The Narrowest Federal Primary Deficit Since 2014

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- Despite the hawkish tone of the FOMC meeting, the BRL managed to stand out as the best-performer among major currencies in the rolling week ended January 27. The BRL closed the period at 5.41 (up 0.5%), making it one of the few currencies that did not lose to the USD in recent days. In our opinion, the move had to do with the continued uptrend in commodity prices and probably some tactical positioning. The local yield curve bear-flattened in recent days, with the sell-off driven by signs of a more difficult disinflation process ahead and the uptrend in U.S. yields on the heels of a hawkish Fed message.
- January's IPCA-15 registered a 0.58% MoM change, above our forecast (0.43%) and market consensus (0.44%). With that result, the YoY change reached 10.20%, well above this year's mid-target of 3.50% and the upper target of 5.00%. The headline and its composition reinforce our concerns about the inflation outlook and the speed of disinflation ahead. We continue to project a "plateau" for the IPCA at ~10% YoY until April 2022 and then a decline to (a still uncomfortable) 6% at the end of this year.
- According to the IBGE's National Household Survey (PNAD), the unemployment rate stood at 11.6% in the three months to November. The result was slightly above our estimate (11.5%) and slightly below the market consensus (11.7%). We calculate that the seasonally adjusted jobless rate stood at 12.1%, a decrease compared to the October level (12.3%). We expect that the normalization in the participation rate and decelerating employment growth will tend to create upward pressure in the seasonally adjusted jobless rate in the coming months. On Monday (January 31), the Ministry of Labor is expected to release the December CAGED formal job creation data, as the release was previously scheduled for Thursday (January 27). Our seasonally adjusted estimate is +130k (November: +275k).
- According to FGV, economic confidence continued to weaken at the start of 2022, as declines were seen for consumers, industry, and the tertiary sector. December industrial output data is scheduled to come out on Wednesday (February 2), and we expect a monthly gain of 1.6% MoM-sa, stemming mainly from atypically strong vehicle production for this time of year, breaking a sequence of six monthly declines in a row.
- On the fiscal front, federal tax collection showed a strong reading for December, capping a notably solid performance in 2021, with a 17.4% jump, mainly on the heels of price effects (i.e., higher inflation and terms of trade). The National Treasury published the 2022 Annual Borrowing Plan (acronym in Portuguese: PAF), pointing to an expected net borrowing requirement of BRL1.23 trillion and with a higher share of issuances of floating-rate bonds. Finally, the fiscal authority is scheduled to publish on Friday (January 28, 2022) the central government budget results for December, and we estimate a full-2021 deficit of BRL35 billion (0.4% of GDP), the best result since 2014. For 2022, we project a federal primary deficit of BRL115 billion as revenues lose steam and spending picks up.
- We remain aligned with consensus, forecasting another 150-bp Selic hike to 10.75% at the February 1-2 Copom meeting. In its statement, we believe the Copom could signal an adjustment of 100-150 bps as a plausible possibilities for the March 15-16 meeting, with the committee seeking greater flexibility to calibrate the total budget of hikes as the cycle nears completion. We continue to forecast a terminal Selic rate of 12.25% at the end of this cycle, meaning a notably tight monetary policy stance.

Most of the information in this report is up to the end of Thursday, January 27, 2022.

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.
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Figure 1. Brazil Macro Agenda for the Week of January 31 - February 4, 2022

