Santander
Macroeconomic Research

BRAZIL MACRO

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MACRO COMPASS

CHANGING GEAR IN MONETARY POLICY

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- Following more aggressive interventions by the Brazilian Central Bank (BCB) and the approval of the *PEC Emergencial* with some future budget curbs, the FX rate managed to ease off the year-to-date highs this week, with BRL standing among the top performing currencies since Tuesday. Led by nearly the same drivers, the nominal yield curve also showed considerable volatility for the same period, but saw a flattening pattern over a week. The front end now prices in an even higher probability of a more hawkish Copom stance for the short term, with the back end still pricing persistent fiscal risks.
- Brazil's COVID-19 situation continues to worsen as more states report hospitals approaching full capacity. *Butantan* announced a preliminary study showing *Butantan*/Coronavac vaccine may be effective against new variants of COVID-19. As of March 11, about 12.1 million doses have been administered in the country (with 3.1 million people having received their second shots).
- The Lower House approved the *PEC Emergencial* with fiscal triggers to help curb mandatory expenses in the future. Yet the final legislation was watered down on the fiscal savings following negotiations to avoid a larger setback for the reform. The bill limits the extra budget (outside the constitutional ceiling) at BRL44 billion. On the political side, a decision by a Supreme Court judge restored the political rights of former President Lula (with a final deliberation still expected ahead).
- February's IPCA registered a 0.86% MoM change (5.20% YoY, a four-year high), significantly above the market's expectation of 0.71% and our forecast of 0.73%. The upside surprises were fairly widely spread among the subcategories, which was also evident in the core measures. The report reinforces an unfavorable inflation outlook for the short term.
- Economic activity indexes showed sequential gains at the start of 1Q21. Industrial production posted its ninth gain in a row, but we noticed some softening at the margin, likely reflecting input shortages in the supply chain. The services volume also increased, but remains well below the pre-crisis mark. For the coming week, the BCB will release its monthly activity indicator, capping the dataset for January. We look for monthly growth of 0.4% (-1.8% YoY), the ninth in a row.
- On Wednesday (March 17), the Brazilian Central Bank (BCB) will announce its monetary policy decision. We anticipate the start of a tightening process, with a Selic rate hike of 0.5 p.p., to 2.50%. In the statement, the Copom should signal further adjustments in the next meetings, with the speed and size of the cycle hinging on the evolution of the inflation outlook and balance of risks, including the pandemic, activity, fiscal risks and underlying inflation. We see upside risks to our Selic rate forecast (4.00% for 2021YE).

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

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

Indicators	Source	Reference	Date	Santander Estimate	Prior
IBC-Br Activity Index (% MoM)	**BCB**	**Jan-21**	**Mon, 15-Mar**	**0.4**	**0.6**
IBC-Br Activity Index (% YoY)	BCB	Jan-21	Mon, 15-Mar	-1.8	1.3
Inflation: IGP-10 (% m/m)	FGV	Mar-21	Tue, 16-Mar	n/a	2.97
Formal Job Creation (thousands)	CAGED	Jan-21	Tue, 16-Mar	210	-68
Copom Meeting - Selic Rate (%)	**BCB**	**--**	**Wed, 17-Mar**	**2.50**	**2.00**
Industrial Confidence (index)	FGV	Mar-21 (p)	Fri, 19-Mar	n/a	107.9

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

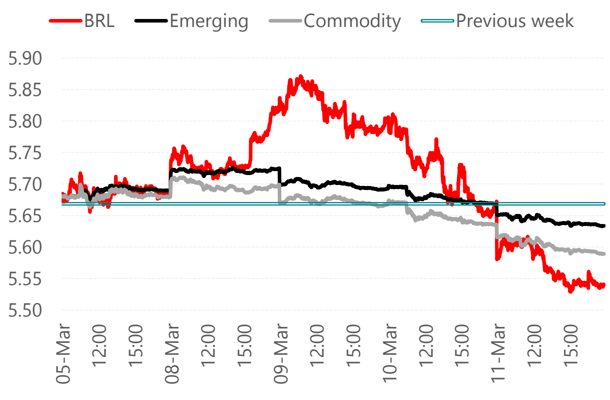
The USD/BRL pair ended the March 11 session at 5.54, which was stronger than the Thursday March 4 reference for the last edition of our weekly report. In our view, the approval of a constitutional amendment that opened room for the Union to run an emergency aid program in 2021 – similar to the paychecks to unemployed persons in the US - combined with budget curbs in the medium term – details in the Fiscal Policy section – had an important influence on that move. Nonetheless, the process of negotiations was far from a smooth one and it raised considerable volatility in the FX market, which led the USD/BRL pair to reach its year-to-date highs of 5.87 last Tuesday, March 9 on an intraday basis.

