BRAZIL MACRO

July 30, 2021

MACRO COMPASS

MONETARY POLICY AND ACTIVITY TAKE MAIN STAGE

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- The BRL was the top performer among a basket of major currencies in the rolling week ended on July 29, as it gained 2.4% versus the greenback and strengthened to USD/BRL5.08. That move was mainly driven by global factors (especially a soft tone from the FOMC), once again underscoring the BRL's high-beta pattern. Despite the good performance of the BRL, the domestic yield curve registered a bear flattening in the period, as the worsening inflation numbers prompted expectations of a more hawkish BCB response.
- Our proxy for a nationwide average of ICU occupancy continues to decline, now reaching close to 57%, the lowest level in our series (begun in January). The vaccination rate continues to hold up at around 1.3-1.4 million/day on average, reaffirming a positive outlook for the control of the pandemic and the reopening of the economy in 2H21, in our view.
- On the fiscal front, June was marked by favorable market conditions for debt management. But the central government posted a hefty primary deficit of BRL73.6 billion for the same month, owing to higher expenditures. On the political front, a cabinet reshuffle was announced this week, with Senator Ciro Nogueira (PP-PI) appointed as the new Chief of Staff.
- July's IGP-M registered a 0.78% MoM change (33.83 % YoY), below the market's median expectation of 0.90% and well below our estimate of 1.13%. We see initial signs that IGP-M is peaking, but we believe this possible cooling in PPIs will take long to reach the CPIs.
- The US$2.8 billion current account surplus registered in the June fell slightly short of our estimate, but its dynamics keeps pointing to a declining path. We expect to see the same dynamics in July: we project a US$9.0 billion trade surplus for the period.
- The Ministry of Economy's establishment survey (CAGED) for June posted a net seasonally adjusted payroll gain of 320.8k, another solid reading. The IBGE's Household Survey (PNAD) for May indicated that the seasonally adjusted unemployment rate decreased (-0.1 p.p.) to 14.3%. In our view, while job market conditions remain fragile, recent labor data show signs of improvement, especially for sectors more dependent on social interaction, as the reopening process continues.
- For the coming week, IBGE will release next Tuesday (August 3) the industrial production data for June: we expect a monthly retreat of 0.5% MoM-sa, which would lead to a quarterly contraction of 2.6% QoQ-sa.
- On Wednesday (August 4), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. In response to an increase in inflationary risks, we forecast a faster policy rate adjustment (of 100 bps), taking the Selic to 5.25%. Along with the decision, we believe that the BCB will abandon the neutral Selic guidance for the end of the cycle (given at the previous meeting) and reinforce its commitment to bringing inflation (and expectations) back to the mid-target for the relevant policy horizon.

Most of the information in this report is up to the end of Thursday, July 29, 2021.

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 August 02-06, 2021

Indicators / Events	Source	Reference	Date	Santander Estimate	Prior
Aggregated Business Confidence	FGV	Jul/21	Mon, 02-Aug	--	98.8
Trade Balance (USD billion)	SECINT	Jul/21	Mon, 02-Aug	9.0	10.4
Vehicle Sales (thousands)	Fenabrave	Jul/21	Mon, 02-Aug	--	182.5
Industrial Production (% MoM)	**IBGE**	**Jul/21**	**Tue, 03-Aug**	**-0.5**	**1.4**
Industrial Production (% YoY)	**IBGE**	**Jul/21**	**Tue, 03-Aug**	**11.3**	**24.0**
Copom Meeting - Selic Rate (%)	**BCB**	**Aug/21**	**Wed, 04-Aug**	**5.25**	**4.25**
Vehicle Production (thousands)	Anfavea	Jul/21	Fri, 06-Aug	--	167

Source: Santander.

