Brazil Macro Compass

Eyeing a Partial GDP Rebound in 3Q

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- **The BRL is poised to end the week with a slight gain vs. the USD, and about in line with the average of peers. This performance has taken place against a constructive global backdrop for EMs (amid hopes for vaccines for COVID-19) and speeches by government officials suggesting no spillover of massive fiscal stimulus for 2021. With no solution for the fiscal dilemma in sight, we continue to anticipate volatility for the BRL in coming weeks.**
- **Under the influence of nearly the same factors as FX, the local yield curve bull-flattened this week. We expect uncertainty about potential fiscal policy actions to continue at least until late 1Q21, so that the yield curve volatility will likely remain high in the coming weeks. Receiving the very front end is the best opportunity, in our view, given the hefty premium and the limited chances of a BCB rate hike in 1Q21.**
- **External sector data for October confirmed, in our view, that balance of payment concerns should remain off market participants' radar in the medium term, with the current account balance having registered another monthly surplus (USD1.5 billion) and continuing its falling trend on an annual basis (reaching USD15.3 billion in 12 months). That reinforces our expectations of a swift and significant adjustment based on a strong contraction of expenditures (e.g., imports, dividends).**
- **On the fiscal front, tax collection improved in October, with payment of deferred taxes and a recovery in domestic activity. As a consequence, the central government recorded a better than expected result in the month. However, the annual deficit keeps reaching new historical highs. In the coming weeks, the market expects the government to unveil its formal draft for fiscal reforms.**
- **November's IPCA-15 registered a +0.81% MoM change (+4.22% YoY), still largely led by food costs. Despite a riskier path likely ahead, we continue to see a benign scenario for IPCA inflation in the medium term. November's IGP-M was also released and registered a +3.28% MoM change (+24.52% YoY). Despite the still high monthly print, the reading at least showed a small deceleration in wholesale prices, in both the agricultural and industrial segments.**
- **October data show that bank lending to households continues to recover, with non-earmarked new loans back to pre-crisis levels. For the corporate segment, new loans decelerated, mostly due to a slowdown in government's programs of credit support. Despite another decrease in NPLs, we maintain our view that delinquencies are likely to increase in the coming months, with the end of the government's emergency aid and of loan payment deferrals.**
- **FGV surveys for November confirm the heterogeneous pace of the recovery among sectors, but we highlight two figures: industry confidence pointing to another month in a row of growth, with high capacity use and low inventories; and retail confidence showing signs of softening due to the gradual reduction in the amount of the monthly stipends related to the emergency aid. The September PNAD (Household) Survey heralds a continued deterioration in labor market conditions, and we expect joblessness to rise significantly in the coming months.**
- **Important activity releases are scheduled for the coming week. On Thursday (December 3), GDP for 3Q20 will be released, and we expect sharp growth of 8.7% QoQ s.a. (-3.4% YoY), though still not enough to fully offset the pandemic's impact. On Wednesday (December 2), IBGE will release data on Industrial Production for October, and we expect a gain of 1.7% MoM s.a. (1.0% YoY).**

Local markets—FX: The Thanksgiving holiday seemed to have contributed to a relatively calm news cycle this week on the international front, with the outcomes of vaccine trials feeding a constructive environment for emerging markets' assets in recent days. On the domestic side, no progress was made in discussions on the fiscal front, but government officials continue to signal the end of massive stimulus at the turn of the year. That has been taken by market participants as an indication that the commitment to fiscal discipline (read the constitutional spending cap) will be the focus as 2021 begins.

This combination favored the performance of Brazilian financial assets, with foreigners returning to the local equity markets, which helped the BRL strengthen compared with a week ago (as of this writing, just before noon, the USD/BRL pair was quoted at 5.35 vs. 5.39 last Friday, against a backdrop of a globally weak USD.) In our view, with the international news cycle likely to continue to be positive regarding the eventual conquest of the pandemic, further strengthening of the BRL will hinge on progress in the domestic debate on fiscal policy. As the discussion is far from reaching a consensus, we would not be surprised to see volatility in the BRL trajectory in the coming weeks.