In our opinion, another important contributing factor to the strengthening of the BRL in recent days was the more aggressive approach of the BCB in its interventions in the domestic FX market. The BCB offered FX swaps (USD2.0 billion) and dollars (USD0.4 billion) in the spot market when the BRL was already showing a strengthening trend between March 5 and 11). We noted a slightly different approach this time than what we usually see from the BCB in that the recent interventions apparently aim to hinder the formation of one-way bets (i.e. just selling) of the BRL. Consequently, the Brazilian currency outperformed other EM and commodity currencies (placing in 4th amid a weekly ranking of emerging markets' currencies).

LOCAL MARKETS—Rates

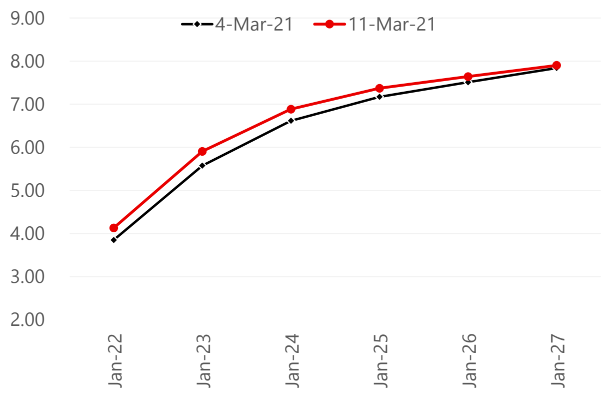
The nominal yield curve flattened a bit more in another highly volatile week. Since our last report (March 5), the front end of the curve (Jan-22 DI future) rose 28 bps to 4.13%, while the back end (Jan-27 DI future) rose 6bp to 7.90%. Hence, the steepness in this segment decreased from 399 bps to 377 bps since Thursday of last week (March 4). At the front end, the market continues pricing in a higher probability of a more hawkish action by the BCB in the next Copom meetings, especially after a higher than expected IPCA reading (see more at the inflation section). Indeed, our call is a 50bps hike at the next meeting, with a non-negligible chance for 75bps. At the long end, markets remained worried during the voting of *PEC Emergencial*. Even though the measure was approved, it was a bit watered down and discussions tended towards a looser fiscal stance (see more at the fiscal section), resulting in the market pricing in higher fiscal risk. We continue to see the potential for rising volatility ahead amid an ever-increasing uncertainty about the fiscal outlook.

Figure 2.A. – USD/BRL Intraday Trends



Sources: Bloomberg, Santander.
Note1: As of the close Thursday, March 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 close Thursday, March 11, 2021.

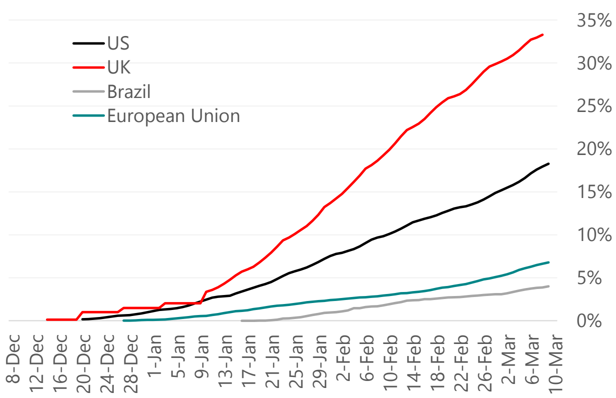
COVID-19 MONITORING

In the U.S., cases are falling rapidly in southern states, likely a result of warmer temperatures coupled with the roll out of vaccines. The vaccination pace of 2.5 million/day (7-day moving average) is encouraging, with nearly 18% of the population having received at least one dose. This figure stands at 33% in the U.K. and at only 6% in the European Union. The U.K. continues to report falling new cases and deaths, suggesting the vaccination is having a positive effect. In the Western European countries, the backdrop is positive and similar to last week, with the exception of Italy where new cases and hospitalizations are rising.

