Santander
Macroeconomic Research

BRAZIL MACRO

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MACRO COMPASS

AND THE BRAZILIAN RALLY GOES ON

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- **Errata: This version corrects our "LOCAL MARKETS – Rates" section with our updated comments on the yield curve.**
- The BRL was the top performer among major currencies in the rolling week ended June 17, being the only one to strengthen vs the greenback in the period (1.0% to USD/BRL 5.01), reaching the strongest level since June 2020. This movement contrasted with the hawkish surprise seen in the FOMC meeting and relatively unfavorable news for commodities prices these days. We believe the maintenance of relatively sanguine market conjectures regarding the fiscal outlook and the tougher wording displayed in the post-decision communiqué of the last Copom meeting are behind the BRL's outperformance. These elements also help explain the bear flattening observed in the domestic yield curve in the same period, with the nominals curve boasting the flattest reading since March 2020.
- Once again, the Copom hiked the Selic policy rate by 75bps (to 4.25%, now), in a decision that was broadly in line with the market expectation. The tone of the statement shows the central bank is responding to the deterioration in the inflation outlook in a adequate, balanced manner. The BCB now plans a full normalization of the policy stance (i.e. Selic hikes up to 6.5%) and has left the door open for an even faster removal of stimulus if expectations deteriorate further. We continue to project a terminal Selic rate of 7% in 1Q22.
- New COVID-19 infections and casualties remain stubbornly high. Yet the vaccination pace is back on the rise, reaching the mark of one million/day (our baseline scenario), and we expect further acceleration in the coming weeks. Meanwhile, the government's official schedule of vaccine shots arriving in the country for July's was revised to 42 million (from 35 million).
- This week (June 15) we published a report in which we explored the fiscal impact from the pandemic and the recent price shocks (higher inflation and terms of trade). In the piece, we also present our fiscal policy projections. In our view, the pandemic's impact took the fiscal consolidation process four years back.
- The BCB's activity indicator (IBC-Br) surprised negatively in April with an 0.4% MoM-sa expansion, below the consensus (1.3%) and our call (0.8%). April's figure placed the economy 0.2% above the pre-crisis mark. Despite the monthly growth, it was not enough to offset March's retreat. We believe this weak start for broad activity reinforces the likelihood of a weaker GDP growth for 2Q21. For the week, FGV will release next week the first batch of consolidated economic confidence data for June.
- We expect June's IPCA-15 (due on Friday, June 25) to rise 0.82% MoM, meaning an acceleration in annual terms to +8.1% YoY (from +7.3% YoY in May), meaning another multi-year high. Headline inflation keeps moving further away from the upper bound of the BCB's target for 2021.
- We expect May's balance-of-payments data (due on Friday, June 25) to show that the Brazilian economy continues to boast a solid external position, favored by a favorable shock in the terms of trade.

Most of the information in this report is up to the end of Thursday, June 17, 2021.

Figure 1. Brazil Macro Agenda for the Week of Jun 21-25, 2021

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
Copom minutes	**BCB**	**--**	**Tue, 22-Jun**	**--**	**--**
Consumer Confidence (index)	FGV	Jun/21	Thu, 24-Jun	**--**	76.2
Quarterly Inflation Report	**BCB**	**2Q21**	**Thu, 24-Jun**	**--**	**--**
Construction Confidence (index)	FGV	Jun/21	Fri, 25-Jun	--	87.2
IPCA-15 Inflation (% MoM)	**IBGE**	**Jun/21**	**Fri, 25-Jun**	**0.82**	**0.44**
IPCA-15 Inflation (% YoY)	**IBGE**	Jun/21	Fri, 25-Jun	**8.1**	7.3
Current Account Balance (US$ billion)	**BCB**	May/21	Fri, 25-Jun	**4.6**	5.7
Foreign Direct Investment (US$ billion)	**BCB**	May/21	Fri, 25-Jun	**2.5**	3.5
Federal Tax Collection (BRL billion)	RFB	May21	21 to 25-Jun	139.7	156.8

Source: Santander.

