BRAZIL MACRO

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MACRO COMPASS

Commodity Prices Trend in BRL Sees (Tentative) Stabilization

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- For the rolling week ended on July 14, the USD/BRL cross once again neared the 5.50 level at one point (peaking at 5.49 this time), but it strengthened back to 5.42 in the last few days (accumulating a weekly loss of ~1.5%, underperforming most other major currencies). In our view, the Brazilian currency is being held back by the global sell-off in risky assets (amid fears related to an even tighter U.S. monetary policy, leading to a possible global recession) and renewed expectations of a riskier fiscal outlook ahead. In our view, structural macroeconomic reforms will have to be a key factor behind a sustained and substantial strengthening of the Brazilian currency.
- The international sell-off of risky assets also spilled over into Brazil's fixed income markets, with nominal yields widening ~30 bps across (most of) the curve for the week. We believe the sell-off is the result of a combination of global and local factors, including expectations of a more hawkish Fed reaction leading to a possible U.S. recession, as well as inflationary jitters with the introduction of additional fiscal stimulus in Brazil (as a new package has just cleared Congress). The market prices in an 80% probability of a 50-bp hike (to 13.75%) at the August 2-3 Copom meeting and a little more tightening subsequently. Expectations of rate cuts for 2023 seem to be fading in the yield curve, amid fears of (even more) persistent inflation.
- Commodity prices fell for another week, the fifth in a row, on growing fears of a global recession, as central banks step up their efforts to quell decade-high inflation pressures. The Bloomberg Commodity Index fell 3.2% in the rolling week ending on July 14. In BRL terms, the index fell 1.3%, as the currency depreciated. Importantly, while commodity prices in BRL terms are down ~11% from the peak seen in March (but still up ~10% in the last six months), the 50-day moving average (a better gauge of the potential for a pass-through to "real economy" prices) has been roughly flat of late, meaning that a broader CPI reaction could still be a few months away.
- The week brought mixed signals from tertiary activities in May, but we continue to expect a strong GDP number for 2Q22. On the one hand, services output continued to strengthen and jumped 0.9% MoM-sa, topping market expectations (+0.2% MoM-sa). On the other hand, broad retail sales disappointed by inching up only 0.2% MoM-sa, lagging the market consensus (+1.7% MoM-sa). As an upshot, the BCB's IBC-Br index — sort of a monthly GDP proxy — inched down 0.1% MoM-sa, the second monthly contraction in a row. Bearing in mind the different methodologies (GDP vs. IBC-Br), we are updating our 2Q22 GDP growth tracking to +0.8% QoQ-sa (from +0.7%). We have recently upgraded our 2022 GDP forecast to +1.9%, but we maintain our expectation of a recession next year, as we look for a 0.6% contraction in 2023.
- The National Congress approved the budget guidelines legislation (LDO, in Portuguese) for 2023, including a central government primary budget deficit target of BRL66 billion (0.7% of GDP), the tenth negative annual number in a row. Also, this week the Lower House passed legislation to boost federal social spending. That change, made via a constitutional amendment, implies BRL42 billion in expenses above the constitutional limit in 2022. June federal tax collection data could be published by the Brazilian Revenue Service sometime next week; we expect a robust performance, led by a strong commodity cycle, an improving job market, and a high inflation picture. Our forecast would mean an all-time high in real tax collection for the month.

Most of the information in this report is up to the end of Thursday, July 14, 2022.

Figure 1. Brazil Macro Agenda for the Week of July 18 to July 22, 2022

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
Inflation: IGP-10 (% MoM)	FGV	Jul/22	Mon, 18-Jul	-	0.74
Federal Tax Collection (BRL billion)	**RFB**	**Jun/22**	**20 to 26-Jul**	**172.1**	**165.3**
Primary Budget Balance (BRL billion)	BCB	May/22	n.a.*	-	39
Net Debt (% GDP)	BCB	May/22	n.a.*	-	58
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

* These data releases have been postponed in the context of the strike of BCB workers, and still have not been rescheduled.

