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Brazil Macro Compass

Brazilian Assets Surf the (Lack of a) Wave

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- **The global rally in risk assets following the early results of the U.S. elections spilled over significantly into Brazilian assets, particularly on the currency side. Following its high-beta pattern, the BRL headed for a hefty weekly gain vs. the USD, standing among the top performers. We continue to anticipate high FX volatility until year-end owing to local factors and uncertainties.**
- **In fixed income, the week saw a flattening pattern in nominal yields, with downward pressures in the back end, possibly reflecting the market's optimism over U.S. election results. Still, we continue to anticipate premium and volatility for the yield curve for the coming weeks and months, until there is more clarity on the domestic fiscal path.**
- **The Brazilian Central Bank (BCB) published on Tuesday (November 3, 2020) the minutes of its October 27-28 policy meeting. The COPOM took the opportunity to provide further insights on its forward guidance, for both the short and the medium term, raising the tone of caution (about inflation risks) in comparison with the communiqué, which had been perceived as soft by market participants.**
- **On the political front, on November 3 the Brazilian Senate approved a bill granting formal autonomy to the Central Bank—which we think probably will pass the Lower House only in 2021. On November 4, the veto on payroll tax breaks was overturned, reducing the margin to comply with the spending cap in 2021 by BRL6.5 billion (already considered in our scenario).**
- **October's IPCA registered a 0.86% MoM change (3.92% YoY). The result was a bit above the market's median expectation (0.84% MoM) and in line with our forecast (0.87% MoM). Pressure on industrial goods continued, pushing core measures upward, although less than we expected. Looking further ahead, we continue to anticipate a benign scenario for inflation, with most of the short-term pressures likely subsiding throughout 2021.**
- **Industrial production data has confirmed expectations of a fifth gain in a row in September and a return to pre-crisis levels, in a favorable environment so far, with available credit, high confidence, and (temporarily) increased income resulting from the government's emergency aid. In the breakdown, manufacturing numbers point to a supply replenishment ahead, in our view.**
- **Next week, IBGE will release September data on retail sales (November 11) and the services sector (November 12); we expect gains of 2.3% MoM s.a. (11.9% YoY) and 3.2% MoM s.a. (10.8% YoY) for core and broad concepts, respectively, and a gain of 1.6% MoM s.a. (-7.5% YoY) for the services sector. Moreover, the IBC-Br will be also available (November 13), and we expect a monthly gain of 0.7% (-1.6% YoY). Based on this information set, our tracking for 3Q20 GDP is at 9.1% QoQ s.a. (-3.1% YoY).**

Local markets—FX: The global rally in risk assets following the preliminary results of the U.S. elections spilled over significantly into Brazilian assets, particularly on the currency side.

In what is turning out to be a very tight race, the results up until the time of this writing (Friday around noon, Brasilia time) were pointing to likely victories by the Democrats for the White House and in the House of Representatives, with Republicans expected to retain a Senate majority. From the standpoint of structural U.S. growth (and its contribution to global potential GDP), the markets could be underestimating the risks from a starkly divided executive-legislative setting in a highly polarized political environment.

Still, regarding divided government in the U.S., markets are looking on the bright side in the short run, as the political divisions reduce the perceived likelihood of higher taxes and tougher regulatory initiatives, which could weigh on stocks. In general, the electoral results prompted participants to reduce the expected value of an upcoming U.S. fiscal package (putting downward pressure on back-end U.S. Treasury yields) while increasing hopes that the Fed will step up stimulus via asset purchases (putting downward pressure on the USD). Additionally, the market sees a hypothetical Biden administration taking a multilateral (or less protectionist) approach when it comes to U.S. trade policies, which also adds to the USD weakening.

Thus, in this (at least temporarily) pro-risk, pro-EM, and weak USD environment, we believe it is once again time for the BRL to put on display its high-beta pattern, as it has been one of the top performing currencies for the week among the majors. At the time of this writing, the Brazilian currency was trading at 5.49/USD (the "strongest" level in more than a month) and is heading for a weekly gain of 4.5% vs. the greenback.

While these external developments confirmed our expectations of a globally weaker USD, taking the USD/BRL pair closer to our year-end forecast (5.30), we believe that local factors may continue to feed volatility and upside risk in coming weeks. Among these factors, from a fundamental standpoint, we mention the pending fiscal decisions (i.e., how to create a new welfare program within the constitutional spending cap) expected after the municipal elections. From a technical standpoint, we think the local FX market will remain uneasy about the "FX over hedge" theme, as financial institutions are still expected to reduce substantially their short USD positions in derivatives markets until year-end, because of regulatory changes implemented by the BCB. The timing and size of an eventual BCB intervention when the time comes (for financial institutions to adjust to their FX positions) is another element seen as a question mark.