Brazil's COVID-19 situation continues to worsen as more states report hospitals close to full capacity. The ICU occupancy rate is above 90% in at least 13 states, 5 more than reported last week, with tighter restrictions still in place across the country. In São Paulo state, Plano SP (reopening plan) pushed the entire state to the "emergency phase" and further restrictions were imposed, such as a mandatory work from home order for non-essential activities. This phase is expected to last until March 30. On Wednesday (March 10) the daily death toll was 2,286, the highest since the beginning of the pandemic. On the same day, *Butantan* announced a preliminary study showing the *Butantan*/Coronavac vaccine may be effective against new variants of COVID-19. This is very positive since this vaccine accounts for 80% of current available doses in the country.

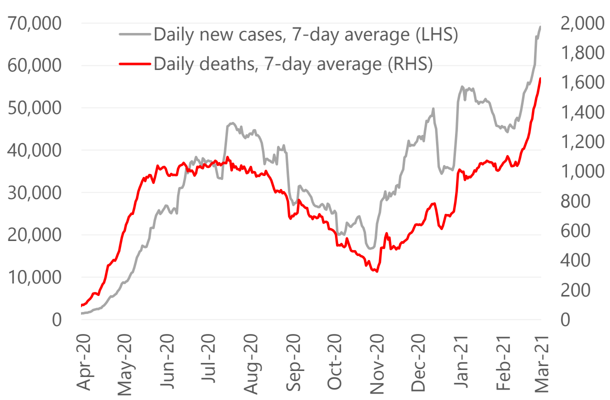
Federal government confirms a 13 million-dose deal with Moderna for 2021. According to the Ministry of Health, 3 million doses are expected for 3Q21 and 10 million for 4Q21. In the near-term, the pace of vaccinations will likely pick up in Brazil as the production and delivery of the *Fiocruz*/AstraZeneca vaccine joins the ongoing deliveries from *Butantan*/Coronavac. Considering supplies already in the country, the *Fiocruz*/AstraZeneca vaccine could bring the total available doses to 60 million by end of April. As of Thursday (March 11, 2021), 12.1 million doses[3] (out of 20 million available) had been administered in the country, with the pace of vaccination at 335k/day (7-day moving average). Johns Hopkins data for Brazil reports an average of 69k daily new cases (7-day moving average) as of Wednesday (March 10, 2021), up 23.2% from last week, while daily deaths (7-day moving average) stood at 1,626, up 22.1% in the same comparison.

Figure 3.A. People Who Received at Least 1 Shot (%)



Sources: Our World in Data, Santander.

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



Sources: Brazil Ministry of Health, Santander.

[3] Out of the 12.1 million shots already administered, about 3.1 million refer to the second dose.

FISCAL POLICY AND POLITICS

On March 11, the Lower House concluded voting on the *PEC Emergencial*, a constitutional amendment that creates a legal framework for an emergency fiscal regime. After a lengthy debate, the house legislators concluded the first-round vote with a 341-121 margin in favor, while the second-round ended with 366-127 votes to approve the bill—it is necessary 308 votes out of 513 deputies to approve changes in the constitution. Since the legislation had already cleared the Senate, the bill will head to promulgation, without the need for presidential sanction (as is the case for constitutional amendments).

Yet the final text saw a watering down of the Government's economics team's proposal, meaning a lower potential for fiscal savings, which was a way to avoid a larger setback on the reform. During the amendments analysis after the first-round, lawmakers removed a provision that would de-link revenues from federal funds (flow). The government could still de-earmark and use an outstanding amount of BRL130 billion for the exclusive purpose of debt payments, meaning a possible instrument to reduce debt issuance in case of unfavorable market conditions. In another amendment to the *PEC Emergencial* vote, to avoid losing the core effect of the proposal (the so-called fiscal triggers, necessary to guarantee the execution of the spending cap), party leaders struck a deal to exclude the possibility to freeze the "career progression" (i.e. automatic, time-base pay rises) for government workers when the triggers are enacted, while still maintaining the overall salary freezes. The fiscal triggers also include a ban for new mandatory expenses and new hires for all government levels (federal and regional). According to our estimates, the potential fiscal savings have been reduced from around BRL13 billion to BRL10 billion per year for the Central Government. The final bill limited the total budget to be allocated (outside the constitutional ceiling) to the Covid relief extension at BRL 44 billion—a positive element, in our view. The government is expected to send shortly a provisional measure to define the parameters of the temporary welfare program.