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: "Better *Activity Expected in the Short Term, with Higher Interest Rates (Even) Longer"* –** July 14, 2022- Available on: https://bit.ly/Std-scenupdate-jul22

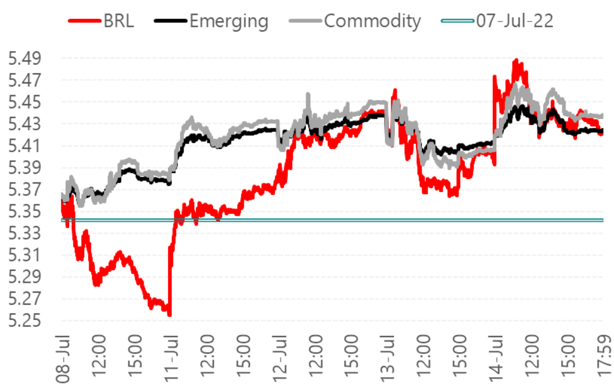
LOCAL MARKETS—FX

For the rolling week ended on July 14, the USD/BRL cross once again neared the 5.50 level at one point (peaking at 5.49 this time), but it strengthened back to 5.42 in the last few days (accumulating a weekly loss of ~1.5%, underperforming most other major currencies). The global sell-off in risky assets keeps weighing on the Brazilian currency. Following the higher-than-expected CPI reading in the U.S., global financial markets see a higher probability of swifter monetary policy tightening in the world's largest economy, which could prompt a strong economic deceleration (or even a recession) that could affect the entire global economy. At the local level, uncertainties regarding the future of domestic economic policy have also affected the performance of the BRL (and other Brazilian assets) lately. In our view, structural macroeconomic reforms would have to be a key factor behind a sustained and substantial strengthening of the Brazilian currency.

LOCAL MARKETS—Rates

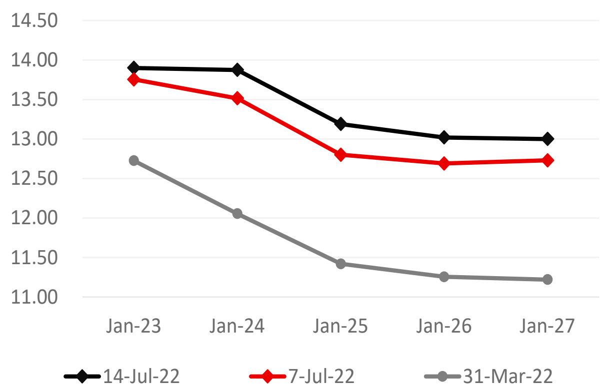
The global sell-off of risky assets also spilled over into Brazil's fixed income markets, with nominal yields widening ~30 bps across (most of) the curve for the week. Since last Thursday (July 7), the front end of the curve (denoted by Jan-24 DI future) rose 36 bps, to 13.88%, while the back end (denoted by Jan-27 DI future) rose 27 bps to 13.00%. The steepness in this segment fell another 9 bps, widening the inversion to -88 bps (with pricing as of the July 14 closing). We believe the sell-off is the result of a combination of global and local factors. On the external front, the higher probability of more front-loaded monetary tightening in the U.S. and the resulting jitters about a possible recession in the world's largest economy keep causing shock waves across the globe, particularly hitting EMs. The international factors seem to be playing a role in the widening of rates at both the front end (via a weaker FX) and the back end (possibly influencing an increase in Brazil's sovereign CDS spread — with the five-year contract reaching 330 bps, the widest since May 2020). On the domestic front, the still-solid trend numbers from real activity in 2Q22 and, most importantly, the addition of further fiscal stimulus (a new bill was finally approved in Congress this week) in the context of an output gap that is apparently more closed than previously thought, implies the risk of even more persistent CPI pressures. In our view, the latest stimulus package seems to be playing a role at both the front end (via expectations of an even higher Selic rate for even longer) and the back end (given perceptions of a more challenging fiscal outlook for the medium run). Judging from the options market, traders price in an 80% probability of a 50-bp Selic hike (to 13.75%) at the August 2-3 Copom policy meeting. Additional hikes also seem to be priced in the futures curve, for both September and October. Moreover, expectations of rate cuts for 2023 seem to be fading in the local yield curve, given the fears of (even more) persistent inflation.

Figure 2. USD/BRL – Intraday Trends



Sources: Bloomberg, Santander.
Note 1: As of the close on Thursday, July 14, 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.

