BRAZIL MACRO February 12, 2021

MACRO COMPASS

ACTIVITY LOSES STEAM AT THE END OF Q4

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- While the BRL got a bit stronger compared to a week ago, nearly in line with peer-currencies, renewed uncertainties related to the fiscal policy outlook stoked further volatility, prompting the BCB to intervene. The nominal yield curve reversed a recent flattening trend, with the 2022-2027 steepening up by 16 bps from last Thursday (February 4). While weaker-than-expected inflation and activity readings reduced a bit the market-implied probability of a more hawkish BCB in the very short term, talks about fiscal stimulus without reforms bumped up the premium for the longer term.
- Amid falling new cases and a plateau of deaths, Brazil continues its vaccine rollout, currently at a pace of 228k/day. A preliminary near-term estimate shows that Brazil could potentially have enough vaccines (in two doses) for every Brazilian aged over 60 by the end of April 2021. As of February 11, ~4.4 million doses have been administered in the country.
- January's IPCA registered a 0.25% MoM change (4.56% YoY), below our forecast (0.31%) and the consensus (0.30-0.31%). Core measures remained under pressure, so the report still shows an unfavorable picture and we continue to see risks tilted to the upside for 2021. Yet we maintain the assessment that inflation pressures are temporary and the IPCA will probably land somewhere close to the target in 2H21.
- The Lower House approved the Central Bank independence bill by a landslide vote. Congress started the debate on the 2021 budget, and a vote is expected by the end of March. Finally, the impasse over the new stimulus lingers on, with increased risk of a non-neutral outcome for government debt.
- On economic activity, the last pieces of December data were released over the past week. Broad retail sales surprised negatively, pointing to a sharp drop of 3.7% MoM-sa and enough to take the index back to February's reading. The services volume was virtually stable (-0.2%), likely reflecting the first effects of the pandemic relapse. The BCB's monthly activity index (IBC-br) showed a monthly increase (0.6%), though with our tracking for 4Q20 GDP is running at 2.8% QoQ-sa.
- Anbima's data for January show domestic new issuance of debt and equity 20% above January 2020. Importantly, 42 IPO operations are in the pipeline, suggesting a favorable outlook for the equity market. On the other hand, BCB data shows that consumer indebtedness is still on the rise, which could mean another headwind for spending in 2021.

Owing to next week's Carnival holidays (February 15 to 17), our next weekly report is due on February 26.

This report uses most information up to the end of Thursday, February 11, 2021.

Figure 1. Brazil Macro Agenda for the Week February 15-19, 2021

Indicators	Source	Reference	Date	Santander Estimate	Prior
National Holiday	--	--	Mon, 15-Feb	--	--
National Holiday	--	--	Tue, 16-Feb	--	--
National Holiday (Part-time)	--	--	Wed, 17-Feb	--	--
No major macroeconomic releases					

Source: Santander Brazil.

For details on Santander's economic forecasts for Brazil, please refer to our last scenario review[1]. For our key views and hypotheses for 2021, please refer to our macro propositions[2].

[1] **Santander Brazil - Macroeconomic Scenario:** ***"The Persistence of (Fiscal) Risks"*** **–** February 11, 2021- Available on: http://bit.ly/Sant-ScenRev-fev21

[2] **Santander Brazil** - **"Macro Propositions: Groundhog Year?"** – February 03, 2021- Available on: http://bit.ly/Sant-macro-prop-2021

LOCAL MARKETS—FX

The BRL ended the trading session of February 11, 2021 stronger than a week ago, although its trajectory during the period resembled a roller-coaster, which led the Brazilian Central Bank (BCB) to intervene in the FX market last Tuesday, when it sold USD1.0 billion in FX swaps. The approval of the formal autonomy of the Brazilian Central Bank by Congress last Wednesday may also have played a role in this strengthening move in our view, but that occurred within a globally weaker USD backdrop.

However, the BRL failed to outperform peers on the heels of renewed concerns about the fiscal policy outlook, which had to do with statements delivered by key figures across the political spectrum about the reintroduction of emergency aid, but without any mention of the resumption of discussions about structural reforms to counterbalance the impact of this potential new round of fiscal stimuli. In our view, this backdrop suggests that, for now, news on the fiscal front should have a bigger impact on Brazilian financial asset prices than any other theme. Given the high level of uncertainty that still persists regarding the conduct of fiscal policy in the short term, one should expect the BRL to continue to follow a roller-coaster trajectory until a clearer picture arises.

