Fiscal Concerns on the Rise

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- **Given the difficulties involved in funding a new welfare program and at the same time maintaining the credibility of the constitutional spending cap, the release of the report on the Federative Pact (constitutional reform) was postponed again this past week. We expect this debate to continue for the rest of the year, but a formal proposal will probably take a few weeks longer.**

- **Doubts regarding the funding source for the implementation of a new welfare program in Brazil have fed fiscal jitters and triggered another round of BRL weakening this week. The Brazilian currency was among the worst performers among the majors in recent days. We believe this reinforces our expectation that news on the budget front will drive the dynamics of the domestic FX market.**

- **The nominal yield curve also sold off this week, on the heels of fiscal concerns. As we anticipate a stable Selic rate throughout 2021, we are still of the view that the market has put a good deal of premium in the belly. But this premium may not erode unless we see clear signs that the constitutional spending cap will not be breached.**

- **The trade surplus observed in September 2020 came in short of our estimate (USD6.2 billion versus USD7.1 billion) on the heels of lower than expected exports. In addition, the economy is gaining momentum, as imports expanded for the second month in a row. We continue to look for a trade surplus of USD60 billion for 2020 (2019: USD48 billion).**

- **August data show that credit to households is recovering but is still below the pre-pandemic level. For the corporate segment, the volume of new loans has been high, especially working capital and credit from emergency programs. The reduction of the emergency aid and the end of loan payment deferrals could raise default rates in the coming months, an issue to be monitored, in our view.**

- **Industrial Production pointed to another sequential gain in August, up 3.2% MoM (s.a.) (consensus 3.6%). This result implies the headline number is down by 2.6% since February (pre-crisis level), meaning that 90.3% of the drop registered in the crisis has already been recovered. On Thursday (October 8, 2020), IBGE is scheduled to publish retail sales data for August, which we expect to show another sequential gain as a result of hefty (but temporary) government stimuli.**

- **On Friday (October 9, 2020), IBGE is scheduled to release IPCA inflation for September. We expect a reading of +0.56% MoM (+3.05% YoY). In our view, the main source of upward pressure will again be food-at-home inflation. This pressure is an upside risk for our 2020 IPCA headline forecast, but we continue to envision a benign scenario for the medium term.**

Local markets—FX: Although a number of emerging currencies are likely to end the week stronger than a week ago, we expect the BRL to follow the Turkish lira and the Argentinian peso as one of the worst performers of the period (as of this writing, the USDBRL was quoted at 5.63, or 1.2% weaker than last Friday). The driver for the weakening of the BRL in recent days was uncertainty regarding fiscal policy, as the federal administration has indicated that it wants to implement a new welfare program in 2021 to help the lowest-income segment of the population, but with no decision made as yet on its sources of funding. Hence, the market's discomfort with regard to the trajectory of the (already high) public expenditures and debt has increased, especially as the government has not indicated that it is likely to reconsider the implementation of the welfare program (see details in the fiscal policy section of this report).

Local markets—rates: Based on prices from Friday morning (time of writing), the nominal yield curve bear-flattened considerably this week. In the front end, the Jan-22 DI future looked poised to close the week at 3.27% (+42 bps from last Friday). In the back end, the Jan-27 DI future was trading at 7.53% (+32 bps from last Friday), driving the steepness in this segment (i.e., 2027s vs. 2022s) down to nearly 426 bps, compared to 436 bps in the previous week and ~150 bps early this year. In our view, this movement was influenced by an increase in fiscal jitters locally (as discussed above). Discussions in the government and legislature regarding fiscal policy are likely to continue in the coming weeks, so uncertainty and volatility should continue for a while for Brazilian assets, in our opinion. Since our baseline scenarios anticipate stable interest rates throughout 2021, we still are of the view that the market has put a lot of premium in the belly. But this premium may not erode unless we see clear signs that the constitutional spending cap will not be breached.

Economic activity: In recent days, FGV has released two of the remaining main confidence indexes for September, which have confirmed the results published last week in FGV's preview. Regarding industrial confidence, the headline index continued to rise, pointing to growth of 8.1% MoM (s.a.) and reaching 106.7 points (the highest value since January 2013). This result was slightly better than in the preview (105.8), and the index has shown its fifth gain in a row following the sharp drop seen in April. The entire drop registered between March and April has already been recovered, with the headline standing 5.2% above February's reading. This positive result follows an increase in both the current situation component (up 9.7%) and the expectation component (up 6.3%). In the survey details, expected demand stands above current demand for the third month running, and expected production also showed a positive result for a fifth straight month, at around the highest level since October 2010. Finally, the inventories surplus (i.e., percentage of respondents that view inventories as excessive minus respondents reporting that inventories are insufficient) reached the lowest value since August 2013. These figures are a tailwind for industrial activity ahead.