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

[1] **Santander Brazil - Macroeconomic Scenario: *"Monetary Stimulus Doomed to End Sooner"* –** May 20, 2021- Available on: http://bit.ly/Std-scr-review-may21

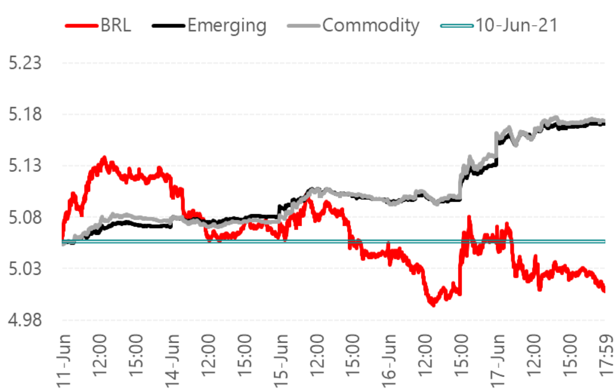
LOCAL MARKETS—FX

The BRL was the only currency among the majors that "survived" the hawkish surprise seen in the FOMC meeting, owing to the tougher wording of the Brazilian monetary authority and (perceived) lower fiscal risks, in our opinion. The Brazilian currency reached its strongest level since June 2020. The projections of interest rate hikes earlier than previously thought displayed in the FOMC's dot plot last Wednesday surprised completely economic agents, as the general expectation was for the maintenance of a more dovish approach. As a result, the USD gained versus all currencies except for the BRL in the rolling week ended June 17. On top of surviving this unexpected hawkish innovation in the FOMC's conduct, the BRL also resisted the negative news cycle for commodities markets on the heels of Chinese attempts to limit the rising trend of their prices – which has led to inflationary pressures in that country – and the release of weaker-than-expected activity indices in the country – which may turn into a milder demand for commodities in the future. The USD/BRL pair ended the period at 5.01, which meant a 1.0% strengthening of the BRL versus the greenback. We believe the maintenance of a relatively sanguine assessment of the domestic fiscal front, stemming from upward revisions in the GDP growth and tax collection, as well as downward revisions in government debt level helped on that move. However, in our view, the greatest influence for the BRL strengthening stemmed from the tougher wording presented in the Copom statement - see details in the Monetary Policy section. While we expect monetary policy to favor the BRL in the short term, lingering fiscal uncertainties should limit the room for a substantial strengthening of the Brazilian FX in the medium run.

LOCAL MARKETS—Rates

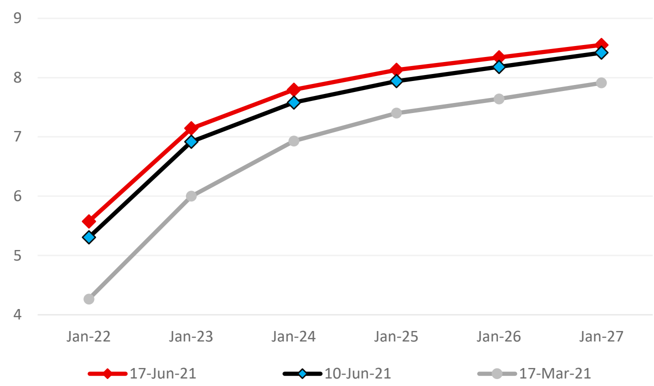
With a bear flattening pattern seen in recent days, the slope of the nominal yield curve dropped to the lowest level since the pandemic began. Since last Thursday (June 10), the front end (Jan-22 DI future) rose 26 bps, to 5.57%, while the back end (Jan-27 DI future) widened 13 bps, to 8.55%. Hence, the curve's steepness in this segment fell 13 bps, reaching 299 bps – the flattest reading since March 19, 2020. The front end continues to move higher, being more recently influenced by a relatively hawkish tone of the Copom statement, signaling a faster removal of policy accommodation by the BCB (see details in the Monetary Policy section). At the long end, the upward pressures from an increase in longer U.S. Treasuries yields and the signs of a sooner BCB normalization were probably cushioned by still optimistic market conjectures about the fiscal policy outlook. While for now the markets will probably chose to keep watching the half-full-glass part of the story, we continue to see a high level of uncertainty regarding the country's capacity to accelerate the potential GDP growth and increase the structural primary balance to levels high enough to stabilize government debt in the medium run. Thus, if macroeconomic reforms do not pick up the pace sharply in coming months, we do not rule out that the sentiment might sour a bit as we head closer to the end of the year, building back part of the premium that recently eroded in the back end of the curve.