Local markets—rates: At the time of writing (Friday just before noon), nominal yields looked poised to observe a bull-flattening pattern for the week. In the front end, the Jan-22 DI future was trading at 3.27% (-9 bps from last Friday). In the back end, the Jan-27 DI future was trading at 7.55% (-19 bps from last Friday). The steepness in this segment (27s vs 22s) was about to close the week at ~428 bps, compared to ~438 bps in the previous week and just ~150 bps before the arrival of the pandemic in Brazil (late February).

This week's bullishness in the local yield curve takes place in a more EM-friendly global market environment—especially amid optimism about a medical solution to the pandemic, following positive news on the vaccine front in recent weeks. At the local level, the news continues to swing around, with no solution in sight for the current fiscal policy dilemma (how to boost welfare programs while retaining the credibility of the constitutional spending cap). Yet investors seem to have found a little (temporary) reassurance in remarks by top government officials suggesting that the baseline scenario is the end of the extraordinary COVID-19 stimulus, effective January 2021. Both of these elements (global and local) seem to have caused downward pressure on yields, particularly on the back end of the curve.

The front end of the curve remains apparently in favor from BCB communications, in our view, as key Copom voting members continue to signal that current inflationary pressures are driven by supply and other shocks, and therefore are of a temporary nature. We continue to believe there is too much premium in the very front end, with more than 50bps in Selic hikes priced in up to 1Q21. In our view, given the extremely limited likelihood of BCB rate moves for that horizon, we believe receiving that part of the curve is the only position where one could have some sort of "conviction". For the rest of the curve, we continue to see a good deal of volatility ahead, amid significant and lingering uncertainty about the next fiscal policy steps. Since a solution is not expected until late 1Q21, we believe the current possibilities lead to a binary set of macroeconomic (and asset-price) outcomes ahead.

Fiscal policy: On November 24, data published by the Brazilian Revenue Service showed that federal tax collection totaled BRL153.9 billion in October, higher than our forecast and the median of market expectations (both at BRL150.5 billion). Tax collection increased 9.6% YoY in real terms, boosted by the payment of tax deferrals (BRL16.3 billion) and cyclical recovery of domestic activity in 3Q20. Year-to-date, revenue continued to record a decline of 9.5%. We continue to expect total federal tax collection to plunge close to 8.5% in real terms this year, equivalent to tax losses of ~BRL135 billion compared to 2019. **For details, refer to the link[1].**

The central government posted a BRL3.6 billion primary deficit in October. It was the second worst number in the historical series for that month—the numbers continue to show a substantial impact on government finances from the COVID-19 crisis. Yet the result was better than our forecast (BRL11.2 billion) and the market median (BRL20 billion). The main difference from our forecast was the return of unused funds worth BRL6.1 billion of credit-related resources from BNDES, lowering the expenses accounted for the month. Although the total expenses related to COVID-19 declined from BRL73.5 billion in September to BRL29 billion in October, featuring BRL21.0 billion related to the emergency aid (second month with BRL300 stipend per beneficiary), total expenses increased 21.8% YoY in October. The YTD primary deficit totals BRL681.0 billion in real terms (9.8% of GDP), anchored in 42.7% YoY growth (+BRL523.5 billion) in expenditures and an 11.6% decline (-BRL 93.6 billion) in net revenue. Although we expect a gradual improvement in fiscal accounts in the coming months, the annual deficit should remain high. For 2020, we continue to forecast the central government's primary fiscal deficit around BRL880 billion (12.4% of GDP).

Balance of payments: The release of Brazilian balance of payments data for October 2020 revealed that both the current balance (CAB) and the net inflow of direct investments in the country (IDP, in the Portuguese acronym) exceeded our estimates by a narrow margin. We expected the CAB to have registered USD1.3 billion and the IDP to have tallied USD1.5

[1] **Santander Macro Brazil Fiscal Policy - *Tax Collection: Good Result in October with Payment of Tax Deferrals and Recovery in Activity*** – November 24, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-fiscal-policy-tax-collection/20-11-25_123852_bz+macro_112420_tax_collection_oct20.pdf

billion, but the actual figures were USD1.5 billion and USD1.8 billion, respectively. In 12-month-to-date terms, the data reinforced our view that the situation continues to be "comfortable" with respect to Brazilian external financing needs, as the IDP continued to exceed the deficit in the CAB. Nonetheless, we call our readers' attention to the fact that this "comfortable" situation has come on the heels of a swift improvement in the CAB in tandem with a declining trend in the volume of IDP.

