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## Brazil Macro Compass

# Keeping the Guidance but Noting the Risks

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- **The local yield curve continued last week's flattening pattern, with downward pressures in the back end, possibly reflecting some global risk-on sentiment, in our opinion, as investors still await more fiscal stimulus in the US. Locally, the fiscal dilemma should continue at least until November's municipal elections, so volatility should linger for some time, in our view.**

- **The relatively neutral news cycle described above has also led the Brazilian FX market to remain on the sidelines, with the USDBRL pair hovering around the 5.60 level in the past couple of days and likely to end the week just a little bit stronger than a week ago, in our view.**

- **Although slightly lower than we expected, the USD2.3 billion surplus registered by the current account balance in September 2020 underpinned our expectation that the annual deficit observed in 2019 is likely to recede further in the coming months.**

- **On the fiscal side, the performance of federal tax collection in September (+2.0% YoY) suggests a gradual recovery, in our view, marking the second consecutive month of growth. On Wednesday, October 21, we published a report (*Spending Cap Rule: Narrowing the Margin for 2021*) analyzing the impact of the mismatch between the impact of two different inflation indexes on the capacity to keep the budget within the spending cap rule.**

- **According to FGV's industrial survey preview for October, headline industrial confidence rose 3.7% MoM (s.a.), 9.2% above February's reading. On the other hand, the recovery in consumer confidence seems to have softened: the headline index posted a decline of -1.2% and is down by 6.2% since February.**

- **October's IPCA-15 registered a 0.94% MoM change (3.52% YoY), considerably above the market's median expectation (0.83% MoM) and a bit above our forecast (0.89% MoM). Pressure on industrial goods has intensified, pushing core measures upward. Looking further ahead, however, we continue to anticipate a benign scenario for inflation, with most of the pressures previously cited likely subsiding throughout 2021.**

- **Next week, FGV will release the remaining consolidated confidence data for October, with a focus on industry confidence, to be released Wednesday (October 28). Moreover, IBGE and the Labor Ministry are scheduled to release important data on economic activity: data on September formal job creation (October 29) and the August unemployment rate (October 30) will be available.**

- **On Wednesday (October 28), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. We expect the Selic rate to remain at the historical low of 2.00%, in line with analysts' expectations and a broad pricing of the local yield curve. If, on the one hand, we see little room for surprise in the decision itself, on the other hand the statement will get the market's attention, amid a greater perception of fiscal risks. We believe the committee will maintain the forward guidance of stable interest rates for the foreseeable future, but possibly raise the tone on the risks generated by an eventual potential change in the fiscal regime.**

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**Local markets—rates:** At the time of this writing (Friday around noon), the weekly change in nominal yields looked poised once again to enter a flattening pattern. In the front end, the Jan-22 DI future was trading at 3.46% (+8 bps from last Friday). In the back end, the Jan-27 DI future was trading at 7.48% (-9 bps from last Friday). This week's movement pattern drove the steepness in this segment to ~402 bps, compared to ~419 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 slight global risk-on sentiment. Market expectations regarding external key themes such as the US fiscal package and presidential race did not significantly change in the past few days, but investors still seem to be awaiting further US stimulus at some point. Locally, we still see Brazil as having a binary set of possible macro outcomes (fiscal convergence or fiscal dominance). In our view, the dilemma between complying with the spending cap rule and expanding welfare programs should continue at least until November's municipal elections, when proposals are due to be announced. In recent days, press sources *(*such as *Valor Economico "Governo estuda realocação de recursos"* October 22, 2020) indicate the likelihood of just a modest increase in welfare spending, making it more feasible to accommodate it within the constitutional boundaries. But the uncertainty remains. As we have been pointing out for weeks, we view the credibility of the spending cap as the main driver for Brazilian assets. Hence, high premiums and volatility in local bonds will linger for some time, in our view, at least until we see clearer signs that a disciplined fiscal regime will be maintained (preferably via economic reforms).