Figure 2.A. – USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note1: As of the close Thursday, June 17, 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, June 17, 2021.

COVID-19 MONITORING

Brazil's vaccination pace picks up to nearly one million/day. As Brazilian states brought forward the schedule of COVID-19 vaccination to the general public, we expect the pace of vaccination to hold above our baseline scenario of one million doses administered a day. Supporting our view is the vaccine inventory available (35 million doses) as well as the fact that deliveries have been outpacing vaccine administration. Meanwhile, the Government's official schedule revised July's figure to 42 million doses (from 35 million). As of Wednesday (June 16), 83 million doses (out of 117 million delivered) had been administered in the country, with the pace of vaccination at 923k/day (seven-day moving average).

New COVID-19 infections and casualties remain stubbornly high. The ICU occupancy rate is above 90% in nine states, an increase from eight last week (18 states in the worst phase). Data from Brazil's Health Ministry showed an average of 72.2k new daily cases (7-day moving average) as of Wednesday (June 16), up 25.6% from last week, while daily casualties (7-day moving average) totaled 2,025, up 20% in the same comparison. See details in the link[2].

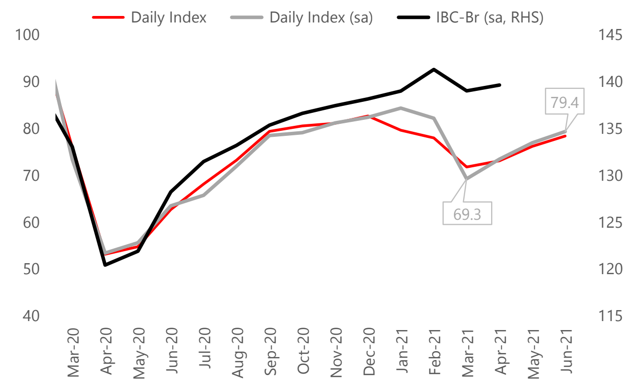
Mobility keeps improving, but at a slower pace. After starting the quarter at high levels, close to the level in June 2020 (~40 points, 7-day average), and our lockdown index (using Google Mobility Report data) posted a consistent downward trend in the last few months, reaching 11.5 points (as of June 10, 2021). This improvement stemmed mainly from mobility increases in the Workplace (which already stands at pre-pandemic marks) and Transit Station segments, which suggests a close link to economic activities, and this recovery path bodes well for economic activity in 2Q21.

Our daily activity index continues to improve across 2Q21. The index — based on daily data on energy consumption, car sales, and mobility — has been improving since the start of 2Q21, showing an upward trend in recent months. On monthly basis, adjusted for seasonality, the index expanded by 6.1% and 4.7% in April and May, respectively. For June, considering the available data (up to the 10th), the index is climbing 3.1%, not enough to fully offset March's retreat (-15.7%) and placing the index at readings still 3.5% below February-21.

Figure 3.A. – Vaccination by Age and Gender (June 14, 2021)

Sources: PNAD, dataSUS, @eliaskrainski, Santander.

Figure 3.B. – Daily Activity Index on Monthly Basis* (Feb/20=100)



Sources: Google, Apple, Fenabrave, ONS, Santander.
* Data are available until June 10, 2021. Seasonal adjustment was made using IBC-Br's seasonal factors.