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

[1] **Santander Brazil - Macroeconomic Scenario:** ***"Improvement in The Short Term, Caution for The Medium Term" –*** Jul 01, 2021- Available on: http://bit.ly/Std-scenrev-070121

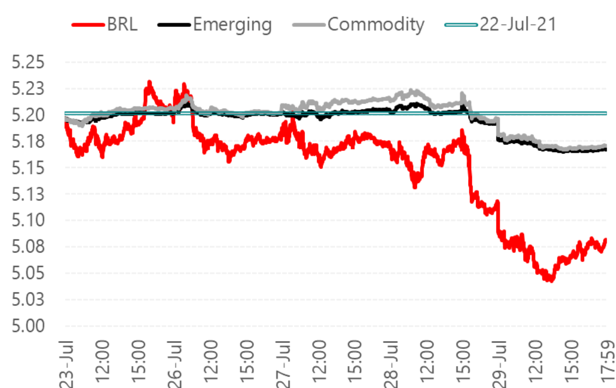
LOCAL MARKETS—FX

The BRL was the top performer among major currencies in the rolling week ended on July 29, just a week after being the worst performer among them, thus underlining its high-beta pattern once again. The USD/BRL pair strengthened to 5.08 from 5.20 in the previous week (a 2.4% gain) on the heels of a more accommodative wording from the FOMC than markets were seemingly expecting, in our opinion. Although the US monetary authority stated that there has been economic progress since its last meeting, the Fed chairman reinforced that “substantial further progress” will need to materialize in order to pave the way for the beginning of the normalization of the monetary policy. The signal of a patient Fed led the USD to weaken in global terms, but the BRL outperformed all major currencies, showing its tendency to outdo market changes in either direction (in other words, a high-beta nature). In our opinion, this international influence overcame the domestic news cycle that bore plenty of economic releases, but which did not bring any significant surprises. However, with the Brazilian parliamentary activities slated to be resumed next week, the domestic news flow may potentially start to generate more volatility for the local FX market in the coming days.

LOCAL MARKETS—Rates

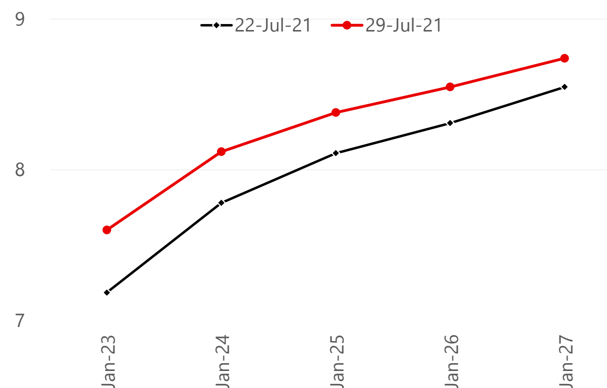
The nominal yield curve saw a significant upshift, with a bear-flattening pattern. Since last Thursday (July 22), the front end of the curve (Jan-23 DI future) rose sharply, 42 bps to 7.60%, while the back end of the curve (Jan-27 future) rose 19 bps, to 8.74%. As a result, the curve’s steepness in this segment fell 23 bps to 114 bps. The rise of the short-end yield was driven by July’s IPCA-15 inflation released last Friday (July 23), which in addition to surprising to the upside, showed quite unfavorable underlying inflation measures (please refer to our data analysis report for more details[2]). As a result, market participants shifted their expectations to a 100-bps Selic hike (instead of 75 bps, which prevailed up to last week). Now the options market prices in a 77% implied probability of a 100-bps hike compared to just 12% probability of a 75-bps hike. Even the tail-risk of a 125-bps hike gained some steam, rising from around 1% of probability to 7%. It is worth noticing that now market prices are in line with our forecast of a 100-bps Selic hike during the next Copom meeting next week, 3-4 August (see more on the Monetary Policy section). At the long end, despite the thin political news flow and basically stable US Treasury yields, the domestic yield rose considerably, probably reflecting a higher perceived probability for an increase in the neutral level of interest rate.

Figure 2.A. – USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note1: As of the close Thursday, July 29, 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, July 29, 2021.

[2] **Santander Brazil Inflation - *“July IPCA-15: Underlying Inflation Deteriorates Further; Services’ Core Reaches 6% 3mma-saar”* –** July 23, 2021 – Available on: http://bit.ly/Std-IPCA15-jul21

