Santander Corporate & Investment Banking

ECONOMICS

07 August 2020

Brazil Macro Compass

Bouncing Back at the End of Q2

Ana Paula Vescovi* and
Brazil Macroeconomics Team
anavescovi@santander.com.br
+5511 3553 8567

- **Amid a relatively negative news flow on both the international and domestic fronts, the BRL has weakened, and we expect it to end the first week of August among the worst performers of the period relative to peers.**

- **The nominal yield curve steepened this week, as the Copom— the Monetary Policy Committee of the Brazil Central Bank (BCB)—did not explicitly announce the end of the easing cycle (pressuring down the front end). The movement also followed less favorable market conditions for EMs and discussions about changes in the spending cap (pressuring up the back end) in recent days. Local rates are pricing in some likelihood of another cut in September, and we think there is too much "fat" (priced hikes or premium) in the front end, up to the 2023s.**

- **July's IPCA registered a 0.36% MoM change (2.31% YoY). The result was in line with market's expectation, but above our estimate of 0.29% MoM. The new average of core measures registered a 0.12% MoM change, with the annualized (and seasonally adjusted) three-month moving average reaching a muted 0.7%, while the target for 2020 is 4.0%. Despite the upside surprise, the number reaffirms our view of a benign scenario for inflation. In particular, we continue to see a muted dynamic for core prices, as economic slack should remain high for a considerable period of time.**

- **June Industrial Production confirmed expectations of a second gain in a row after the massive plunge in April, on the back of a gradual easing of the social distancing measures. The monthly gain of 8.9% was better than the market consensus (7.9%). Overall, the incoming numbers of real activity point to sequential gains, following the economy's sudden stop in April. Yet it will take time before we see a return to the pre-crisis level.**

- **The trade balance registered an all-time high monthly surplus of USD8.1 billion in July in the wake of muted import outlays and the maintenance of exports' more resilient performance, underpinning our expectation of a USSD60.5 billion annual surplus in 2020.**

- **As expected, the BCB cut the Selic for a ninth meeting, slowing down the pace now to 25 bps. The new policy rate level of 2.00% is a fresh historical low. More important than the decision *per se* was the forward guidance, where the authority not only keeps the door ajar for the possibility of further cuts down the road, but also indicates an intention to maintain the level of stimulus subsequently (i.e., no hikes on the plans). In other words, the BCB hints at a flight plan to hold the Selic rate at 2.00% or below for some time. Our baseline scenario contemplates BCB on hold all the way until early 2022, when we envision the start of a gradual normalization of the policy stance. Tuesday's (August 11) Copom minutes could shed more light on the BCB scenario assessment and forward guidance.**

- **For the coming week, June activity data take the main stage, capping the core of the information set necessary to estimate Q2 GDP. We project another monthly gain for the IBC-Br (due next Friday), yet not enough to move back February (pre-crisis) levels.**

IMPORTANT DISCLOSURES/CERTIFICATIONS ARE IN THE "IMPORTANT DISCLOSURES" SECTION OF THIS REPORT.
U.S. investors' inquiries should be directed to Santander Investment at (212) 350-0707.
* Employed by a non-US affiliate of Santander Investment Securities Inc. and is not registered/qualified as a research analyst under FINRA rules, is not an associated person of the member firm, and therefore may not be subject to FINRA Rules 2241 and 2242 and incorporated NYSE Rule 472 restrictions.

Local markets—FX: After having registered a 4.5% strengthening against the USD last month, the BRL started this month reversing nearly the entire move, making it one of the worst performers of the week among emerging market currencies. In the U.S. Democrats and Republicans failed to reach an agreement approving a new package of fiscal incentives, while in Brazil doubts about the compliance to the public spending cap rule in 2021; both weighed on the dynamics of the Brazilian FX market and led the BRL to weaken in recent days. On top of that, the additional cut in the base interest rate by the BCB last Wednesday (August 05) and its indication that the Selic target rate should stay in the new historical low for quite a while have also contributed for the performance of the BRL, in our view. As we have been stating for some time (for details, see our June 25 report, *Updating our Inflation, FX and Interest Rate Forecasts*), whether or not the BRL appreciates in the coming months hinges on developments in the reformist agenda..