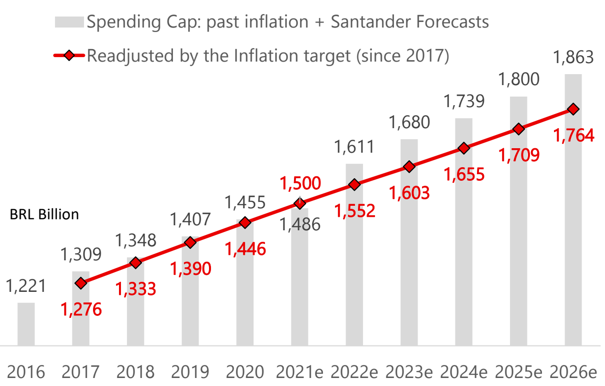
[2] **Santander Brazil Covid Monitor -** June 15, 2021 - Available on: https://bit.ly/Std-COVID-150621

FISCAL

This week (June 15) we published a report in which we explored the main impacts on the fiscal accounts by analyzing the pandemic's impact and the current favorable price shock effect (inflation and terms of trade), as well as discussing our outlook. See details in the link[3].

For fiscal accounts, the current more persistent and intense inflationary shock and the better terms of trade are acting as a breath of fresh air, in our view, because they have reduced the fiscal risk perception in the short run. The price shock is directly affecting fiscal accounts, resulting in lower debt-to-GDP levels, while boosting revenue at the federal and regional levels. However, we expect several challenges with respect to compliance with the fiscal rule and political pressure for new expenditures ahead. Through a higher GDP deflator, the impact of inflation on nominal GDP "eliminated" the risk that the gross debt-to-GDP ratio will reach 100% of GDP, which is regarded by the market as a danger sign. In our current tracking, gross debt has dropped 8 pp, to ~82% of GDP from ~90% of GDP. The inflation shock's impact on the GDP deflator and on federal revenues directly accounts for 65% of the improvement in the fiscal indicator. Considering a greater inflation effect on revenue, in our current tracking, the public sector primary deficit improved to -1.9% of GDP in 2021 from -3.0% of GDP, as discussed in our report dated May 20, 2021 (Monetary Stimulus Doomed to End Sooner). In addition, we estimate that federal net revenue will rise by 0.1 pp of GDP per year, due to the positive shock related to terms of trade, depending on the impact and duration of the commodity boom. Additionally, based on our forecasts, we see inflation converging to the mid-target only in 2023, and thus, compliance with the constitutional spending cap up to 2026 is now more feasible than before. In our view, an important consequence of the inflationary shock in 2020-2021 is that the spending cap has lost some of its anchoring power, and the fiscal rule is a necessary but not sufficient condition to assure consistent fiscal consolidation. This is especially true if favorable conditions such as terms of trade, convergence of inflation to the target, and lower neutral interest rates are no longer maintained. In a simulation comparing the inflation scenarios during the period 2017-2026, the expenditures subjected to the spending cap rule will be around 3.1% higher (around BRL470 billion in nominal terms) in our inflation scenario compared to a contrafactual simulation, readjusting the fiscal rule with the center of the inflation target. Of this amount, we forecast that 88% will be during the period 2022-26, which means more room for new expenditures ahead. In light of this, we believe the fiscal rule is losing its initial purpose: to make expenditures more efficient through structural reforms, rather than generating further increases in the tax burden. In our view, the inflationary shock should provide some time for the country to seek a more structural adjustment in its fiscal accounts, yet this will depend on the duration of the commodity boom and other extraordinary factors. However, these quasi-fiscal measures cannot affect the net debt trajectory—and a decline in net debt is essential for achieving long-term fiscal sustainability, in our view.

Figure 4.A. – Spending Cap Max. Total Limit



Sources: National Treasury, Santander.

Figure 4.B. – Primary Surplus Simulation: When?

Elasticity: GDP-Revenues	GDP Growth 1.0%	GDP Growth 1.5%	GDP Growth 2.5%	GDP Growth 3.0%
0.9	2038	2032	2029	2027
1	2031	2028	2027	2026
1.1	2028	2027	2026	2025
1.2	2027	2026	2025	2024
1.3	2026	2025	2024	2024

Assumptions: GDP deflator: 4.0% after 2023; Net revenue from the 2nd bimonthly government report; Santander expenses scenario.

Sources: Santander.