Incidentally, the three-month moving-averages of seasonally adjusted figures for both indicators suggest to us that the CAB is running at a pace compatible with an annualized surplus near USD20.0 billion, while the IDP annualized gauge is in line with a net outflow around USD3.0 billion. In our view, that is a combination nowhere near favorable to an emerging economy, and it reinforces the need to implement changes in Brazil's economic structure in order to lure investors back to the country.

As we expect the economy to remain on a gradual recovery trend in the coming years and anticipate the resumption of debate about a reformist agenda in Congress, we think Brazil is likely to witness some reversal in this recent trend further down the road. **For details, refer to the link[2].**

Inflation: November's IPCA-15 registered a 0.81% MoM change (4.22% YoY). The result was above the market's median expectation (0.72% MoM) and our forecast (0.75% MoM). Food-at-home was the major upward surprise (+3 bps), but food service also surprised (+2 bps), which contributed to pressure core measures. Industrial goods also continued to pressure core measures, but were in line with expectations. Core inflation on an annual basis continues to run at tame levels, despite a recent pickup.

Despite the mounting pressures for the short term, we maintain a constructive view for inflation ahead. Our baseline scenario continues to be that Brazil will eventually take a path of fiscal responsibility (i.e., not extending income emergency aid, nor breaching the spending cap), and that there should be a fiscal cliff reducing demand and allowing the BRL to appreciate. With the economy reopening, the consumer's basket should also normalize, in our view, reducing demand for goods (fiscal cliff also helping on that) while the industry recovers, ending the mismatch between supply and demand. Finally, our scenario calls for a significant negative output gap and a high unemployment rate, suggesting low inflation with a benign composition. Thus, despite a riskier path, our high-frequency tracking is at 3.8% for 2020 and 3.3% for 2021, below the BCB's target. **For details, refer to the link**[3].

November's IGP-M was also released, registering a 3.28% MoM change (24.52% YoY). The result was in line with our forecast (3.26%) and also close to the median market expectation (3.22%). Despite the still high monthly print, the reading at least showed a small deceleration in wholesale prices (the IPA index, for both the agricultural and industrial segments), compared to November's IGP-10. We see the cooling off of wholesale prices, particularly in agriculture, as important, as they are linked to much of the recent pressures on IPCA (food-at-home).

Bank lending: Total outstanding loans in the National Financial System (SFN) posted inflation-adjusted growth of 0.5% MoM in October (BRL3.8 trillion), with 0.8% MoM to households and 0.2% MoM to non-financial corporations. New loans adjusted for inflation and seasonality decreased 0.8% in the month compared to September, with the contraction driven by corporations. For households, growth in the non-earmarked segment was 1.8% MoM, s.a.—the sixth consecutive gain, now a full recovery to February's reading (pre-pandemic). For companies, there was a decrease of 1.4% MoM, s.a. in the non-earmarked segment. The earmarked segment saw a decrease of 44.6% MoM, s.a. due to a slowdown in disbursements from emergency credit-support programs (Pronampe, Pese, and FGI) in October. However, the accumulated year-to-date new loans (inflation adjusted*)* to corporations are 10.5% above the same period in 2019. We highlight that the BCB has announced revisions to statistics regarding loans from these programs: new loans related to these will be reclassified from non-earmarked to earmarked loans, changing the composition of the results somewhat.

The average interest rate for non-earmarked new loans was 38.9% p.a. for households (compared to 38.0% p.a. in September) and 12.0% p.a. for corporations (compared to 11.5% p.a. in September). The spread on non-earmarked new loans was 33.4% (+0.5 p.p. from September) and 7.6% (same as September) for households and corporations, respectively.