**Local markets—FX:** As described in the previous section, the key macro themes preoccupying investors showed barely any change in the last couple of days. On the external front, investors continue to see the outcome of the US elections as not likely to generate frictions and favoring the approval of a new fiscal package to boost the US economy, probably after the elections. On the domestic front, the federal administration signaled that the budget constraints imposed by the spending cap rule may lead it to slightly enlarge the reach of the current welfare program (*Bolsa Família*) instead of introducing a new one. In our view, this brings some respite regarding worries about fiscal discipline after the pandemic.

On the heels of this relatively neutral news cycle, the BRL has hovered around the USDBRL5.60 level, and we see it as likely to end the week just a little lower than at the close last Friday (as of this writing, the USDBRL pair was quoted at 5.62 from 5.64 a week ago).

**Balance of payments:** The release of Brazilian sector data for September 2020 indicates that the current account balance registered a USD2.3 billion surplus in the period, which was below our estimate (USD2.7 billion) and the market median forecast (USD3.0 billion). The outcome reinforces our assessment that the current account deficit is likely to continue to shrink in 12-month-to-date terms, as this gauge receded to USD20.7 billion last month compared with USD50.9 billion in December 2019. When we adjust figures for their seasonal pattern and annualize the average of the last three months (3MMA saar), we get an indication that the current account balance is running at a rate that indicates the possibility of generating a USD26.4 billion annual surplus. However, it is important to bear in mind that the continuation of the Brazilian economic recovery that we expect in the coming months should lead to some softening in that pace, and September data seems us to have been a turning point in the recent trajectory of improvement.

Despite the positive indications shown by the continuation of the adjustment in the current account balance, we highlight the behavior of direct investments in the country (IDP, in the Brazilian acronym), which came in short of our estimate (USD1.6 billion vs. USD2.0 billion) and led volume in 12-month-to-date terms to decline to USD50.0 billion, compared with USD73.5 billion in December 2019, reflecting market participants' skepticism concerning the prospects for the Brazilian economy. It is true that IDP volume remains more than enough to finance Brazil's current account deficit, thus indicating a comfortable situation regarding Brazilian external financing needs, in our view, but the downward trajectory could work as a reminder to us that the Brazilian economy needs to improve its business environment in order to lure international investors. The 3MMA saar outcome indicates that IDP is running at a rate compatible with a USD19.3 billion inflow, the lowest level since 2006.

On the other hand, September was the fourth month in a row in which foreign investors have increased their portfolio of Brazilian financial assets in the domestic market (USD1.2 billion), with fixed income bonds accounting for the bulk of that (USD2.2 billion), whereas the equity portfolio registered a USD1.0 billion outflow. Curiously, Brazilian investors have also increased their portfolio of foreign financial assets by the same amount (USD1.2 billion), with a more balanced distribution between equities and mutual funds (USD0.5 billion and USD0.6 billion, respectively). That amount is in line with the average monthly flows observed this year, and, in our opinion, it is not evidence that Brazilian citizens are sending money out of the country. For details, refer to today's report on the subject[1].

[1] BZ Balance of Payments – September 2020. Available on:
https://cms.santander.com.br/sites/WPS/documentos/arq-fast-balance-of-payments/20-10-23_172745_bzmacrobop102320.pdf

**Fiscal policy:** As published on October 21 by the Brazilian Revenue Service, federal tax collection totaled BRL119.8 billion in September, close to market forecasts (BRL119.7 billion) and higher than our estimate (BRL117.2 billion). Tax collections increased 2.0% YoY in real terms in September, suggesting a gradual recovery and marking the second consecutive month of growth, after five months of steep decreases due to the impact of COVID-19. For this year, we continue to expect total federal tax collection to plunge close to 8.5% in real terms—equivalent to tax losses of ~BRL135 billion compared to 2019. This estimate already considers the likely creation of a new tax amnesty program that would allow taxes to be paid in installments over the next few years. (For more details, see our report on tax collections dated October 21 [2].)