Local markets—rates: Based on prices from this Friday morning (time of writing), the nominal yield curve steepened once again this week. In the front end, the Jan-22 DI future was on the verge of closing the week at 2.58% (-7 bps from last Friday, July 31). In the back end, the Jan-27 DI future was trading at 6.23% (+16 bps from last Friday July 31), pushing the steepness in this segment (i.e., 2027s vs. 2022s) to nearly 365 bps, compared to 342 bps in the previous week and ~ 150 bps early this year. The reasons behind this movement seems to include the Copom statement about keeping door ajar for possible rate cuts ahead (see our comment below), pressuring down the front end. It also reflects the less favorable market conditions for EMs in recent days and news on attempts to breach the constitutional spending cap, pushing yields higher at the back end.

Following the Copom announcement, the local rates market seems to price in nearly a 30% probability of a (25-bp) Selic cut for the September 15-16 policy meeting. We think the most likely scenario is rate stability until 1Q22, but recognize that the likelihood of another cut is clearly not zero, should market conditions improve, inflation expectations decline and threats to the constitutional spending fade. Thus, we think it makes sense to receive the front end (up to the 2023s), given what seems to us an excessive fat (i.e., price hikes or premium). As per the back end, we remain with little conviction given the high premia (in a context of plentiful global liquidity) on one hand and the mounting fiscal policy risks on the other hand.

Economic activity: Industrial Production has confirmed the expectations of a second gain in a row after April's sharp drop. The headline index pointed to growth of 8.9 % MoM (s.a.) in June, a better result than our forecast (6.4%) and market consensus (7.9%). In relation to June 2019, there was a decline of -9.0%, while our projection and consensus were pointing to -11.4% and -9.9%, respectively. Mining and manufacturing industries posted monthly gains of 5.5% and 9.9%. In terms of trends, the three-month average (headline) still points to a decrease (-1.8%), while the quarterly change (s.a.) was down 17.6 %. This positive result for June means that 49.1% of the points lost between March and April have already been recovered, but the level is still 13.6% below the reading observed in February.

Among the categories, the positive highlights were Durable Goods and Capital Goods, registering monthly gains of 82.2% and 13.1%, respectively. Durable goods pointed to growth after May's sharp rise of 112.6%. Building and Capital goods—categories related to investment—posted gains of 13.9% and 13.1%. Regard the accumulated drop, Building and Intermediate goods have already recovered 70.8% and 47.2% of the points lost between March and April, while Durable goods recovered 52.5%. In comparison with the reading observed in February, the categories are still 9.5%, 9.7% and 40.1% below the pre-crisis mark.

The data continue to show that the industrial sectors that were the least affected by the pandemic have had slight gains. Pharmaceutical Products showed a slight decrease of 0.1% and Food Products posted a slight increase of 1.0 %. The positive highlights this month were observed in Vehicles and Other Equipment of Transport, posting gains of 251.4% and 380%, respectively. In general terms, the Diffusion Index (percentage of industrial categories with monthly growth) reached 91.4%, a better result than the reading in May (72.3%), on the heels of a largely statistical rebound.

The IBGE's National Household Survey (PNAD) was released this week. The unemployment rate was reported at 13.3% (of the economically-active population) in the three months to June, slightly below consensus (13.2%). This reading represents a gain of 1.3 p.p. from the year-ago level. We calculate that seasonally-adjusted joblessness rose to 12.9%, compared to 12.3% in May. This is the highest reading since May 2017. The details of the survey show that employment recorded its deepest decline on record, down 10.7% YoY; the economically-active population (PEA) also fell by 9.4% YoY. The labor market participation rate reached an all-time low of 55.3%. The decline in the job-market participation rate is “concealing” the extent of the increase in the unemployment rate, from the standpoint of actual labor market conditions. In a simple counterfactual exercise, if the work force had remained stable at the same levels of February, the unemployment rate would have reached an all-time high: 21.4% (20.0% s.a.).

