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Brazil Macro Compass

Adapting the Forward Guidance?

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- **The BRL fared quite well this week due to a constructive news cycle abroad related to auspicious signs regarding vaccines against COVID-19 and a greater likelihood of a new fiscal package in the U.S. Likewise, indications from top Brazilian government officials that the emergency stimulus will end this year brought some respite (at least for now) from perceived risks about the fate of the fiscal regime and consolidation process. As a result, the BRL moved back below the level of 5.20/USD, standing among the top performers among EM FX for the week.**
- **Led by the same drivers as the FX, the nominal yield curve bull-flattened once again this week, with the gap between Jan-22 and Jan-27 (in DI futures) approaching a one-month low. We still think there is too much "fat" (priced rate hikes or premium) in the very front end, as we see limited likelihood of a BCB rate hike in the near term (i.e., 1Q21).**
- **October's fiscal performance was "better" than expected, driven by non-recurring factors. Yet the primary deficit trend continues to deteriorate, following six consecutive months with deficits equivalent to "full-year readings". Government debt continue to reach multi-year highs. Additionally, with the recent increase in inflation, the margin for the spending cap continues to narrow for 2021.**
- **The USD3.7 billion trade surplus registered in November 2020 reinforced our perception that, after being hard hit by the pandemic earlier this year, imports are on a rising trend, thus adding evidence to support expectations for the economic recovery to continue in the coming months. We expect a USD57.2 billion trade surplus for 2020, consistent with a near-zero current account deficit.**
- **October's industrial performance confirmed expectations of a new monthly gain, marking a favorable start to the sequence of 4Q20 releases. Third quarter GDP data has confirmed the expectation of a sharp reversal a pandemic-induced sudden stop in 1H20. But the numbers still show a partial and heterogeneous recovery. We see dwindling chances for a sequential 4Q20 decline, which raises the upside risks to our projection of a 4.8% contraction in 2020.**
- **Important activity releases for October are scheduled for the coming week. On Thursday (December 10), retail sales will be available, and we expect growth of 0.7% MoM s.a (7.9% YoY) and 0.5% MoM s.a. (5.5% YoY) for core and broad indexes, respectively. On Friday (December 11), data for the services sector will be released, and we expect growth of 2.3% MoM s.a. (-6.8% YoY).**
- **The decision by Aneel (energy sector regulator) to resume the tariff flag system in the energy sector changed our IPCA tracking to 4.3% for 2020 and 3.0% for 2021. On Tuesday (December 8), IBGE is scheduled to release November's IPCA, and we expect another high reading of +0.82% MoM (4.24% YoY). Once again, we expect the main source of upward pressure to be food-at-home inflation. Although we think inflation should continue to be pressured in the short term, we have begun to see the first signs of cooling in those shocks, which reinforces our benign view for inflation in the medium term.**
- **Copom week: on Wednesday (December 9, 2020), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We expect the Selic rate to remain at the historical low of 2.00%, in line with analysts' expectations and the broad pricing of the local yield curve. In its statement, we believe the committee could drop mentions of possible rate cuts (adapting the communication to new conditions) but keep the forward guidance of stable interest rates for the foreseeable future under the conditions of an unchanged fiscal regime and anchored inflation expectations. In our view, the BCB continues to see these conditions being met for now.**

Local markets—FX: The USD/BRL pair is about to end this week below the 5.20 threshold for the first time since late July 2020 (as of this writing, the pair was trading at 5.16), on the back of a constructive news cycle on the international front, which favored a risk-on approach among market participants. News on the development of vaccines against COVID-19 continued to be favorable, with the U.K. having already announced that it will begin to immunize its population in the coming weeks. In addition, an agreement among US lawmakers regarding the approval of a new fiscal package to support the economy appears to have become more likely, in our view, which helped to reduce risk aversion among markets.

On the domestic side we also had some positive updates, with top members of the Brazilian government announcing an intention to end the emergency stimulus in 2021. Against a more constructive global backdrop, we think investors have decided to give Brazil the benefit of the doubt, with the comments by government officials generating a positive influence on Brazilian financial assets, thus buttressing our perception that as market participants become less skeptical about the maintenance of the fiscal framework, the path toward further strengthening of the BRL should become clearer. In that regard, we think it is important to bear in mind that concrete decisions are likely to emerge only after elections for the speakers of both houses of Congress, a process that will be not be concluded until February 2021. Until then, although the constructive international environment and signals regarding the likely compliance with the spending cap on the domestic side should limit the scope for a substantial weakening of the BRL, the robustness of a BRL strengthening will hinge on decisions regarding the conduct of fiscal policy in the coming years.