In our scenario, the triggers will be binding only in 2024 (or later) when the ratio 'mandatory expenses to total expenses' is above 95%. This value was 92.6% in 2020, and it is estimated by the government at 93.5% in 2021. In our view, the triggers will allow fiscal savings of BRL30 billion during 2024-26, meaning that the government and Congress still need to pass further fiscal reforms and maintain the fiscal discipline. We anticipate a necessity of BRL100 billion to comply with the spending cap until 2026.

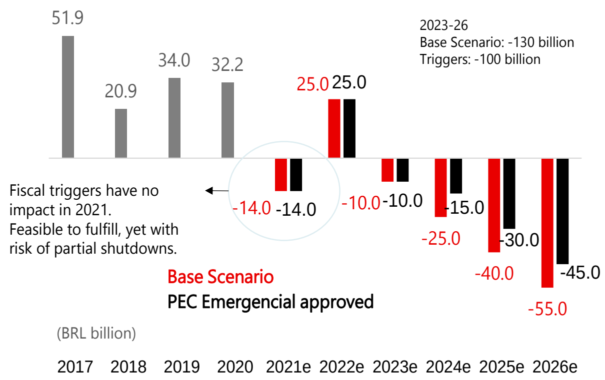
On the political side, on March 08, a Supreme Court judge annulled the sentences against former president Lula. The decision could clear the way for Lula to run for the presidency in 2022. This is not the final decision as a vote could take place at the Supreme Court floor or the Court's second panel.

Figure 4.A. *PEC Emergencial* Summary

- Allows the Emergency Aid in 2021 ('waiver for fiscal rules') – limited at BRL44 billion.
- Fiscal triggers when 'Mandatory expenses/Total expenses' is above 95% (~ in 2024)
- Subnational fiscal triggers regulation (~ in 2023)
- 6 months to create a plan to reduce tax exemptions (needs more enforcement),
- A calamity 'clause' that could be used by congress, easing fiscal rules (triggers will be enacted only during the calamity period),
- De-indexation of Public Funds stock (BRL130 billion) to use in Debt Management – improving the 'Liquidity Cushion' of the National Treasury
- Revokes "Lei Kandir" (transfers);
- Revoked Treasury Judicial claims borrowing lines for subnational entities.

Sources: National Congress, Santander.

Figure 4.B. Compliance With the Spending Cap



Sources: Brazilian Central Bank, Santander.
Note: (+) Excess; (-) Shortfall

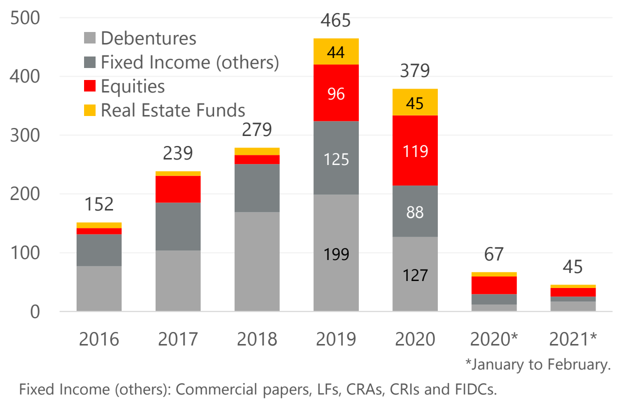
CREDIT

Anbima figures on capital markets activity for February show that new issuances totaled BRL26.2 billion, 45% below the February 2020 volume (BRL47.9 billion, which had been inflated by a single Petrobrás issuance of BRL22 billion). Issuances of fixed income accounted for BRL16.2 billion; equities totaled BRL8.7 billion; and real estate funds came in at BRL1.2 billion. **Importantly, ongoing offerings account for BRL24.6 billion.**

Local bond issuances (i.e. debentures) accounted for BRL 12.6 billion, an increase from January (BRL 4 billion). Looking at the allocation of proceeds from debentures issuances so far in 2021, we note that 37% were allocated for infrastructure investments, up from 12% in 2020**. This is likely a result of issuances under law 12.431, which is a government attempt to foster long term funding in capital markets for infrastructure projects.** Working capital also saw a significant shift to 22% in 2021 from 51% in 2020. For real estate funds, the volume of issuances decreased, an accommodation from at least four consecutive strong figures.