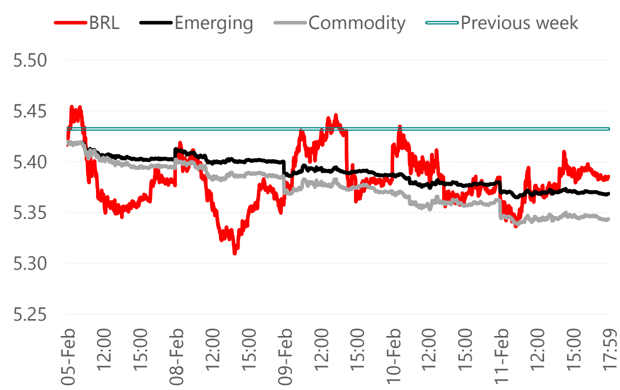
LOCAL MARKETS—Rates

The nominal yield curve steepened in recent days. The front end of the curve (Jan-22 DI future) fell 3 bps to 3.34% since our last report, while the back end (Jan-27 DI future) rose to 7.12% (+13 bps since our last report). Hence, the steepness in this segment rose from 362 bps to 378 bps since last Thursday.

At the front end, lower-than-expected January IPCA inflation and weaker-than-expected December retail sales led market participants to price in a reduction of the probability of a more hawkish action by the BCB in the next Copom meeting. At the long end, despite the positive sign provided by the approval of central bank autonomy, markets became worried about the possible advance of a new round of income emergency aid without a concomitant approval of a measure to reduce expenses in the long run.

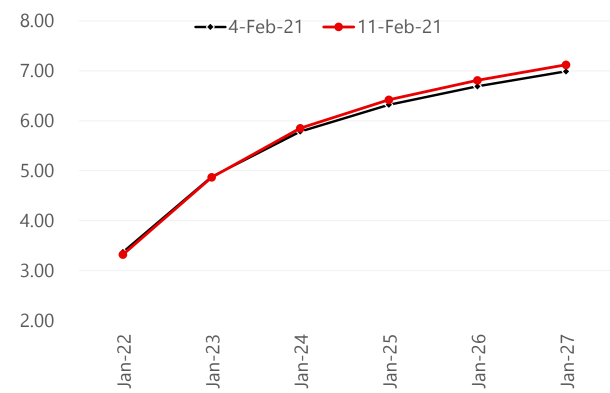
We continue to see the potential for volatility ahead, amid lingering uncertainties about the next fiscal policy steps. Although we believe there may still be a little premium in the short end of the curve, we still think that receiving the belly is more attractive at this juncture. But that view only holds in case our new baseline scenario (a little additional stimulus offset by reforms) materializes. An eventual decision to postpone the adjustment could put pressure on the back end and prompt further steepening.

Figure 2.A. – USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note1: As of the closing of Thursday, February 11, 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 closing of Thursday, February 11, 2021.

COVID-19 MONITORING

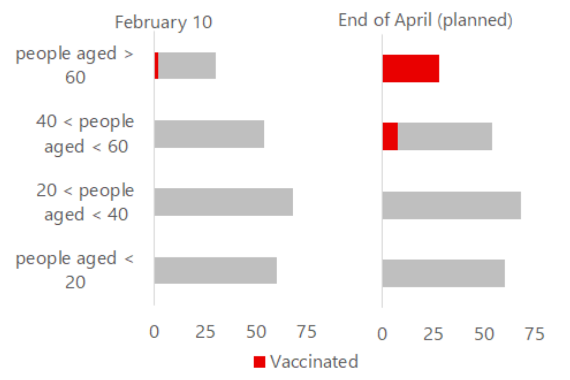
Declining deaths is another encouraging trend in the U.S. COVID-19 pandemic. After several weeks of plummeting new cases, deaths in the U.S. are finally falling. The pace of vaccinations in the country is currently at 1.5 million/day (7-day moving average), with nearly 10% of the population having received at least one dose. In the U.K., 19% of population received at least one dose, so that the vaccination has been outpacing the European Union, where only 2.7% of the population got (at least one shot of) vaccines. New cases in Spain continue to fall, while in France new cases are flattening, with mobility restrictions having been imposed last week.