Local markets—rates: Based on prices from Friday just before noon (time of writing), the nominal yield curve looks poised to bull-flatten once again this week. In the front end, the Jan-22 DI future was on the verge of closing the week at 3.08% (-20 bps from last Friday). In the back end, the Jan-27 DI future was trading at 7.04% (-45 bps from last Friday), pushing the steepness in this segment (i.e., 2027s vs. 2022s) to nearly 397 bps, compared to 422 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 in about a month.

This bull-flattening movement follows the influence of nearly the same factors as last week. Optimism regarding a medical solution brought by positive vaccine news continues to feed a "risk-on" sentiment in global markets, with participants also expecting a resolution on the upcoming U.S. fiscal package, both of which could favor EMs, with the effect on yields more visible on the back-end of the curve.

Locally, from a technical standpoint, successful bond auctions by the Brazilian National Treasury both internally (largest placement of inflation-linked bonds in history) and externally (strong demand for USD-denominated bonds) also contributed to this a "feel-good" factor. From a macroeconomic perspective, the unexpected decision by Brazilian regulator Aneel to resume the tariff flag system on December 2020, raising the tariff-flag to the top level this year, provided a little relief for 2021 inflation projections, which had been seeing some upward pressures of late (see details in the inflation section above). We believe this added a bit of downward pressure in the front end of the curve.

Our baseline scenario continues to see a limited likelihood of BCB hiking interest rates in the very near term (say, in 1Q21). While the fiscal dilemma remains (boosting welfare programs versus 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. That said, we continue to see value receiving in the very front end of the nominal yield curve, since we believe there is too much premium (or too much probability of Selic rate hikes priced in).

Fiscal policy: On November 30, according to BCB, the public sector posted a primary result of +BRL3.0 billion in October, better than our forecast (-BRL2.0 billion) and the market consensus (-BRL6.6 billion). The "better" result came mainly from non-recurring factors.

The general government net revenues increased +9.8% YoY, boosted by the payment of tax deferral (BRL16.3 billion). On the expenses side, there was the transfer of unused funds back to the Treasury (BRL6.1 billion), lowering the expenses accounted for the month. In addition, total expenses related to COVID-19 declined from BRL73.5 billion in September to BRL29 billion in October.

Year to date, the public sector's primary fiscal balance is a negative BRL633.0 billion (10.6% of GDP), the worst number in the entire historical series. In addition, gross debt reached 90.7% of GDP in October, an increase of 15.0 percentage points from the end of last year. Meanwhile, net debt reached 61.2% of GDP, 5.5 percentage points higher than 2019. For details see our report[1].

[1] **Santander Macro Brazil Fiscal Policy - *Consolidated Public Sector: "Better" October Performance* –** November 30, 2020- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-consolidated-public-sector-better/20-11-30_201108_bzmacrofscl113020.pdf

Additionally, the mismatch between the inflation indexes continues to squeeze the spending cap margin for 2021. Considering our inflation tracking, our estimate of the shortfall to comply with the spending cap rule has risen to BRL11.3 billion (previously BRL 1.5 billion), making its fulfillment in 2021 even more challenging**.** On the other hand, we think this mismatch will help the margin for 2022, which increases to +BRL15 billion (from BRL 10 billion), according to our numbers. For details see our report[2].

On December 3, the federal budget watchdog (TCU, in Portuguese acronym) approved a limited easing of the rules for the execution, next year, of unpaid deferrals from the 2020 budget. The unpaid remainder of the regular budget for infrastructure works will be subject to the constitutional spending cap. In our view, this decision does not imply a change in the fiscal framework, or in our projections, although it slightly raises the risks of execution and the challenges involved in imposing greater fiscal discipline in the debate on the 2021 budget (expected to kick off in February).

On the political front, the Senate president scheduled for December 16 a session to vote on the Budget Guidelines Law (LDO, in Portuguese acronym) of 2021. The approval of the LDO allows the government to spend 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 machinery of government could be paralyzed.

Trade balance: The Brazilian trade balance registered a USD3.7 billion surplus in November 2020, which was below our estimate (USD4.3 billion), on the heels of USD17.5 billion in exports and USD13.8 billion in imports (our estimates were USD17.7 billion and USD13.4 billion, respectively). Based on that, the trade surplus reached USD51.2 billion in November, from USD47.4 billion in the previous reading in year-to-date terms, while it increased to USD57.1 billion in 12-month-to-date terms from USD56.9 billion in the previous reading and USD48.0 billion in December 2019.