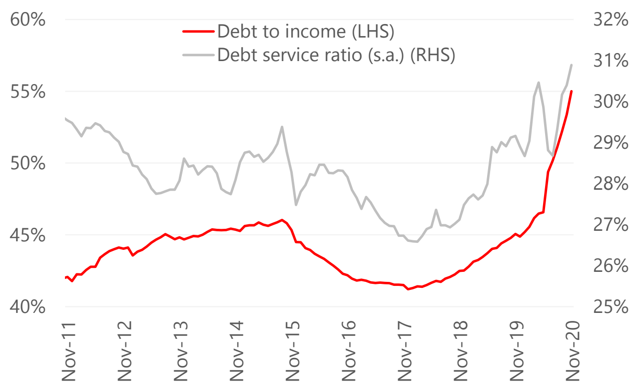
Consumer indebtedness on the rise. Brazilian Central Bank (BCB) data for November show household debt to income at 55.0%, up 1.6 p.p. from October (+9.9 p.p. from November 2019), with the historical average standing at 41.8%. The household debt service ratio was 30.9%, up +0.5 p.p. from October (+1.7 p.p. from November 2019), with the average standing at 27.8%. December data was due to be released this week.

Figure 5.A. – Issuances in Domestic Markets (BRL billion, CPI adjusted)



Sources: Anbima, Santander.

Figure 5.B. – Consumer Indebtedness (% of Expanded Aggregate Income)



Sources: Brazilian Central Bank, Santander.

ECONOMIC ACTIVITY

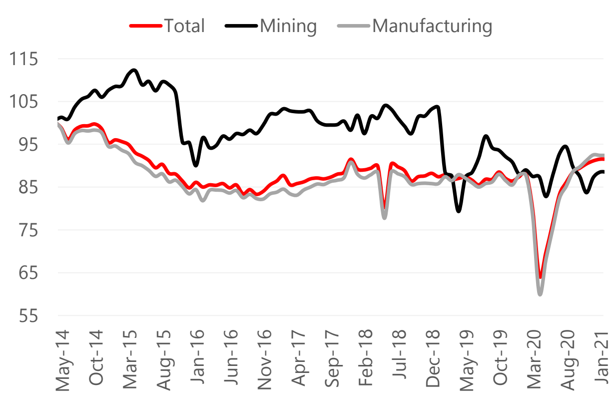
Industrial production data confirmed our expectation of a sequential gain at the start of 2021. The headline index increased 0.4% MoM-sa, which highlights a full recovery from the economic impact of the Covid crisis and takes industrial production to levels 3.7% above the pre-crisis mark (February 2020). January's result was mainly driven by Capital Goods (+4.5%), which bodes well for likely increases in investments spending. Durable Goods declined (-0.7%), breaking a string of eight gains in a row, reflecting, in part, the monthly fall seen in auto production. In terms of the outlook, we expect industrial production to be supported in 1H21 by an inventory replenishment process despite lower demand for industrial goods. Accordingly, downside risk to this scenario is the widespread shortage of inputs to manufacturing (also a worldwide issue), which may compromise supply capacity of the domestic industry. (See link below[4].)

Services revenue increased on a sequential basis, but still remains well below the pre-crisis mark. The headline index pointed to an increase of 0.6% MoM-sa (-4.8% YoY), in line with market consensus (-4.9% YoY). January's result underlines that the services sector is still the laggard in the economic recovery: overall service provision was 3.0% below the pre-crisis mark, while industry and retail sales have already reached full recovery readings**.** Among the subsectors, the segments related to firms are the highlights, with January's increase stemming mainly from Professional (3.4%) and Transport (3.1%) services. Services to Families, more related to social interaction, contributed negatively (-1.5%) for the second month in a row, and its recovery is likely to take place only after the vaccination campaign advances further, in our view. In terms of outlook for the services sector, the first month's result implies a carryover of 1.4% for 1Q21, but we still expect a deterioration of economic activity given the setback in the reopening process and the sequential decrease in mobility. Our estimate for 1Q21 GDP is -0.4% QoQ-sa. (See link below[5].)

IBGE released on Friday (March 12) the retail report for January: the broad index fell -2.1%, consistent with our scenario of a deterioration of the tertiary sector in 1Q21.