[3] **Santander Brazil Fiscal Policy - *"Fiscal Accounts: Pandemic Impact, Price Shock Contribution, and Outlook"* –** June 15, 2021 - Available on: http://bit.ly/Std-special-fiscal-061521

MONETARY POLICY

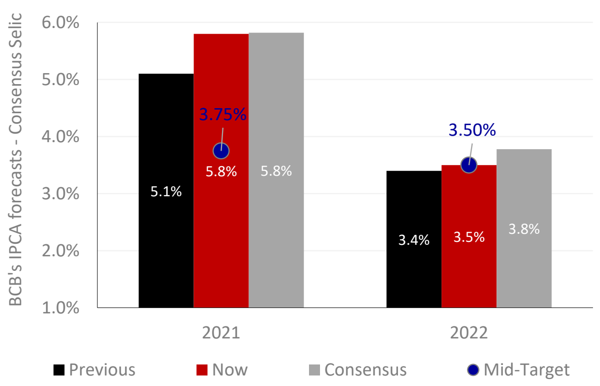
Once again, the Copom has hiked the Selic policy rate by 75bps (to 4.25%), in a decision that was broadly in line with macro analysts' expectations and consistent with yield curve projections.

The tone of the statement shows the central bank is responding to the deterioration in the inflation outlook in a balanced and adequate manner. A key takeaway from the statement is the change in the BCB's flight plan: if in previous meetings the authority was signaling a "partial normalization" of the policy rate, now the BCB is hinting that, at this moment (i.e., conditional on the outlook and risks), "the Copom's baseline scenario indicates, as appropriate, a normalization of the policy rate to a level considered neutral." The justification for the higher tone here is the necessity to curb "the dissemination of the temporary shocks to inflation." The Copom's decision to seek a full normalization (or neutralization) of the monetary policy stance mirrors the results from the BCB's own inflation simulations. According to the models, with the FX rate starting at 5.05 (and moving along with PPP afterwards), a path of Selic rate hikes to 6.25% for YE2021 and 6.50% for YE2022[4] would produce a disinflation to the mid-target of 3.5% for the key policy horizon of 2022 (note: the previous forecast was 3.4%). That would follow a hefty print of 5.8% this year (previously: 5.1%), now topping the upper target for 2021 (5.25%).

Another important element in the policy guidance is that the authority projects for the next meeting "the continuation of the monetary normalization process with another adjustment of the same magnitude", also conditional on the outlook and risks. The authority did leave room for a bolder action (maybe in the next meeting), as the BCB signals that "a deterioration of inflation expectations for the relevant horizon may require a quicker reduction of the monetary stimulus." While for now another Selic hike of 75bps (to 5.00%) is likely in the making for the August 3-4 Copom meeting, the BCB does not discards a move of 100bps depending on 2022 IPCA forecasts. But that faster pace could also be implemented with more hikes of 75bps. **The Copom minutes (Tuesday, June 22) may shed more light on this debate. Also worth keep an eye on the BCB's policy-oriented research presented in Q2 inflation report (Thursday, June 24).**

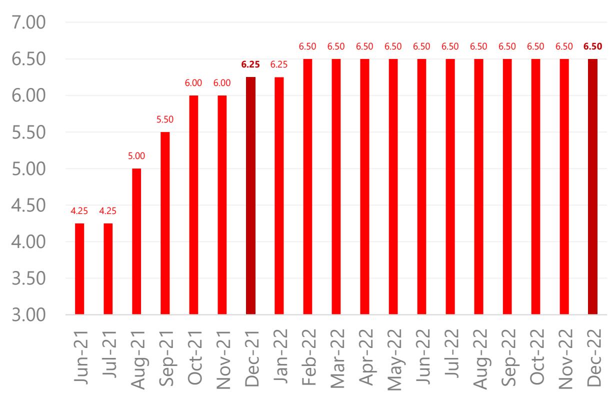
Our scenario projects a Selic rate of 6.50% at the end of this year, with a terminal Selic of 7.00% in 1Q22. While our forecast is consistent with our neutral interest rate assumption ~4% in real terms, our estimate for the terminal Selic could also materialize if the BCB realizes ahead that a slightly tight stance is necessary to bring inflation back to mid-target in 2022 (a possibility we see on the rise). See details in the link[5].