The outcome reinforced our perception that exports were less hard-hit than imports in the early stages of the pandemic. Nonetheless, the latter have shown signs of recovery lately. According to our calculations, when we factor out deals related to oil platforms—which are not really either exports or imports, but rather accounting operations derived from tax issues—and adjust for the number of working days in the month, the exports daily average expanded 3.5% MoM in seasonally adjusted (s.a.) terms (or -1.3% YoY) in November. As for the imports daily average, after having broken a six-month streak of contractions in August 2020, it has registered the fourth consecutive seasonally adjusted monthly increase in the period (an astounding 18.0% MoM s.a., according to our calculations). We consider this a positive signal for the continuation of the recovery of the Brazilian economy, even though we do not expect this pace to continue in the coming months.

In any case, by annualizing the exports and imports daily average of the last three months, we come to an indication of a USD68.1 billion annual trade surplus, which is higher than our forecast for 2020 (USD57.2 billion). Incidentally, the reversal of the upward trend registered by this annualized trade balance metric between March and September 2020 appears to reinforce our expectation of a lower annualized result at the end of the year. For details see our report[3].

Economic activity: Industrial production data for October has confirmed expectations of a sixth consecutive monthly gain (1.1%.), following April's sharp drop and marking a favorable start to the sequence of 4Q20 IP releases. Consensus was 1.4% Mom s.a., but an upward revision for September partially offset this error projection. October's positive result implies a sequential gain for industrial production, in our view, but also suggests a deceleration of industrial activity, which is already 1.4% above February's reading. In our view, we still see no evidence of a sequential 4Q20 decline.

The soft data for November points to continued industrial production improvement, with industrial business confidence running at the highest level since 2010. While industrial capacity utilization is running close to the historical average, it does not indicate severe and lasting supply constraints, in our view, and inventories are running at the lowest level ever, which we see as a good indicator for future production. We still are unconcerned about supply/demand mismatches in the medium term, as we also expect demand to shift from the goods to the services sector on the heels of the economy's reopening, and part of the solid demand for goods is about to fade with the end of fiscal stimuli, in our view. Based on this preliminary data, we project a rise of 2.0% MoM (s.a.) (4.7% YoY) for November. For details see our report[4].

[2] **Santander Macro Brazil Fiscal Policy -** ***Spending Cap Rule: Squeezing the 2021 Margin, Relieving 2022*****–** December 03, 2020- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-special-spending-cap-rule-squeezing-the-2021+/20-12-03_204357_bzmacrospndngcap120320.pdf

[3] **Santander Macro Brazil External Sector – Trade Balance: November 2020**- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-trade-balance-november-2020/20-12-03_174345_201201+-+trade+balance+nov20.pdf

[4] **Santander Macro Brazil Economic Activity -** ***Sequential Improvement in Industrial Production*** **– December 02, 2020**- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-sequential-improvement-in-industrial/20-12-03_174754_201202_pim_oct20.pdf

Following COVID-19's strong impact on 2Q20, 3Q20 GDP grew 7.7% QoQ s.a. (-3.9% YoY), vs. consensus of 8.7% QoQ s.a. (-3.6% YoY)—though an upward revision of 2Q20 results offset in part the discrepancy between consensus projection and actual results. As expected, this figure reinforced the heterogeneous pattern of recovery between the goods market vs, services. We must take into account the notably depressed comparison basis, as well as the effect of the massive and temporary income transference program; in comparison to the pre-crisis level, GDP is still down 4.1% since 4Q19. In terms of outlook, we still see no evidence of a sequential 4Q20 decline: our preliminary tracking indicates quarterly growth of ~2%. These figures are in line with a possible upward revision of our projection of a 4.8% contraction in 2020 economic activity. For details see our report[5].

Inflation: Late Friday last week (November 27), Aneel (energy sector regulator) released an unexpected decision to resume the tariff flag system[6] on December 2020, and defined it as Red 2 (the highest level). The decision had a major impact on our IPCA trackings: IPCA 2020 was increased by 45 bps, with December's IPCA rising from 0.76% MoM to 1.22%, leading the year-end number to 4.3% (from 3.8%). However, as we continue to forecast Green flag for December 2021, our IPCA forecast for 2021 fell by 45 bps falling from 0.59% to 0.23% (under Yellow flag, by our expectation) in January 2021, and in February 2021 moving from 0.32% to 0.22% (back to Green flag, where we expect it to remain until April 2021) Our IPCA tracking for 2021 now stands at 3.0%.

