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Brazil Macro Compass

Global Uncertainties Add to Idiosyncratic (Fiscal) Issues

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- **Amid a global risk-off on the heels of the worsening outbreak of the COVID-19 in the Northern Hemisphere, the BRL once again put on display its high-beta pattern this week, standing among the worst-performing currencies. Local themes (fiscal uncertainties from a fundamentals standpoint, banks" over-hedging from a technical standpoint) provided no respite either, despite additional BCB interventions (in the spot market) to ease volatility. We anticipate high FX volatility until year-end and see upside risk to our USD/BRL forecast (5.30 for end-2020).**

- **The local yield curve steepened further this week, with upward pressure in the back end, possibly reflecting the global risk-off sentiment, in our view. The softer-than-expected tone of the Copom statement (especially the part of the forward guidance indicating the possibility of a small rate cut) may also have contributed to that movement, given the market's inflation jitters currently. As key fiscal decisions have been postponed until after November's municipal elections, we expect uncertainty and yield curve volatility to remain high.**

- **As was widely expected, at the most recent Copom policy meeting (October 27-28, 2020), the Brazilian Central Bank (BCB) kept the Selic rate at the historical low of 2.00%. The authority believes that inflationary pressures are transitory and sees the current policy stance as "adequate," by means of both the policy rate and forward guidance.**

- **September's fiscal performance was again equivalent to a full-year deficit (for a sixth month), yet "better than" the five previous months due to the reduction in the emergency aid stipend (first month with BRL300 in aid per individual). The numbers continue to show a substantial impact from the COVID-19 crisis, with an increase in the primary deficit and debt, owing to the emergency measures.**

- **September data show that bank lending to households has been recovering, with non-earmarked new loans practically back to pre-crisis levels. For the corporate segment, new loans have been growing, especially for working capital and lending from emergency programs. The reduction of the emergency aid and the end of loan payment deferrals herald upside risk for NPLs (and broad credit conditions) in the coming months, in our view.**

- **FGV surveys for October reinforce 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 emergency aid. In the PNAD Survey, August numbers herald a continued deterioration in labor market conditions, and we expect joblessness to grow significantly in coming months. Next week (November 4), IBGE will release data on Industrial Production for September, and we expect a gain of 1.8% MoM s.a. (2.0% YoY).**

- **On Friday (November 6), IBGE is scheduled to release IPCA inflation for October. We expect a reading of +0.87% MoM (+3.93% YoY). We anticipate that the reading will continue to be pressured by food, but this time industrial goods and services should also play a role in accelerating the MoM reading. Despite those temporary upward pressures in 2020, we continue to anticipate a benign scenario for 2021.**

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Local markets—FX: The continued rise in COVID-19 cases and hospitalizations in the Northern Hemisphere – notably in the U.S. and Europe – prompted major risk-off sentiment in global markets this week. The souring in investors' risk appetite spilled over into most asset classes, such as stocks, commodities, EM, rates and currencies. With the USD rising against nearly all of the major currencies, the BRL once again put on display its high-beta pattern, standing among the worst-performing currencies for the week. By the time of writing (Friday around noon, local time), the Brazilian currency was trading at 5.77/USD (one of the weakest nominal levels since May) and is heading for a weekly loss of 2.6% versus the greenback.

If the global backdrop has been unfavorable in recent days, the local news cycle did not provide any sort of respite for local assets in general. With the key fiscal decisions (e.g., new welfare program, measures to support the execution of the spending cap, definitions for the 2021 budget) all pushed back until after the municipal elections, there is still a sense of uncertainty and a lack of clarity regarding the policy priorities, in terms of both executive branch proposals and the subsequent negotiations with Congress. All of this means a perception of higher execution risk for the spending cap – still the main anchor for the Brazilian economy – and the (already worsening) outlook for government debt. From a technical standpoint, the local FX market is also showing signs of unease about the "FX over hedge" theme, as financial institutions are expected to reduce substantially their short USD positions in derivatives markets until year-end, as a consequence of regulatory changes implemented by the BCB.

Amid this sell-off in the currency, the central bank intervened in the local FX market (as it usually does in times when the authority sees a "dysfunctional" market) with sales of hard currency in the spot market on Wednesday and Friday. Despite occasional BCB actions with a view to ease FX volatility, we believe the high uncertainty about both global and local scenarios will continue to cause large swings in the BRL in the coming weeks and months. That also implies upside risk to our USD/BRL forecast (5.30 for end-2020).