In the services sector, confidence confirmed FGV's preview. The headline index pointed to growth of 3.4% MoM (s.a), reaching 87.9 points (85.3). The index has shown its fifth gain in a row, and the headline number is down by 6.9% since February, meaning that 85% of the points lost between March and April have already been recovered. This result was mainly driven by the expectation component, up 5.8% (reaching the pre-crisis level), while the current component pointed to slight growth of 0.1%. In the survey details, expected demand and expected employment posted gains of 6.1% (close to the pre-crisis level) and 8.8%, respectively, while current demand was virtually stable (up 0.1%). All in all, these figures reinforce that the services sector is still the laggard in the economic recovery.

Regarding the labor market, the IBGE has released the National Household Survey (PNADC) for July, and the Labor Ministry has published the data for formal job creation for August. The unemployment rate stood at 13.8% (of the economically active population) in the three months to July (consensus 13.7%), a year-over-year gain of 2.0 p.p (11.8 in August 2019). We calculate that seasonally adjusted joblessness moved up to 13.4%, compared to 12.9% in June, reaching an all-time high. Job market participation stood at 55.1%, well below the reading in February (61.4%). This low rate is "concealing" the bad signal sent by 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 as in February, the unemployment rate would have reached 22.7% (21.2% s.a.). All in all, we believe the numbers herald a deterioration in labor market conditions. Going forward, we expect joblessness to grow in the coming months, following the more lasting effects of the COVID-19 crisis. We assume that the workforce will return to the pre-crisis level in 2Q 2021, with the unemployment rate reaching 16.3%.

According to the CAGED (establishment) survey, formal job creation continued to show an improvement in August. Net (unadjusted) job creation stood at 249k, a result considerably better than the historical average for the month (net job creation of 26k). After seasonal adjustments, the number recorded was 166k, and the year-to-date cumulated balance stands at -1.018k (286k in 2019 and the historical average of 485k). The three-month moving average now indicates a likely payroll expansion of 92k jobs, a much better result than that reached in April (all-time low, contraction of almost 500k) and pointing for the first time since February to a positive trend in formal job creation.

Industrial Production has confirmed the expectations of a fourth gain in a row after April's sharp drop. The headline index pointed to growth of 3.2% MoM (s.a.), a result slightly worse than our forecast (4.5%) and market consensus (3.8%). Relative to August 2019, there was a decline of 2.7 %, almost closing the year-over-year gap. Mining and Manufacturing posted monthly gains of 2.6% and 3.5%, respectively. This positive result for August implies the headline number is down by 2.6% since February (pre-crisis level), meaning that 90.3% of the drop registered between March and April has already been recovered. With today's result, supposing no growth in the remaining months of the quarter, growth for 3Q20 is projected at 20.8% QoQ (s.a.).

Among the categories, the positive highlight was Durable Goods, up 18.5% MoM (s.a.). Construction Supplies and Capital Goods, related to investments, posted increases of 1.5% and 2.4%, respectively. In our view, the behavior of these measures points to a possible rise in investments in the third quarter, especially in an environment with looser financial conditions. Regarding the accumulated drop, Construction Supplies and Intermediate Goods have already recovered all the losses registered in the crisis, while Durable Goods has recovered 96.4%. In comparison with February's reading, Intermediate Goods and Construction Supplies are 2.3% and 1.4% above the pre-crisis mark, while Capital Goods and Consumer Goods are the laggards, still 13.6% and 5.0% below that mark. In the survey details, the positive highlights were Vehicles (19.2%), Clothing Manufacture (11.5%), and Leather and Travel Items (14.9%); on the other hand, Personal Care and Printing posted declines of 9.7% and 7.1%, respectively. In general terms, the monthly gains are not widespread as in the previous month, with the Diffusion Index (percentage of industrial categories with monthly growth) reaching 60.0% (vs. 92.0% in July).

Bank lending: In August, the outstanding balance of credit loans in the National Financial System (SFN) posted an acceleration to 9.5% from 8.8% in the year-over-year comparison, driven by loans to corporations (to 14.0% from 12.4%) and to households (to 6.2% from 6.1%). In both cases, payment deferrals due to the pandemic have contributed to the acceleration.

New loans (seasonally adjusted) advanced 3% in the month compared to July. For households, growth in the non-earmarked segment was 4.4% MoM (s.a.). Compared to August 2019, those loans remain 5.7% lower. In the earmarked segment, real estate financing increased significantly (+71.7% YoY). Corporate saw a reduction of 1.3% MoM (s.a.) in the non-earmarked segment. However, cumulative year-to-date (January to August) new loans for working capital are 83.3% above the same period last year. In the earmarked segment, disbursements from the National Support Program for Micro and Small Enterprises (Pronampe) continued.

