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Brazil Macro Compass

A Solid 4Q in the Making

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- **Local markets remained in a risk-on mode this week, following the lead from global markets based on a greater probability of a new fiscal package in the U.S. and favorable COVID-19 vaccine news. Domestic factors are also driving the good mood, reflecting further signals favoring the maintenance of the fiscal policy framework in Brazil. With additional help from a hawkish BCB policy statement, the BRL continued to strengthen in recent days, making it one of the top-performing currencies this week.**
- **Led by nearly the same drivers as the FX, the nominal yield curve flattened once again this week, with the gap between Jan-22 and Jan-27 (in DI futures) approaching early August's level. Despite the Copom's signal that it may soon scrap its forward guidance, we continue to see value receiving the very front end of the curve.**
- **As widely expected, the Brazilian Central Bank (BCB) kept the Selic rate at the historical low of 2.00%. The statement was more hawkish than expected, as the BCB signaled it may soon scrap its forward guidance, in which the authority has been signaling a willingness to maintain monetary stimulus under certain conditions. Our sense is that the authority is not getting ready for immediate hikes but that the stage is being set for possible moves in 2H21. The Copom minutes (due December 15) and 4Q inflation report (due December 17) will provide more details on the BCB's views and plan.**
- **On the political front, Congress advanced on the microeconomic agenda. The *PEC Emergencial* began to be discussed among the leaders of the Senate; however, the final version will only be presented in 2021. Next Wednesday (December 16), a joint congressional session will take place to vote on the Budgetary Guidelines Law (LDO), an essential law for maintaining the execution of public spending in the first months of 2021, before the final budget approval.**
- ***Anbima* November's data show that capital market issuances in 2020 are still below the year-ago period. Debentures (bond) issuances contributed the most to the overall decrease. On the other hand, funding for equity and real estate funds posted growth relative to 2019's volume.**
- **Retail sales started 4Q with a large sequential gain, above our expectations. For November, our proprietary coincident indicator (IGet) is pointing to another month of sequential growth. The services sector, the laggard in the recovery process, is slowly benefiting from the economy's reopening, posting another sequential gain in October. The BCB will release on Monday (December 14) the IBC-Br for October, and we expect sequential growth of 1.3% MoM s.a. (-1.8% YoY), reinforcing the likelihood of solid sequential growth in 4Q20.**
- **November's IPCA registered a 0.89% MoM change (4.31% YoY). The result was well above the market's median expectation (0.78% MoM) and above our forecast (0.82% MoM). Food-at-home continues to exert upward pressure and was the major upside surprise (+6 bps), while core measures came in lower than expected (0.44% MoM vs. 0.50% forecasted). Though the shocks are lasting longer than we expected, we begin to see signs they are coming to an end, so we maintain a benign view for the medium term.**
- **We expect the release of the balance of payments data for November 2020, due next Friday, to show a nearly even current account balance (USD0.1 billion surplus) in the period, in tandem with a sizeable entry of portfolio-related flows (above USD6.0 billion), which would be the sixth positive result in a row.**

Local markets—FX: The BRL continued to strengthen against the USD this week and was poised to end the period among the top performers among emerging currencies (as of this writing, the USD/BRL pair was quoted at 5.08 compared with 5.13 a week ago). In our view, part of the move had to do with the maintenance of the risk-on mode among market participants in response to the progress of vaccines against COVID-19 and a higher probability of the approval of a new fiscal package in the U.S. before the end of 2020. On top of that, additional signals that the Brazilian government will not extend the emergency measures into 2021 also helped to improve market participants' confidence, as such signals indicated the maintenance of the current framework of fiscal policy (i.e., the constitutional spending cap). Still in the fiscal arena, the statement made by the National Treasury confirming that its financing needs until April 2021 have already been met eased market participants' minds regarding the roll-over of BRL654 billion (approximately USD130 billion) of bonds falling due in the first four months of next year.

Additionally, the hawkish wording in the post-Copom communiqué indicated that the normalization of monetary policy may start earlier than previously thought (more details in the "Monetary Policy" section of this report). Usually, the higher the interest rate, the stronger the currency, and, consequently, the BRL was also influenced by that indication.

Besides these fundamental factors, some technical issues also contributed to the appreciation of the BRL in the last couple of days. The Brazilian Central Bank (BCB) is tendering USD swaps to deal with the augmented demand for USD derivatives on the heels of the reversal of hedge operations due to changes in taxation. Consequently, the potential pressure seems to have been reduced, in our view, which favors strengthening of the BRL.

All in all, both structural and technical factors continue to point toward further appreciation of the BRL in the coming weeks, in our view, assuming a lack of negative news regarding the Brazilian fiscal framework.