COVID-19 MONITORING

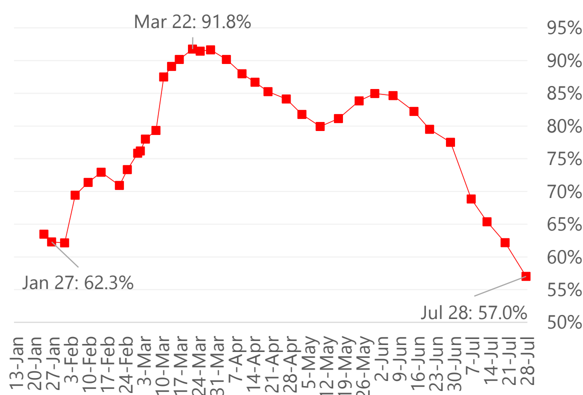
Brazil's vaccination pace remains around 1.3-1.4 million/day on average. We expect the daily average pace of vaccinations to stand at 1.5 million doses in 2H21, as vaccine inventories remain high (40 million doses) and deliveries are expected to remain above the levels of vaccine administration. On Tuesday (July 27), Brazil's Health Ministry affirmed it will hold the guidance of a 90-day interval between doses (of Pfizer and AstraZeneca shots) until all the adult population is vaccinated with the first dose.

Our proxy for a nationwide average ICU occupancy rate[3] continues to decline, now reaching close to 57%, the lowest level in our series (started in late January). That number compares to a previous peak of 92% (late March). As the pandemic gradually eases, we believe local governments will probably continue to lift restrictions further. That is the case for the state of São Paulo, where services (e.g., restaurants) will be allowed to operate until midnight (effective August 1). Additionally, all restrictions will come to an end in the state of São Paulo by August 17. Data from Brazil's Health Ministry showed 46k new daily cases (7-day moving average) as of Wednesday (July 28), up 22% from last week (driven by a one-off revision in the state of Rio Grande do Sul), while daily casualties (7-day moving average) stood at 1,082, down 7% in the same period.

Mobility continues to increase in 3Q21. July's data so far indicates an increase in mobility levels**,** with our lockdown index now moving to 4.4 points (as of July 25, 2021) from 6.9 points (as of July 8, 2021). If we exclude the 2020 Christmas period (December 22 to 24), this is the lowest level of our lockdown index since the pandemic began. This move stems from a mobility increase in all the main categories, with Retail as the highlight since our last update and Workplaces already returning to the pre-pandemic levels.

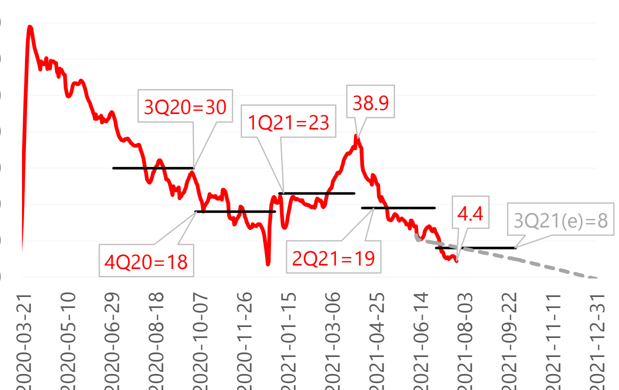
Our daily activity index started 3Q21 at a slower pace. The index—based on daily data on energy consumption, car sales, and mobility—has been improving since the start of 2Q21, showing an upward trend in recent months. On a monthly basis adjusted for seasonality, the index expanded by 5.6%, 3.0% and 4.2% in April, May and June, respectively. For July, considering the daily average up to the 25th, the index points to a drop of 0.5%-sa, placing the index about 4.2% below the mark of February 2021.

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 July 20, 2021.

[3] The nationwide average proxy is a weighted average (by state population) of state ICU occupancy rates. Hence, it does not reflect the actual national occupancy rate = Total beds occupied in Brazil / Total beds available in Brazil.