Brazilian Ministry of Health seeks deal with two more vaccines. Gamaleia/Sputnik V (10 million doses) and Bharat/Covaxin (20 million doses) could boost the supply of vaccines available to Brazilians. *Butantan* is negotiating an additional 20-million-dose deal for 2H21, and expects to submit this month to *Anvisa* (Brazil's national sanitary watchdog) the application for official approval—a requirement for broad use in the population. The authority decided this week to exempt any vaccine from the COVAX coalition from official approval.

A preliminary near-term estimate shows that Brazil could have enough vaccines (2 doses) for every Brazilian aged over 60 by the end of April 2021. According to recent statements, *Butantan* could deliver 600k doses/day, starting from February 23 while *Fiocruz* could deliver another 1 million doses/day, starting from March 19. Provided that the current flow of these two vaccine suppliers continues, Brazil would have an additional 78 million doses, bringing the total number of available doses to 90 million by the end of April 2021. This amount is enough to cover the first and the second priority groups of 37 million Brazilians (people aged over 60, health workers and native Brazilians) with 2 shots. This is relevant information since data from the Brazilian Ministry of Heath reveals that 74% of deaths and 58% of hospitalizations caused by COVID-19 were among people aged over 60. Hospitalization numbers are naturally the key drivers for mobility-related policies.

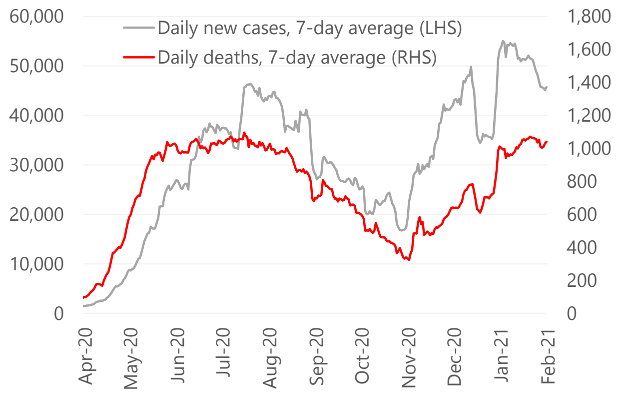
As of Thursday (February 11), 4.4 million doses (out of 12 million available) have been administered in the country, with the pace of vaccination at 228k/day (7-day moving average). Johns Hopkins data for Brazil reports an average of 45k daily new cases (7-day moving average) as of Wednesday (February 10, 2021), down 6.6% from last week, while daily deaths (7-day moving average) stood at 1,041, down 1.5% in the same comparison.

Figure 3.A. – Vaccinated Brazilians Estimate (million)



Sources: Our World in Data, Santander.

Figure 3.B. – Daily COVID-19 Cases, Deaths in Brazil



Sources: Brazil Ministry of Health, Santander.

INFLATION

Upward Inflation Pressure Persists. January's IPCA registered a 0.25% MoM change (4.56% YoY), below our forecast of 0.31% and the market's median expectation (also at 0.30-0.31%).

On downside surprises, food-at-home contributed -6 bps. Also surprising to the downside, services rose only 0.07% MoM, contributing -5 bps of deviation between our forecast and the headline inflation — one particular item drew attention: transportation apps, which have a small weight (0.20%), but fell -12%, alone contributing -3 bps of deviation of our forecast from headline inflation. Industrial goods, which have been a source of pressure and upward surprises lately, did not surprise, coming in line with our expectation (at a high level).

Core measures remain upwardly pressured, influenced mainly by industrial goods, which saw its 3mma-saar rising a bit more and reaching 9.3%. However, services' downward surprise helped the average of the main core measures stabilize a bit, although still at a high level (5.6%). Also, on a more positive tone, diffusion (seasonally adjusted) fell from 67% to 63%.

All in all, despite the downside surprise, we see January's IPCA still showing an unfavorable picture and we still see risks tilted to the upside, although the preliminary signs of cooling down reinforce our view that inflation is under control and should not overshoot the target.