Local markets—rates: Based on prices from Friday just before noon (time of writing), the nominal yield curve looks poised to flatten once again, though less than last week. In the front end, the Jan-22 DI future was on the verge of closing the week at 3.06% (-3 bps from last Friday). In the back end, the Jan-27 DI future was trading at 6.81% (-11 bps from last Friday), pushing the steepness in this segment (i.e., 2027s vs. 2022s) to nearly 375 bps, compared to 383 bps in the previous week and ~150 bps early this year before the arrival of the pandemic in Brazil (late February). That is the flattest showing of the curve in this segment since early August.

In our view, the backdrop in global markets continues to be positive, contributing to the bull movement, with optimism brought by news of earlier-than-expected vaccine rollouts in general. Market participants are also expecting a resolution regarding the U.S. fiscal package, still in negotiation, that could favor EMs even further. We see this paving the way for a little rally at the belly and back end of the curve, with that rally also driven by recent signals from Brazilian government officials that the emergency fiscal stimulus will not be extended into 2021—favoring the execution of the constitutional spending cap. The flattening movement of the curve also comes on the heels of the Copom's statement, in which the BCB signaled that it may soon scrap its forward guidance. In our opinion, that came a bit sooner than expected (see the "Monetary Policy section" below), sounding like "hawkish" wording that propped up the yields a bit at the front end.

The combination of favorable global financial conditions and preliminary signs of willingness to proceed with the fiscal adjustment process from 2021 onward is favoring massive bond auctions by the Brazilian National Treasury. The increased issuances in recent months and a more conservative budget execution late in 2020 are paving the way for a reduced financing risk for 1H21, in our view. We believe this helps ease investor concerns in the meantime.

In summary, while the fiscal dilemma continues (boosting welfare programs vs. retaining the credibility of the spending cap rule), the temporary solution of no increase in mandatory expenses for now brings a bit of respite to Brazilian assets, especially against a more positive global backdrop. Since we continue to see limited probability of BCB rate hikes in 1Q21, we continue to see some value receiving in the very front end of the nominal yield curve.

Fiscal policy: On the political front, Congress advanced on the microeconomic agenda this week. The Lower House concluded deliberations on cabotage reform (Law PL 4199), with final approval in Congress expected in 2021. Senators approved a new housing program (*Casa verde amarela*) and a bidding law on government procurement processes. Both measures await presidential approval. The Upper House has also approved the new legal framework for the gas industry; however, considering the amendments that have been introduced, the bill will have to go back to the Lower House.

On December 8 Senate party leaders began analyzing the preliminary version of *PEC Emergencial,* a key piece of legislation (constitutional amendment) establishing cuts in mandatory expenses and creation of budget triggers to guarantee the feasibility of the constitutional spending cap. But that is still not the official version that will be brought to a vote. According to an official note from the rapporteur (Senator Marcio Bittar), the final version will only be presented in 2021. The measure may make it possible to comply with the spending cap rule after 2022, according to our calculations, assuming no new mandatory spending is created.

In our view, the most important item in Congress is a vote on the Budget Guidelines Law (LDO, in the Portuguese acronym) of 2021, which has been scheduled by the Senate president to take place December 16. Approval of the LDO would allow the government to authorize temporarily at least one twelfth of the amount forecast for the year until Congress approves the final budget. Without the LDO, there is no legislation to regulate the interim execution of the budget, so that the government and its services could come to a halt. After the vote on the LDO, we think Congress is likely to leave for its recess. Consequently, we expect further advances in the agenda and in the debate over the budget for 2021 only after the elections for speakers of the Lower House and Senate in the first days of February 2021.

Credit: *Anbima* figures on capital markets activity for November show that new issuances totaled BRL25.8 billion, a slowdown from October's volume (BRL39.6 billion). Issuances in fixed income accounted for BRL14.4 billion; equities totaled BRL6.7 billion; and real estate funds came in at BRL4.6 billion.

Considering total financing between January and November (BRL305 billion, inflation adjusted), there was a decrease of 19.7% in issuances relative to the year-ago period. Fixed income, notably debentures, contributed the most to the overall decrease, as issuances for this debt instrument in 2020 are 43.9% lower than in the year-ago period. The uncertainty triggered by the COVID-19 pandemic prompted a risk-aversion movement, especially in 1H20, increasing debt cost for corporations and dragging down the upward trend of issuances observed up to the pandemic's outset. In line with banking credit, working capital has been leading the allocation of proceeds (36.7% in 2020 against 30.4% in 2019).

In the opposite direction, still in the same comparison, equity issuances in 2020 are 28.4% higher than 2019's volume, which in our view is likely due to a portfolio shift generated by historically low interest rates. In November, IPOs accounted for BRL6.1 billion, the second highest in the year. Follow-on issuance volume plunged from October's volume, falling to BRL0.6 billion. For real estate funds, the accumulated volume of issuances in 2020 is 9.1% above the year-ago period.