In addition, on October 21 we published a report (*Spending Cap Rule: Narrowing the Margin for 2021*[3]) analyzing the impact of the mismatch between the impact of two different inflation indexes on the spending cap limit. Beyond the possibility of creating a new welfare program, the mismatch between the inflation index (and time window) that is used to readjust the spending cap and the index used to adjust government transfers should generate pressure to comply with the spending cap in 2021, as we believe it will contribute to faster growth in spending vis-à-vis the cap. Compliance with the spending cap remains feasible, in our view; however, it could lead to a decline in discretionary expenses, and thus to the partial shutdown or temporary interruptions of some public services.

On the political front, the president of the Senate scheduled a floor vote on central bank autonomy (PLP 19/19) for November 3, and votes on whether to overturn several presidential vetoes on November 4. 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.

**Economic activity:** According to FGV's industrial survey preview for October, industrial business confidence continued to rise in October, posting a gain of 3.7% MoM (s.a.) and reaching 110.7 points (vs. 106.7 in the previous month), the highest value since April 2011. In comparison to the pre-crisis level, the headline index is standing at a level 9.2% above February's reading. In terms of outlook, Industrial Capacity utilization rose to 79.9% (78.2% in the previous month), a much better result than the all-time low reached in April (57.3%), and 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 (which reached an all-time high), in the worst month for economic activity (April) inventories reached the highest levels since October 2015, but as of September inventories were running at the lowest levels since 2013, which we view as a favorable indication for future production.

Regarding consumer confidence, the headline index posted a decline of 1.2% MoM s.a., reaching 82.4 points (79.5 in the preview). This was the first negative result after five gains in a row since April's tumble; the headline number is down by 6.2% since February. This result was mainly driven by the expectation component, down -1.4%, while the current component pointed to a decline of -0.3%. In our view, one reason behind this decline 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. Another reason is the price hikes for essentials goods, especially food prices, which could be eating into the budgets of a number of (lower income) households. In the survey details, the intention to purchase durable goods points to a decline of -2.0%, but is still at a level 4.2% above February's reading, and the labor differential (i.e., percentage of respondents finding it hard to get a job minus respondents who are finding it easy) was down slightly to 92.4% (from 93.3%), although it is still high. This number highlights some continuing headwinds in the job market.

**Inflation:** October's IPCA-15 registered a 0.94% MoM change (3.52% YoY), considerably above the market's median expectation (0.83% MoM) and a bit above our forecast (0.89% MoM).

Gasoline surprised on the upside (+4bps), along with industrial goods (+6bps). For industrial goods, we have argued that the economy's reopening (increasing demand), ongoing government emergency aid (supporting income), continued BRL depreciation, and some (temporary and specific) supply shortages are spurring short-term upward pressure. However, we note that perfume (a highly volatile item that usually is not a reliable sign of a trend) was behind much of the surprise, but the print was high anyway. On the other hand, food-at-home, which has also upwardly pressured the IPCA, surprised to the downside (-6bps), and the surprise was widespread (in fresh food, proteins, and industrialized items), thereby reducing some of the upside risk we anticipate for the group, but it is still tilted to the upside. Finally, services were in line with our expectation, with particular pressure on airline tickets—something that we do not expect to continue in the medium term.

[2] BZ Fiscal Policy - Tax Collection Gradually Improving as Activity Recovers. Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-tax-collection-gradually/20-10-21_204942_bzmacrotax102120rfd.pdf

[3] BZ Fiscal Policy - Spending Cap Rule: Narrowing the Margin for 2021. Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-special-spending-cap-rule/20-10-21_204025_bzmacrospcap102120.pdf

Core measures' (EX0, E3, DP, MS, and P55) new average registered a 0.54% MoM change, with the annualized (and seasonally adjusted) three-month moving average accelerating, rising to 3.4% from 2.1%, while the target for 2020 is 4.00%. In particular, the trend for the IPCA EX3 core gauge—a measure highly correlated with the output gap—also accelerated considerably, to 3.5% from 1.4% MM3saar. Additionally, the diffusion index stood at 60.1% on a seasonally adjusted basis, still close to the lowest historical levels, although it has been rising a bit.