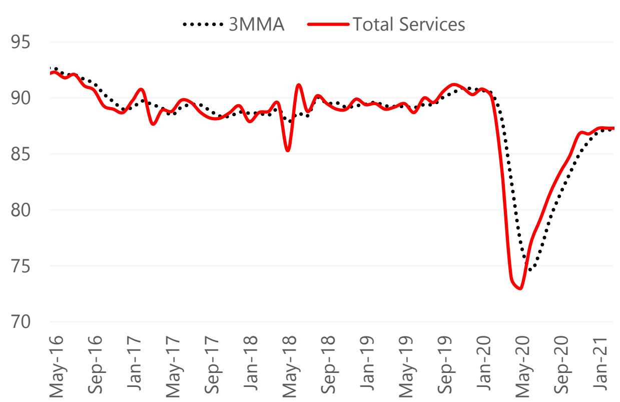
For the coming week, BCB will release its monthly broad activity indicator (March 15), capping the batch of economic activity indexes for January. We look for monthly growth of 0.4% MoM-sa (-1.8% YoY), the ninth in a row, placing the economy 1.0% below the pre-crisis (i.e., February 2020) levels, according to this indicator**.** In the employment front, we expect January CAGED (March 16) to post a 210k net formal job creation. **(For more details regarding our economic activity scenario, see link below[6].)**

Figure 6.A. – Industrial Production (sa, 2012=100)



Sources: IBGE, Santander.

Figure 6.B. – Total Services (sa, 2014=100)



Sources: IBGE, Santander.

[4] **Santander Brazil Economic Activity -** ***"Sequential Increase at the Start of 2021" –*** March 5, 2021- Available on: http://bit.ly/Sant-econact-050321

[5] **Santander Brazil Economic Activity -** ***"Sequential Increase at the Start of 2021, but Still the Laggard" –*** March 9, 2021- Available on: http://bit.ly/Sant-econact-090321

[6] **Santander Brazil Economic Activity -** ***"Economic Activity Chartbook - Lingering impacts to slow the recovery" –*** February 23, 2021- Available on: http://bit.ly/Sant-econact-chart-fev21

INFLATION

February's IPCA registered a 0.86% MoM change (5.20% YoY), significantly above the market's median expectation of 0.71% and our forecast of 0.73%. Upside surprises were fairly widely spread among the groups. Food-at-home contributed +4 bps of the deviation from the headline forecast as did industrial goods. Services contributed +2 bps of deviation from the headline forecast, while administered prices contributed +3 bps.
Core measures continued to experience upward pressure. The average of the main core measures saw a slight deceleration to +5.4% (from +5.5%) in the trend (3mma-saar), continuing the persistently high level. Moreover, diffusion rose (seasonally adjusted) from 63.1% to 66.0%, indicating spill-over effects from recent shocks to general prices.

Therefore, February's IPCA reading reinforces an unfavorable outlook for short-term inflation, in our view, indicating upward pressures remain strong.

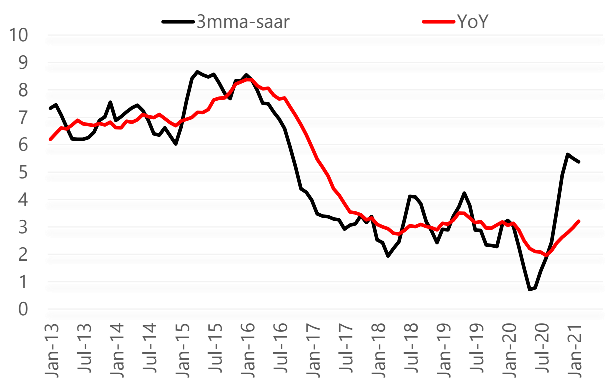
Looking ahead, we believe most of the pressures (commodity prices rising, a depreciated BRL, supply chain disruption, etc.) should continue for a while, keeping short-term IPCA risks tilted to the upside. Our IPCA 2021 high-frequency tracking was at 4.80% before today's number, but we have revised it to 4.9%, and risks remain tilted to the upside. For IPCA 2022 we still believe that most of the pandemic-related influences will have faded and that prices will return to being more determined by weak demand, causing IPCA to stay close to the target. However, greater inertia from 2021 and a trickier fiscal scenario tilt the risks to the upside, in our view. (See link below[7].)