On Tuesday (December 8), IBGE is scheduled to release IPCA inflation for November. We expect another high reading of +0.82% MoM (4.24% YoY). Once again, we expect the main source of upward pressure to be food-at-home inflation. The shock is taking longer to pass than we expected, and we should anticipate another high monthly print, at 2.90% MoM. Industrial goods also continue to be pressured, though we expect a slight deceleration in MoM terms to 0.71%. In services, we forecast the group to have another soft print of 0.42% MoM. Finally, we forecast administered prices to rise 0.34% MoM.

Although we still expect inflation to be pressured in the short term, as the fading of recent shocks is taking longer than we initially supposed, we are starting to see the first signs of cooling on those shocks. First, the BRL appreciated considerably during the last week, and, second, high-frequency price surveys showed a considerable deceleration of agricultural prices at the wholesale level. 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).

Monetary policy: On Wednesday (December 9, 2020), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We expect the Selic rate to remain at the historical low of 2.00%, in line with analysts' expectations and the broad pricing of the local yield curve.

We share the view of other market observers that the current level of the policy rate is notably expansionary—i.e., below the structural level. For now, the amount of stimulus still seems in accordance with the fact that inflation expectations are slightly below or at the mid-target for the relevant policy horizons and that economic slack should remain wide for a considerable period of time. In our view, these factors warrant holding the interest rate steady at this Copom meeting.

Since the last Copom meeting, the evolution of the macroeconomic scenario shows a rebound of real activity in the 3Q20 and a nice start to 4Q20, following a sudden stop prompted by the pandemic (and the resulting social distancing measures) in late 1Q20 and early 2Q20. Yet the activity recovery occurs in a heterogeneous manner across sectors, with goods-related segments outdoing the segments dependent on services and (live) social interactions. The dataset also shows a notable inflation pickup for the short run, predominantly owing to volatile items (such as food), but also with signs of an exchange rate pass-through to industrial goods and slight spill-overs for both core measures and 2021 projections.

We maintain our assessment that the current pace of both economic recovery and inflation pickup are based on temporary factors, notably the large volume of government transfers to households implemented during the pandemic. In the case of consumer prices, the acceleration underway also reflects a temporary shift in the consumer spending profile, with a temporary migration of spending away from services and into goods. An exogenous shock in food and energy prices and a pass-through of the FX depreciation complete the list of culprits for the higher than expected inflation print this year, with IPCA poised to end 2020 at 4.3% (mid-target: 4.0%).

[5] **Santander Macro Brazil Economic Activity – GDP: *Strong Growth, with Partial Recovery*– December 03, 2020**- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-GDP-review-strong-growth/20-12-03_203623_201202+-+gdp+3q20.pdf

[6] On a simple note, the system aims at balancing demand for energy when hydrology (water level of reservoirs) is unfavorable. Green flag means there is no extra charge for consumers (which was the flag valid until November); Yellow means an extra BRL1.34 per KW/h; Red 1 means an extra BRL4.17 per KW/h; and finally, Red 2 means an extra BRL6.24 Kw/h for consumers.

We see the "anecdotal" signs of supply-demand imbalances (e.g., reported scarcity of some inputs) more as temporary frictions rather than as a sign of a systemically overheated economy. Assuming the end of emergency stimuli in December, we expect the expanded wage bill to slump between 7% and 8% in real terms in 2021 (after an expected gain of 4% in 2020), and the average annual unemployment rate is expected to exceed 16%, from (an expected) average of 13.4% in 2020 and 11.9% in 2019. Furthermore, the reopening of the economy should bring about a normalization of the consumer basket, in our view, favoring a rebalancing of supply-demand in the goods market. The latter is to offset effects of a probable comeback in services activities (and inflation).

Assuming a commitment by policymakers to the effectiveness of the constitutional spending ceiling and the credibility of the fiscal consolidation process ahead, our baseline scenario is predominantly disinflationary for 2021 and 2022, and we have difficulty spotting signs of demand-led inflation for this horizon. Yet we believe the fiscal risks remain quite high, and, in our opinion, that is far and away the greatest threat to the monetary policy outlook and our call for a stable Selic rate throughout 2021.