The formalization rate of the labor market reached 60.1% of the employed population, which is the all-time high and 3.2 p.p. above the reading in February (56.9%). This result follows the asymmetrically stronger employment impact from the pandemic (in particular, the need for social isolation measures) on the category of informal workers (-4.5 % MoM),

in comparison with formal workers (-2.0 % MoM). This asymmetry also affected wage statistics, which show that real average income was up 6.9% YoY, whereas the real wage bill fell 4.4% YoY. In other words, the increase in real average income is due to a (spurious) composition effect, as low-wage informal workers out of the labor market move out of the wage statistics. Not by coincidence, the real wage bill is heading south, and this is the most important sign for consumer spending, for which the attenuating factor in the short term is the transitory effect from the massive programs of government transfers to households.

All in all, June numbers herald a continued deterioration in labor market conditions. Looking ahead, we expect joblessness to grow significantly and wages to remain sluggish (at best) in the coming months, following the more lasting effects of the COVID-19 crisis (in the so-called “new normal”).

Trade balance: The USD8.1 billion surplus registered by the Brazilian trade balance in July 2020 came in line with our estimate (USD8.1 billion), with minor discrepancies between what we forecast for export proceeds (USD19.6 billion vs. USD19.5 billion, respectively), as well as for import outlays (USD11.5 billion vs. USD11.4 billion, respectively). On the heels of this result, the trade balance surplus increased to USD50.3 billion in 12-month-to-date terms from USD44.7 billion in the previous reading and USD48.0 billion in December 2019.

This outcome reinforced our perception that the pandemic has hit exports in a milder fashion than it has weighed on imports. 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 5.6% MoM in seasonally adjusted (s.a.) terms (or -2.9% YoY) in July. As for the imports daily average, it declined 0.6% MoM s.a. (or 32.9% YoY) in the period. By annualizing exports and imports daily average of the last three months, we come to an indication of a USD80.4 billion annual trade surplus, which is far higher than our forecast for 2020 (USD60.5 billion). However, it is important to bear in mind that we assume that the Brazilian economy should resume a gradual recovery in 2H20, which should foster some revival in imports during that period.

Inflation: July’s IPCA registered a 0.36% MoM change (2.31% YoY). The result was in line with market’s expectation, but above our estimate of 0.29% MoM.

The upside surprises were concentrated in free prices. The food-at-home group rose 0.14% MoM (+9.2% YoY), while we expected it to have a negative change. The divergence contributed +5 bps to the actual headline result compared with our estimate. Industrial goods were the other upside surprise (+6 bps), rising 0.29% MoM compared to our estimate of almost stable variation—some tradable goods not so affected by the fall of demand are still suffering some exchange rate passthrough. However, a downside surprise came in services (-2 bps), which fell -0.10% MoM (+1.51% YoY), while we expected -0.05% MoM—apparently, even with the gradual reopen of the economy, the demand is pretty low, making it difficult for establishments to raise prices. Finally, administered prices also surprised a bit to the downside (-3 bps), because gasoline prices rose less than expected.

The new average of core measures (EX0, E3, DP, MS, and P55) registered a 0.12% MoM change (a little below our forecast of 0.15%), with the annualized (and seasonally adjusted) three-month moving average reaching a muted 0.7%, while the target for 2020 is 4.0%. In particular, the trend for the IPCA EX3 core gauge—a measure highly correlated with the output gap—is hovering around -0.4% MM3saar. Additionally, the diffusion index stood at 60.4% on a seasonally adjusted basis, still close to the lowest historical levels.