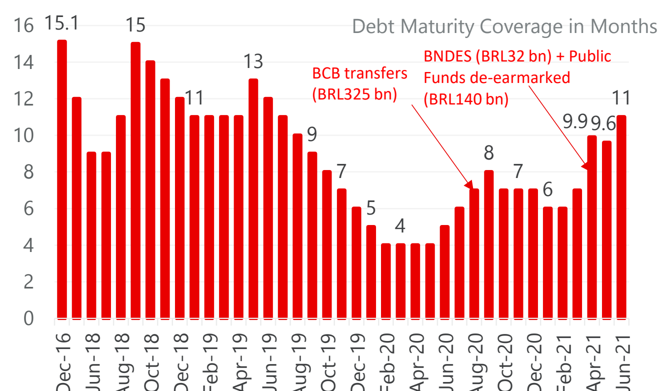
FISCAL POLICY AND POLITICS

June was marked by favorable market conditions for debt management. On July 28, the National Treasury published the Monthly Debt Report for June. Debt issuance reached a monthly record (in real terms) of BRL142.1 billion, the tenth consecutive month above BRL140 billion (the average in 2019 was BRL63 billion/month). The average term of new issues (4.58 years) was the longest since Mar-20 (5.46 years). Non-residents posted a positive flow in June (+BRL7.6 billion, YTD: +BRL54.9 billion), with total participation reaching 9.7% as debt holders. The debt maturing totaled BRL649 billion until December—most of which came in October (BRL266 billion). The percentage maturing in 12 months dropped to 22.5% of the total, from 22.9% in May, reflecting the issuance and maturity profile in June. Although the cost of new issuance rose to 5.8% from 5.5% in May (Selic increase and longer term), the average cost of debt remains close to 7.1% per year, a tad lower than last month (-0.16 p.p.), The public debt liquidity reserve rose BRL130.6 billion in June (totals BRL1,167 billion), with the current level sufficient for ~11 months of debt maturities. In our view, the outlook for debt management improved in the short run, yet it remains challenging for the medium term and dependent on maintaining the current fiscal framework and advancing on reforms, the level of the liquidity reserve, and favorable market conditions.

Additionally, according to National Treasury data published on July 29, the central government posted a hefty primary deficit of BRL73.6 billion in June, on the heels of higher expenditures. The result was higher than our forecast and the market's median estimate, both close to BRL67 billion. Affected by fiscal stimulus, it was the second highest deficit for the month and the third in year-to-date terms in the historical series. In 1S21, total revenue rose 28.5% YoY, on the heels of positive federal tax collection. Total expenditures dropped 22% YoY, driven by the lower level of discretionary spending (-22% YoY in 2021)—currently BRL1.8 billion above the all-time low in 12-month real terms registered in May (BRL102 billion). In the 12-month reading, the deficit reached BRL401 billion (4.7% of GDP). For 2021, we estimate a central government primary deficit of ~BRL195 billion (2.3% of GDP), with a slightly upward bias. We believe that the primary result could be better if the effect of the commodity boom is more intense than we anticipated.

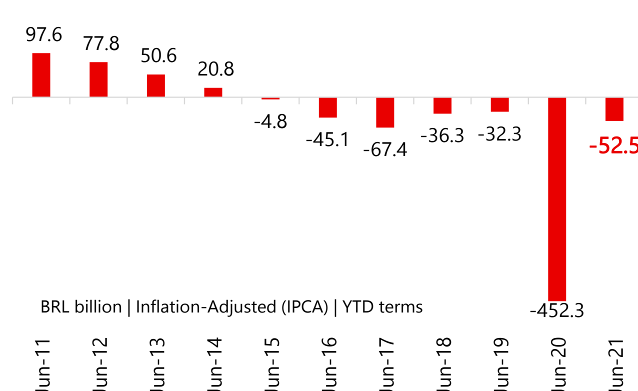
On the political front, a cabinet shuffle was announced this week: Senator Ciro Nogueira (PP-PI) was officially appointed as the new Chief of Staff. In addition, the Ministry of Labor and Social Security has been officially recreated through a provisional decree, as a spin off from the Ministry of Economy (which has become super-sized in the current presidential term). Next week marks the end of the mid-year congressional recess. In coming days, the draft of the income tax overhaul by the lower-house rapporteur Celso Sabino (PSDB-PA) should be announced. In our view, negotiations over the government's proposal will continue; the rapporteur has already announced he will backtrack on slashing tax incentives to employee benefits and maintaining tax breaks for some sectors. In addition, he is analyzing a dividend tax exemption for small companies (under the *Simples* regime). Based on Sabino's draft bill (made public on July 13) we estimate a revenue drop of 0.2%-0.4% of GDP per year, with the new modifications could mean further revenue loss. For August, we also expect a new legislative proposal to introduce a revamped *Bolsa Familia* social welfare program, and the government should unveil the budget bill (PLOA) for 2022 by August 31.