Local markets—rates: At the time of writing (Friday around noon), the weekly change in nominal yields looked poised to indicate a steepening pattern. In the front end, the Jan-22 DI future was trading at 3.46% (-1 bps from last Friday). In the back end, the Jan-27 DI future was trading at 7.59% (+12 bps from last Friday). This week's movement drove the steepness in this segment to ~413 bps, compared to ~400 bps in the previous week and ~150 bps before the arrival of the pandemic in Brazil (late February).

The local yield curve seems to have been influenced by a global risk-off sentiment, which we think probably contributed to push back-end yields higher. Locally, the virtual stability observed in the front end seems to have been influenced by downward pressures on the heels of the BCB's maintaining its forward guidance in the Copom statement, especially when it comes to the possibility of a small rate cut at some point (a situation which we see as even more unlikely). The softer-than-expected tone of the statement could also have fed the upward pressures on the back end, amid high inflation fears (which we see as likely overblown) currently seen in the market.

All in all, for those who, like us, still work with a baseline scenario of fiscal convergence (i.e., a still credible constitutional spending cap in coming years), the yield curve can be thought to have considerable premium. But that will not materialize until the markets see clear signs of a credible fiscal consolidation process ahead, once the pandemic is over. As key fiscal decisions on welfare programs, macro reforms, and the spending cap are postponed until after November's municipal elections, we expect uncertainty and volatility in Brazil's fixed income markets to remain high for some time.

Monetary policy: As widely expected, the Brazilian Central Bank (BCB) kept the Selic rate at the historical low of 2.00% at the most recent Copom policy meeting, held on October 27-28, 2020. The communiqué brought an updated assessment of the macroeconomic scenario, especially highlighting the recent inflation pickup, seen more as a temporary development on the heels of weaker FX, higher commodities prices, and emergency government transfers to households.

While recognizing upwardly skewed risks, especially owing to the fiscal challenges, the BCB signaled a constructive medium-term inflation outlook, with inflation simulations hinting at numbers around the mid-range of the target even when assuming a stable Selic rate. That enables the authority to see the current policy stance as "adequate," by means of both the policy rate and forward guidance. As per the latter, the BCB still sees conditions holding for its flight plan of no hikes ahead, particularly highlighting that the fiscal regime has not been changed.

With inflation expectations running below the mid-target for the medium run and with the economy expected to operate below its (sustained) potential for a considerable time, we continue to see favorable inflation fundamentals. In particular, we anticipate a lack of demand-led price pressures for the relevant monetary policy horizon. The major risk on that front, in our view, continues to lie in the possibility of a fiscally led de-anchoring of inflation expectations. Our baseline scenario sees the Copom on hold all the way until early 2022, assuming no change in the fiscal regime. Concerns about the effectiveness of

the constitutional spending cap are still the main threat for the inflation and monetary policy outlook in Brazil, in our view. For details, see our report[1].

Fiscal policy: September's fiscal performance was better than expected (due to a surprise in the regional governments result). This was the first month with the reduction in the emergency aid stipend (first month with BRL300 per beneficiary), yet the numbers continue to show a substantial impact on government finances from the COVID-19 crisis.

According to data published on October 30 by the BCB, the public sector posted a primary budget deficit of BRL64.6 billion in September, relatively better than our forecast (BRL71.4 billion) and the market consensus (BRL70.0 billion). The main surprise was in the regional governments result, which posted a surplus of BRL10.0 billion, probably affected, in our view, by the emergency aid's impact on local economies (totaling BRL24.2 billion in September)—which improved tax collection—and transfers from the central government to offset the decline in tax collection (BRL19.3 billion in September). In 12-months, the consolidated primary deficit reached BRL655.3 billion (9.1% of GDP).

In addition, gross debt reached 90.6% of GDP in September, an increase of 14.8 percentage points from the end of last year. Meanwhile, net debt rose to 61.4% of GDP, 5.8 percentage points higher on the same basis of comparison. We expect both to continue deteriorating in the coming months. The figures reinforce our forecast that the 2020 public sector primary fiscal deficit will amount to 12.4% of GDP, leading the gross general government debt to nearly 95% of GDP. For details see our report[2].