Figure 5.A. – BCB's Inflation Simulations



Sources: Brazilian Central Bank, Santander.
Note: Selic from Focus survey; USD/BRL at 5.05, evolving with PPP.

Figure 5.B. – Consensus Selic Rate Forecasts



Sources: Brazilian Central Bank, Santander.
Note: Based on the BCB's weekly Focus survey as of June 11, 2021.

[4] According to the Focus survey, the trajectory of the Selic rate reaches 6.50% in 1Q22.
[5] **Santander Brazil Monetary Policy - *"Copom: A New (Farther) Route for The Flight Plan"* –** June 16, 2021 – Available on: https://bit.ly/Std-COPOM-jun21

ECONOMIC ACTIVITY

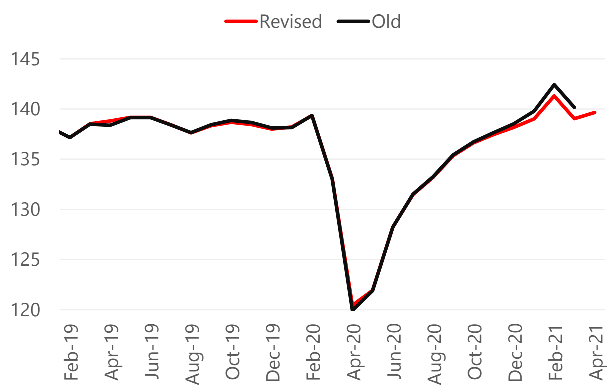
The BCB's activity indicator surprised negatively in April. The headline index was up by 0.4% MoM-sa (15.9% YoY), considerably below the market consensus (1.3%) and in line with our call (0.8%). April's figure placed the economy at a level 0.2% above the pre-crisis mark, after it fell slightly below that with the retreat in March. Regarding the key sectors, this monthly expansion reflects the positive surprises seen in the tertiary sector, with services and broad retail sales climbing 0.7% and 3.8%, respectively, but the result was dragged down by the tumble in industrial production (-1.3%). Agriculture's weak number may also have contributed negatively. **The monthly growth was not enough to offset March's retreat (-1.6%) and left a carryover of -0.1% to 2Q21.** We believe this result reinforces the likelihood of a weak figure for 2Q21 GDP, in line with our tracking of -0.3% QoQ-sa (+12% YoY) and +4.8% for 2021. See details in the link[6].

Aggregated business confidence preview rises in June. According to FGV's confidence survey preview, the aggregated business confidence index was up by 4.7% in June, surpassing the 100-points neutral mark and reaching the highest reading since 2013. June's figures imply a quarterly growth of 6.2%, fully offsetting the previous 3.4% retreat. Among the sectors, the consumer index climbed 7.7%, likely reflecting the new round of emergency aid; in quarterly terms, the index ended 2Q21 climbing 4.0%, not enough to fully give back the previous decline (-8.5%). Regarding the industrial sector, the index grew 2.8%, not enough to avoid a quarterly contraction (-2.7%).

Services to families seem to keep recovering in June, as mobility continues to increase. According to the preview of our proprietary indicator (IGet Services), services to families should climb for the third month in a row, following March's retreat. Based on IGet, our tracking for services to families in June stands at 1.7% MoM-sa (98.6% YoY). It's worth saying that services to families are highly correlated to the segment of Other Services (nearly 10% of GDP), which is still running at well-depressed levels. As this segment gradually fills its pre-crisis gap, the services sector should gain momentum, contributing positively to the economic recovery this year. See details in the link[7].