Household indebtedness: BCB data for September show household debt to income at 49.0%, up +1.0 p.p. from August (+4.4 p.p. from September 2019). It is the largest monthly increase since 2005. The household debt service ratio was 21.3%, up +0.7 p.p. from August (+1.3 p.p. from September 2019). This increase in consumer indebtedness is another indication, in our view, that NPLs are likely to rise in the coming months.

Housing market: In October, the volume of real estate financing hit its highest level in nearly five years. Looking ahead, we believe this market will remain robust, as shown in our recent study. For details see our report[1].

Economic activity: Data on retail sales for October released by IBGE highlighted continued strength in spending on goods. The number has surprised market expectations, with the headline core index pointing to growth of 0.9% MoM s.a. (8.3% YoY), considerably above consensus (0.1%). For the broad retail sales number (including auto and construction), more directly related to GDP, there was an increase of 2.1% MoM s.a. (6.0% YoY), vs. consensus at 1.5%. These figures show that we began 4Q20 with a large sequential gain, above our expectations, which suggests still good momentum going into 4Q. In comparison to the pre-crisis level, these numbers imply that core and broad indexes are 8.0% and 4.9% above February's reading, reflecting both a temporary change in the consumer spending profile (with a shift out of services and into goods), as well as the massive government stimulus (*coronavouchers*). With this result, assuming no growth in the remaining months of the year, the carryover for 4Q20 is at 2.2% and 4.2%, respectively. Our proprietary coincident indicator of retail sales (IGet) registered a drop in November, but our tracking based on this data is at 0.7% MoM s.a. (3.5% YoY) for broad retail sales, respectively. For details see our reports[2].

Data on the services sector released by IBGE was in line with market's expectations of another sequential gain in October. Relative to October 2019, the headline posted a variation of -7.4% vs. consensus of -7.7%. After seasonal adjustments, the monthly gain was 1.7% MoM s.a. (over a higher basis, since there was an upward revision in September). This is the fifth gain in a row after April's sharp drop and the bottom in May, but it still is not enough for a full recovery from the losses registered in the crisis, with the headline index still 6% below the pre-crisis level. These figures underline that despite the recent improvement, the services sector is still the laggard in the economic recovery, and the details show a heterogeneous recovery, with sectors that were less affected by social isolation measures already running above pre-crisis levels. In

[1] **Santander Macro Brazil Credit – *Housing market Picking Up* –** December 9, 2020- Available on: https://bit.ly/Sant-credit-housing

[2] **Santander Macro Economic Activity– *Retail Sales: Sequential Improvement at the Start of 4Q20* –** December 10, 2020- Available on: https://bit.ly/Sant-retail-sales-4q20

Santander Macro Economic Activity– *IGet: Acomodação a caminho no 4T20* – December 10, 2020- Available (in Portuguese) on: https://bit.ly/Sant-iget-nov quarterly terms, assuming no growth in the remaining months of the year, the services sector would reach a 4.1% QoQ s.a. gain in 4Q20, which is consistent with our view of a sequential improvement in 4Q20 GDP. For details see our report[3]

Inflation: November's IPCA registered a 0.89% MoM change (4.31% YoY). The result was well above the market's median expectation (0.78% MoM) and above our forecast (0.82% MoM).

The upside surprise was concentrated on food-at-home (+6 bps), where the recent shocks are taking longer to pass than we expected. On the bright side, services (-1 bps), which are more related to core measures, surprised a bit to the downside. Another group more related to core measures, industrial goods (-1 bps), also surprised somewhat to the downside (although the MM3saar is still running at high levels). On the average of core measures, despite another acceleration in MM3saar terms to 5.1%, there was a downward surprise in MoM terms: 0.44% MoM vs. our expectation of 0.50%. In annual terms, the average of core measures stands at 2.6% YoY, still way short of the BCB's inflation target for relevant policy horizon.

Despite the recent upward shocks, we continue to call for a benign scenario for inflation for the medium term. We updated our short-term IPCA forecasts to 1.34% for December (from 1.26%), 0.16% for January (from 0.24%), and 0.39% for February (from 0.23%). Our tracking for IPCA 2020 went to 4.5% from 4.3%, while the tracking for IPCA 2021 was kept at 3.0%. We believe the balance of risks from January onward is starting to turn more symmetric, even tending slightly to the downside. For details see our report[4].

November's IGP-DI was also released and registered a 2.64% MoM change, below market's median expectation of 2.80% MoM and our forecast of 2.83%. Wholesale prices in both the industrial and agricultural sectors surprised a bit to the downside, which we believe is a good sign for price pressures down the road in coming weeks and months.