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
Formal Job Creation (thousands)	**CAGED**	**Dec/21**	**Mon, 31-Jan**	**-181**	**324**
Formal Job Creation (thousands, sa)	**CAGED**	**Dec/21**	**Mon, 31-Jan**	**130**	**275**
Net Debt (% GDP)	BCB	Dec/21	Mon, 31-Jan	56.7	57.0
Primary Budget Balance (BRL billion)	BCB	Dec/21	Mon, 31-Jan	18.2	15.0
Trade Balance (USD billion)	SECINT	Jan/22	Tue, 01-Feb	1.8	3.9
Industrial Production (% MoM)	**IBGE**	**Dec/21**	**Wed, 02-Feb**	**1.6**	**-0.2**
Industrial Production (% YoY)	**IBGE**	**Dec/21**	**Wed, 02-Feb**	**-6.1**	**-4.4**
Copom Meeting - Selic Rate (%)	**BCB**	**Feb/22**	**Wed, 02-Feb**	**10.75**	**9.25**
Vehicle Sales (thousands)	Fenabrave	Jan/22	01 to 03-Feb	--	207.1
Vehicle Production (thousands)	Anfavea	Jan/22	04 to 07-Feb	--	210.9

Sources: Bloomberg, IBGE, Santander.

For details on Santander's economic forecasts for Brazil, please refer to our last Scenario Update[1]. Also refer to our Macro Propositions for Brazil in 2022[2].

[1] **Santander Brazil – Scenario Update: *"Inflation Still a Concern"* –** January 20, 2022- Available on: https://bit.ly/Std-scenupdate-jan22

[2] **Santander Brazil – Macro Propositions 2022: *"Navigating the Uncertainties"* –** January 07, 2022- Available on: https://bit.ly/Std-Macroprop22

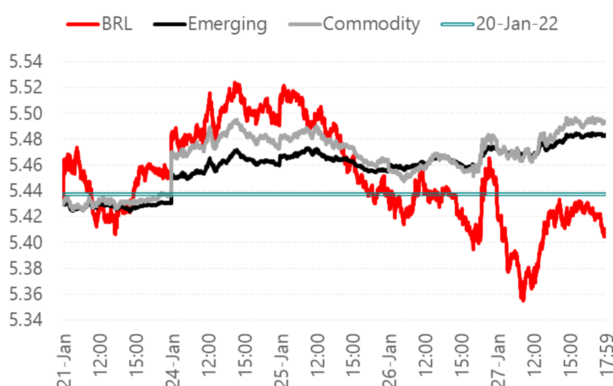
LOCAL MARKETS—FX

Despite the hawkish tone of the FOMC meeting, the BRL managed to stand out as the best-performer among major currencies in the rolling week ended January 27. The BRL closed the period at 5.41 (up 0.5%), making it one of the few currencies that did not lose to the USD in recent days. In our opinion, the move had to do with continued uptrend in commodity prices and probably some technical factors, such as asset allocation flows directed mainly toward the Brazilian equity market, reflecting bargain hunting. Constructive expectations about local politics, amid elevated carry gains, also seem to be feeding some tactical (i.e., short-term) positioning in Brazilian fixed income, in our view. Despite these positive short-term dynamics, we continue to see limited room for the BRL to strengthen in a sustainable fashion given still considerable uncertainty about economic policy and reforms in the future. Thus, we think that this rally will probably be short lived.