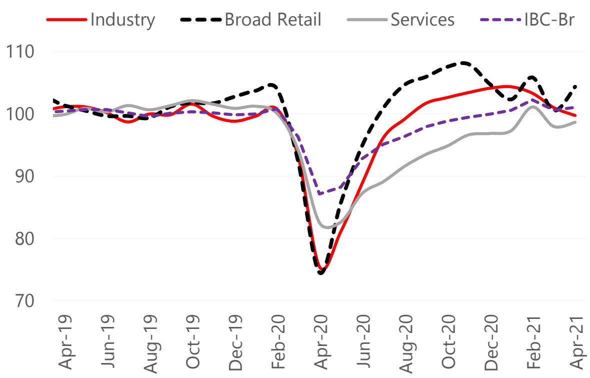
For the coming week, FGV will release the first batch of consolidated economic confidence data for June. The consumer index is due out on Thursday (June 24), while the construction index is due out on Friday (June 25). **For details on Santander's activity outlook, please refer to our last chartbook[8].**

Figure 6.A. – IBC-Br Broad Activity Index (sa, 2003=100)



Sources: BCB, Santander.

Figure 6.B. – Economic Activity Breakdown (sa, Jan/19=100)



Sources: IBGE, BCB, Santander.

[6] **Santander Brazil Economic Activity - *"Weak Start of 2Q21 for Broad Activity"* –** June 14, 2021 – Available on: http://bit.ly/Std-Econact-IBC-140621
[7] **Santander Brazil Economic Activity - *"Serviços Seguem Mostrando Crescimento"* –** June 17, 2021 – Available (in Portuguese) on: https://bit.ly/Std-IGETser-previa-jun-21
[8] **Santander Brazil Economic Activity - *"Chartbook – Positive Surprises with Risks On The Upside"* –** May 25, 2021- http://bit.ly/Std-chart-econact-may21

INFLATION

We expect June's IPCA-15 (due on Friday, June 25) to rise 0.82% MoM, meaning an acceleration in annual terms to +8.1% YoY (from +7.3% YoY in May). Just another multi-year high (since 2016).

Administered prices inflation should rise 1.8% MoM, a monthly deceleration if compared to May's IPCA, backed by lower energy and gasoline inflation. Industrial goods should also decelerate compared to May's IPCA, but still post a substantial seasonal change of +0.98% MoM, that would mean an acceleration of the 3mma-saar metric to 11.4%. On the bright side, we forecast services prices will rise 0.15% MoM—which would be compatible with the trend denoted by the seasonally adjusted quarterly annualized moving average (3mma-saar) running at around +1.8%, a low level, but also compatible with core services at +3.7%, a not so low level. Finally, we expect food-at-home to rise +0.35% MoM, in line with seasonality, but not enough to push the 3mma-saar metric further down.

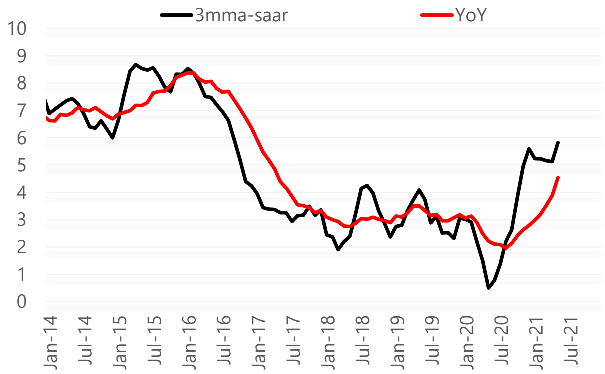
In terms of underlying inflation measures, the EX3 core should rise around +0.44% MoM, as per our projection, meaning a slight acceleration to +5.2% 3mma-saar (from +5.0%). This is a persistently high level—it would be the eighth month of the EX3 core running between +4.8% and +5.9% in 3mma-saar terms (headline CPI target is 3.75% for 2021 and 3.50% for 2022)—suggesting non-negligible risks of a spreading of primary shocks to general prices.

Figure 7.A. – June's IPCA-15 Forecast (%)

	MoM		YoY	
	Santander	Contrib.	May-21	Jun-21
IPCA	0.82	0.82	7.3	8.1
Administered	1.8	0.47	11.3	13.3
Free	0.47	0.35	5.9	6.3
Food-at-home	0.35	0.05	15	14.7
Industrial goods	1.05	0.24	7.4	8.3
Services	0.15	0.05	1.6	2.0
EX3 Core	0.44	0.44	4.1	4.7

Sources: IBGE, Santander.