Monetary policy: As widely expected, the Brazilian Central Bank (BCB) kept the Selic rate at the historical low of 2.00%. The statement was more hawkish than expected, as we think the most important point was that the BCB signaled it may soon scrap its forward guidance, in which the authority has been signaling a willingness not to "reduce the monetary stimulus as long as specified conditions are met." In our view (and probably the market's), that came a bit sooner than expected.

For now, we believe this future change in plan seems related to the switching of the policy horizon from end-2021 (when inflation is seen below the target with a stable Selic next year) to end-2022 (when inflation is seen at the target, but only with Selic hikes next year). Our sense is that the authority is still not getting ready for immediate rate hikes but that the stage is being set for possible moves in 2H21.

While we continue to forecast limited demand-led inflation next year and project IPCA below the target for 2021 and 2022, we are mindful of the BCB's new upcoming flight plan, and see much greater chances for a sooner start in the BCB's policy rate normalization process next year. For details see our report[5].

Balance of payments: On the heels of a stronger pace of imports than in previous months, we expect the current account balance to have registered a nearly even number in November 2020 (USD0.1 billion) after a three-month streak of surpluses higher than USD1.0 billion. This reinforces the (general) perception that the Brazilian economy remains on a recovery trend, which we expect to continue to push imports up but which should not lead to a substantial shrinkage in the trade balance for now, as the prospects for exports remain favorable as well (high commodity prices, faster than anticipated revival of international trade flows, economic recovery of main trading partners, etc.) Hence, we do not anticipate a substantial deterioration in the current account balance soon, especially as the gradual recovery should lead services and primary income deficits to continue running at much lower levels than in previous years.

On top of soothing signals that we expect to come from the current account balance, we expect the financial account to bring some favorable updates as well. It is true that the net inflow of direct investments in the country should have run at relatively low levels compared with previous years (USD1.0 billion, according to our estimates, vs. a monthly average of USD6.6 billion between 2010 and 2019), but we are likely to witness a sizeable net entry of portfolio-related flows, as preliminary figures presented by the BCB indicated the acquisition of USD6.1 billion of Brazilian financial assets in the domestic market until November 20. If confirmed, that will have been the sixth positive result for that item, thus signaling a

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[3] **Santander Macro Economic Activity– *Services Sector: A Breath of Fresh Air at the Start of 4Q20* –** December 11, 2020- Available on: https://bit.ly/Sant-serv-oct-20

[4] **Santander Macro Brazil Inflation – *IPCA November: Another High Print, But with Some Positive Surprises* –** December 9, 2020 - Available on: https://bit.ly/Sant-ipca-nov-20

[5] **Santander Macro Brazil Monetary Policy - *COPOM DECISION: Planning a Change in Plan* –** December 9, 2020- Available on: https://bit.ly/Sant-copom-dec

stronger appetite for riskier assets, which we believe will tend to contribute to the strengthening of the Brazilian currency in the coming months (in the absence of negative surprises on the domestic fiscal front, it is important to remember).

Also next week: On Monday (December 14), the BCB will release the IBC-Br for October, capping the batch of economic activity indicators releases for this month, and we are expecting sequential growth of 1.3% MoM s.a. (-1.8% YoY).

On inflation, December's IGP-10 will be released next week (on Tuesday, December 15). We expect a 1.98% MoM change. Despite being another high print, this would be a deceleration compared with both last month's IGP-10 (3.51% MoM) and IGP-DI (2.64% MoM). It is worth highlighting that we expect the deceleration to be driven by wholesale prices, both in the industrial and agricultural segments, which is a favorable sign for a probable softening of prices at the consumer level (IPCA).

On Tuesday, the minutes from the December 8-9 Copom meeting will come out, and the market will search for more information on possible drivers for an earlier abandonment of the forward guidance, as well as details of the BCB's scenario assessment. On Thursday, the BCB publishes the 4Q inflation report, bringing more clarity on the BCB's inflation simulations and new studies that provide the basis for BCB's policy steps.

MACRO AGENDA

Indicator	Reference	Date	Estimate	Prior
IBC-Br Economic Activity (% MoM)	Oct	Mon, 14-Dec	1.3	1.29
IBC-Br Economic Activity (% YoY)	Oct	Mon, 14-Dec	-1.8	-0.77
Copom Minutes	9-Dec	Tue, 15-Dec	-	-
IGP-10 Inflation (% MoM)	Dec	Tue, 15-Dec	1.98	3.51
Central Bank Inflation Report	4Q	Thu,17-Dec	-	-
Current Account Balance (USD billion)	Nov	Fri, 18-Dec	0.1	1.5
Foreign Direct Investment (USD billion)	Nov	Fri, 18-Dec	1.5	1.8

Sources: Bloomberg, Santander.

For details on our Brazil economic forecasts, please refer to our latest scenario review[6].

[6] **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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