Here, delays in defining the direction of fiscal policies coupled with inflationary shocks (even if predominantly from supply, by nature) seem to feed risks for the anchoring of inflationary expectations, in our view. Although we still see recent increases in economists' projections for 2021 IPCA, mainly associated with exogenous shocks and weather-related risks and events, we see a risk of losing the anchoring power in the absence of greater clarity about future fiscal policy steps.

We continue to see fiscal risks propping up the effective lower bound for interest rates, with the current Selic rate likely at that level now. We maintain our assessment, and with greater conviction now, that new stimuli via interest rates at this point could, with high probability, generate counterproductive effects on the economy.

Given the potentially adverse effects of a fiscal deterioration on the neutral interest rate and, especially, on the anchoring of inflationary expectations, we believe that this remains an appropriate time to keep the monetary policy stance unchanged.

In our view, the time is ripe to observe the direction of fiscal policy and how the economy responds to the strong stimuli already implemented. In particular, it will be important to observe how the economy will react to the end of emergency aid (*coronavouchers*), especially in the 1Q21.

In terms of the Copom statement, we believe the scenario assessment will probably show that the committee continues to see current price pressures as temporary, expecting those to dissipate in the relevant horizon (increasingly 2022). Also, we think the BCB will probably continue to recognize a significant but uneven recovery in economic activity, highlighting downside risks with the end of the stimuli expected for early 2021. On the policy message, we believe that the committee could mention possible rate cuts, adapting the communication to a different context (with no risks of an actual deflationary pattern, and further evidence of closeness to the effective lower bound).. But we believe the authority could keep the (most important part of the) forward guidance of stable interest rates for the foreseeable future under the conditions of an unchanged fiscal regime and anchored inflation expectations. In our view, the BCB probably continues to see those conditions being met.

Also next week: Important activity releases for October are scheduled for the coming week, marking the start of the sequence of 4Q20 data for some indexes. On Thursday (December 10), retail sales will be available, and we expect growth of 0.7% MoM s.a (7.9% YoY) and 0.5% MoM s.a. (5.5 % YoY) for core and broad indexes, respectively. On Friday (December 11), data for the services sector will be released, and we expect growth of 2.3% MoM s.a. (-6.8% YoY). These figures will be essential in the tracking of 4Q20 activity, reflecting the initial effects of lower paychecks from the emergency aid (which we see as offset by the economy's reopening).

On inflation, November's IGP-DI will also be released next week (on Monday, December 7). We expect a 2.83% MoM change. Despite being another high print, this would be a deceleration compared to November's IGP-M (3.28% MoM). It is worth highlighting that the deceleration should be driven by wholesale prices, in both the agricultural and industrial sectors, which is a signal that those goods could also decelerate further on the consumer level (IPCA).

On Monday (December 7), *Anbima* will release capital markets data for November 2020. We expect debentures issuance to increase, closing the gap with the year-ago period. The accumulated issuance in the year (BRL84 billion) is still down from 2019's volume in the same period (BRL151 billion). For equities, we expect a decrease in issuances from October's volume (BRL19 billion). On Wednesday (December 9), BCB will release September's data for household debt to income and debt service ratio. We expect both of these to post increases.

MACRO AGENDA

Indicator	Reference	Date	Estimate	Prior
Anfavea Vehicle Production (units)	Nov	Mon, 07-Dec	--	236,468
IGP-DI Inflation (% MoM)	Nov	Mon, 07-Dec	2.83	3.68
IGP-DI Inflation (% YoY)	Nov	Mon, 07-Dec	24.52	22.12
IPCA Inflation (% MoM)	Nov	Tue, 08-Dec	0.82	0.86
IPCA Inflation (% YoY)	Nov	Tue, 08-Dec	4.24	3.92
COPOM - Selic Rate %	--	Wed, 09-Dec	--	2.00
Core Retail Sales (% MoM)	Oct	Thu, 10-Dec	0.7	0.6
Core Retail Sales (% YoY)	Oct	Thu, 10-Dec	7.9	7.3
Broad Retail Sales (% MoM)	Oct	Thu, 10-Dec	0.5	1.2
Broad Retail Sales (% YoY)	Oct	Thu, 10-Dec	5.5	7.4
Services Sector Volume (% MoM)	Oct	Fri, 11-Dec	2.3	1.8
Services Sector Volume (% YoY)	Oct	Fri, 11-Dec	-6.8	- 7.2

Sources: Bloomberg, Santander.

For details on our Brazil economic forecasts, please refer to our latest scenario review[7].

[7] **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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