Still with respect non-earmarked loans, the seasonally adjusted default rate (% of 90-day past due loans) dropped another 0.1 p.p. in the month for households, reaching 4.4%. For corporations, there was a reduction of 0.1 p.p., to 1.5%. In both cases, it is the lowest value observed in the historical series that began in March 2011. Despite another decline for both, we are still of the view that delinquencies are likely to increase in the coming months due to the pending end of loan payment deferrals and of the government's emergency aid.

Economic activity: In recent days, FGV has released the final readings of confidence indexes for November, which have

[2] **Santander Macro Brazil Balance of Payments October 2020** – November 26, 2020 – Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-external-sector-balance-of-payments-october/20-11-26_183836_201125+-+bop+oct20.pdf
[3] **Santander Macro Brazil Inflation – *IPCA-15 November: Despite the Risks, the Scenario Is Still Benign*** – November 24, 2020 – Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-inflation-ipca-15-november/20-11-25_145511_brzipca112420.pdf

confirmed the mixed results published last week in FGV's preview. Regarding industrial confidence, the headline index continued to rise in November, pointing to growth of 1.7% MoM (s.a.) and reaching the highest value since 2010. In comparison to the pre-crisis level, confidence is up 11.5% since February; this result was mainly driven by the current component, up 4.0%, while the expectation component posted a decrease of 0.6%. In the survey details, for the first month since June, expected demand stands below current demand, and expected production fell for the first time since April (down 4.2%); these figures may be a sign of accommodation of industrial activity ahead, in our view. Industrial capacity utilization was virtually stable (moving to 79.7% from 79.8%). While this number is running close to the historical average (80.0%), it does not seem to indicate severe and lasting supply constraints, in our view. Inventories are running at the lowest levels ever, which we see as a good indicator for future production. We remain unworried about supply-demand mismatches in the medium term, as we also we expect demand to shift from goods to the services sector on the heels of the reopening of the economy. Additionally, part of the solid demand for goods is about to fade with end of fiscal stimuli, in our view.

For the other sectors, FGV surveys posted only negative results. Consumer and Retail Sales confidences posted declines of 0.8% and 2.4%, respectively, the second decreases in a row. In our view, one reason behind these declines is the gradual reduction in the amount of emergency aid, since the lower paychecks started to arrive at the end of September, with significant effects only in October onward. Construction recorded the first monthly decrease (-1.5%) since April's tumble, though it is still above February's reading.

Job market numbers took the stage this week, painting a mixed picture. According to the CAGED (establishment) survey, formal job creation continued to show an improvement in October: net (unadjusted) job creation stood at 394k, considerably better than the upper bound of expectations (340k). After seasonal adjustments, we estimate a reading of 342k, an all-time high. About 60% of the jobs lost in the crisis have already been recovered. With recent studies pointing to difficulties in the reporting of data by firms that are closing down, these numbers should be read with a grain of salt, as they could be overestimating the actual employment conditions. In fact, in comparison to the pre-crisis reading, the number of respondents in this survey dropped from 830k to 630k in September, after reaching 514k in May. Additionally, with government-sponsored wage subsidy programs poised to expire at the end of the year, formal job creation is about to face substantial headwinds into 2021.

According to the IBGE's National Household Survey (PNAD), the unemployment rate stood at 14.6% in the three months to September, slightly lower than market consensus (14.8%), implying a gain of 2.8 p.p. from the year-ago level (11.8%). We calculate that the seasonally adjusted jobless rate moved up to 14.3%, compared to 14.2% in August: this is the highest reading in the historical series. In a simple counterfactual exercise, if the work force had remained at February's level, the unemployment rate would have reached 22.2% (21.1% s.a.). All in all, September numbers in the PNAD survey herald a continued deterioration in labor market conditions. Looking ahead, we expect joblessness to rise significantly, following the gradual economic reopening and the workforce's return to pre-crisis levels.

