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Brazil Macro Compass

A Busy Macro Calendar for the Coming Week

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- **On top of global news reinforcing the positive market sentiment regarding the likelihood of a medical solution to the pandemic in 2021, the BRL reacted positively to the Brazilian Central Bank's (BCB) announcement that it might tender USD instruments—if necessary—to deal with possible pressures related to the adjustment in banks' FX position at the end of year (to address the "over hedge" theme).**

- **The local yield curve steepened further this week, possibly on the heels of a larger than expected National Treasury bond auction on Thursday. Further signs that domestic fiscal decisions will remain on hold (at least) until the end of month also contributed to push back-end yields higher, in our view. We expect uncertainty and yield curve volatility to remain high in the coming weeks.**

- **Preliminary results for FGV's confidence indexes in November reinforce the mixed signals sent by the various sectors. On one hand, Industry picked up in the month, reaching the highest level since 2011. On the other hand, retail sales posted no change, and consumer confidence fell for the second month in a row. In our view, the later follows the reduction in the size of the emergency aid stipend and price hikes for essential goods (namely foods), which could be eating into the budgets of a number of (lower-income) households.**

- **Next week, FGV will begin to release the final soft data for November, making available the confidence data for consumers (November 25), retail sales (November 26), and industry (November 27). Moreover, labor market data will come out: formal job creation (November 26) and unemployment rate (November 27) will be available for October and September.**

- **On Wednesday (November 25), the BCB is scheduled to publish the balance of payments report for October. We expect the current account balance to have registered a USD1.3 billion surplus, which—if confirmed—will have been the seventh positive outcome in a row, thus reinforcing our perception of a nearly balanced result for the year as a whole (we estimate a USD2.5 billion deficit for 2020 compared with a USD50.9 billion shortfall in 2019).**

- **On Tuesday (November 24), IBGE is scheduled to release IPCA-15 inflation for November. We expect a reading of +0.75% MoM (4.16% YoY). We anticipate that the reading will continue to be pressured by food and industrial goods. Services should also rise, in our view, but at a much slower pace. The fading of the recent shocks is being postponed, meaning that potential upside risks should continue for the short term (up until 1Q21, estimated), but we continue to see these price shocks as temporary.**

- **On the fiscal side, the margin for complying with the spending cap in 2021 continues to decrease, given the uptrend in our inflation trackings for 2020 and the mismatch between the inflation index that readjusts the spending cap (annual IPCA up to June 2020) and the government transfers (full-2020 INPC). October tax collection and central government budget results are expected to come out during the week.**

Local markets—FX: We think the BRL is likely to end the week as the top performer among emerging market currencies (at the time of writing, it was quoted at USDBRL5.37, +1.6% versus the USD) on the back of an international news cycle that reinforced the positive sentiment regarding an expected fading of the pandemic in 2021. In the last couple of days, the apprehension regarding the second wave of Covid-19 contagion—especially in advanced economies, and notably in the U.S.—seemed to have less impact on market conditions than the constructive outlook associated with the preliminary results of vaccine trials. This backdrop helped the majority of emerging market currencies to strengthen against the USD, reflecting a risk-on mode among market participants. In addition to its high-beta pattern (i.e., a tendency to appreciate faster than other currencies in times of weak USD, and vice versa), why then has the BRL strengthened more than its peers?

In our opinion, the move had to do with the BCB's announcement that (if necessary) it might tender USD instruments in the next couple of weeks in order to cope with expected adjustments in banks' short USD futures position resulting from a change in taxation on banks' foreign assets (i.e., the so called "over hedge" theme). This had been a source of wariness among market participants for the last couple of months, especially given that capital inflows present a negative seasonal pattern in the final quarter of each year (although recent updates have indicated the other way round for 2020—for details, see our recent report[1]). Hence, on the back of this signal conveyed by the BCB that the FX market is unlikely to become dysfunctional at the end of the year, a source of pressure on the BRL has dwindled, paving the way for a positive performance of the Brazilian currency this week, in our view.

Local markets—rates: At the time of writing (Friday around noon), the weekly change in nominal yields looked poised to indicate a steepening pattern in the term structure. In the front end, the Jan-22 DI future was trading at 3.35% (just +1 bps from last Friday), as the BCB's communications continue to signal probable maintenance of the forward guidance (flight plan of stable interest rates), given that inflation pressures are seen as supply-driven and temporary. In the back end, the Jan-27 DI future was trading at 7.67% (+21 bps from last Friday). This week's movement drove the steepness in this segment to ~433 bps, compared to ~412 bps in the previous week and ~150 bps before the arrival of the pandemic in Brazil (late February).

As per this steepening pattern, local factors seem to have been in the drivers' seat. From a technical standpoint, investors saw a larger-than-expected National Treasury bond auction on Thursday, which we think probably contributed to push back-end yields higher. From a macroeconomic perspective, local news provided no respite in the yield curve either, as the key fiscal decisions remain on hold until the run-offs of the municipal elections (November 29, 2020). Markets apparently still see a high execution risk for the fiscal adjustment process after the pandemic.