Figure 4.A. – Debt Cushion Debt Coverage



Sources: National Treasury, Santander.

Figure 4.B. – Central Gov. Primary Result



Sources: National Treasury, Santander.

INFLATION

July's IGP-M registered a 0.78% MoM change (33.83 % YoY), below the market's median expectation of 0.90% and well below our estimate of 1.13%. Although still a high level, the headline trend continued to lose a bit of steam, passing from 28% in 3mma-saar terms to 26%. Indeed, this is the second IGP-M reading in a row that shows annual inflation deceleration, coming from 37% YoY in May to 36% in June and 34% now. In any case, the numbers remain at highly uncomfortable levels.

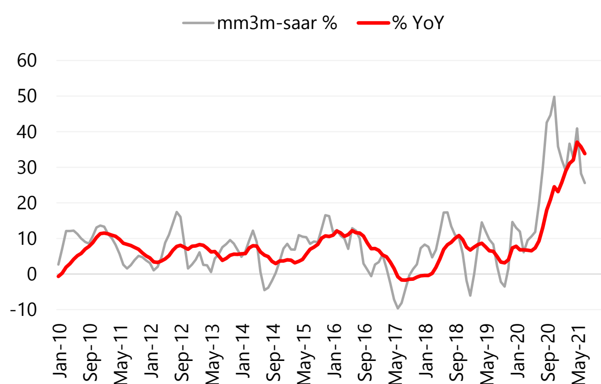
Agricultural prices fell 1.33% MoM, with the trend decelerating to 24% 3mma-saar from 43% last month. The annual measure, however, does not show a clear peak yet—it stopped accelerating, but is plateauing around 50% YoY. And the recent frost in some Brazilian regions could hit some crops, meaning upside risk for the short term.

Industrial prices rose 1.50% MoM, and its trend decelerated 35% 3mma-saar to 33%. In that sector, inflation seems to be peaking—the annual change already passed from 48% in May to 45% in June and 43% now. Yet it might be too soon to be sure, as it is not clear yet whether the supply chain disruption is coming to an end shortly.

All in all, despite the uncertainties, in our opinion, it is likely that IGP-M annual inflation is peaking— we forecast 19% IGP-M inflation for 2021. First there is the base effect: the low base of comparison from the first half of 2020 leaves the 12-month comparison base. Second, some shocks should start to dissipate. In our opinion, the commodities rally should cool down and prices should at least rise at a slower pace or even start to fall a bit. The exchange rate can also settle at a lower level following the interest rate hikes (at least in the short term, while the 2022 Presidential election is still not a theme for the markets). Agricultural prices might spike because of an inclement weather this winter, but the impact should be short-lived in our view. Finally, although we do not yet see clear signs of an end of the supply chain disruption, we believe that it should not get worse, at least at the margin, so upward price pressures should be weaker.

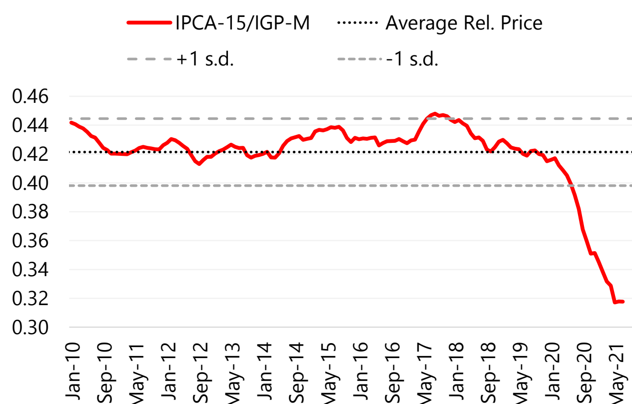
It is worth noticing that, even with a cooling down of inflation at the producer level (IGP-M), prices at the consumer level are still lagging the raises at the producer level, so consumer's inflation (IPCA) should remain under pressure in the short term, particularly because IPCA also accounts for services inflation—which has a much lesser weight in the composite IGP-M index (out of which CPI accounts for only 30%). We expect services costs to accelerate with the reopening of the economy.

Figure 5.A. – IGP-M Annual Inflation (%)



Sources: FGV, Santander.

Figure 5.B. – Relative Price Level: IPCA-15/IGP-M



Sources: FGV, IBGE, Santander.