COMMODITIES

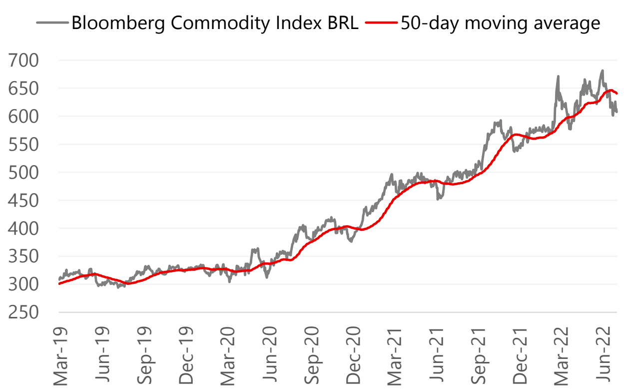
Commodity prices fell for another week, the fifth in a row, on growing fears of a global recession, as central banks step up the efforts to quell decade-high inflation pressures. The Bloomberg Commodity Index fell 3.2% in the rolling week ending in July 14. The biggest contributor was the Metals Subindex, which fell 7.4%, while Energy fell 3.1% and Agriculture was down 2.7%. In BRL terms, the Bloomberg Commodity Index fell 1.3%, as the currency depreciated during the week. Importantly, while commodity prices in BRL terms are down ~11% from the peak seen in March (but still up ~10% in the last six months), the 50-day moving average (a better gauge for the potential for a pass-through to "real economy" prices) has been roughly flat of late, meaning that a broader CPI reaction could still be a few months away.

Brent oil prices are consolidating levels below USD 100/bbl this week. On Tuesday (July 12), the Brent oil price was at USD99.50/bbl. Throughout the week the dynamic worsened a bit, and the commodity ended at USD99.10/bbl, an 5% decline, marking the lowest level since the beginning of the war in Ukraine. Markets continue to struggle under the weight of recession fears and are anticipating a slowdown in global economic activity (and therefore lower oil demand). However, supply issues continue to loom, as the supply of Russian gas to Europe worsened at the margin, given that negotiations for the delivery of a Russian turbine (now undergoing maintenance in Canada) do not seem to be advancing. When winter in the Northern Hemisphere draws near, we believe supply constraints will again start to weigh on price formation, leading to an oil price rebound back above USD100/bbl. Our forecast is USD115/bbl for YE2022.

Agricultural prices also fell in aggregate, but corn prices managed to post gains. Recession fears continue to affect the agriculture sector as well, especially after the U.S. government raised its stock estimate on the heels of a lower demand forecast. However, the weather still means (upward) risks for grain prices: that led to a partial rebound as traders monitor the risks for crops in the U.S. and Europe. Corn prices in USD terms ended the week higher (+0.5%) after that rebound, but soybeans remained in the red (down 1.6% for the week). In BRL terms, however, corn prices rose 2.5% and soybean prices were flat. We believe that stock-use ratios remain at historically low levels even with slowing demand, thus sustaining prices, and we forecast a price rebound in the medium term.

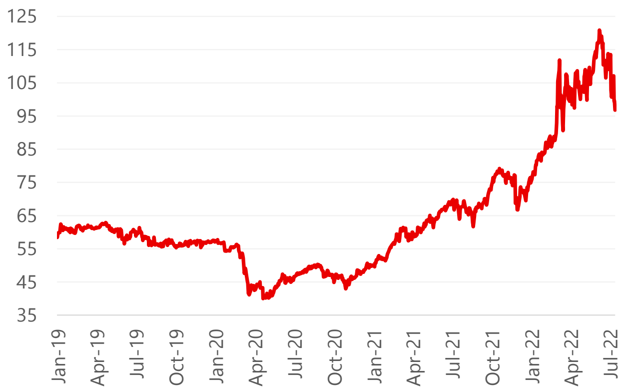
Metals were the focus, with iron ore plummeting 12%. In China, COVID-related news (and the possibility of further lockdowns in major cities) worsened at the margin, which possibly weighed on expected metals demand (and prices). Amid fears of a global recession, iron ore was one of the most intensely battered commodities (price-wise) this week; prices are down 40% since the last peak in March and 55% below a previous peak in May 2021. Looking ahead, we foresee a rebound in metals prices once the economy safely reopens (with reduced risks of new lockdowns) and as China implements more economic stimulus.

Figure 4. Bloomberg Commodity Index in BRL



Sources: Bloomberg, Santander.

Figure 5. Oil (brent) First Future (US$/bbl)



Sources: Bloomberg, Santander.