Despite the upside surprise, the number reaffirms our view of a benign scenario for inflation. In particular, we continue to see a muted dynamic for core prices, as economic slack should remain high for a considerable period of time, despite the cushioning of demand generated by government stimulus and the reopening of a number of regional economies. We believe the well-anchored inflation expectations should also play an important role in price dynamics in Brazil. We forecast IPCA inflation to decelerate to around zero already in August and to close the year at 1.5% for 2020 (the upside risks are now much lower). Finally, for 2021 we estimate IPCA inflation at 2.7%, with the usual inflation determinants (economic activity, imported inflation, inflation expectations and inertia) suggesting downside risks.

Monetary policy: For the ninth consecutive meeting, the Copom decided this past Wednesday (August 05) to cut the Selic policy rate. As widely expected (judging from economists’ surveys and asset prices), the authority slowed the pace of easing to 25 bps, taking the Selic to 2.00% - another fresh new historical low. Since the apparent arrival of the pandemic in Brazil (February-March), the BCB has cut the Selic rate by 225 bps.

More important than the decision *per se* was the forward guidance, where the authority not only keeps the door ajar for the possibility of further rate cuts down the road, but also indicates an intention to maintain the level of stimulus subsequently (i.e., no planned hikes).

In the first, old, short-term oriented part of the forward guidance, the authority expresses the belief that "that the current economic conditions continue to recommend an unusually strong monetary stimulus", but recognizes that the remaining space for additional stimulus "if it exists, should be small". Judging from the statement, prudential and financial stability matters apparently continue to impose a lower bound for interest rate, in the BCB mindset. The authority also claims that eventual rate cuts in the future would occur with "with additional gradualism", maybe meaning one minimal cut for every two or more meetings, conditional on the perception of the fiscal trajectory and the inflation outlook.

In the second, new, medium-term oriented part of the forward guidance, the BCB makes it clear that despite upwardly skewed risks for inflation "the Copom does not foresee reductions in the monetary stimulus" for as long as inflation projections (both by consensus and BCB) remain far below the mid-target for the relevant horizon. Importantly, that horizon encompasses not only the calendar-year of 2021, but also the calendar-year of 2022, even at lesser extent for the latter. This last part of the forward guidance is also conditional "on the maintenance of the current fiscal regime and on the anchoring of long-term inflation expectations".

In the balance of risks, the Copom sees the same elements as in the last meeting, which are seen inducing upwardly skewed risks for inflation, according to the committee. The authority mentions the demand support from government transfer programs and the risk of permanent fiscal deterioration or frustrations about economic reforms as upside risks, with the deflationary impact of large economic slacks and precautionary savings following an eventually slower reversal of the pandemic as downside risks.

Elsewhere in the statement, just a few notable changes. Official inflation projections continue to point to headline CPI figures below the target for key horizons, thereby supporting the theoretical (or perceived) room for rate cuts. Assuming the USD/BRL exchange rate at 5.20, versus 4.95 previously, the Copom now simulates IPCA inflation at 3.0% (previously: 3.2%) for 2021 and 3.4% for 2022, assuming Selic rate at 2.00% for year-end 2020, at 3.00% for year-end 2021, and at 5.00% for year-end 2022. With policy rate constant at 2.25%, the BCB sees IPCA inflation at 3.0% (stable) for 2021 and 3.7% for 2022. The mid-target for next year is 3.75%; for 2022, the mid-target is 3.50%.

In the scenario assessment, the BCB slightly upgrades the activity view, citing a "partial recovery". Yet the BCB refers to an asymmetry with depression in sectors "more directly affected by social distancing measures" (read services). The authority continues to see great uncertainty about the pace of recovery towards the end of the year, amid a likely fading of emergency stimulus measures. In the external scenario, the BCB mentions "the largest economic downturn since the Great Depression" and still sees a "challenging environment" for EMs, despite "promising signs of recovery in major economies, and some moderation in financial assets volatility".