LOCAL MARKETS—Rates

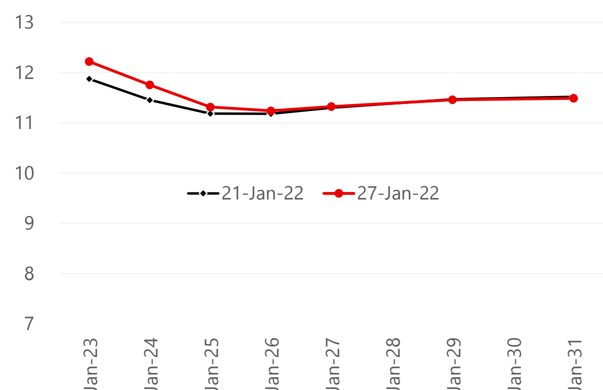
The local yield curve bear-flattened in recent days, with the sell-off driven by signs of a more difficult disinflation process ahead and the uptrend in U.S. yields on the heels of a hawkish Fed message. Since last Thursday (January 20), the front end of the curve (Jan-24 DI future) jumped 32 bps to 11.76%, while the back end of the curve (Jan-27 DI future) gained 23 bps to 11.33%. The curve's steepness in this segment fell further, by 9 bps to -43 bps, deepening the inversion. At the front end, we think the upward pressure likely resulted from the higher-than-expected headline and the adverse composition of the January IPCA-15 report (see details in the Inflation section). The nominal curve continues to price in a 150-bp Selic hike at the next meeting (February 1-2) and roughly 100 bps at the following meeting (March 15-16). At the back end, we see the sell-off as still likely driven by the upward movement in longer U.S. Treasury yields, whose impact seems somewhat cushioned by constructive expectations about the political situation locally. Fundamentally speaking, we continue to see an environment of high uncertainties for the domestic economy, particularly regarding the fiscal consolidation process. Moreover, the Fed's hawkish response means additional risks for local interest rates going forward, especially if the U.S. inflation outlook points to a likely increase in the neutral level of interest rates. All that said, we continue to see space for domestic yields to re-steepen, which could occur after both IPCA inflation and the Selic rate see a peak.

Figure 2. USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note 1: As of the close on Thursday, January 27, 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 Thursday, January 27, 2022.

COMMODITIES

Commodities prices saw another bullish week, despite the hawkish tone from the Federal Reserve, whose stance could eventually create headwinds for commodity prices at some point. The Bloomberg Commodity Aggregate Index rose 1.6% in the rolling week ended January 27: the Agriculture Subindex rose 1.4% and the Energy Subindex gained (a whopping) 5.8%, whereas the Industrial Metals Subindex fell 0.5%. In our view, commodity strength continues to mirror the signs of less economic impact from the Omicron variant of COVID-19 vs. previous variants, as well as indications that economic stimulus in China will limit the downside risks for activity in the world's second largest economy. We believe low inventories and idiosyncratic factors also continue to feed the commodity rally early in 2022.

Brent oil rallies near $91/bbl despite a strong USD. Brent crude oil rose 5% from last week to $91/bbl (the highest level since October 2014). In our view, the market is likely pricing in a potential energy supply disruption resulting from the Russia-Ukraine crisis, more directly affecting European gas prices, which rose 22% from last week. We still see the oil market in output deficit, as global inventories are low and producers (ranging from OPEC+ members to independent U.S. shale companies) struggle with underinvestment in recent years. OPEC+ meets next week (February 2), and we expect its members to stick to their plan for a hike of 400,000 barrels a day.

Once again, agriculture commodities prices continued to soar, accompanying the oil surge. Soybean prices reached the highest level since July 2021, and corn prices hit the highest level since June 2021. Prices of these commodities continued to climb on expectations that the rally in oil prices will likely increase biofuel demand, along with concerns about dry weather conditions in South America. Wheat saw a reversal from last week, amid preliminary signs of de-escalation in the tensions between Russia and Ukraine (two major exporters). We continue to see risks that the downward trajectory for grain prices will be gentler than previously thought, as global stocks will take longer to replenish from the drawdown of previous years.

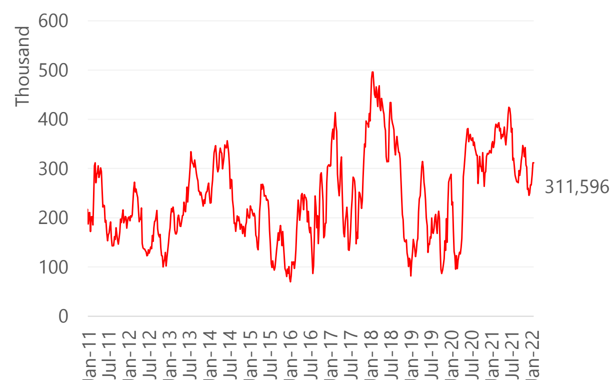
Iron ore leapt above $140, amid mixed economic signals. Iron ore has strongly rebounded since December on expectations that consumption will pick up this year due to Chinese government efforts (read stimulus) to stabilize the economy. Still, the latest batch of China's housing market data has been weak, and Chinese steel output fell 7% YoY in December. January/February steel output is likely to remain tepid, in our view, but we expect pollution-related controls to ease in March, after the Winter Olympics.