ECONOMIC ACTIVITY

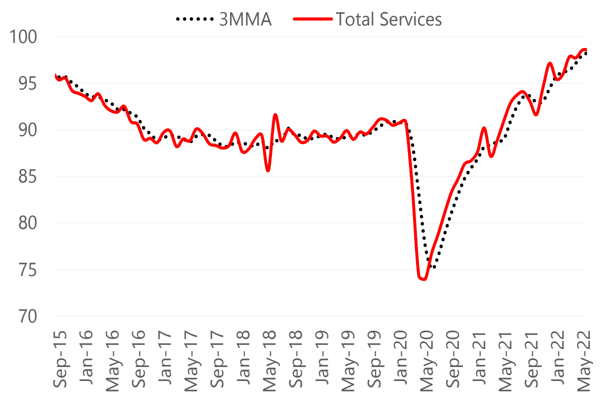
Services' real revenue topped expectations with solid and widespread growth in May. The headline index expanded 0.9% MoM-sa, beating market consensus of +0.2% MoM-sa, and compared to the same month in 2021, services output rose 9.2% YoY, also above market expectations of +8.5% YoY. May's print placed the index 8.4% above the pre-pandemic benchmark (February 2020) and at the highest reading since March 2015. The diffusion index rose to 83% (vs. 58% in April), with services provided to families (+1.9% MoM-sa), information services (+0.9% MoM-sa), and professional services (+1.0% MoM-sa) being the highlights. May's result led to a solid carryover of +1.9% QoQ-sa to 2Q22. See details in the link[2].

Retail activity disappointed and virtually flattened in May. Broad retail activity inched up 0.2% MoM-sa, well below market expectations of +1.7% MoM-sa. In comparison with the pre-pandemic mark, broad retail sales are up 1.2%. The details pointed to a mixed composition bag, with six of ten retail activities surveyed posting monthly gains. May's tepid print stemmed mainly from the strengthening of fuels (+2.1%), supermarkets (+1.0%), and clothing (+3.5%). Conversely, sales of other personal items (-2.2%), building materials (-1.1%), and furniture and home appliances (-3.0%) shrank at the margin. May's result led to a +1.2% QoQ-sa print for the broad index. See details in the link[3].

BCB's monthly GDP proxy marked a new retreat. The IBC-Br inched down 0.11% MoM-sa in May, slightly below market consensus of 0% MoM-sa and close to our call of -0.3% MoM-sa. The carryover calculated to 2Q22 was 0.2% QoQ-sa (+1.0% in 1Q22), and for June, we expect growth of 0.4% MoM-sa. Our 2Q22 GDP tracking was updated to +0.8% QoQ-sa (from +0.7% QoQ-sa previously). We believe domestic activity will turn sour in 2H22 once the effects of a tighter monetary policy start to kick in, but the additional recent fiscal stimulus could partially support demand in the period (with smoother weakening than previously thought). We forecast 1.9% GDP growth in 2022 and a 0.6% retreat in 2023. See details in the link[4].

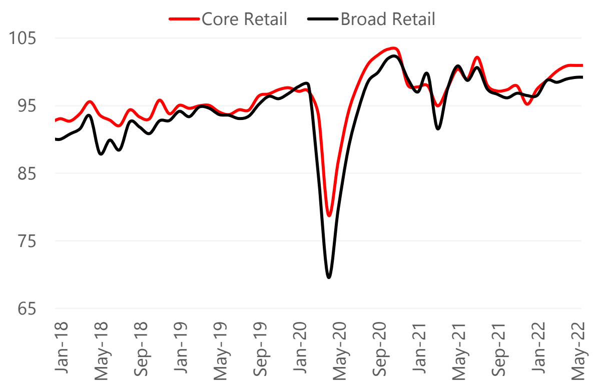
For details on Santander's economic outlook, please refer to our last reports[5].

Figure 6. Services Output (sa, average 2014=100)



Sources: IBGE, Santander.

Figure 7. Retail Sales (sa, average 2014=100)



Sources: BCB, Santander.

[2] **Santander Brazil Economic Activity: "*Solid and Widespread Growth for Services in May*"** – July 12, 2022 – Available on: https://bit.ly/Std-econact-071222
[3] **Santander Brazil Economic Activity: "*Tepid Retail Activity in May*"** – July 13, 2022 – Available on: https://bit.ly/Std-econact-071322
[4] **Santander Brazil Economic Activity: "*A New Weak Print for IBC-Br*"** – July 14, 2022 – Available on: https://bit.ly/Std-econact-071422
[5] **Santander Brazil Special Report: "*Nowcasting Brazilian GDP with LASSO*" –** June 14, 2022 – Available on: https://bit.ly/Std-special-051622
Santander Brazil Special Report: "*A Model to Forecast Probability of Recession in Brazil*" – June 08, 2022 – Available on: https://bit.ly/Std-special-060822
Santander Brazil Special Report: "*Resilience Factors for GDP Growth: What Has Changed Since January*" – June 30, 2022 – Available on: https://bit.ly/Std-special-GDP-062922