BALANCE OF PAYMENTS

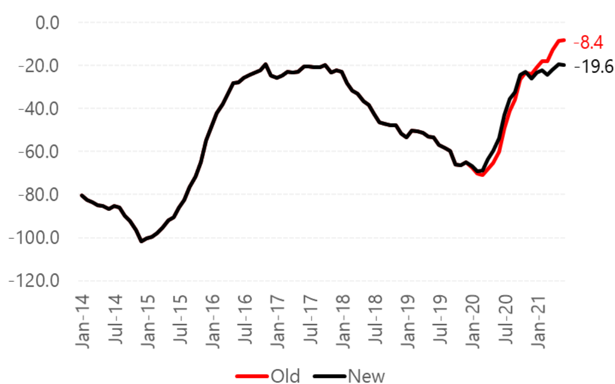
We believe the upward shift in the current account deficit on a 12-month basis stemming from the semi-annual data revision carried out by the BCB has not altered the constructive perception about the Brazilian balance of payments. And the latter should be reinforced by another sound result we expect the trade balance to register in July (release on August 2, next Monday).

The BCB released on Tuesday (July 27) the balance of payments numbers for June. Although the US$2.8 billion monthly surplus in Brazilian current account was just a tad below our estimate (US$3.0 billion surplus), the highlight was the data revision in its historical series, which resulted in larger current account deficits in 2020 and 2021 than previously thought.

Despite this adjustment in historical data—which, on the flip side, translated into an increase in the volume of direct investments in the country in the same period—the recent positive dynamics we have observed in the Brazilian current account balance remained intact, namely, robust trade performances compensating (shrinking) deficits in the services and primary income accounts. And we continue to project a falling current account deficit for the end of the year. See details in the link[4].

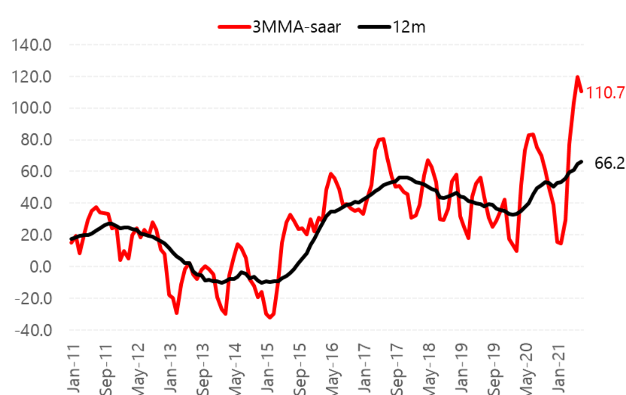
In that sense, we believe that the release of July 2021 trade balance on Monday (August 2) should help to underpin this impression. According to our calculations, Brazilian export revenue should reach US$26.5 billion in the period, while import outlays are expected to tally US$17.5 billion, thus generating a US$9.0 billion surplus. If confirmed, this outcome will mean a US$66.2 billion surplus on a 12-month basis, which will be the seventh consecutive month of expansion in these terms, thus underpinning our expectation for the annual trade surplus to end 2021 at US$77.8 billion (2020: US$50.4 billion). All in all, the constructive market perception about the Brazilian balance of payments will not change, in our view.

Figure 6.A. – Current Account Balance: Old and New series (USD billion, 12m)



Sources: Brazilian Central Bank, Santander.

Figure 6.B. – Trade Balance (USD billion)



Sources: SECINT, Santander.

[4] **Santander Brazil – External Sector: *"New Characters, but the Same Plot"* –** July 27, 2021- Available on: https://bit.ly/Std-extsec-270721