Considering the extended credit to the corporate segment (SFN loans and debt issues in the capital market) between January and August 2020, there was an increase of 15.1% in the amount raised (in comparison with the same period in 2019). Issuances in the capital market were 35% lower, while SFN loans were 24% higher. The other indicators followed the trend observed in recent months, with a reduction in interest rates, spreads, and delinquency rates. The latter is worthy of attention: the reduction of the emergency aid and the end of payment deferrals could increase the portfolio percentage of past-due loans, in our view.

Fiscal policy: August's fiscal performance was slightly better than expected, yet the numbers continue to show a substantial impact on government finances from the COVID-19 crisis. The figures reinforce our forecast that the 2020 public sector primary fiscal deficit will amount to 12.6% of GDP, leading gross general government debt to nearly 96% of GDP, on the heels of massive spending measures and deferrals of tax payments, as well as a cyclical revenue downturn.

According to data published on September 30 by the BCB, the public sector posted a primary budget deficit of BRL87.6 billion in August, relatively close to our forecast (BRL90.7 billion) and better than market consensus (BRL98.0 billion). The main surprise was in the regional governments result, which posted a surplus of BRL9.1 billion, probably due to the emergency aid's impact on local economies (totaling BRL45.3 billion in August), improving tax collection, and transfers from the federal government to offset the fall in tax collection (BRL15 billion in August).

The consolidated primary balance headline for August 2020 compares with a full-2019 gap of BRL61.9 billion (0.9% of GDP). It is the fifth consecutive month in which the monthly deficit has been higher than a full year in recent years. So far in 2020, the public sector's primary fiscal balance is a negative BRL571.4 billion (12.2% of GDP), the worst level in the entire historical series. The 12-month primary deficit also points in the same direction, standing at BRL611.3 billion (8.5% of GDP), the lowest balance ever recorded.

The BCB numbers show a relatively “better” performance from subnational entities (in comparison with the central government) year to date. Altogether, regional governments posted a primary fiscal surplus of BRL22.5 billion (0.31% of GDP) over the last 12 months. Government-owned firms posted a primary fiscal surplus of BRL14.4 billion (0.20% of GDP) for the last 12 months. Given the considerable headwinds for the economy and tax collection, we expect a deterioration of the fiscal position of subnational entities—particularly states and municipalities—in the coming months. In our view, subnational entities will face a challenge in reestablishing fiscal equilibrium after these fiscal stimuli are over.

Year to date, BCB calculations indicate that the central government’s primary fiscal deficit stands at BRL601.9 billion (12.8% of GDP), by far the worst ever first half of the year for the fiscal accounts since the series’ 1997 inception. Before 2020, the worst primary balance for the first half of the year had been in 2017 (-1.7% of GDP). Over the last 12 months, the central government’s fiscal gap (from the standpoint of the BCB estimates) is now BRL648.2 billion, or 9.0% of GDP, also the worst number on record.

In addition, gross debt reached 88.8% of GDP in August, an increase of 13.0 percentage points from the end of last year. Meanwhile, net debt rose to 60.7% of GDP, 5.0 percentage points higher on the same basis of comparison. Both are expected to continue deteriorating in the coming months.

The massive government measures to mitigate the economic and public health impact of the outbreak of COVID-19 continue to cause Brazilian fiscal accounts to deteriorate. The primary deficit and debt continue to increase, owing to the extension of the emergency measures. We believe that the massive fiscal stimulus will be temporary but that the risk of creating new mandatory spending has increased significantly, which could undermine the fiscal consolidation framework. In order to return to the gradual fiscal adjustment, it will be important to comply with the spending cap constitutional amendment from 2021 onward. To comply with the rule and curb mandatory expenses is essential for the approval of fiscal reforms, in our view.

Additionally, the release of the report on the Federative Pact (constitutional reform) was postponed again, amid controversy generated by the plans announced to finance a revamped social welfare program (renamed *Renda Cidadã*). The discussion included provisions to limit the funds originally intended to pay court-ordered debts (“precatórios”) owed by the federal government and to redirect resources from education fund Fundeb (a proposal that has been rejected previously)to finance *Renda Cidadã*. The measure is controversial in a legal sense: it would imply higher debt (in a broader sense), as it would open room for a permanent mandatory expense by postponing another mandatory (yet more erratic) spending program. The government is continuing discussions seeking a way to finance the new welfare program through this reform, but they have not yet reached a consensus on the fiscal measures to curb mandatory expenses. The rapporteur of the Federative Pact promised to announce his draft of the proposal in the coming weeks, if there is an agreement on the Federative Pact proposal. Our baseline scenario assumes that a new welfare program, if created, would be financed by a reduction in other mandatory expenses, so that the implementation of the spending cap would remain feasible up to 2022. Finally, the vote whether to overturn several presidential vetoes was also postponed—with no new date being set.