CFTC[3] reports an increase in speculative long positions in WTI crude oil. Money managers increased their net long WTI crude futures and options positions in the week ended January 18, the CFTC reported on Friday (January 21). The positions in futures and options increased by 23,770 contracts to 311,596.

Figure 4. ICE Brent Crude Oil (USD/Barrel)

Sources: ICE, Santander.

Figure 5. CFTC NYMEX Crude Oil Managed Money Net Total (Number of contracts)



Sources: COT, Santander.

[3] U.S. Commodity Futures Trading Commission.

INFLATION

January's IPCA-15 registered a 0.58% MoM change, above our forecast (0.43%) and market consensus (0.44%). With that result, the YoY change reaches 10.20%, still quite close to the highs of 4Q15-1Q16 and well above this year's target of 3.50% and its upper limit of 5.00%. Although the peak—strictly speaking—of IPCA-15 YoY was in November 2021, at 10.73%, we believe inflation will continue hovering around 10% until April 2022, implying a plateau rather than a clear peak. As for the trend at the margin, it decelerated to 8.4% 3MMA-saar from 10.5%. We believe the 3MMA-saar measure will continue to cool down until it reaches around 5%, but then we expect it to remain at that lofty level for most of the year, suggesting that the disinflation process will be slow, difficult and risky.

The major upside surprise came in industrial goods, due to some residual rebound of Black Friday-related discounts. Industrial goods rose 1.46% MoM (vs. 0.90% expected), contributing +13 bps to the headline forecast error. This was enough to push the trend to 15.5% 3MMA-saar from 13.7%. Services rose 0.51% (contributing +6 bps to the headline forecast error), meaning its trend decelerated to 4.9% from 6.7% 3MMA-saar. As for core services, the 3MM-saar remained flat at 7.1%. We highlight that more inertial services and those more related to activity accelerated at the margin. Food-at-home was actually below our expectation, rising only 1.03% MoM and continuing its decelerating trend in both YoY and 3MMA-saar terms. Finally, regulated prices were in line with our expectation (-0.32% MoM), but communication was a surprise, contributing +4 bps to the headline forecast error. Another highlight was the surprise in registration and licensing (owing to the annual auto ownership tax, IPVA), which rose 1.7% MoM. This item's rate of change will be maintained throughout the year (IBGE's methodology), implying upside risk to our 2022 forecast. **In general, qualitative measures remained unfavorable.** The average of the main core gauges rose 0.90% MoM, and the trend remained basically stable, at 9.1% 3MMA-saar. Moreover, the diffusion index rose to 71.3% from 71.0% (seasonally adjusted).

All in all, this reading reinforces our concerns about the inflation outlook. We think it is still too soon to be convinced that inflation is already in a consistent deceleration trend, especially because the qualitative measures are still quite unfavorable: services accelerating, while industrial goods remain under upward pressure (and surprising to the upside). Although our view is that inflation has no room to accelerate further in YoY terms, we also think it is not likely to peak until April 2022. So, the performance we expect is a plateau at ~10%, followed by more clear relief, down to around 9% only in May 2022 (mainly because of the base effect coming from the end of the Red 2 "Hydro Scarcity" tariff flag in electrical energy; the peak could become clear before that if this exceptional flag is dropped before May). Moreover, we think the disinflation process afterward will be difficult and sticky, rather than a sharp deceleration.