On Thursday (December 3), GDP for 3Q20 will be released. Following the significant impact of the COVID-19 crisis in 2Q20, for 3Q20 we expect a sharp increase of 8.7% QoQ s.a. (-3.4% YoY). This positive result would be consistent with a sequential resumption of activity for other key sector-based indicators in 3Q20 (e.g., industrial production, retail sales, and the services sector). On the supply side, we expect a widespread quarterly increase among the sectors, but with the services sector posting a slow recovery, as it has been most affected by the crisis. On the demand side, we expect a large contribution of domestic absorption to the quarterly gain, particularly due to household consumption, on the heels of emergency aid payments. Investments and net exports should also contribute positively to GDP, per our projections. If confirmed, this sharp increase would mark an all-time high for quarterly growth, though still not enough to fully offset the pandemic's impact. In our scenario, in comparison with pre-crisis level, GDP will still be 4% below the 4Q19 reading. **For details, refer to the link**[4]

Also next week: On Sunday (November 29) there will be the second round of municipal elections in a total of 57 Brazilian cities. In our view, more intense legislative activity is likely in Congress after the elections. Will we get details on the formal drafts of the fiscal reforms (*PEC emergencial*)? The markets continue to ask this question, amid a sea of uncertainty on the fiscal front.

On Monday (November 30), the BCB will publish the consolidated public sector's fiscal balance for October 2020, which encompasses the federal government, regional governments, and state-owned companies. We anticipate a monthly primary deficit of -BRL2.0 billion and forecast that net debt will reach 62.9% of GDP in October (from 61.4% of GDP in September).

On Tuesday (December 1), we will learn the trade balance for November, which we expect to register USD4.3 billion, on the back of a 4.5% monthly increase in exports and a 14.6% monthly expansion in imports in seasonally adjusted terms.

[4] **Santander Macro Brazil Economic Activity – *Strong Growth, but Partial Recovery Expected Ahead*** – November 26, 2020 – Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-GDP-preview-strong-growth/20-11-26_191548_201126+3q20+gdp+preview.pdf

We expect the latter result to confirm our assessment that the Brazilian economy continues to recover from the impact of the pandemic earlier this year. Taking into account the three-month moving average of the seasonally adjusted figures, we believe we are likely to see an indication of a USD70.4 billion surplus in annualized terms, which is compatible with our forecast of USD71.8 billion for 2021, thus supporting our view that the trade balance should continue to contribute to the improvement of the current account balance in the near future.

On Wednesday (December 2), IBGE will release data on Industrial Production for October, starting the cycle of publications of the main activity indicators for the first month of 4Q20. Based on the information set available up to now, we project monthly growth of 1.7% (1.0% YoY). On Thursday (December 3), GDP for 3Q20 will be released (see details in the economic activity section above).

MACRO AGENDA

Indicator	Reference	Date	Estimate	Prior
Primary Budget Balance (BRL billion)	Oct/20	Mon,30-Nov	-2.0	-64.6
Nominal Budget Balance (BRL billion)	Oct/20	Mon,30-Nov	-	-103.4
Net Debt (% GDP)	Oct/20	Mon,30-Nov	62.9	61.4
Trade Balance Monthly (USD billion)	Nov/20	Tue,01-Dec	4.3	5.5
Exports Total (USD billion)	Nov/20	Tue,01-Dec	17.7	17.9
Imports Total (USD billion)	Nov/20	Tue,01-Dec	13.4	12.4
Fenabrave - Vehicle Sales (units)	Nov/20	Tue,01-Dec	-	215,053
Industrial Production (%MoM)	Oct/20	Wed,02-Dec	1.7	2.6
Industrial Production (%YoY)	Oct/20	Wed,02-Dec	1.0	3.4
GDP (%QoQ)	3Q20	Thu,03-Dec	8.7	-9.7
GDP (%YoY)	3Q20	Thu,03-Dec	-3.4	-11.4
GDP 4Qtrs Accumulated	3Q20	Thu,03-Dec	-3.4	-2.2
Anfavea - Vehicle Production (units)	Nov/20	Fri,04-Dec	-	236,468

Sources: Bloomberg, Santander.

For details on our Brazil economic forecasts, please refer to our latest scenario review[5].

[5] **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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