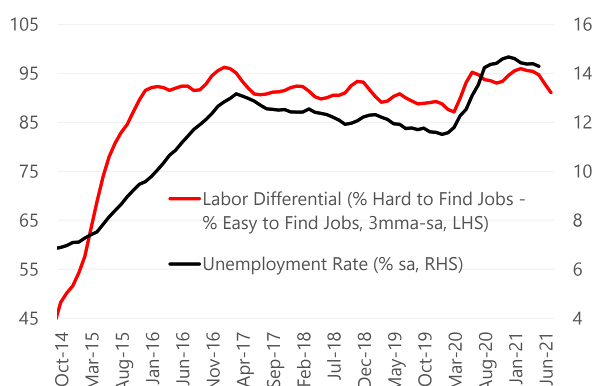
ECONOMIC ACTIVITY

The job market continues to recover. According to the June CAGED survey, net formal job creation stood at +309.1k (consensus: +270k; Santander estimate: +267.6k). We estimate that the seasonally-adjusted figure increased to +320.8k in June, from +274.4k in May. This acceleration resulted in the return to job creation levels close to those observed in 1Q21, as some additional mobility restrictions were lifted in June. Additionally, the new round of the government's BEm program continued to prevent a larger number of layoffs. In June, the greatest contribution to the result came from the services sector. In a separate report, IBGE's National Household Survey (PNAD) showed that the unemployment rate stood at 14.6% in the three months to May (consensus: 14.5%; Santander estimate: 14.4%). After our seasonal adjustment, the jobless rate stood at 14.3%, a slight decrease compared to the April level (14.4%). This result stemmed from variations of +1.6% MoM sa and +1.4% MoM sa in the employed population and the labor force, respectively. In our view, the job market remains fragile and has considerable slack, especially considering informal workers, which the CAGED survey does not capture. However, once again, the current batch of labor market data indicates signs of improvement for some sectors that are more dependent on social interaction, as shown by the job creation in retail and services sectors in CAGED.

Economic confidence data point to a positive start of 3Q21. According to FGV, the consumer confidence index was up by 1.6% MoM-sa in July, the fourth gain in a row and placing the index at the highest readings since October 2020. Despite these positive results, the index is still running well below the pre-pandemic period: in comparison to February 2020, consumer confidence is down by 6.4%. In the survey details, regarding employment figures, the labor differential (i.e., the percentage of respondents seeing jobs hard to get minus respondents seeing jobs easy to get) was down, to 89.3 (from 90.2), the fifth decline in a row. That is the lowest reading since March-20. This figure is a good sign for the job market ahead, as this series highly correlates with the unemployment rate. FGV also reported that industrial confidence continued to expand in July, with the headline index climbing 0.7% MoM-sa, the third gain in a row, and reaching readings 6.9% above the pre-crisis mark. The survey details indicate that the inventories surplus (i.e., the percentage of respondents seeing inventories as excessive minus respondents seeing inventories as insufficient) was down for the first time in three months, reaching -2.1 points (1.5 in the previous month) after standing above the neutral zero-mark since April. This level of inventories bodes well for production growth ahead, but as long as global supply disruptions ease and local industry is able to overcome the high costs and shortage of inputs.

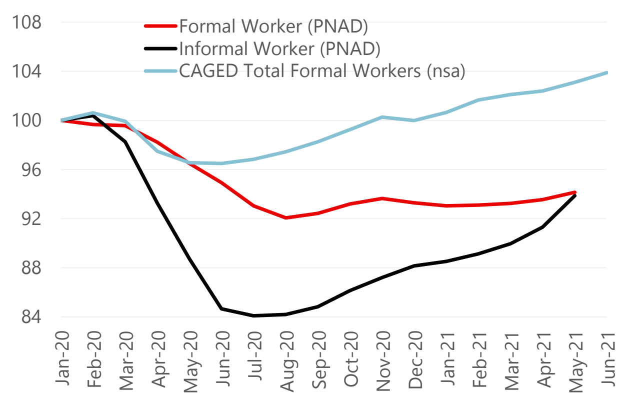
For the coming week, IBGE will release the industrial production data for June. We expect a monthly retreat of 0.5%, which would imply a quarterly contraction of 2.6% in 2Q21 (-0.4% in 1Q21). This figure corroborates our view that industry should weigh on economic activity in the short run, likely reflecting the costs increases and widespread shortage of inputs. **For details on Santander's activity outlook, please refer to our last chartbook[5].**

Figure 7.A. – Unemployment x Labor Differential



Sources: IBGE, FGV, Santander.

Figure 7.B. – Employed Population (sa, Jan-20=100)



Sources: IBGE, Ministry of Economy, Santander.

[5] **Santander Brazil Economic Activity - *"Chartbook – Better Outlook Due to Mobility and Commodities"* –** July 6, 2021 - Available on: https://bit.ly/Std-chart-econact-jul21

MONETARY POLICY

On Wednesday (August 4), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision.