We continue to see the BCB in a sticky situation from a policy perspective. On one hand, the pandemic's clearly disinflationary effects continue to support the notion that additional stimuli remains necessary to bridge the gap between expected inflation and the center target for the relevant policy horizon. Our own Taylor rules would point to an interest rate below 1% in times of fiscal normality, judging from a purely cyclical (supply-demand, inflation-gap) standpoint. On the other hand, the deterioration of the fiscal outlook—especially in the case of an emerging economy like Brazil—leads to a clear deterioration in the balance of risks and indicates the need for greater caution in monetary policy steps, especially as the BCB navigates unchartered waters with a good deal of stimulus already in place. Overdoing the dose here could mean risks for the anchoring of expectations and policy transmission.

Our baseline scenario contemplates a stable Selic rate at 2.00% all the way until early 2022, when we envision the start of a gradual removal of stimuli and normalization of the policy stance (note: for now, our scenario still has as key assumption an expected compliance with the constitutional spending cap, which plays a decisive role in keeping inflation expectations anchored). We sense that the first part of the BCB forward guidance keeps our level of conviction low for the short term—where a hypothetical combination of better financial conditions, further declines in inflation expectations and, if the case, no signal of changes in the fiscal regime—could encourage the authority to test an even greater level of stimulus. Even if this could be implemented at a pace of one or two cuts of 25 bps spread across 4Q20 and 1Q21. The second part of the BCB forward guidance, however, strengthens our confidence in our scenario for the medium term of lower interest rate for even longer, following a slow erosion of economic slacks.

Next week: On economic activity, the week's highlight is the release of retail sales next Wednesday (August 12), both core and broad concepts, following the publication of hard data for June that started this week. Our expectation is of gradual recovering of economic activity, following the preliminary soft data released that pointed to continued improvement. We project monthly gains of 4.9% and 7.0% for both concepts, respectively. Monthly Services Survey (August 13) and BCB's monthly activity index, IBC-Br (August 14) will also be released, ending the sequence of the main economic activity indicator for June. As per the latter we look for a gain of 2.3% MoM, making the headline index

accumulate a drop of 11.6% from February. On monetary policy, the BCB publishes the Copom minutes this coming Tuesday (August 11), possibly providing more information on the BCB's scenario assessment and forward guidance.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Copom minutes	Tue, 11-Aug	-	-
Core Retail Sales Jun/20 (% MoM sa)	Wed, 12-Aug	4.9	13.9
Core Retail Sales Jun/20 (% YoY)	Wed, 12-Aug	-2.1	-7.2
Broad Retail Sales Jun/20 (% MoM sa)	Wed, 12-Aug	7.0	19.6
Broad Retail Sales Jun/20 (% YoY)	Wed, 12-Aug	-4.4	-14.9
Services Survey Jun/20 (% MoM sa)	Thu, 13-Aug	-	-0.9
Services Survey Jun/20 (% YoY)	Thu, 13-Aug	-	-19.5
BCB's Activity Index Jun/20 (% MoM sa)	Fri, 14-Aug	2.3	1.3
BCB's Activity Index Jun/20 (% YoY)	Fri, 14-Aug	-8.8	-14.2

Sources: The National Treasury Secretariat, Brazilian Central Bank, IBGE and Santander.

Recent Publications (Available on Our Website)

- *FX Compass – BRL: Turning point?* (July 30, 2020)
- *Updating our Inflation, FX and Interest Rate Forecasts* (June 25, 2020)
- *FX Compass – BRL: A roller-coaster ride* (June 25, 2020)
- *Inflation: How Low and How Long?* (June 17, 2020)
- *FX Compass – BRL: Despite a little help from our friends* (May 21, 2020)