Local markets—rates: At the time of this writing, the weekly change in nominal yields pointed to a flattening pattern. In the front end, the Jan-22 DI future was trading at 3.45% (-1 bps from last Friday). In the back end, the Jan-27 DI was trading at 7.42% (-15 bps from last Friday). The steepness in this segment poised to end the week at ~397 bps, compared to 411 bps in the previous week and ~130 bps prior to the arrival of the pandemic in Brazil (March).

In our view, the back-end rally likely follows the global risk-on sentiment following the preliminary results from the U.S. elections. That said, we believe the flattening probably reflects the fact that front-end yields seemed upwardly influenced by the more cautious tone of the BCB in the Copom minutes, as the authority apparently recalibrated the softer-than-expected tone of the previous week's communiqué (see the monetary policy section below).

As our baseline scenarios anticipate stable interest rates throughout 2021, assuming a still credible fiscal consolidation process for the coming years, we still are of the view that the market has put a lot of premium in the entire yield curve. Yet we recognize that a good deal of this premium will only erode after there is more clarity on the upcoming budget choices ahead. Thus, yield curve volatility should remain high for the coming weeks and months, in our view.

Monetary policy: The BCB published the minutes of its October 27-28 policy meeting. The COPOM took the opportunity to provide further insights on its forward guidance, for both the short and medium term, recalibrating the tone of the communiqué that has been perceived by market participants as quite soft when it comes to dealing with inflation risks).

The COPOM clarified that rate cuts are not possible for now, as the majority of the board believes that the Selic rate is already close to the effective lower bound. Fiscal uncertainties (via an asymmetrical balance of risks) are now considered a key factor standing in the way of further stimulus.

The BCB reaffirmed its medium-term forward guidance (i.e., no hikes ahead), as the committee sees conditions as still justifying its maintenance. Those conditions include an unchanged fiscal regime, inflation estimates below the target for the medium run, and well-anchored expectations for the long run. The committee provided details on the interpretation of the fiscal clause of its forward guidance, where eventual changes adversely affecting the debt trajectory and fiscal anchor would lead to a reassessment (i.e., the end of the guidance), but with no automatic rate hikes subsequently.

Assuming no change in the effectiveness of the spending cap, our baseline scenario sees the COPOM on hold until 1Q22, and we believe that fiscal uncertainties still pose a major threat for the monetary policy outlook. For details, refer to our report[1].

On November 3, the Senate approved (by 56 to 12 votes) a bill (PLP 19/19) that gives formal autonomy to the Brazilian Central Bank. The legislation set price stability as the main objective for the BCB, and included as secondary objectives (i.e., subordinate to the primary one) the pursuit of full employment, the smoothing of economic cycles, and assuring financial system efficiency. The bill also proposes fixed terms for the entire BCB board of directors, which will be disconnected from the term of the president of the republic - the latter will only appoint a new BCB governor in the third year in office. The draft bill had the support of BCB governor Roberto Campos Neto, as the initiative further improves the framework for central banking in Brazil. If fiscal conditions allow it, this bill is expected to help consolidate the process of anchoring of long term inflation expectations in Brazil.

On the same day, the Senate also approved a bill regulating (voluntary) excess reserves deposits in the Central Bank, creating an additional monetary policy instrument that can be used to replace repo operations (possibly yielding lower methodological estimates for gross government debt). Both measures need to be endorsed by the Lower House and, considering a tight legislative calendar for 2020, this is not likely to be confirmed until 2021, in our view.

Inflation: October's IPCA registered a 0.86% MoM change (3.92% YoY). The result was a bit above the market's median expectation (0.84% MoM) and in line with our forecast (0.87% MoM).

As expected and as already seen in the most recent readings (particularly October's IPCA-15), the pressure on industrial goods prices continued strong. This pushed core measures upward, making the qualitative read a little worse, although less than we expected (core rose 0.55% MoM, whereas we expected 0.67%)—probably because services surprised to the downside. Finally, food inflation also continued to experience pressure, but surprised to the downside.

We have not changed our high-frequency tracking for IPCA 2020, which continues to stand at 3.3%, but we continue to see upside risks.

Looking further ahead, we continue to anticipate a benign scenario for inflation, with most of the upward pressures subsiding throughout 2021, while services inflation should continue to run at low rates, as we expect a weak job market. We believe that well-anchored inflation expectations could also play an important role in Brazil's price dynamics.

In that scenario, we believe core measures will continue to run at a low level, along with the headline, which we forecast at 2.9% for IPCA 2021 (although short-term pressures pose an upside risk for 1Q21, which could inch our year-end forecast a bit higher). For details, refer to our report[2].