FISCAL POLICY AND LEGISLATION

On July 12, the National Congress approved the 2023 Budget Guidelines (LDO, in Portuguese). The government not only targets a primary deficit for the central government in 2023, for the tenth year running, but also has extended the expectation of a primary budget deficit until 2024. The law establishes a primary deficit target of BRL65.9 billion for the central government in 2023 and BRL27.9 billion in 2024. A primary surplus of BRL33.7 billion is seen for 2025. As far as our forecasts go, we anticipate a deficit of ~BRL120 billion for 2023, higher than the primary deficit target set by the LDO. On the expenditure side, a significant difference between our forecast and the official numbers is the estimated level for the constitutional spending cap in 2023: the PLDO estimates this limit will grow by 6.5%, compared to 7.9% in our calculations, based on our own inflation outlook[6]. This means that government expenses could potentially increase by an additional BRL25.2 billion, meaning extra room (under the cap) compared to PLDO, if our number is confirmed. Congress included a provision whereby the legislature can change the primary target and define the IPCA estimate for calculating the spending cap in the budgeting process. Congress also kept a budget allocation for the rapporteur's budget amendments (RP-9), worth BRL19 billion, but the executive branch retained the ability to freeze part of that if necessary. All in all, we believe that the government will face difficulties in accommodating spending demands in the 2023 budget proposal, so the LDO implies a challenging fiscal outlook for next year. Another downside risk (for fiscal performance) is the real activity assumptions, as the guidelines foresee 2.5% real GDP growth for 2023 (our estimate is -0.6%). This means revenue could eventually be revised down in the future steps of the budgeting process. Having been approved, the text will be signed into law by the president. Next week Congress begins its midyear recess, returning to its activities in August.

The Lower House approved in two rounds the constitutional amendment proposal (PEC 15/22) aimed at increasing fiscal transfers. For a third year running, we have seen a constitutional amendment to increase fiscal stimulus outside the constitutional spending cap limit (for which we see no fiscal margin for additional outlays). This legislation would entail BRL42 billion in government outlays outside the spending cap limit. The legislation includes a top-up of the welfare program *Auxílio Brasil* (with a "temporary" increase of BRL200 per month, starting in August), the doubling of cooking gas vouchers (*Auxílio Gás*) for low-income families, and the creation of a new diesel voucher for truckers. We estimate the monthly disbursement for *Auxílio Brasil* will rise to BRL12.7 billion per month (from BRL7.4 billion) by the end of the year. This new piece of fiscal legislation not only led us to revise down our budget balance estimate for 2022, but it also increases the downside risks for fiscal performance in 2023 and beyond.

June federal tax collection could be published by the Brazilian Revenue Service sometime next week, and we anticipate a solid performance, meaning the best result for the month in the inflation-adjusted series, totaling BRL172.1 billion (or +12.1% YoY, in real terms) on the heels of the price-shock effect and a recovery in employment-related revenue. **For details on Santander's fiscal outlook, please refer to our last chartbook**[7].

Figure 8. 2023 Budget Guidelines

BRL billion	2023e Budget Guidelines - LDO	Santander estimates	Difference Santander - LDO
Total Revenue	2,230.0	2,234.9	4.9
Transfers by Revenue Sharing	429.4	441.3	11.9
Net Revenue	1,800.9	1,793.6	-7.3
Total Expenditure	1,866.8	1,913.3	46.5
Social Security Benefits	849.5	854.6	5.1
Payroll - Public Servants	356.4	366.4	10.0
Other Mandatory Expenses	423.9	446.6	22.7
Expenses Subject to Financial Programming	237.0	245.7	8.7
Discretionary Expenses	108.2	120.0	11.8
Central Gov. Primary Balance	-65.9	-119.6	-53.7
Spending cap Limit - 2023	1,789.1	1,814.3	25.2
IPCA Dec % YoY - 2022	6.5	7.9	1.4

Sources: Ministry of Economy, Santander.

Figure 9. *PEC dos Auxílios* – Fiscal Stimulus

Expenditures	BRL billion	%GDP
Double Auxilio Gas Budget	2	0.0%
Transport for eldery (subsidy)	2.5	0.0%
Truckers voucher (1k benefit)	5.4	0.1%
Taxi Drivers voucher and Alimenta Brasil	2.5	0.0%
Ethanol (subsidy)	3.8	0.0%
Complement to Auxilio Brasil (BRL600) 2022	26	0.3%
Total	**42.2**	**0.4%**

Sources: Ministry of Economy, Santander.

[6] Note: the 2022 spending cap is adjusted by annual IPCA as of December 2022.
[7] **Santander Brazil Fiscal Policy:** ***"Chartbook - Back to Primary Deficit with Fiscal Stimulus"*** **–** July 14, 2022 – Available on: https://bit.ly/Std-chart-fiscal-jul22

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