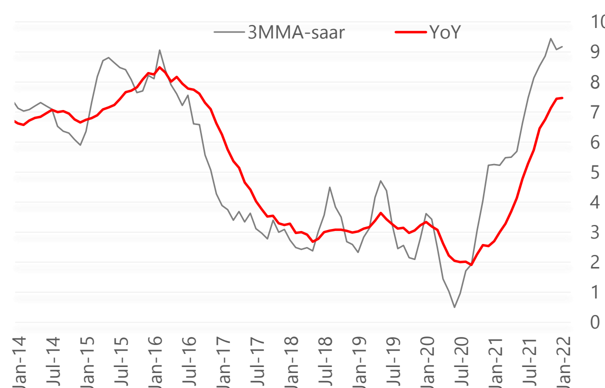
Our IPCA 2022 high-frequency tracking is at 6.0%, while for IPCA 2023 it is at 3.5%. Both numbers are above the target of the BCB (3.5% for 2022 and 3.25% for 2023, both with +/-1.5% tolerance band). See details in the link[4].

Figure 6. January's IPCA-15 Details (%)

	MoM			YoY	
	Jan-22	Santander	Dev.	Dec-21	Jan-22
IPCA-15	0.58	0.43	0.15	10.4	10.2
Administered	-0.32	-0.33	0.00	18.2	16.6
Free	0.92	0.71	0.15	7.8	8.0
Food-at-home	1.03	1.29	-0.04	9.2	8.5
Industrial goods	1.46	0.90	0.13	11.6	12.3
Services	0.51	0.33	0.06	4.8	5.1
EX3 Core	1.37	1.04	0.12	6.9	7.5

Sources: IBGE, Santander.

Figure 7. Core Average Inflation (EX0, EX3, DP, MS, P55) (%)



Sources: IBGE, Santander.

[4] **Santander Brazil – Inflation:** ***"January's IPCA-15: Upside Surprise in First Print of the Year"*** **–** January 26, 2022- Available on: https://bit.ly/Std-IPCA15-jan22

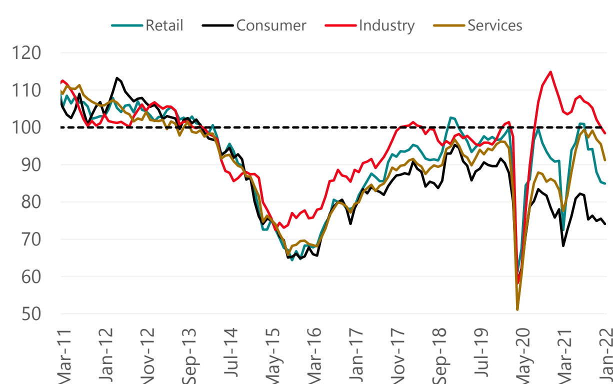
ECONOMIC ACTIVITY

According to the IBGE's National Household Survey (PNAD), the unemployment rate stood at 11.6% in the three months to November. The result was slightly above our estimate (11.5%) and slightly below the market consensus (11.7%), implying a 2.8 p.p. drop from the year-ago level (14.4%). We calculate that the seasonally adjusted jobless rate stood at 12.1%, a decrease compared to the October level (12.3%). The drop in seasonally adjusted unemployment rate stemmed from a 0.2% increase in the employed population, while the labor force fell 0.1% MoM sa. The labor market participation rate stood at 62.3% (sa), higher than in October result (62.1%). All PNAD data is based on a three-month moving average and we estimate that the monthly unemployment rate figure stood at 11.9% (sa) in November, compared to 11.7% in October. This result followed +0.1% and +0.4% MoM sa variations in employed population and the labor force, respectively. The usual real wage bill had a 0.8% MoM sa decrease in November and is now 8.4% below the pre-crisis mark. The November PNAD result shows that the labor market has decelerated at the margin. We expect that the normalization in the participation rate and a slowdown in employment growth will tend to create upward pressure on the seasonally adjusted jobless rate in the coming months.