Bank lending: The data (BCB) for September reveals household lending has been recovering, which we think has possibly helped support economic activity (and a consumer spending spree) in recent months. For this category, non-earmarked new loans are already at 98% of February's volume, meaning nearly a full recovery from the pandemic.

As for the corporate segment, new loans are still moving higher, reflecting expansion in both non-earmarked credit for working capital and earmarked lending through government fiscal measures. Importantly, while the increase in bank lending for non-financial firms is offsetting the retracement in capital market transactions, we think it is possible that Brazilian companies may be more willing to hoard cash (to protect against hypothetical liquidity constraints) than to boost investment.

Last, and reflecting the expansionary monetary policy stance and limited delinquency, the Credit Cost Indicator (ICC), interest rates, and spreads for both households and non-financial corporations all continue their downward trend. Default rates are 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. For details see our report[3].

Economic activity: In recent days, FGV has released the remaining confidence indexes for October, which have confirmed the results published last week in FGV's preview. Regarding industrial confidence, the headline index continued to rise in October, pointing to growth of 4.2% MoM (s.a.) and reaching the highest value since April 2011. In comparison to the pre-crisis level, confidence is up 9.7% since February; this result was mainly driven by the current component, up 6.0%, while the expectation component pointed to an increase of 2.5%. In the details, expected demand stands above current demand for the fourth month in a row, and expected production also reached the highest reading since 2010; these figures are a better sign of industrial activity ahead, in our view. Industrial Capacity utilization rose to 79.8%, close to the historical average of 80%. While this is the highest level since November 2014, it does not seem to indicate severe and lasting supply constraints, in our view. 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 end of fiscal stimuli.

FGV surveys posted mixed results for other sectors. In the retail sector, headline confidence was in line with the preview, posting a monthly decline of -3.8%, the first negative result since April's tumble, and the headline number is down by -4.0% since February. In our view, one reason behind this decline is the gradual reduction in the amount of emergency aid, since

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[1] **Santander Macro Brazil Monetary Policy - *COPOM: Staying the Course Amid Temporary Pressures*** – October 28, 2020- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-copom-staying-the-course-amid/20-10-29_131322_201028+-+copom+decision.pdf
[2] **Santander Macro Brazil Fiscal Policy - *Consolidated Public Sector: Another "Yearly" Deficit in September*** – October 30, 2020- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-consolidated-public-sector/20-10-30_150652_201030_fiscal_sep20.pdf
[3] **Santander Macro Brazil Credit - *Strong Household Credit in September*** – October 26, 2020- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-strong-household-credit-in-september/20-10-30_152042_bzmacrocredit102620.pdf

the lower paychecks started to arrive at the end of September, with significant effects only in October. Regarding the services sector, the headline index also posted a decline of -0.5%, with the index standing 7.3% below February's reading, which reinforces the view that the sector is still the laggard in the economic recovery, being the most directly affected by social distancing. In construction, the headline index rose 4.0%, a positive surprise since the preview had pointed to no gain for this month. In the details, expected employment has surpassed February's reading for the first time, which is a positive figure from the standpoint of the labor market, since construction is a labor-intense sector.

Regarding the labor market, also a mixed picture. According to the CAGED (establishment) survey, formal job creation continued to show an improvement in September: net (unadjusted) job creation stood at 313k, considerably better than consensus (242k). After seasonal adjustments, the number recorded was 251k, with 39.0% of the jobs lost in the crisis having already been recovered. With recent studies pointing at 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.

According to the IBGE's National Household Survey (PNAD), the unemployment rate stood at 14,4% in the three months to August, a slightly higher result than the market consensus (14.2%), implying a gain of 2.6 p.p. from the year-ago level (11.8%). We calculate that the seasonally adjusted jobless rate moved up to 14.3%, compared to 13.8% in July, the highest reading in the historical series. All in all, August numbers in the PNAD survey herald a continued deterioration in labor market conditions. Looking ahead, we expect joblessness to grow significantly, with wages remaining sluggish (at best) in the coming months, following the gradual economic reopening and the workforce's return to pre-crisis levels. For details, see our report[4].