CONTACTS / IMPORTANT DISCLOSURES

Macro Research			
Maciej Reluga*	Head Macro, Rates & FX Strategy – CEE	maciej.reluga@santander.pl	48-22-534-1888
Juan Cerruti *	Senior Economist – Argentina	jcerruti@santander.com.ar	54 11 4341 1272
Ana Paula Vescovi*	Economist – Brazil	anavescovi@santander.com.br	5511-3553-8567
Juan Pablo Cabrera*	Economist – Chile	jcabrera@santander.cl	562-2320-3778
Guillermo Aboumrad*	Economist – Mexico	gjaboumrad@santander.com.mx	5255-5257-8170
Piotr Bielski*	Economist – Poland	piotr.bielski@santander.pl	48-22-534-1888
Fixed Income Research			
Juan Arranz*	Chief Rates & FX Strategist – Argentina& FX	jarranz@santanderrio.com.ar	5411-4341-1065
Mauricio Oreng*	Senior Economist/Strategist – Brazil	mauricio.oreng@santander.com.br	5511-3553-5404
Juan Pablo Cabrera*	Chief Rates & FX Strategist – Chile	jcabrera@santander.cl	562-2320-3778
Equity Research			
Miguel Machado*	Head Equity Research Americas	mmachado@santander.com.mx	5255 5269 2228
Alan Alanis*	Head, Mexico	aalanis@santander.com.mx	5552-5269-2103
Andres Soto	Head, Andean	asoto@santander.us	212-407-0976
Claudia Benavente*	Head, Chile	claudia.benavente@santander.cl	562-2336-3361
Walter Chiarvesio*	Head, Argentina	wchiarvesio@santanderrio.com.ar	5411-4341-1564
Daniel Gewehr*	Head, Brazil	dhgewehr@santander.com.br	5511-3012-5787

Electronic

Bloomberg	SIEQ <GO>
Reuters	Pages SISEMA through SISEMZ

This report has been prepared by Santander Investment Securities Inc. ("SIS"; SIS is a subsidiary of Santander Holdings USA, Inc. which is wholly owned by Banco Santander, S.A. "Santander"), on behalf of itself and its affiliates (collectively, Grupo Santander) and is provided for information purposes only. This document must not be considered as an offer to sell or a solicitation of an offer to buy any relevant securities (i.e., securities mentioned herein or of the same issuer and/or options, warrants, or rights with respect to or interests in any such securities). Any decision by the recipient to buy or to sell should be based on publicly available information on the related security and, where appropriate, should take into account the content of the related prospectus filed with and available from the entity governing the related market and the company issuing the security. This report is issued in Spain by Santander Investment Bolsa, Sociedad de Valores, S.A. ("Santander Investment Bolsa"), and in the United Kingdom by Banco Santander, S.A., London Branch. Santander London is authorized by the Bank of Spain. This report is not being issued to private customers. SIS, Santander London and Santander Investment Bolsa are members of Grupo Santander.

ANALYST CERTIFICATION: The following analysts hereby certify that their views about the companies and their securities discussed in this report are accurately expressed, that their recommendations reflect solely and exclusively their personal opinions, and that such opinions were prepared in an independent and autonomous manner, including as regards the institution to which they are linked, and that they have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report, since their compensation and the compensation system applying to Grupo Santander and any of its affiliates is not pegged to the pricing of any of the securities issued by the companies evaluated in the report, or to the income arising from the businesses and financial transactions carried out by Grupo Santander and any of its affiliates: Ana Paula Vescovi*.

*Employed by a non-US affiliate of Santander Investment Securities Inc. and not registered/qualified as a research analyst under FINRA rules, and is not an associated person of the member firm, and, therefore, may not be subject to the FINRA Rule 2242 and Incorporated NYSE Rule 472 restrictions on communications with a subject company, public appearances, and trading securities held by a research analyst account.

The information contained herein has been compiled from sources believed to be reliable, but, although all reasonable care has been taken to ensure that the information contained herein is not untrue or misleading, we make no representation that it is accurate or complete and it should not be relied upon as such. All opinions and estimates included herein constitute our judgment as at the date of this report and are subject to change without notice.

Any U.S. recipient of this report (other than a registered broker-dealer or a bank acting in a broker-dealer capacity) that would like to effect any transaction in any security discussed herein should contact and place orders in the United States with SIS, which, without in any way limiting the foregoing, accepts responsibility (solely for purposes of and within the meaning of Rule 15a-6 under the U.S. Securities Exchange Act of 1934) for this report and its dissemination in the United States.

© 2020 by Santander Investment Securities Inc. All Rights Reserved.