Continued weakening of economic confidence at the start of 2022. FGV's economic confidence surveys for January pointed to widespread declines across sectors. Consumer confidence confirmed a falling trend with a 1.9% MoM-sa, drop, while industrial confidence retreated 1.7% MoM-sa, the sixth tumble in a row. The tertiary sector also posted weak figures, with the confidence headlines for retail and services dropping 0.5% MoM-sa and 4.5%% MoM-sa, respectively. These numbers imply the third decline in a row and the lowest figures since 3Q21 (for both indexes).

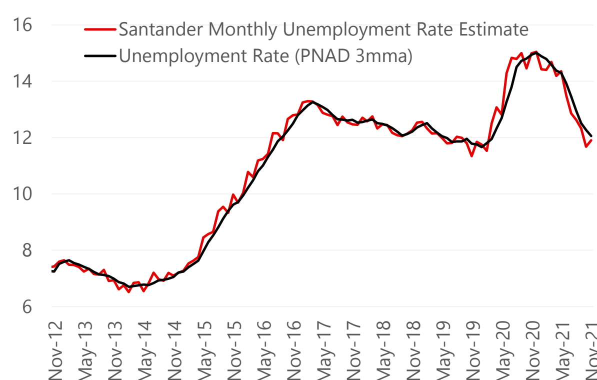
Next week, industrial output for December is one of the key data releases. On Wednesday (February 2), IBGE will release the monthly industrial production survey for the last month of 2021, and we expect sequential growth of 1.6% MoM-sa (with risks skewed to the upside). Our expectation rests mainly on good contributions from vehicles production (+14.9% MoM-sa growth in the month, according to Anfavea), in a usually unfavorable seasonal period for car production. Still, we do not see this positive result as a definite reversal for industrial output (mainly in manufacturing) for 2022, which still faces pressure on costs, scarcity of inputs, and increasing political and economic uncertainty. On Monday (January 31), the Ministry of Labor is expected to release the December CAGED formal job creation data, whose release was postponed from Thursday (January 27). Our estimate stands at -181k nsa, following the seasonal pattern of net job destruction in December. This estimate is equivalent to +130k sa, according to our preliminary calculations (November: +275k). For details on Santander's activity outlook, please refer to our last chartbook[5] and our most recent special report[6].

Figure 8. Economic Confidence Indexes (sa, points)



Sources: FGV, Santander.

Figure 9. Unemployment Rate (sa)



Sources: IBGE, Santander.

[5] **Santander Brazil Economic Activity - *"Chartbook – Lowering (Again) Our GDP Estimates"* –** December 8, 2021 – Available on: https://bit.ly/Std-chart-econact-dec21

[6] **Santander Brazil Economic Activity - *"Special Report – Resilience Factors for 2022 GDP Growth"* –** January 14, 2022 – Available on: https://bit.ly/Std-special-011422