Inflation: On Friday (November 6), IBGE is scheduled to release IPCA inflation for October. We expect a reading of +0.87% MoM (+3.93% YoY). Once again, the main source of upward pressure will be food-at-home inflation, in our view. We forecast this group will rise 2.68% 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. But this time, both industrial goods and services should also rise considerably, according to our projections. Industrial goods continue to be pressured by the same drivers as food and, in addition, the sector is also suffering some (localized and temporary) supply shortages, so we believe industrial goods inflation will rise 0.94% MoM. In services, which has been registering notably low prints since the beginning of the pandemic, we expect the pressure on this reading will be tightly concentrated on one item – airline tickets, which we know from IPCA-15 will rise 39.9% MoM – but the rest of the sector should continue to show only minor changes, in our view; we forecast the group will rise 0.62% MoM. Finally, administered prices should rise 0.16% MoM, per our estimates.

The risk for our 2020 headline IPCA forecast tilts to the upside (mainly because of food-at-home, but also because of industrial goods), although the advance of the COVID-19 second wave in Europe and its impact on commodities prices should start to reduce that upside risk. Our (recently revised[5]) official number for 2020 is 3.3%. For 2021 (also recently revised) we estimate IPCA inflation at 2.9%. We believe food inflation will cool down next year and that the wide negative output gap will play its role in keeping services and industrial goods at low levels – that is, core measures are likely to continue on a benign path. Hence, we maintain our benign view for inflation, anticipating it will continue below BCB's targets until 2022.

Also next week: On the economic activity agenda, next Wednesday (November 4) IBGE will release data on Industrial Production for September, starting the cycle of publications of the main activity indicators for the last month of the third quarter. Based on the information set available up to now, we project monthly growth of 1.8% (2.00% YoY), which implies a quarterly gain of 21.5% in 3Q20 (-17.4% in the previous quarter).

On inflation, October's IGP-DI will be released on Friday (November 6), and we expect a reading of 3.42% MoM, a bit above September's reading and October's IGP-M reading. The deceleration we were expecting on IGPs is taking longer than to materialize than expected, with wholesale prices (both agro and industrial) continuing to be a source of pressure in the short term.

On the political front, the president of the Senate scheduled a floor vote on the central bank's formal independence (PLP 19/19) for November 3, and scheduled the votes on whether to overturn several presidential vetoes for November 4 (highlight: the veto of payroll tax breaks for 2021, which could further reduce the budget margin vis-à-vis the spending cap next year).

[4] **Santander Macro Brazil Economic Activity - *Mixed Signals in Labor Market Data*** – October 30, 2020- Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-mixed-signals-in-labor-market-data/20-10-30_150830_201030_pnad_aug+bzmacro_final.pdf

[5] **Santander Macro Brazil - Inflation: Revising Inflation Forecasts and Discussing the IGP x IPCA Distortion** – October 28, 2020 - Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-revising-inflation-forecasts/20-10-30_154022_bzmacroinflation102820.pdf

It is important to note that these dates are close to the municipal elections (first round on November 15), and consequently we think it is possible that these votes could be postponed again.

Last but not least, the Copom minutes comes out next Tuesday (November 3), with more information on the BCB's scenario assessment and policy guidance. We will pay particular attention to possible explanations about the maintenance of the forward guidance for the short term, which indicates to us the possibility of a small rate cut at some point.

MACRO AGENDA

Indicator	Date	Estimate	Prior
Copom Minutes	Tue, 03-Nov		
Trade Balance Monthly (Oct/20) (USD billion)	Tue, 03-Nov	6.2	6.3
Exports Total (Oct/20) (USD billion)	Tue, 03-Nov	18.4	18.5
Imports Total (Oct/20) (USD billion)	Tue, 03-Nov	12.2	12.3
Fenabrave - Vehicle Sales (Oct/20) (thousand units)	Tue, 03-Nov	--	208k
Industrial Production (Sep/20) (% MoM)	Wed, 04-Nov	1.8	3.20
Industrial Production (Sep/20) (% YoY)	Wed, 04-Nov	2.0	-2.70
FGV Inflation IGP-DI (Oct/20) (% MoM)	Fri, 06-Nov	3.42	3.30
FGV Inflation IGP-DI (Oct/20) (% YoY)	Fri, 06-Nov	21.82	18.44
IBGE Inflation IPCA (Oct/20) (% MoM)	Fri, 06-Nov	0.87	0.64
IBGE Inflation IPCA (Oct/20) (% YoY)	Fri, 06-Nov	3.93	3.14
Anfavea - Vehicle Production (Oct/20) (thousand units)	Fri, 06-Nov	--	220k

Sources: Bloomberg and Santander.

For details on our Brazil economic forecasts, please refer to our latest scenario review[6].

[6] **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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