As such, we are still of the view that Brazil faces a binary set of macro outcomes. Either the credibility of the constitutional spending cap will be maintained, leading to a relief rally in local bonds, or there will be a possible breach of the fiscal regime, potentially feeding further rounds of sell-offs in local yields.

Fiscal policy: On the fiscal side, this week (November 17) the Ministry of the Economy updated its economic forecasts. The inflation index used to readjust the minimum wage (INPC[2]) went from 2.4% to 4.1%. If the number is confirmed, the minimum wage would rise to BRL1,088 in 2021 (from BRL1,045 in 2020). This fact compresses further the margin for complying with the spending cap in 2021, because of the mismatch between the inflation index that is used to readjust the spending cap limit, 12-month IPCA until Jun-20 (+2.1%), and the INPC (year-end) used to adjust budget benefits. For details, refer to our report[3].

We recently revised our forecast for the INPC to 3.3% for 2020. This implied a decrease of BRL10 billion in the gap between the actual budget and the spending cap, leading to an insufficiency of BRL1.5 billion. Considering our IPCA tracking for 2020 (now at 3.6%), the INPC should end the year close to 4.0%, per our estimate. Consequently, we forecast the margin of the spending cap should be close to an insufficiency of BRL6.5 billion for next year.

The compliance with the spending cap remains feasible—although requiring higher fiscal discipline, in our view. However, it could lead to a decline in discretionary expenses, and thus to the partial shutdown of some public services, implying a higher execution risk for the spending cap regime.

[1] **Santander Macro Brazil External Sector – *Brazilian Weekly Spot FX Flows*** – November 18, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-fx-nov-9-13/20-11-20_135118_201118+-+spot+fx+flow.pdf

[2] **National Consumer Price Index - INPC**, aimed at the correction of the purchasing power of salaries by means of the measurement of price changes in the basket of the lowest-income salaried population.

[3] **Santander Macro Brazil Fiscal Policy - *Spending Cap Rule: Narrowing the Margin for 2021*** – October 20, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-special-spending-cap-rule/20-10-21_204025_bzmacrospcap102120.pdf

Economic activity: As has been the case since April, FGV has anticipated preliminary results for its confidence indexes in November, with the survey being conducted between November 1 and November 13 (the original publication calendar remains as scheduled, with the final confidence indexes being released from next week onward). The report shows that the confidence level continued to decrease this month, with the aggregate business confidence level registering the second decrease in a row (-0.9 p.p.). Yet the number remains roughly in line with February's (pre-crisis) reading. Among the sectors, mixed signals were sent this month. Industry picked up in the month (+1.5 p.p.), reaching the highest level since 2011, while the retail sector was stable (no change). In contrast, services (-1.2 p.p.), construction (-3.3 p.p.) and consumer (-2.2 p.p.) posted declines for the second month in a row. Compared to the period before the social distancing measures took effect (February), the industrial sector is running 11.0% above February's reading, but the remaining sectors that compound the business index are all below this mark. We highlight consumer confidence, which shows the largest difference from its previous level (8.7% below) and is close to the services sector (8.6% below), well-known as the most laggard sector in this economic recovery.

In our view, one reason behind the decelerating trend in consumer and retail sales confidence in the last two months is the gradual reduction in the amount of emergency aid, since the lower paychecks started to arrive at the end of September, with probable effects from October onward. Another reason is the price hikes for essential goods, especially food, which could be eating into the budgets of a number of (lower-income) households.

Balance of payments: On Wednesday (November 25), the BCB publishes the balance of payments report for October. Based on another sound outcome registered by the trade balance for that month, together with the maintenance of relatively restrained outlays related to tourism and remittance of profit and dividends, we expect the current account balance to have registered the seventh monthly surplus in a row (USD1.3 billion), which—if confirmed—will have reduced the USD50.9 billion annual deficit observed in December 2019 to a USD20.7 billion imbalance last month.

We believe the outcome will support our assessment that the current account balance adjustment will continue in the coming months and lead to a nearly balanced number by the end of this year (we estimate a USD2.5 billion annual deficit for 2020). However, when we look at the seasonally adjusted figures, we calculate that the three-month moving average annualized result to be indicated by October data will point to the end of the improving trend that we have observed in that indicator since March 2020. We take that as an indication that the economic recovery is gaining momentum, but given our expectation of a gradual healing process, we do not anticipate a rapid worsening of the current balance in the medium term (we project a USD3.5 billion annual deficit in 2021).

In tandem with low deficits in the current account balance, we expect the country to continue to witness net inflows of foreign direct investments—in October 2020, the monthly volume should have reached USD1.5 billion (or USD44.6 billion in 12-month-to-date terms). As this is more than enough to finance the projected current account deficits, we believe the Brazilian balance of payments should remain off market participants' radar as a source of concern.