Trade balance: The Brazilian trade balance registered a USD6.2 billion surplus in September 2020, which was below our estimate (USD7.1 billion), on the heels of USD18.5 billion in exports and USD12.3 billion in imports (our estimates were USD19.4 billion and USD12.3 billion, respectively). Based on that, the trade balance surplus reached USD42.4 billion in September from USD36.3 billion in the previous reading in year-to-date terms, while it increased to USD54.5 billion in 12-month-to-date terms from USD52.1 billion in the previous reading and USD48.0 billion in December 2019.

The outcome reinforced our perception that exports were less hard hit than imports in the early stages of the pandemic. Nonetheless, the latter have started showing signs of recovery lately. According to our calculations, when we factor out deals related to oil platforms—which are not really either exports or imports, but rather accounting operations derived from tax issues—and adjust for the number of working days in the month, the exports daily average receded 2.3% MoM in seasonally adjusted (s.a.) terms (or -1.8% YoY) in September. As for the imports daily average, after having broken a six-month streak of contractions in the last reading, it registered an expansion of 5.0% MoM s.a. in the period, which followed a 6.2% MoM s.a. increase in August. Despite this positive signal, it is important to note that the imports daily average was 17.9% lower than a year ago, which in our view indicates the protracted recovery the Brazilian economy is likely to experience in the coming months. In any case, by annualizing the exports and imports daily average of the last three months, we come to an indication of a USD83.4 billion annual trade surplus, which is far higher than our updated forecast for 2020 (USD59.7 billion). However, it is important to bear in mind that we assume that the economic recovery will continue in 4Q20, which should support the revival of imports during that period. Incidentally, based on September's figures, the upward trend registered by this annualized trade balance metric since March 2020 seems to us to have peaked, thus underpinning our expectation of a lower annualized result at the end of the year.

Inflation: On Friday (October 9, 2020), IBGE is scheduled to release IPCA inflation for September. We expect a reading of +0.56% MoM (+3.05% YoY).

In our view, the main source of upward pressure will again be food-at-home inflation. We forecast this group will rise 2.70% MoM, on the heels of increased external and domestic demand owing to a change in the consumer basket, along with income support and a depreciated BRL. Conversely, industrial goods (+0.25% MoM) and services (+0.12% MoM) should continue posting mild increases, according to our projections, amid still compressed demand. Finally, we forecast administered prices to rise 0.30%, with gasoline inflation decelerating.

The risk for our 2020 headline IPCA forecast is tilted to the upside (mainly because of food-at-home). Our official number is 2.3%, but our high-frequency tracking is at 2.5%, and we cannot rule out numbers closer to 3.0%. For 2021, however, we continue to forecast of IPCA inflation at 2.7%. We believe food inflation will cool down next year and that the wide negative output gap will play its role to keep services and industrial goods running at low levels—that is, we see core measures continuing on a benign path.

Next week: September's IGP-DI inflation will be released on Wednesday (October 7, 2020) and we forecast it will decelerate—compared to September's IGP-M—to 3.06% MoM. Wholesale prices (both industrial and agro) will be the drivers of the deceleration, in our view. On Thursday (October 8, 2020), IBGE is scheduled to release retail sales for August, and our projections point to another monthly gain. Following the trend observed up to now, we forecast another month of growth for core retail sales (3.0% MoM, s.a.). Regarding broad retail sales, we also expect another month of growth (6.2%), largely due to an increase in vehicle sales.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Vehicle Production Anfavea Sep/20 (units)	Tue, 06-Oct	-	210,860
Vehicle Sales Anfavea Sep/20 (units)	Tue, 06-Oct	-	183,395
Vehicle Exports Anfavea Sep/20 (units)	Tue, 06-Oct	-	28,126
IGP-DI inflation Sep/20 (% MoM)	Wed, 07-Oct	3.06	3.87
IGP-DI inflation Sep/20 (% YoY)	Wed, 07-Oct	18.16	15.23
IBGE Retail Sales Aug/20 (% MoM)	Thu, 08-Oct	3.0	5.2
IBGE Retail Sales Aug/20 (% YoY)	Thu, 08-Oct	8.9	5.5
IBGE Broad Retail Sales Aug/20 (% MoM)	Thu, 08-Oct	6.2	7.2
IBGE Broad Retail Sales Aug/20 (% YoY)	Thu, 08-Oct	6.7	1.6
IPCA inflation (% MoM)	Fri, 09-Oct	0.56	0.24
IPCA inflation (% YoY)	Fri, 09-Oct	3.05	2.44

Sources: Bloomberg and Santander.

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