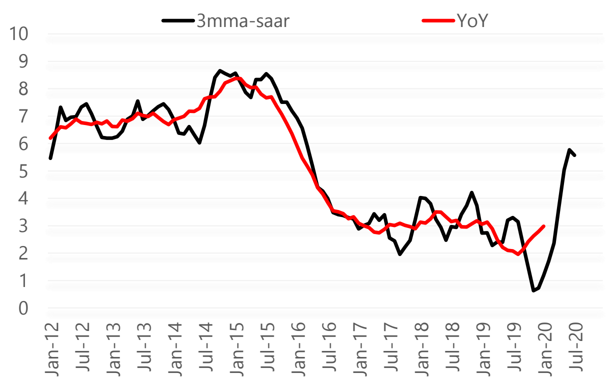
We maintain our short-term forecasts at 0.58% MoM for February, 0.27% for March and 0.50% for April. Our high-frequency tracking for IPCA 2021 also remains at 3.60% (the official forecast is at 3.0% but is under revision with a bias toward the tracking). Finally, our forecast for 2022 also remains at 3.20%. See link below[3].

Figure 4.A. – IPCA by Groups (%)

	MoM			YoY	
	Jan-21	Santander	Dev.	Dec-21	Jan-21
IPCA	0.25	0.31	-0.06	4.5	4.6
Administered	-0.29	-0.49	0.05	2.6	1.8
Free	0.44	0.58	-0.11	5.2	5.5
Food-at-home	1.06	1.49	-0.06	18.2	19.2
Industrial goods	0.61	0.60	0.00	3.2	4.1
Services	0.07	0.19	-0.05	1.7	1.5
EX3 Core	0.56	0.60	-0.04	2.4	2.9

Sources: IBGE, Santander.

Figure 4.B. – Core Inflation Average (%)



Sources: IBGE, Brazilian Central Bank, Santander.

[3] **Santander Brazil Inflation - *"IPCA January: Upward Inflation Pressure Persists"* –** February 9, 2021- Available on: http://bit.ly/Sant-IPCA-jan21

FISCAL POLICY AND POLITICS

The Lower House passed the bill granting central bank independence by a wide margin. Congress kick-started the discussion on the 2021 budget with the creation of a budget committee. Finally, the deadlock over a new income transfer program lingers on.

On February 10, the Lower House voted 339-114 to give the central bank autonomy (PLP 19)—topping the constitutional threshold (308 votes). The measure now heads for presidential sanction.

The bill regulates the mandate of the monetary authority, the terms of appointment for board members (9 in total, including the governor), as well as the criteria for appointment and dismissal of board members. The project proposes four-year terms for the Central Bank governor and the 8 directors—no longer coinciding with the presidential term and with expiry spread along the four-year term. All board members are appointed by the President and approved by the Senate. According to the new legislation, the main goal of the BCB will be assuring price stability and, without hurting the main objective, the authority will also seek financial stability, the smoothing of fluctuations in economic activity and full employment.

Until up to 90 days after the law is enacted, the BCB board will have to be (re-)appointed, with the governor and two directors having their term expire on December 31, 2024, and the rest of the board with terms ending on the last day of 2021, 2022 and 2023 (two directors are expected to leave or be reappointed each year). Each board member can be reappointed once.

In our view, the approval of the bill is a positive change for the medium-term outlook, as it improves the monetary authority's governance. As the literature shows, the credibility gains from an independent central bank should help keep inflation in check. See references below.[4]

Moreover, Congress set up the joint budget committee (CMO) to debate the 2021 budget. According to the proposed schedule the final vote will be held by end of March. It is worth noting that the budget guidelines (LDO) temporarily authorized to spend at least one twelfth of the amount forecast for the year until Congress approves the final budget.

Finally, the deadlock over emergency aid resumption continues. The economic team has eased its tone a bit about a temporary benefit outside the constitutional spending cap, yet they contend it must come alongside measures to cut spending to finance the relief package. The lower house speaker said during this week that he would be in favor of exceptional spending—yet maintaining fiscal discipline. The government will need to find a consensus to structure and approve the resumption of the emergency aid. We expect a more intense debate and a grand bargain on fiscal policy after next week's Carnival holidays.

"The Central Bank Independence bill was approved by 339 votes in the Lower House."