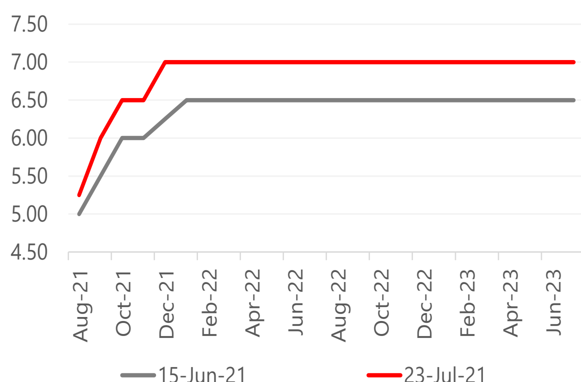
We expect that not only will the COPOM proceed with the withdrawal of monetary stimulus, but that it also will start moving at an even faster pace, in response to an increase in inflationary risks and in view of stronger signs of greater persistence and spreading of (upward) inflationary shocks. We forecast an increase in the policy rate (Selic) of 100 bps, to 5.25%. Analysts' expectations and asset prices suggest to us that this decision is already widely expected by the market, especially after the release of the July IPCA-15 numbers about a week ago.

In conjunction with the decision, we believe that the BCB will again raise the tone of the statement, abandoning the neutral Selic guidance for the end of the cycle (given at the previous meeting) and reinforcing its commitment to bringing inflation (and expectations) back to the mid-target for the relevant policy horizon. Implicitly, this will mean that interest rate will need to rose above the neutral level and reach a contractionary territory.

In terms of future guidance regarding the COPOM's total adjustment, we believe that the COPOM is likely to abandon the signal given at its last meeting, which pointed to a neutral Selic (i.e., 6.50%) at the end of the adjustment process. We estimate that the BCB's inflation models will indicate the need for a higher Selic (than the level suggested at the last meeting) to ensure the achievement of the mid-target in 2022 (3.50%). Therefore, we believe that the BCB will seek to reinforce the message that it will do whatever is necessary to bring inflation (and expectations) back down to the center target in 2022. In this context, we think it is possible that the authority may mention the need for a slightly contractionary level of interest rates at the end of the cycle.

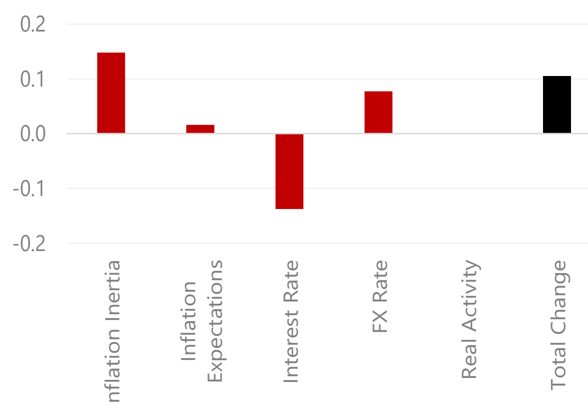
As for the speed of the adjustment (the next decision is scheduled for September 21-22), we doubt whether the BCB will continue to explicitly point to a more likely outcome for the following COPOM meetings (i.e., should the BCB scenario be confirmed before the next one), as it has been doing in recent months. While we believe that transparency (especially regarding the conditions for monetary policy decisions) is welcome, increased uncertainty in the current context may make the authority less clear about the next step. In any case, if the COPOM does choose to signal the next step, we believe that the scenario to be indicated will more likely be another increase of 100 bps (to 6.25%). See details in the link[6].

Figure 8.A. – Median Selic Rate Expectations (% p.a., monthly path)



Sources: Brazilian Central Bank, Santander.
Note: As of the BCB Focus report.

Figure 8.B. – What to Expect for the BCB's IPCA Forecasts for 2022 (Change from Previous Estimate)



Sources: Brazilian Central Bank, Santander.
Note: At the *June 15-16* meeting, BCB simulated IPCA at 3.5% for 2022.

[6] **Santander Brazil – Monetary Policy: *"Going 100 And Suggesting A Tight Policy Stance"* –** July 30, 2021- Available on: https://bit.ly/Std-COPOM-p-aug21 (Note: This link will become available in the afternoon of Friday, July 30).

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