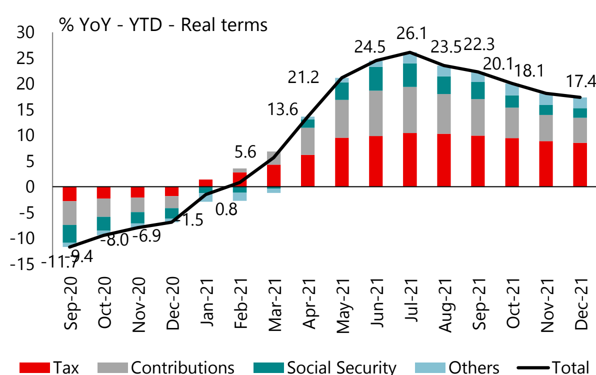
FISCAL POLICY AND LEGISLATION

Federal tax collection showed a strong performance in 2021, reaching an all-time high with 17.4% YoY growth. On January 25, the Brazilian internal revenue service published the data for December 2021. The monthly result (BRL193.9 billion, or +10.8% real YoY) came close to our forecast (BRL194.3 billion). This was the best result for the month since 1995. Compared to the December 2019 result, real growth was +14.3% YoY (meaning roughly a 7% annual increase). In 2021, we observed a strong performance considering the activity recovery and price effect (both inflation and terms of trade), with real tax collection up by 17.4% (meaning a 9.3% gain compared to 2019). The result was also “helped” by extraordinary revenues that totaled BRL40.0 billion in 2021, compared to BRL8.0 billion in 2020. We think these revenues are probably related to corporate restructuring activities (M&A, IPOs). In the breakdown, we highlight the effect of the iron ore price (up 67% YoY) and oil price (Brent up 50.6% YoY) on tax collection. In light of this, royalties revenues rose 53.7% YoY real in 2021. For the coming months, we continue to expect positive results for federal tax collection, considering the impact of higher commodity prices, but we expect a slowdown in the disinflation process, especially in 2Q22 and beyond. For 2022, we forecast tax collection growth of 1.0% YoY in real terms.

The National Treasury released (on January 26) the Annual Borrowing Plan[7] (Portuguese acronym: PAF) for 2022. The total outstanding debt reached ~BRL5.6 trillion in December 2021 and could reach BRL6 trillion this year, according to the fiscal authority’s plan. The average maturity is expected to remain close to ~4.0 years, according to the PAF. In the debt profile, the National Treasury stated that it intends to increase the floating-rate total relative to fixed-rate bonds. Additionally, the net borrowing requirements for 2022 totaled BRL1.23 trillion, lower than our forecast (~BRL1.37 trillion)—which also considers that BNDES will repay the Treasury BRL50 billion. According to the official Treasury calendar, 50 auctions are scheduled for the year, which would result in an average weekly issuance of BRL24.7 billion to maintain the current level of liquidity reserves. In addition, the debt liquidity cushion reached BRL1,185 billion in 2021, equivalent to ten months of debt maturities (using data up to December). In our view, the outlook for debt management remains challenging in the medium term, especially after the increase in both the Selic and IPCA, pressuring the cost of debt. The trajectory depends on the credibility of the fiscal framework, the level of liquidity reserves, and external market conditions. For the short term, however, we believe the liquidity cushion is at a comfortable level to navigate the uncertainties this year.

Finally, on January 28 (Friday) the Treasury publishes the central government results for December. We expect a primary surplus of BRL13.8 billion for the month, implying a primary deficit of BRL35.5 billion for the full year result. If this result is confirmed, it will be the lowest primary deficit since 2014, when the deficit was BRL20.5 billion. For 2022, we expect that the central government will post a BRL115 billion deficit, based on an increase in expenditures and some softening in revenue growth.

Figure 10. Federal Tax Collection



Sources: Federal Revenue of Brazil, Santander.

Figure 11. Annual Borrowing Plan (PAF) 2022

INDICATORS	PAF 2021		Dec-21	PAF 2022	
	Min	Max	-	Min	Max
Outstanding Debt (BRL billion)	5,500	5,800	5,615	6,000	6,400
Average Maturity (years)	3.4	3.8	3.8	3.8	4.2
% Maturing in 12m	22.0	27.0	21.0	19.0	23.0
Profile (%) Fixed-rate	31.0	35.0	28.9	24.0	28.0
Profile (%) Inflation-linked	26.0	30.0	29.3	27.0	31.0
Profile (%) Floating Rate	33.0	37.0	36.8	38.0	42.0
Profile (%) FX	3.0	7.0	5.0	3.0	7.0

PAF - Annual Borrowing Plan (in Portuguese)

Sources: National Treasury, Santander.

[7] Annual Borrowing Plan is the main instrument used to inform the market players and society about the financing guidelines for the Federal Public Debt (FPD) management, including the goals and strategies proposed.