Fiscal policy: On November 4, Congress overturned a presidential veto on payroll tax breaks for 17 labor-intensive economic sectors until the end of 2021. In our view, continuation of the payroll tax exemption means further difficulty in complying with the spending cap for 2021—adding up to BRL6.5 billion in new expenses (as the Treasury has to "repay" part of the nearly BRL12 billion in tax breaks to the INSS, or social security institute). We already consider this fact in our fiscal scenario.

Finally, Congress also approved the reallocation of budgetary funds, totaling BRL 6.1 billion, to Regional Development and Infrastructure; the objective is to use the resources to complete unfinished infrastructure projects by the end of the year.

Economic activity: Industrial production data has confirmed expectations of a fifth consecutive gain, following April's sharp drop and capping a batch of 3Q20 industrial production releases, with the headline index pointing to growth of 2.6% MoM (s.a.), vs. consensus of 2.3%. September's positive result implies that the entire drop registered between March and April has already been recovered, and in comparison to the pre-crisis level, the headline number is up by 0.2% since February. With this result, industrial production ends 3Q20 registering a quarterly increase of 22.3%, after posting a sharp fall of 17.4% in the previous quarter, with a consistent recovery pace in a favorable environment with available credit, high confidence, and temporarily supported income due to the emergency aid from the government.

Preliminary soft data for October points to continued improvement in industrial production. According to the FGV, industrial business confidence stands at its highest since 2011, and industrial capacity utilization has far surpassed the pre-crisis level, registering a reading close to the historical average. While this is the highest level since 2014, it does not seem to indicate severe and lasting supply constraints, in our view.

[1] **Santander Macro Brazil Monetary Policy -** ***COPOM Minutes: Forward Guidance Further Clarified*** – November 03, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-copom-minutes-forward-guidance/20-11-05_132308_201103+-+copom+minutes.pdf

[2] **Santander Macro Brazil Inflation -** ***IPCA October: No News on the Margin*** – November 06, 2020- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-ipca-october-no-news-on-the-margin/20-11-06_174659_brzipca110620.pdf

Regarding the mismatch between industry and retail sales (as the former outgrew the latter quite markedly in recent months), it is important to note that inventories are running at the lowest levels since January 2013, which we see as a good indicator of future production. Despite that, in our view, this decoupling will not be sustained in the coming quarters, since we expect demand to shift from goods to the services sector on the heels of the reopening of the economy, and since part of the solid demand for goods is about to fade with the end of fiscal stimuli. For details, see our report[3].

Also next week: On the macro agenda, several important numbers are scheduled to be published. The IBGE will release data on retail sales (November 11) and the services sector (November 12) for 3Q20. We expect gains of 2.3 % MoM s.a. (11.9% YoY) and 3.2% MoM s.a. (10.8% YoY), for core and broad indexes, respectively, and a gain of 1.6 % MoM s.a. (-7.5% YoY) for the services sector. On Friday (November 13), the BCB will also release its monthly activity index (IBC-Br), and we expect a monthly gain of 0.7% (-1.6% YoY). These figures will be essential for tracking economic activity recovery for the third quarter relative to the depressed basis of 2Q20. Based on this information set, our tracking for 3Q20 GDP is at 9.1% QoQ s.a. (-3.1% YoY).

MACRO AGENDA

Indicator	Reference	Date	Estimate	Prior
IBGE Broad Retail Sales (% MoM)	Sep/20	Wed, 11-Nov	3.2	4.6
IBGE Retail Sales (% MoM)	Sep/20	Wed, 11-Nov	2.3	3.4
IBGE Broad Retail Sales (% YoY)	Sep/20	Wed, 11-Nov	10.8	3.9
IBGE Retail Sales (% YoY)	Sep/20	Wed, 11-Nov	11.9	6.1
IBGE Services Sector (% MoM)	Sep/20	Thu, 12-Nov	1.6	2.9
IBGE Services Sector (% YoY)	Sep/20	Thu, 12-Nov	-7.5	-10.0
IBC-Br Economic Activity (% MoM)	Sep/20	Fri,13-Nov	0.7	1.1
IBC-Br Economic Activity (% YoY)	Sep/20	Fri,13-Nov	-1.6	-3.9
CNI Industrial Confidence points	Nov/20	Fri,13-Nov	--	61.8

Sources: Bloomberg and Santander.

For details on our Brazil economic forecasts, please refer to our latest scenario review *[4], Santander Macro Brazil Scenario Review – Waiting for the Fiscal Decisions.*

[3] **Santander Macro Brazil Economic Activity - *Industrial Production: A consistent third-quarter recovery*** – November 04, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-industrial-production-a-consistent/20-11-05_132620_201104_pim_september.pdf

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

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