking up, while industrial goods inflation remains upwardly pressured at the margin, which is an unfavorable composition for IPCA inflation (both groups are closely related to core measures). Our forecasts are at 7.3% for IPCA 2021 and 4.1% for IPCA 2022, but we are seeing upside risks for both horizons. See details in the link[6].

Figure 7.A. – July's IPCA Results Details (%)

	MoM			YoY	
	Jul-21	Santander	Contrb.	Jun-21	Jul-21
IPCA	0.96	0.95	0.01	8.3	9.0
Administered	1.68	1.58	0.03	13.0	13.5
Free	0.70	0.72	-0.01	6.8	7.4
Food-at-home	0.78	0.84	-0.01	15.3	16.0
Industrial goods	0.69	0.65	0.01	8.8	9.2
Services	0.67	0.70	-0.01	2.2	3.0
EX3 Core	0.54	0.65	-0.11	5.1	5.6

Sources: IBGE, BCB, Santander.

Figure 7.B. – Average Core Inflation (IPCA %)



Sources: IBGE, BCB, Santander.

[6] **Santander Brazil Inflation - *"July IPCA: Composition Worsens Again, With Underlying Inflation Deteriorating Further"* –** August 10, 2021 - Available on: http://bit.ly/Std-IPCA15-jul21

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*	Economist – Inflation	daniel.karp@santander.com.br	5511-3553-9828
Tomas Urani*	Economist – Global Economics	tomas.urani@santander.com.br	5511-3553-9520
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
Gabriel Couto*	Economist – Special Projects	gabriel.couto@santander.com.br	5511-3553-8487
Gilmar Lima*	Economist – Modeling	gilmar.lima@santander.com.br	5511-3553-6327
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
Mariana Cahen Margulies*	Head, Brazil	mmargulies@santander.com.br	5511 3553 1684
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