MONETARY POLICY

We remain aligned with consensus and forecast another 150-bp Selic hike to 10.75% at the February 1-2 Copom meeting. We believe that in its statement, the Copom will maintain its previous monetary policy message. Specifically, we expect the Committee to signal that it will advance "even more in the contractionary territory", with the Brazil Central Bank (BCB) still identifying fiscally driven risks for the process of anchoring inflation expectations.

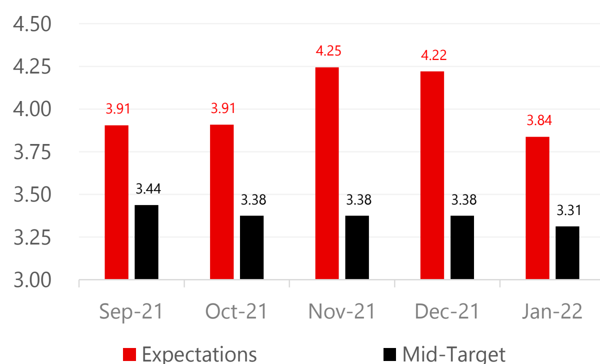
In terms of guidance for the next steps, although we project a further increase of 150 bps in the Selic at the March 15-16 meeting, we believe the BCB will seek greater flexibility in what could eventually turn out to be the last movement of this cycle. Thus, in next week's statement, we believe that the BCB will leave its options a little more open for the subsequent meeting, granting itself even more freedom (than has been the norm) to calibrate the terminal level of the Selic rate sometime between late 1Q22 and early 2Q22.

In order to avoid an undesirably high dispersion of expectations regarding the end of the Selic hiking cycle, the BCB could signal an adjustment of 100-150 bps as plausible actions for the March Copom meeting. In our view, however, the BCB will not yet signal that this future move would be the last, leaving the next steps a little more data-dependent.

We continue to forecast a total adjustment taking the Selic rate to 12.25% at the end of this cycle (and leaving it unchanged for the rest of the year). This means a notably tight monetary policy stance, as a response to risks that could be both external (e.g., commodities) and domestic (e.g., fiscal de-anchoring). These factors could potentially hamper the speed of the disinflation process going forward, in our view.

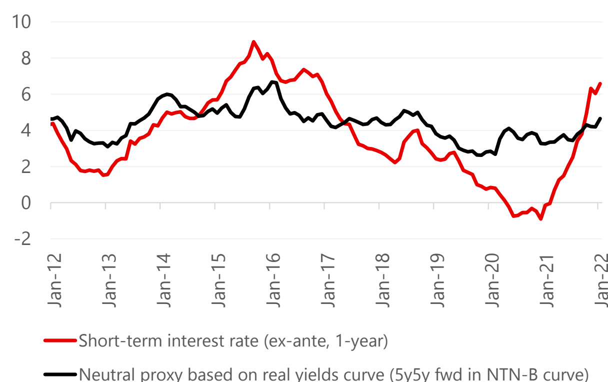
See details in the link[8].

Figure 12. Calendar-Adjusted Estimates (18 months ahead)



Sources: IBGE, Santander.
Note 1: IPCA expectations and target adjusted for the weight of each calendar-year as a policy horizon. For 1Q22, this means 25% for 2022 and 75% for 2023.
Note 2: End of month figures (for this month, data from the January 21, 2022).

Figure 13. Real Yields: Short Term vs. Long Term (monthly average, % annual)



Sources: IBGE, Santander.
Note 1: Based on historical averages, the neutral rate proxy based on long nominal yields is adjusted by a constant term premium of 200bps, with the neutral rate proxy based on real yields adjusted by a premium of 100bps.
Note 2: Average data for January 2022 up to January 21, 2022.

[8] **Santander Brazil – Monetary Policy: *"COPOM PREVIEW: Preparing to Land?"* –** January 27, 2022- Available on: https://bit.ly/Std-COPOM-p-feb22

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