Given the upward surprise, we raised our IPCA 2020 high-frequency tracking further to 3.3%, owing to industrial goods, in light of the previously stated pressures that we expect to continue until year-end. Moreover, we continue to see upside risks for food; specifically, a new risk has been increasing: the climate (La Niña, in particular), which could delay the deceleration of the group. Looking further ahead, however, we continue to anticipate a benign inflation scenario, with most of the previously cited pressures subsiding throughout 2021, while services inflation should continue to run at low rates, as we expect the job market to be weak. We believe that well-anchored inflation expectations could also play an important role in Brazil's price dynamics. Therefore, we continue to anticipate a benign inflation scenario in the medium term, with core measures running at low levels, and we forecast 2021 headline IPCA at 2.7% (although short-term pressures pose an upside risk to 1Q21, which could inch our year-end forecast closer to 3.0%). For details, refer to today's report on the subject[4].

**Monetary policy:** On Wednesday (October 10, 2020), the Brazilian Central Bank (BCB) is scheduled to announce its monetary policy decision. In line with (practically unanimous) analysts' expectations and the broad pricing of the yield curve (only 10% of risk for a rate hike), we anticipate the policy Selic rate to remain on hold at the historical low of 2.00%. If, on the one hand, we see little room for surprise in the decision itself, on the other hand the statement—which brings an assessment of the scenario and an indication of the flight plan ahead—will get the market's attention, amid a greater perception of fiscal risks. The latter have important implications for the macroeconomic outlook and, in particular, for the BCB's monetary policy strategy.

We believe the Copom will maintain the most important part of the forward guidance, whereby the authority signals its intention not to raise interest rates in the foreseeable future as long as inflation expectations remain below the central target for the relevant horizon and well-anchored for the long term, and as long as the fiscal regime (i.e., the constitutional spending cap) remains credible. Despite the volatile news cycle in recent weeks, amid discussions about creating a new welfare program that is (hopefully) within tightening constitutional budget limits, there have been no concrete changes (not even a formal proposal is out), and announcements are expected only after municipal elections (November 15 and 29). Thus, although we think it is possible that the BCB will explicitly highlight an increase in the execution risk for the fiscal adjustment process after the pandemic, we understand that there is no material evidence that, at this moment, would invalidate the necessary conditions listed by the authority to keep the "forward guidance" (i.e., the BCB flight plan of stable interest rates) in place.

Amid a short-term inflation pickup, mainly on the heels of price increases for volatile items (notably food) and a moderate FX pass-through (affecting certain industrial goods), we believe the Copom may continue to expect an absence of more persistent and widespread (demand-led) price pressures for the medium term. We believe that this is likely due to still well-behaved core gauges and inflation fundamentals still stable for the relevant policy horizon, considering the well-anchored expectations and the elevated slack in the labor market.

Although we do not expect an alarmist (or "extremely hawkish") tone on the part of the BCB on current inflation, it is possible that the Copom could—formally and explicitly—point toward an even lower likelihood of further rate cuts in the short term. We think such a statement, if it comes, could weaken the first part (in our opinion of less importance) of the BCB's forward guidance. The lower likelihood that we see of a cut in interest rates is due in large part to a recent increase in market tensions related to the (apparently) rising execution risks for the fiscal adjustment process after the pandemic, making even more binding the (already mentioned) restrictions imposed by an effective lower bound for interest rate.

Furthermore, even if stemming from volatile items, upward price pressures can also help to induce additional caution on the part of the authority, in our view. The same goes for an apparently firmer recovery in economic activity, as signaled by preliminary data for 3Q20, pointing to sequential growth around 9% QoQ. Driven by a continued economic reopening process and massive (albeit temporary) fiscal stimuli, we believe the activity improvement will probably contribute to reduce the sense of urgency for the BCB to introduce additional stimuli in the economy, given the already highly expansionary stance of monetary policy.