Inflation: On Tuesday (November 24), IBGE is scheduled to release IPCA-15 inflation data for November. We expect a high reading of +0.75% MoM (4.16% YoY). Once again, we expect the main source of upward pressure to be food-at-home inflation. The shock is taking longer than we expected and we expect to see another high monthly print, at 2.49% MoM for the group, decelerating just a bit from the latest release (IPCA 2.57% in October). Industrial goods also continue to be pressured; we expect +0.87% MoM. In services, however, after a recent high print due to a volatile item (airline tickets), we forecast the group to decelerate in MoM terms to 0.29% (from 0.55% in October's IPCA). Finally, we forecast administered prices to rise 0.36% MoM.

The fading of the recent shocks is being postponed, leading us to estimate higher IPCA trackings for 2020 and maintaining upside risks for the short term (up until 1Q21). Yet we continue to see these shocks as temporary and predominantly supply-driven. As a result, with fading shocks, a negative output gap, and anchored inflation expectations, we believe inflation should continue below the target and with a benign composition (low core measures) in the medium term. For 2020, we recently revised our high-frequency tracking from 3.3% (official forecast) to 3.6%, because of the continuing shocks. For 2021 our tracking has also risen, from 2.9% (official forecast) to 3.1%, because of a recent unexpected announcement of price adjustments on health insurance, and the risk is also tilted to the upside because of possible weather-related shocks potentially affecting food and energy costs.

Also next week: There is a heavy macroeconomic schedule next week in terms of release of data. On the economic activity agenda, several reports are scheduled to be released. FGV will begin to release the final soft data for November, making available the confidence data for consumers (November 25), retail sales (November 26), and industry (November 27). If the preview's data is confirmed, industry confidence will be at the highest level since 2011. Regarding the labor market, formal job creation (November 26) and unemployment rate (November 27) will be available for October and September, respectively. These figures will be essential for tracking the deterioration in labor market conditions amid a gradual reopening of the economy.

On the fiscal side, the Brazilian internal revenue service will publish (there is no set date) the federal tax collection information for October 2020. Our estimate is BRL150.5 billion, which would mean an increase of ~7.5% compared to October 2019, in real terms. The result will be affected by the receipt of the deferred tax for the month of May (BRL15 billion in our estimative); this was a measure to mitigate the effects of COVID-19 in the second quarter. Tax collection has been recovering gradually, driven by the better performance of economic activity. Considering this revenue data and extraordinary budget expenses of BRL29 billion, we estimate that the central government's primary deficit will have totaled BRL31.5 billion in October 2020—this report is scheduled to be published on November 27.

On inflation, November's IGP-M will also be released (on Friday, November 27). We expect, again, a high monthly print, but with a small deceleration compared to November's IGP-10, from 3.51% MoM to 3.26% MoM. Wholesale prices (agricultural and industrial) continue to be the main sources of pressure.

October's bank lending data by the BCB will be released on Friday (November 27). Compared to September, we expect a deceleration in new loans for both households and non-financial corporations. Importantly, BCB announced that revisions have been made regarding the effects of emergency credit-support programs. New loans related to these will be reclassified from non-earmarked to earmarked loans, changing the composition of the results somewhat.

MACRO AGENDA

Indicator	Reference	Date	Estimate	Prior
IBGE Inflation IPCA-15 (% MoM)	Nov/20	Tue,24-Nov	0.75	0.94
IBGE Inflation IPCA-15 (% YoY)	Nov/20	Tue,24-Nov	4.16	3.52
FGV Consumer Confidence (points)	Nov/20	Wed,25-Nov	--	82.4
Current Account Balance (USD billion)	Oct/20	Wed,25-Nov	1,300	2,320
Foreign Direct Investment (USD billion)	Oct/20	Wed,25-Nov	1,500	1,597
Federal Debt Total (USD billion)	Oct/20	Thu,26-Nov	--	4,527
Caged Formal Job Creation (Total)	Oct/20	Thu,26-Nov	--	313,564
FGV Inflation IGP-M (% MoM)	Nov/20	Fri,27-Nov	3.26	3.23
FGV Inflation IGP-M (% YoY)	Nov/20	Fri,27-Nov	24.50	20.93
National Unemployment Rate (%)	Sep/20	Fri,27-Nov	--	14.4
Total Outstanding Loans (BRL billion)	Oct/20	Fri,27-Nov	3,886	3,810
Central Govt Budget Balance (USD billion)	Oct/20	Fri,27-Nov	-31.5	-76.2

Sources: Bloomberg and Santander.

For details on our Brazil economic forecasts, please refer to our latest scenario review[4].

[4] **Santander Macro Brazil Scenario Review – Waiting for the Fiscal Decisions** – October 28, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-macroeconomic-scenario-oct/20-10-30_174317_201028+santander+brazil+macro+scenario.pdf

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