Figure 7.B. – Core Inflation (IPCA EX3, %)



Sources: IBGE, Santander.

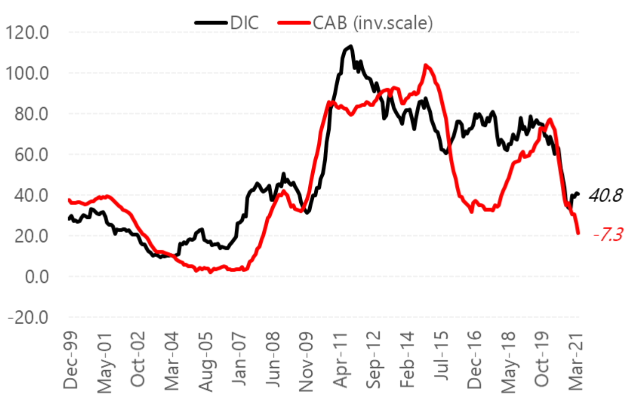
BALANCE OF PAYMENTS

We expect Brazilian balance-of-payments data due next Friday (June 25) to reinforce our perception of a sound external position the Brazilian economy.

The Brazilian current account balance should have registered a US$4.6 billion surplus in May 2020 compared with a US$0.5 billion deficit observed a year ago. If confirmed, the outcome will have meant another improvement on a 12M-to-date basis, with the US$12.4 billion deficit seen in the previous reading receding to US$7.3 billion last month. We project this performance to have stemmed from the maintenance of favorable price levels for commodities – which has bolstered the trade surplus – in tandem with depressed services outlays and low remittances of profits and dividends for historical standards. We expect this dynamic to continue in the coming months, which should lead the current account balance to end 2021 with a US$4.9 billion annual surplus versus a US$24.1 billion deficit in 2020. See details in the link[9].

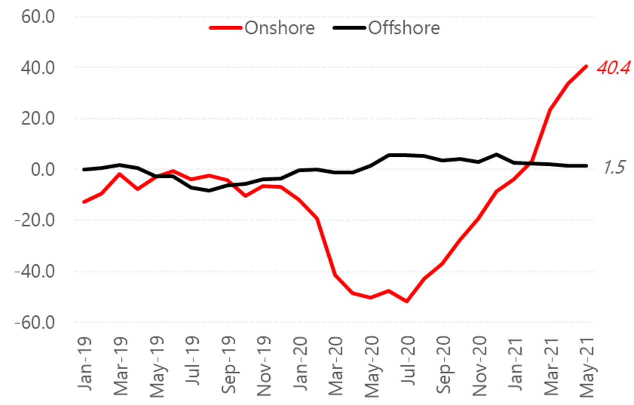
We reckon that recent positive surprises regarding 1Q21 economic data and the (eventual) acceleration in the immunization process in Brazil may translate into a faster recovery of the Brazilian economy and, consequently, larger volumes of imports, services outlays and remittances of profits and dividends in the future. In that case, the improvement we expect to witness in the current account balance may be milder. On the other hand, we believe that this development may also mean larger inflows in the financial account stemming from more constructive prospects for both direct investments in the country and acquisitions of domestic financial assets by foreigners. Incidentally, we estimate these items registered net inflows last month (US$2.5 billion and US$4.5 billion, respectively). Therefore, even under a less constructive environment for the current account balance, we think the fundamentals of the Brazilian balance-of-payments should remain supportive for more than a while.

Figure 8.A. – Current Account Balance versus Direct Investment in the Country (US$ billion, 12M-to-date)



Sources: Brazilian Central Bank, Santander.

Figure 8.B. – Net Foreign Portfolio Investments (US$ billion, 12M-to-date)



Sources: Brazilian Central Bank, Santander.

[9] **Santander Brazil - Macroeconomic Scenario: *"Monetary Stimulus Doomed To End Sooner"* –** May 20, 2021- Available on: http://bit.ly/Std-scr-review-may21

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