[4] BZ Inflation – Pressure Intensifies for 2020, but Still a Benign Scenario for 2021. Available on: https://cms.santander.com.br/sites/WPS/documentos/arq-fast-pressure-intensifies-for-2020/20-10-23_174047_bzmacroipca102320.pdf

**Also next week:** A heavy macroeconomic schedule for the week in terms of release of data. On the economic activity agenda, several reports are scheduled to be released. FGV's confidence data for Retail (October 26), Construction (October 27), Industry (October 28), and Services (October 29) will be published next week. If the preview's data is confirmed, industry confidence will be at the highest level since April 2011. Regarding the labor market, formal job creation (October 29) and unemployment rate (October 30) will be available for September and August, respectively. These figures will be essential for tracking the deterioration in labor market conditions amid a gradual reopening of the economy.

On the fiscal side, we estimate that the central government's primary deficit will have totaled BRL79.8 billion in September 2020. On the revenue side, we forecast extraordinary revenue of BRL5.1 billion associated with the renewal of railway concessions. In expenses, we project the extraordinary budget will add up to BRL73.6 billion for September, featuring BRL24.2 billion related to the emergency aid, BRL19.3 billion in transfers to regional governments, and BRL17.0 billion in credit programs. In turn, next Friday (October 30) the BCB will publish the consolidated public sector's fiscal balance for September 2020, which encompasses the federal government, regional governments, and state-owned companies. We anticipate a monthly primary deficit of BRL74.2 billion, with the following breakdown: -BRL80.4 billion for the federal government; +BRL5.7 billion for states and municipalities; and +BRL0.5 billion for state-owned companies.

Finally, on inflation, IGP-M for October will be released, and we expect a deceleration in MoM terms, but still to a high level of 2.80% MoM.

**MACRO AGENDA**

| Indicator | Date | Estimate | Prior |
|---|---|---|---|
| Total Outstanding Loans Sep/20 (USD billion) | Mon, 26-Oct | 3,814 | 3,737 |
| Outstanding Loans Sep/20 (% MoM) | Mon, 26-Oct | 2.1 | 1.9 |
| Household Default Rate (Non-earmarked) Sep/20 (%) | Mon, 26-Oct | 4.7 | 4.8 |
| FGV Construction Costs Oct/20 (% MoM) | Tue, 27-Oct | -- | 1.15 |
| Federal Debt Total Sep/20 (USD billion) | Tue, 27-Oct | -- | 4412 |
| Selic Rate (%) | Wed, 28-Oct | -- | 2.00 |
| FGV Inflation IGPM Oct/20 (% MoM) | Thu, 29-Oct | 2.80 | 4.34 |
| FGV Inflation IGPM Oct/20 (% YoY) | Thu, 29-Oct | 20.43 | 17.94 |
| Central Govt Budget Balance Sep/20 (USD billion) | Thu, 29-Oct | -79.8 | -96.10 |
| Formal Job Creation Total Sep/20 | Thu, 29-Oct | -- | 249 k |
| PPI Manufacturing Sep/20 (% MoM) | Fri, 30-Oct | -- | 3.00 |
| PPI Manufacturing Sep/20 (% YoY) | Fri, 30-Oct | -- | 13.52 |
| National Unemployment Rate Aug/20 (%) | Fri, 30-Oct | -- | 13.80 |
| Net Debt Sep/20 (% GDP) | Fri, 30-Oct | 61.8 | 60.70 |
| Primary Budget Balance Sep/20 (USD billion) | Fri, 30-Oct | -74.2 | -87.60 |
| Nominal Budget Balance Sep/20 (USD billion) | Fri, 30-Oct | -- | 121.90 |

Sources: Bloomberg and Santander.

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