[4] IMF Staff Papers Vol. 56, No. 2. Central Bank Autonomy: Lessons from Global Trends. Available on: https://bit.ly/2MMH3U6
Alesina and Summers (1993) Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence. - Available on: https://bit.ly/3qm1eXa

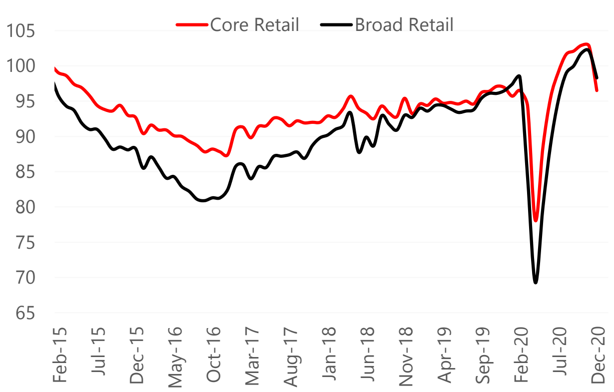
ECONOMIC ACTIVITY

Retail sales fall back towards the pre-crisis level. Despite the expectations of a decline in December, data on broad retail sales surprised negatively, pointing to an even sharper drop of 3.7% MoM-sa (vs. consensus of -1.0%). That was the first decline since April, and enough to take the index back to the level of February 2020. The core index (which excludes vehicles and building materials) slumped by 6.1%. Despite the sharp drop at the end of the quarter, broad retail sales ended 2020 posting a quarterly gain of 2.8% QoQ-sa. The December drop in sales was widespread. We highlight Clothing (-13.3%) and Other Personal Articles (-13.8%), while Supermarkets, which use to be the main driver of the core index, was virtually stable (-0.3%). In terms of outlook, we expect a deterioration in 1Q21 as the fiscal cliff (i.e. end of government stimulus) materializes, with an impact especially on the income-led segments, which performed well last year amid a decline in the "labor-driven" wage bill (without transferences). Based mainly on our proprietary coincident indicator (IGet), our tracking for broad retail sales in January 2021 is at -2.9% MoM-sa (-4.0% YoY), which suggests a loss of momentum in consumer spending reflecting the end of the large government transfers. See link below[5].

December services volume starts to reflect the relapse of the pandemic. The headline index fell by 0.2% MoM-sa (-3.3% YoY), the first decline after six gains in a row following the bottom in May and April's sharp drop. In quarterly terms, despite this slight decrease at the margin, the services sector registered growth of 5.8%, reinforcing, in our view, the likelihood of solid growth of economic activity in the final quarter of the year, in the wake of the economy's reopening. In annual terms, as the sector was the most hurt by the pandemic, it recorded a steep decline of 7.9% in 2020, stemming mainly from the sharp drop seen in 2Q20. December's figure underlines that the services sector is the laggard in the economic recovery seen in 2H20: although almost 80% of the losses registered during the crisis have already been recovered, in comparison to February's reading (pre-crisis mark), the headline index is down by 3.8%, whereas industrial production has already fully recovered from the impact of the crisis. In terms of outlook, we expect a deterioration in 1Q21 economic activity, given the setback in the reopening process with a sequential decrease in mobility. Following December's data, we expect the services sector, which we had expected to be the main driver of the recovery, to be hit, contributing to a probable GDP decline in 1Q21. See link below[6].

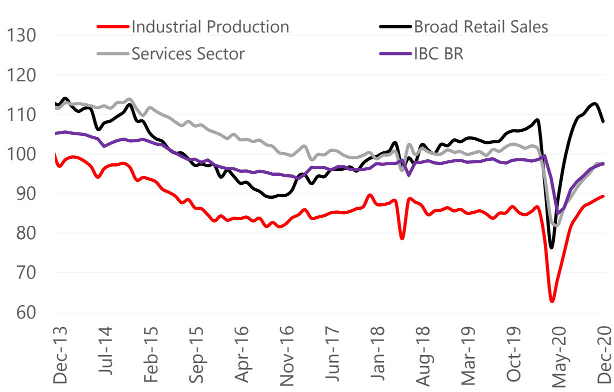
The IBC-Br, the BCB's monthly activity index, capped the batch of economic activity releases for December. The index showed a slight monthly increase of 0.6%, the eighth in a row, placing the economy 1.4% below the pre-crisis mark, according to this indicator. Regarding GDP, our tracking for 4Q20 GDP is at 2.8%.