Figure 7.A – IPCA by Groups (%)

	MoM			YoY	
	Feb-21	Santander	Dev.	Jan-21	Feb-21
IPCA	0.86	0.73	0.13	4.6	5.2
Administered	1.69	1.58	0.03	1.8	3.8
Free	0.58	0.44	0.10	5.5	5.7
Food-at-home	0.28	0.05	0.04	19.2	19.4
Industrial goods	0.81	0.62	0.04	4.1	4.6
Services	0.55	0.49	0.02	1.5	1.4
EX3 Core	0.45	0.30	0.15	2.9	3.1
Average of cores	0.51	-	-	3.0	3.2

Sources: IBGE, Santander.

Figure 7.B. – Core Inflation Average (%)



Sources: IBGE, Brazilian Central Bank, Santander.

[7] **Santander Brazil Inflation - *"IPCA February: No Respite from Inflation"* --** March 11, 2021- Available on: https://bit.ly/Sant-IPCA-feb21

MONETARY POLICY

On Wednesday (March 17), the Brazilian Central Bank announces its monetary policy decision. We (and the street) anticipate the start of a tightening process, with a Selic rate hike of 0.5 p.p., to 2.50%. At the last Copom meeting, the BCB already signaled a bias towards the withdrawal of monetary stimulus through an “anticipated” abandonment of the forward guidance (of stable interest rate). Additionally, the tone of the statement and the minutes showed the committee was already considering a timely removal of stimulus.

We believe the evolution of the scenario since the last Copom meeting reinforces expectations for the kick-off of an interest rate adjustment cycle. Activity was steady in 4Q20, albeit with great asymmetry between sectors (industry going strong and with no idleness; tertiary sector moving anemically with wide slack). The Copom may continue to see a drop in economic slack (or output gap), owing to the positive GDP data out recently. However, there is evidence of a loss of impetus in activity in December, with preliminary data for 1Q21 also pointing to slowdown in the wake of lesser fiscal stimulus and increasing mobility restrictions. And with even more restrictive measures recently adopted by a number of regional governments, amid alarming levels of ICU occupation rates (and still a gradual Covid-19 vaccination process), a further weakening of the labor market can be expected leading to further employment slack (which we see increasing until the end of 1H21).

Inflation continues to rise, reflecting a series of shocks that, although temporary, are proving far more persistent and intense than we expected. With the escalation of production costs in local currency, because of a combination of high commodity prices and a depreciated FX rate, the numbers show a certain spreading in price pressures for industrial goods, even though services remain relatively contained. The underlying inflation measures seem to be softening, but remain at high levels. We project inflation above the target for 2021, and around the center target for 2022 (but already accounting for Selic rate hikes).

On the fiscal side, the debates over the extension of stimulus (even at values well below the gigantic budgetary impulse implemented in 2020), alongside measures of future expenditure restraint generated a great deal of volatility in asset prices and economic expectations. With some zigzagging in the discussions and, at the end, a watering down of the effects in the proposed budget curbs, we see a higher perception of execution risk for the long (but necessary) process of fiscal consolidation ahead. Thus, the fiscal debate should have kept an even stronger upward bias in the balance of risks for inflation, according to the BCB's view.

In view of this complex environment with risks in both directions, but prevailing upward bias the need to withdraw monetary stimuli was largely anticipated by the market as a way to prevent secondary effects from the inflationary shocks (i.e. avoiding a more persistent inflation ahead). In addition, an increase in the Selic to levels probably above the effective lower bound (ELB) in Brazil to 3% or 4% may help mitigate exchange rate pressures that have intensified the inflationary impact of such a cost push inflation, particularly in case of raw materials. And all this adds to the committee's perception of dwindling economic slack, which suggests to the BCB a lesser need for extraordinary monetary stimulus.

In terms of policy signaling, we believe the BCB will probably point to a gradual process of (perhaps partial) normalization of interest rates, possibly indicating its intention to keep some stimulus at the end of this adjustment. Most importantly, we believe the BCB is to indicate some data-dependency with respect to both speed and depth of the adjustment, providing it some flexibility to adjust the flight plan if necessary, amid macro uncertainties. Bearing in mind an increase in risk for the materialization of an orderly process of structural budget adjustment, we see rising odds for an even greater adjustment cycle in the Selic rate amid continuous inflationary surprises from cost hikes and also partly lax fiscal and monetary policies. Our scenario of 4.00% Selic for 2021YE and 4.50% for 2022YE is under revision.

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