Figure 5.A. – Retail Sales (sa, 2014=100)



Sources: IBGE, Santander.

Figure 5.B. – Economic Activity (sa, 2011=100)



Sources: IBGE, Santander.

[5] **Santander Brazil Economic Activity - *"Retail Sales Back to Pre-Crisis Mark"* –** February 10, 2021- Available on: http://bit.ly/Sant-econact-100221

[6] **Santander Brazil Economic Activity - *"A Slight Decline in the Services Sector"* –** February 11, 2021- Available on: http://bit.ly/Sant-econact-110221

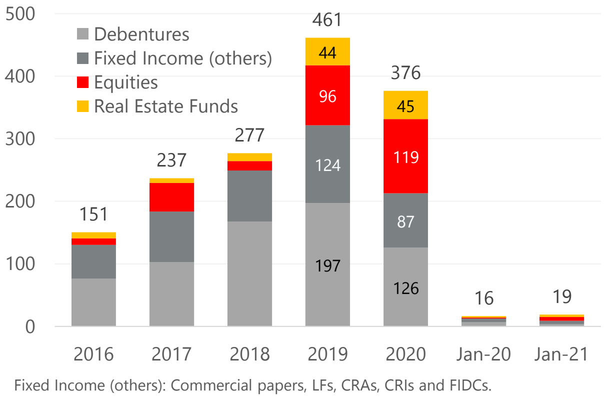
CREDIT

Anbima figures on capital markets activity for January show that new domestic issuance totaled BRL19 billion, the lowest monthly figure since May 2020 but still 20% above January 2020 (BRL15.7 billion). Issuance in fixed income accounted for BRL9.1 billion; equities totaled BRL5.8 billion; and real estate funds came in at BRL4.1 billion. **Importantly, 42 IPO operations are in the pipeline, suggesting a favorable outlook for the equity market.**

Domestic bond issuance ("debentures") accounted for BRL 4.0 billion, a significant drop after a strong December (BRL 28.6 billion). Looking at the allocation of proceeds of equity issues, an interesting change in pattern is evident. In January 2020, 100% of the proceeds were allocated to debt refinancing, whereas in January 2021 most of the proceeds (61%) were allocated to asset purchases and operational purposes. In our view, this suggests a less conservative investment stance by firms. For real estate funds, the volume of issuance maintained the strong pace seen last year and provides further evidence of a heated housing market, in our view.

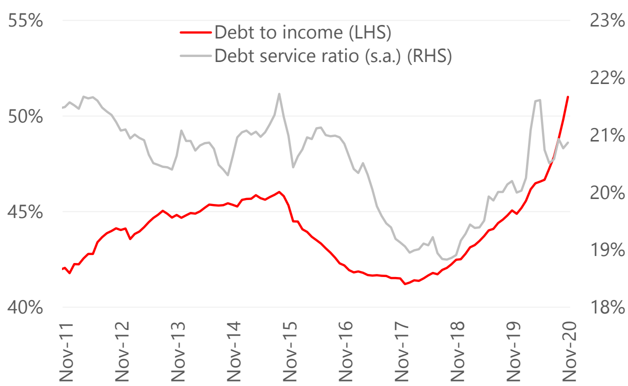
Consumer indebtedness still on the rise. Brazilian Central Bank (BCB) data for November show the household-debt-to-income ratio at 51.0%, up +1.2 p.p. from October (+5.9 p.p. from November 2019). The historical average stands at 38.1%. The household debt service ratio was 20.9%, up 0.1 p.p. from October (+0.7 p.p. from November 2019). The historical average stands at 19.5%. This increase in consumer indebtedness is another indication, in our view, that nonperforming loans (NPLs) should rise in the coming months, as the amount of fiscal support is (greatly) reduced.

Figure 6.A. – Issuances in Domestic Markets (BRL billion, CPI adjusted)



Sources: Anbima, Santander.

Figure 6.B. – Consumer Indebtedness (% of Expanded Aggregate Wages)



Sources: Brazilian Central Bank, Santander.

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